CHAPTER 15

SCRIP ISSUES AND SALES OF RIGHTS

All statutory references are to the Taxation of Chargeable Gains Act (TCGA) 1992 unless stated otherwise.

15.1 Scrip Issues

A scrip issue is when a shareholder is **offered new shares in the company, instead of the cash dividend.** A scrip issue is sometimes referred to as a scrip dividend or a stock dividend. These terms are interchangeable and mean the same thing.

Consider a taxpayer who has 10,000 shares in ABC Plc. ABC Plc declare a dividend of 10p per share. At the same time, ABC Plc offer a "1 for 10" scrip alternative. This means that a shareholder has a choice between two things:

1) He can take the cash dividend of £1,000; or

2) The shareholder can reject the cash dividend, and instead accept 1 new share for every 10 existing shares he holds. Here a 1 for 10 scrip dividend would give the shareholder 1,000 new shares.

A company is under no obligation to offer a scrip alternative. Many companies will simply pay a cash dividend with no alternative choice. Many large companies often offer a scrip alternative, as it enables them to retain cash within the company. Shareholders are often tempted to accept the new shares, because it is a way of acquiring shares without any associated brokers fees.

There are two types of stock or scrip dividend:

1) "Normal" stock dividends. Here the value of the new shares received by the shareholder is approximately **equal to the cash dividend** that the shareholder gives up. For example, a shareholder would be swapping a cash dividend of £1,000, for new shares worth £1,000.

2) "Enhanced" stock dividends. Here the value of the new shares received by the shareholder, is **"substantially" greater than the cash dividend** foregone. In this context, "substantially" means that the difference between the cash dividend alternative and the share capital's market value equals or exceeds 15% of that market value. SP A8

   For example, if a shareholder exchanges a cash dividend of £1,000 for new shares worth £1,500, this is an "enhanced" stock dividend as the difference of £500 exceeds 15% of the new share's market value, being £225 (£1,500 @ 15%)

Companies offer enhanced stock dividends as an incentive for the shareholders to take the new shares rather than the cash.

15.2 Income tax implications of stock dividends

To understand the capital gains treatment of stock dividends, it is first worth a reminder about how stock dividends are charged to income tax. ITTOIA 2005, S. 412

If a taxpayer receives a **normal stock dividend**, he is charged to **income tax on the cash dividend he gives up.** For example, if a shareholder swaps a cash dividend of £1,000 for shares worth £1,000, he is taxed on the cash of £1,000 which he has given up.

However, if a shareholder receives an **enhanced stock dividend**, he is **taxed on the market value of the shares he receives**. For example if a shareholder swaps a cash dividend of £1,000 for shares worth £1,500, for income tax purposes he is taxed on £1,500.

The amount charged to income tax is then treated as a net dividend. This figure will therefore be grossed up by 100/90 and entered into the dividend column in the tax computation (with a 10% tax credit).

15.3 *CGT* implications of stock dividends

TCGA 1992, s.142

Scrip shares are simply treated like normal purchases of shares.

The shareholder is deemed to have bought the shares for an amount equal to the net amount charged to income tax.

Illustration 1

Janice bought 10,000 shares in PQR Plc for £8,000 in January 1987. She bought a further 15,000 shares in April 2002 for £18,000.

In January 2011, PQR Plc declare a dividend of 5p per share. As Janice has 25,000 shares, she will be entitled to a cash dividend of £1,250.

PQR Plc also offer a scrip alternative. The company offer 1 new share for every 25 shares held, instead of a cash dividend. If Janice accepts the scrip alternative, she will receive 1,000 new shares.

In January 2011, the PQR shares are valued at £2.00 each. This is an **enhanced scrip dividend**, because the value of the new shares offered – i.e. £2,000 – is substantial. The difference between the cash dividend (£1,250) and the market value of the new shares (£2,000) of £750 is greater than 15% of the market value of the new shares being £300 (£2,000 @ 15%).

Janice therefore takes the shares instead of the cash.

In March 2011, Janice sells 6,500 shares for £13,750.

All the shares are in the S.104 pool:

Date	*Shares*	*Cost*
		£
January 1987	10,000	8,000
April 2002	15,000	18,000
	25,000	26,000
Jan 2011 (1:25 scrip issue) - Note	1,000	2,000
	26,000	28,000
Less: Sale (March 2011)	(6,500)	(7,000)
Balance c/fwd	19,500	21,000

Gain;

	£
Proceeds	13,750
Less: CGT base cost (above)	(7,000)
Capital gain	£6,750

Note: the base cost of the 1,000 new scrip shares is the net amount charged to income tax. As this is an enhanced scrip, the net amount charged to income tax is the value of the new scrip shares at issue – i.e. £2,000.

