Greta's great takeover

The sale of one company to another can cause tax complications for the shareholder, as NICOLE NEVILLE explains.

I had been so looking forward to Friday, a 'work from home day', which I had set aside to plan the capital gains tax course I was teaching the next week. I put the kettle on, dropped the teabag into my mug and, annoyingly, found that I had run out of milk. So I popped down the road to my local grocer.

I took a pint of milk from the fridge and walked over to the till where Greta the grocer was grinning madly.

'I have just been made an incredible offer,' she exclaimed. 'Morrisbury, the supermarket chain, has approached me about buying my shop. I can sell up and retire!'

'Lucky you,' I replied.

Then Greta's face fell. 'Actually, the supermarket rep told me it was an incredible offer, but I don't really understand the details.'

Since I had my milk, I was quite keen to get home for my cup of tea, but Greta continued.

'The offer was to buy all my shares in Greta's Grocers Ltd in return for £500,000 cash, 100,000 Morrisbury ordinary shares valued at £2 a share and £100,000 of loan stock in Morrisbury plc valued at £300,000. The rep said I should snap up the offer because, even after capital gains tax, I would make a large profit. I got caught up in the excitement of it, but now I think about it I am confused. What would I do with Morrisbury shares? And I don't understand what "loan stock" means.'

I gave Greta a sympathetic look as I paid for my milk.

KEY POINTS

- A small business is taken over with several elements to the consideration.
- Cash proceeds will result in an immediate chargeable gain.
- Under the share-for-share exchange rules, the new assets have the cost of the old.
- Receipt of qualifying corporate bonds can result in a gain being deferred.
- The share-for-share exchange rules can be disapplied to benefit from entrepreneurs' relief.

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'Hey, you know a bit about tax,' Greta said, looking at me hopefully. 'Maybe you can explain this offer to me?'

'Put the kettle on Greta,' I said resignedly, 'and I'll talk you through it over a cup of tea.'

When I finally returned home, I thought I would recount my explanations as a case study.

The package

First, we established the value of the takeover package that Morrisbury had offered Greta.

Asset	*Value £*
Cash	500,000
Morrisbury shares (100,000 x £2)	200,000
Morrisbury loan stock	300,000
Total	1,000,000

This consideration would be in return for her shares in Greta's Grocers Ltd (which I shall call Grocers shares from now on). Greta told me that she had subscribed for these shares in 2005 for £500, when she set up her company and started to trade.

Because Greta's consideration has a mixture of elements we must split out the base cost of her Grocers shares and attribute a part to each element of the consideration. We do this is by apportioning the cost of her Grocers shares by reference to the market value of each element of the consideration.

Half of the total takeover package of £1m is represented by £500,000 cash, so half of the cost of the Grocers shares (£500 x ½ = £250) will be attributed to this element of the consideration.

The Morrisbury shares are worth £200,000, so 20% of the cost of Grocers shares is allocated there: £500 x 20% = £100.

VALUES AND BASE COSTS

	Value of package £	*Base cost of Grocers shares* £
Cash	500,000	250
Morrisbury shares 100,000 x £2	200,000	100
Morrisbury loan stock	300,000	150
Total	1,000,000	500

The loan stock is worth £300,000 out of £1m, so the cost of the Grocers shares allocated to that part of the consideration is £500 x 30% = £150.

The ***Values and Base Costs*** table summarises the position so far.

I explained to Greta that this table has all the numbers we need to prepare the capital gains tax calculations.

The tax implications

We can now address the tax implications. To do this we must consider each element of the consideration in turn.

Cash

To the extent that cash is received in return for Grocers shares, an immediate chargeable gain will arise. All we need to do is use the numbers in the table to calculate it:

	£
Proceeds/ash received	500,000
Less: cost	250
Chargeable gain	499,750

Greta can deduct her annual exemption from the chargeable gain, currently £11,100 (assuming this is the only disposal she makes in the tax year). Capital gains tax is calculated on the balance. So the taxable gain would be:

	£
Chargeable gain	499,750
Less: annual exemption	1,100
Taxable gain	488,650

Greta was keen to impress me by demonstrating that she had some knowledge of capital gains tax. She piped up at this point saying that, because she was a higher-rate taxpayer, she expected she would have to pay tax at a rate of 20%.

Greta was right, but I was keen to impress her in return by advising that this disposal appeared to meet the conditions for entrepreneurs' relief and she could pay at only 10% if she made a claim to HMRC

The conditions for entrepreneurs' relief are that:

- Greta owns at least 5% of the shares in her company (she owns all of them);
- Greta is an employee of the company (she is the 'chief executive officer', she proudly told me);
- Greta's Grocers Ltd is a trading company; and
- all the above conditions have been met for at least a year.

So the capital gains tax due on the share-for-cash element of the takeover would be £488,650 x 10% = £48,865.

Shares

We next consider the share consideration that Greta receives.

When Greta receives these shares she will, in fact, receive a 'piece of paper', a share certificate, stating that she is the owner of 100,000 Morrisbury plc shares. In return, she is giving up the 'piece of paper' that says she owns the Greta's Grocers Ltd shares.

What we have here is a 'paper for paper' exchange, Greta is not receiving any cash. Greta looked worried at this point.

'How can I pay capital gains tax on this element of my gain if all I am receiving is 'paper' and not cash?'

