

Group reconstructions

Aidan Clifford examines some simplified models of a complex process of business reorganisation

Planning for a client's retirement and longer-term taxation planning can often result in quite complex group structures being put in place. This can happen even for quite small clients. The reconstruction is usually planned by a tax department and it can be a bit of a challenge to get the accounting and company law issues correct. Here are a number of common structures and their accounting.

De-merger

This is used to split a company into two parts, both owned by the same shareholders in the same proportion as they owned the single

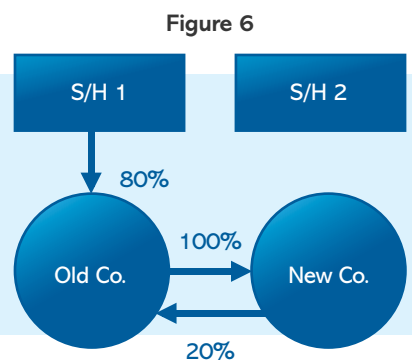
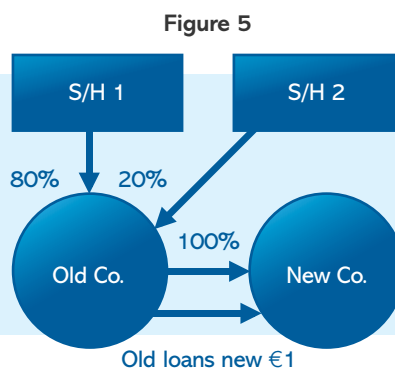
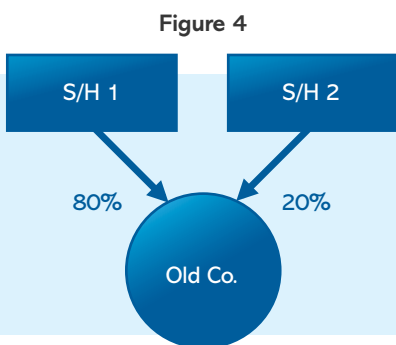
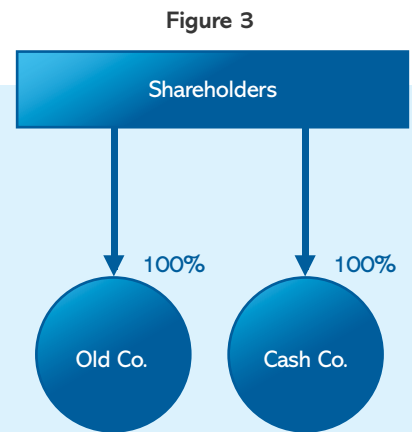
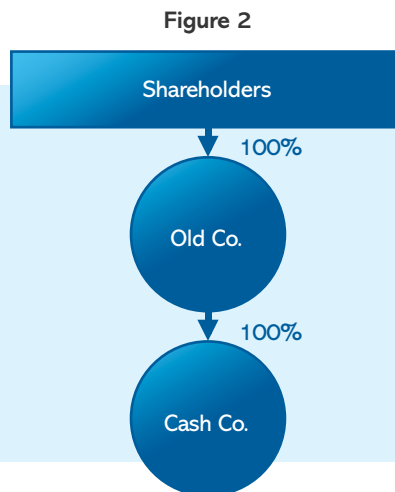
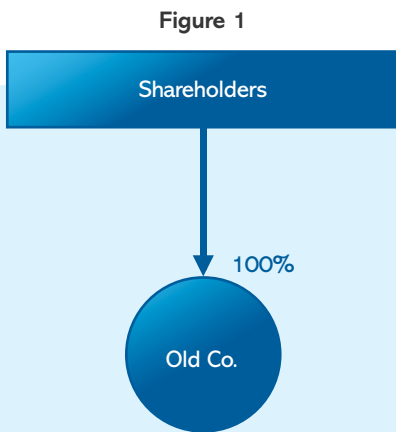
company. Typically, a trade is split out leaving a property or cash shell or visa versa.

In this example, the shareholders have a lot of cash in the company and want to pass on the business, but not the cash, to their children. Old Co. forms a new subsidiary and subscribes for shares in the new subsidiary (Fig. 2). The entries in Cash Co. are Dr bank and Cr share capital. The entries in Old Co. are Dr investment in subsidiary and Cr bank. Old Co. now "de-merges" Cash Co. (Fig 3). The entries being Dr retained earnings and Cr investment in subsidiary. The same process

could be used to take a building out of a trading company and to hold it separately.

Buy back of a minority where there are insufficient retained earnings

A share buy back can only be undertaken where there are sufficient retained earnings to cover the entire buy back amount including any premium on redemption. Where there are insufficient profits but there is sufficient cash or access to borrowings, the following procedure can be used. The procedure will require the directors to follow the requirements of Section 60 of the companies Act 1963.



In this example, a 20 per cent minority shareholder (S/H2) wants to be bought out (Fig. 4), but there are no retained earnings in Old Co. so a share buy back is not legal. A subsidiary company is formed and either money is loaned to the subsidiary or the subsidiary issues redeemable preference shares which are purchased by Old Co. (Fig. 5). New Co. uses the money to buy the 20 per cent shares of Old Co. The loan receivable in Old Co. will need to be impaired tested and the justification for not impairing it would not be based on the book value of 20 per cent of A but would be based on the fact that Old Co. has internally generated goodwill as well as its book value.

‘Liquidation’ of a thinly capitalised company

In this example, Old Co. has €1m in cash and no other assets. The shareholders form a new €2m company (New Co.). The shareholders loan New Co. €1m (Fig. 7) and New Co. uses this €1m to buy Old Co. off the shareholders (Fig. 8). Old Co. then pays a dividend to New Co. of €1m and, as this is a dividend out of pre-acquisition profits, it is netted against the “investment in subsidiary”. New Co. uses the cash to

repay the shareholders loan (Fig. 9). Both companies are then voluntarily struck off. This scheme is dependant on their being sufficient distributable profits in Old Co. to make the distribution, so this method only works where there is a thinly capitalised company and this company issues €1m redeemable preference shares which are purchased by Old Co. (fig. 10) New Co. uses the €1m to purchase 20 per cent of Old Co. Where this is part of a genuine restructuring of the ownership of Old Co. the €1m may be at CGT rates.

Preference share groups

In this case a new company is formed and this company issues €1m redeemable preference shares which are purchased by Old Co. New Co. uses the €1m to purchase 20 per cent of Old Co. Where this is part of a genuine restructuring of the ownership of Old Co. the €1m would be at CGT rates. Where this was an artificial transaction, Revenue may insist on this being treated as income rather than capital gains.

The accounting issue is that Old Co. has preference shares whose only supporting valuation is 20 per cent of Old Co. itself. Like in the earlier examples, the 20 per cent is worth

20 per cent of the price that would be received if Old Co. were sold and not 20 per cent of the book value of the net assets in Old Co.

Conclusion

There are many other reconstruction methods used by larger groups and some additional techniques such as “capital contributions” and conversion to IFRS used to facilitate these reorganisations. Some tax practitioners seem to take a particular joy in coming up with a scheme that only they can understand and to do the accounting correctly, the accountant needs to fully understand the transaction. Legal advice should be sought where you are unsure if the scheme complies with company law. As an auditor you would need to be careful of both company law compliance and the possibility of what was initially designed as a capital cash extraction being deemed by Revenue to being subject to income tax. It would be insufficient to rely on an opinion letter from the tax consultant that designed the scheme, especially when these opinion letters usually come with numerous disclaimers.

Aidan Clifford is Advisory Services Manager with ACCA Ireland.

