

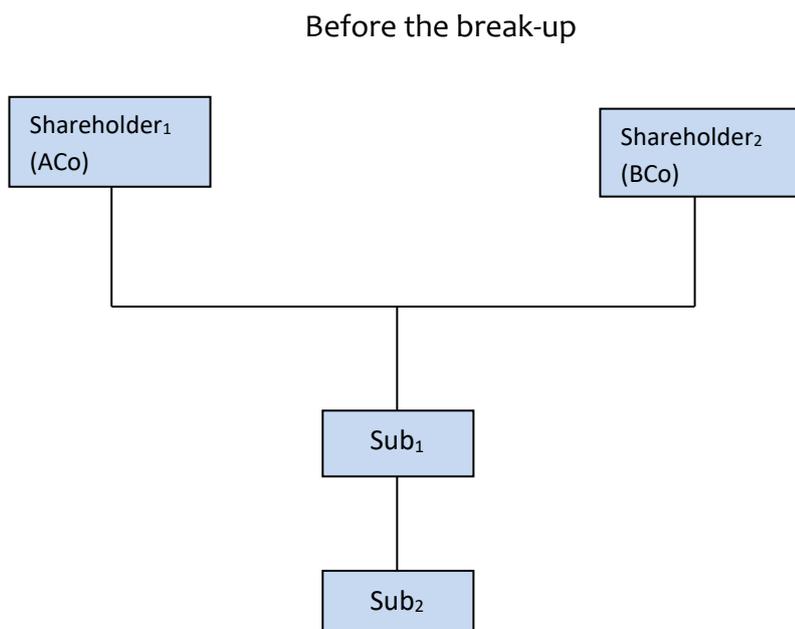


DAUDS ADVISORY

Tax

Corporate Break-Ups: Are They Hard To Do?

1. The unbundling of a group involves what is typically referred to as a break-up, demerger, severance, separation or fission. The break-up may take any form — spin-off, split-off, split-up or spin away — all ultimately having the same end-result, although the finer details in respect of each may differ slightly. A corporate break-up may diagrammatically be illustrated as follows—



After the break-up



Before the break-up, Sub₁ was owned by two shareholders. These two shareholders in turn owned Sub₂ indirectly, i.e. through their ownership of Sub₁. After the break-up, each of the shareholders owns one of the subsidiaries, in other words, Sub₂ is no longer owned by Sub₁ (which in turn is owned by the shareholders). Rather, Sub₂ is now owned directly by Shareholder₂, while Sub₁ is owned by Shareholder₁. This type of break-up might occur where the two subsidiaries are engaged in two very different lines of businesses, e.g. oil refinery and food processing. The strength of shareholder₁ might lie in oil refinery and that of shareholder₂ in food processing, and each shareholder might wish to focus on its particular strength to grow the business. The two shareholders might then initiate a break-up plan the result of which is that each party will end up with one of the companies, thus allowing each party to focus on its unique strength to grow the business.

2. A corporate break-up involves a number of tax issues, for instance, one company (called the unbundling company) distributes shares (shares of the unbundled company) to its shareholders. In the above illustration, the unbundling company is Sub₁ while the unbundled company is Sub₂. The normal tax rules would require the recognition of any gain in the value of the shares being disposed of the shareholders.

This gain will attract capital gains tax (CGT). The transfer of shares by the unbundling company to its shareholders may also be regarded as a distribution *in specie* (a dividend in kind), which may in turn trigger a dividends tax.

3. In the diagrammatic illustration, Sub₁ owns the shares in Sub₂. As part of the break-up, Sub₁ (the unbundling company) distributes the shares it holds in Sub₂ (the unbundled company) to its shareholders. Before the break-up, the shares in Sub₁ and Sub₂ were owned by both shareholders (although they indirectly owned the shares in Sub₂, i.e. through their ownership of the shares in Sub₁). After the break-up, the shares in Sub₁ and Sub₂ continue to be held by the two shareholders — albeit separately, i.e. the one shareholder directly owning Sub₁ and the other shareholder directly owning Sub₂. In these circumstances, it may be argued that the shares have not left corporate solution, which should in turn not trigger a capital gains tax or a dividends tax for that matter. For this reason, and also to facilitate corporate break-ups where it would make business sense to do so, the tax provisions of many jurisdictions, if satisfied, may lead to a deferral of the tax consequences of a break-up. In other words, neither the capital gains tax rules nor the dividends tax rules would apply, at least not until the capital gains tax rules are triggered by some (recognition) event at some future date. The question is, though, how easy or difficult are break-ups to accomplish?

4. Different jurisdictions have their own provisions which apply to corporate break-ups. A break-up may either be complete or partial. A complete unbundling may involve an unbundling company and unbundled company where both are listed. It may also involve an unbundling company which is listed while the unbundled company is unlisted. Tax provisions often specify the threshold of percentage equity holding — often referred to as the “qualifying shareholder interest” — which the unbundling company is required to hold in the unbundling company. As part of the unbundling process, the unbundling company may be required to distribute all the shares it holds

in the unbundled company to its (the unbundling company's) corporate shareholders in accordance with their (the shareholders') shareholding (their effective interest) in the unbundling company.

5. Where the unbundling involves a listed entity and an unlisted entity, it may be referred to as a partial unbundling. In this case, the unbundling company may be unlisted. In such a case, the tax provisions may require the unbundling company to distribute the shares it holds in the unbundled company to a shareholder that forms part of the same group of companies as the unbundling company. An unbundling may also involve a foreign entity where the unbundled company which is the foreign company, and in which case the unbundling company is required to distribute the shares it holds in the unbundled company to either a resident corporate shareholder or a shareholder which forms part of the same group as the unbundling company. Where the shareholder is not a resident, it may be the controlled foreign company (CFC) of a corporate resident which forms part of the same group of companies as the unbundling company.

Are the requirements for a break-up easily achievable?

6. Often where both the unbundling company and unbundled company are listed, the requirements for a break-up tend to be relatively easily achievable. However, the requirements begin to become a tad difficult where the unbundled company is unlisted. In this case the unbundling company cannot distribute its shares in the unbundled company to just any (corporate) shareholder. Rather, it may be required to distribute those shares to a group member, and group membership typically requires a relatively high equity interest.