I explained that HMRC is sympathetic in such a case and, consequently, this is not considered to be a chargeable disposal for capital gains tax purposes. In other words, because there is no disposal there is no gain to calculate on this element of the consideration. The technical reason is that relief is given under TCGA 1992, s 135.

> ***"Rather than dividends being received on the shares, she would receive interest on this loan stock."***

The Morrisbury shares 'stand in the shoes' of the Grocers shares. In other words, the former shares take over the base cost of her Grocers shares.

Referring back to the ***Values and Base Costs*** table, we can see that the base cost of the Morrisbury shares will be £100. This means that when Greta sells the Morrisbury shares and calculates her gain, she will deduct £100 as the cost (not the £200,000 value of the shares on takeover). This lower base cost will give Greta a higher capital gain when she sells the Morrisbury shares.

Loan stock

I dealt with Greta's confusion over what loan stock is by explaining that it is simply an 'IOU'. It means that Morrisbury will owe her the money and repay her (redeem) the loan stock at some future date. Rather than dividends being received on the shares, she would receive interest on this loan stock.

Some types of loan stock meet the definition of a qualifying corporate bond (QCB), which is loan stock that is:

- expressed in sterling; and
- cannot be converted into any other currency.

I think it is safe to assume that the Morrisbury loan stock meets the definition of a QCB.

Again, Greta expressed concern that if she is receiving an IOU for some of her Grocers shares she would not have cash to pay any capital gains tax.

I explained that, unlike the share-for-share element of the takeover, this is a chargeable event.

However, HMRC will not insist that capital gains tax is due immediately. Instead Greta will need to calculate the gain arising on the QCB consideration. This is frozen, in other words it is not chargeable, until she disposes of the QCB (see TCGA 1992, s 116).

“ She could elect to disapply the share-for-share rule and be taxed immediately on the share-for-share element of the gain. ”

Using the numbers in the ***Values and Base Costs*** table, we can easily calculate the gain in respect of the QCB as:

	£
Proceeds	300,000
Less: cost	150
Chargeable gain	299,850

This gain is not chargeable until Greta either sells the loan stock or Morrisbury redeems it by repaying her.

Greta was concerned that there might be capital gains tax to pay on the disposal of the QCB itself, but I reassured her that it was an exempt asset for capital gains tax purposes (TCGA 1992, s 115).

The overall position

Before I could even ask for a refill of my cup of tea, Greta jumped in and said that she was so grateful for my explanations and felt confident she understood. She summarised as follows.

On takeover, she would have capital gains tax of £48,865 to pay on the cash element of the consideration.

This would leave her with net cash proceeds of £451,135 (£500,000 – £48,865), a nice nest egg to start her retirement.

Further, she was aware that she would own Morrisbury shares with a base cost of £100 and would be subject to capital gains tax on a gain of £299,850 on the disposal of the loan stock.

‘So I might have more capital gains tax to pay in the future,’ said Greta. ‘But at least the rate of capital gains tax will be 10% because my Grocers shares qualify for entrepreneurs’ relief.’

‘You are quite right about there being more capital gains tax, Greta,’ I replied, ‘but I am afraid entrepreneurs’ relief won’t be available.’

I explained further that, although her Grocers shares qualified for this relief, her Morrisbury shares would not. She would not be a Morrisbury employee and, as generous as its offer might be, she was unlikely to own at least 5% of their shares. Because all of the conditions mentioned above must be met for entrepreneurs’ relief to be available, she would definitely not be eligible.

‘But when I dispose of the loan stock, won’t I be entitled to entrepreneurs’ relief because I am crystallising the frozen gain on my Grocers shares that do qualify?’ Greta asked hopefully.

‘I am afraid not,’ I said. ‘When the gain crystallises, you will no longer meet the conditions in respect of your Grocers shares because you will have sold them, so entrepreneurs’ relief will not be available.’

‘Oh dear,’ said Greta. ‘So if I continue to be a higher rate taxpayer and capital gains tax rates remain as they are I will have to pay tax at 20% on both the disposal of my Morrisbury shares and the loan stock.’

‘It’s not all doom and gloom,’ I replied. ‘Put the kettle back on. I think I need a refill and I can explain how you can disapply the takeover rules to take advantage of entrepreneurs’ relief.’

Disapplying share-for-share rules

As the kettle was boiling, I told Greta that she could elect to disapply the share-for-share rule (TCGA 1992, s 169Q) and be taxed immediately on the share-for-share element of the gain.

Using the numbers in the table, Greta would have a gain as follows:

	£
Proceeds = value of Morrisbury shares	200,000
Less: cost	100
Chargeable gain	199,900

The benefit of being taxed on it immediately is that she would be entitled to entrepreneurs’ relief and would pay capital gains tax of 10%. The downside, of course, is that she might struggle to find the cash to pay it. The same goes for the share for loan stock element of the gain. She could elect not to freeze this part of the gain and instead be taxed immediately on the £299,850 and also benefit from entrepreneurs’ relief and pay tax at 10%.

‘Oh, so plenty to think about,’ said Greta. ‘I’ll open some chocolate digestives to dip in our tea as we go through my options.’

Ah well … so much for a break from teaching, but Greta has been a capable student. And at least I have my capital gains tax course for next week planned. I think I might start with a session on takeovers…

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