15.4 Sale of rights

In the previous chapter, we looked at rights issues.

If a company announce a rights issue, they are giving their shareholders the right to buy a certain number of new shares. In order to persuade the shareholders to buy the shares, the company usually offer the shares at a discount.

A rights issue is essentially therefore a piece of paper, giving the shareholders the right to buy shares for less than they are presently worth. This piece of paper – i.e. this right - therefore has a value of its own, and can be sold to a third party.

Note here, that the shareholder is **selling his right to buy shares** and not the shares themselves.

If a shareholder sells his rights and makes a profit, that capital gain will be chargeable to CGT. This process is known as the **"sale of rights nil paid"**.

The sale of rights is treated as a **part disposal** of the original shares. Therefore in order to calculate the gain on the sale of the right, we do a part disposal calculation using the usual formula: TCGA 1992, s. 123

$$\frac{A}{A+B} \times \text{base cost of shares}$$

The "A" in the fraction is the cash received from the sale of the right, whilst the "B" is the market value of the shares remaining.

Illustration 2

James bought 100,000 shares in Doves plc in September 2004 for £500,000.

In October 2010, Doves plc announced a 1 for 2 rights issue at £6 per share. The value of the Doves plc shares at the date of the rights issue is £7.

James decides not to take up the company's offer to buy the new shares, but instead he sells his right for £20,000.

This is treated as a part disposal of James' shares. The gain is calculated as follows:

	£
Proceeds	20,000
Less: cost × $\frac{A}{A+B}$	
£500,000 × $\frac{20000}{20000+700000}$	(13,889)
Gain	£6,111

James still has 100,000 Doves plc shares but his CGT base cost is now:

	£
Original cost	500,000
Less; used in part disposal	(13,889)
New base cost	486,111

15.5 Sale of rights – "small" proceeds

We do not need to prepare this capital gains computation, if proceeds from the sale of rights are "small". Proceeds are "small" if they are **not more than £3,000**. If proceeds exceed £3,000, they are still regarded as "small" if they are **not more than 5% of the value of the shares** at the date of the rights issue.

TCGA 1992, s. 122

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If proceeds are small, there is no part disposal for capital gains tax. The proceeds received from the sale of the rights are instead **deducted from the base cost of the shares for CGT** purposes.

The small proceeds rules apply automatically – no election is required by the shareholder.

However HMRC will allow the sale of a right to be treated as a disposal even if proceeds are "small" – this may be beneficial for the taxpayer if he/she has an annual CGT exemption which will wipe out the resulting capital gain.

Illustration 3

Returning to the example of James (above).

	£
Proceeds from sale of rights	20,000
Value of shares at date of rights (100,000 x £7)	700,000
$\frac{\text{Proceeds}}{\text{MV of shares}} = \frac{20{,}000}{700{,}000} =$	2.85%

The proceeds from the sale of the rights are less than 5% of the value of the shares at that date, therefore HMRC will not treat this as a part disposal. Instead the proceeds of £20,000 will be deducted from the base cost of James' shares and no capital gain will arise.

James' CGT base cost is now;

	£
Original cost	500,000
Less; rights proceeds	(20,000)
New base cost	480,000

However, if James has not otherwise used his annual CGT exemption, he can ask HMRC to treat the receipt as a part disposal. This will give him:

i. a gain of £6,111 as above – covered by the AE;
ii. & a higher CGT base cost (£486,111) when he eventually sells his shares.

Example 1

Basil bought 50,000 shares in Fawlty Ltd in May 2002 for £100,000.

Fawlty Ltd announced a 1:5 rights issue at £2.50 per share in December 2004 which Basil took up in full.

In June 2007, Fawlty Ltd announced another rights issue, this one being 1:10 at £3 per share.

Basil did not take up this offer but instead sold his rights for £2,000.

In February 2011, Basil sold 30,000 shares for £4 each.

Basil makes other disposals each year which utilise his annual exemption.

Calculate Basil's capital gain in February 2011.

Answer 1

Sale of rights June 2007:
Proceeds < £3,000 so treat as "small"
Deduct from base cost of shares in S.104 pool.

	Shares	*Cost*
		£
May 2002	50,000	100,000
December 2004 (1:5 rights issue @ £2.50)	10,000	25,000
	60,000	125,000
Less; Sale of rights (June 2007)		(2,000)
		123,000
Less: Sale (February 2011)	(30,000)	(61,500)
Balance c/fwd	30,000	61,500

Gain

	£
Proceeds (30,000 x £4)	120,000
Less: CGT base cost (above)	(61,500)
Capital gain	£58,500