CHAPTER 16

TAKEOVERS

16.1 Introduction

TCGA 1992, s. 135

In this chapter, we shall consider the capital gains tax implications of the **takeover** by one company of another company. This will happen when company "A" acquires more than 50% of the shares of company "B".

For example, assume a taxpayer owns all the shares of Widget Co Ltd. A larger company - Big Co Plc - wishes to take over Widget Co Ltd by acquiring all of its shares. After the takeover has taken place, Big Co Plc will own all of the shares of Widget Co Ltd. To acquire all of the shares of the "target" company, Big Co Plc must purchase them from the shareholder(s). Big Co Plc can do this in a number of ways.

The consideration paid by Big Co Plc to the shareholder(s) could be either;

1) wholly in cash; or
2) new shares in Big Co Plc in exchange for shares in Widget Co Ltd (a "**share for share exchange**"); or
3) a mixture of cash plus new shares.

If the shareholders accept the offer, they will be disposing of their shares in Widget Co Ltd, and we must therefore consider the capital gains implications.

16.2 Share for share exchanges

Share for share exchanges are also called "paper for paper" exchanges. A shareholder is simply swapping one piece of paper - i.e., a share certificate in one company - for a certificate in another.

TCGA 1992, s. 127

Where "old" shares are swapped for "new" shares, **there is no disposal for capital gains tax purposes**. As such, no gain will arise on a share for share exchange.

This applies automatically and no formal claim is required.
The simple logic is that on a "paper for paper" exchange, the vendor has no cash, and therefore has no means of paying any subsequent CGT liability.

This is a general principle of capital gains tax – i.e. if a taxpayer disposes of an asset and he is paid in non-cash form, there is unlikely to be a corresponding tax liability.

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Illustration 1

Terry bought 1,000 shares in Widget Co Ltd in May 1991 for £10,000. Widget Co Ltd is taken over by Big Co Plc. In return for his Widget Co shares, Terry receives 500 new shares in Big Co Plc.

As this is a share for share exchange, no disposal takes place for capital gains tax purposes. Terry will therefore have no tax liability on the disposal of his original Widget Co Ltd shares.

For CGT purposes, the new Big Co Plc shares "**stand in the shoes**" of the old Widget Co Ltd shares. This means that for CGT purposes, Terry is treated as having bought 500 new Big Co Plc shares for £10,000 in May 1991 – i.e., the **new shares have the same base cost and acquisition date as the original shares.**

Terry will therefore have a CGT liability when he eventually sells his new Big Co Plc shares.

For the above rules to apply, the exchange must take place for **"bona fide commercial reasons".** HMRC do not regard tax avoidance as a bona fide commercial reason.

TCGA 1992, s. 137(1)

The acquiring company – in this case Big Co Plc – can approach HMRC and ask them to give **advance clearance** that this condition has been met.

TCGA 1992, s. 138(2)

16.3 Takeovers involving cash

A chargeable **gain will only arise** if all or part of the consideration given to the vendor on a takeover **involves cash**.

If old shares are exchanged for cash, this is a disposal of all of the original shares and a gain will arise. The gain is calculated in the normal way – i.e. using the share matching rules.

If old shares are exchanged for a **mixture of new shares plus cash**, this is a **part disposal** for CGT. A gain will arise on the cash element, but a gain will not arise on the shares element. We use the part disposal rules, because only part of the consideration is paid in cash form.

Wherever a part disposal arises, we calculate the allowable cost by using the formula:

$$\frac{A}{A+B} \times \text{original cost}$$

In this instance, "A" is the cash received on the takeover, whilst "B" is the market value of the new shares received.

Illustration 2

Terry buys 1,000 shares in Widget Co Ltd for £10,000 in May 1991. Widget Co Ltd is taken over by Big Co Plc in July 2010. The consideration paid to Terry by Big Co Plc, is made up of £20,000 in cash and 500 new shares in Big Co Plc. The value of the new shares is £80,000.

Terry has received £100,000 in total for the sale of his shares, but only part of this has been paid in cash. In 2010/11, Terry will pay capital gains tax in respect of the cash element only. Because only part of the consideration is paid in cash form, we calculate the gain by using the part disposal rules.

As only 20% of the consideration was paid in cash form, only 20% of the cost of the shares is allowable.

	£
Proceeds	20,000
Less: cost	
$10{,}000 \times \frac{20000}{20000+80000}$	(2,000)
Chargeable gain	£18,000

Terry is left with 500 shares in Big Co Plc. He will have a capital gain in the future when he sells these shares and at that point we will need to ascertain their base cost.

The base cost of the new shares is part of the base cost of the old Widget Co Ltd shares. Because 80% of the consideration was paid in new shares, the base cost of the Big Co Plc shares is 80% of the original base cost of the Widget Co Ltd shares. Terry is therefore deemed to have bought 500 Big Co Plc shares in May 1991 for £8,000 (i.e. 80% x £10,000).

So in summary, the cost of the original Widget Co Ltd shares (£10,000) is split using the ratio of the market value of the different elements of the consideration on takeover (Cash and Big Co shares) as follows:

	Market value	Cost
	£	£
Cash	20,000	2,000
Big Co plc shares	80,000	8,000
	100,000	£10,000

When the Big Co shares are sold in the future, they are treated as if they had been bought when the Widget Co Ltd shares were bought for £8,000.

The remaining £2,000 cost of the Widget Co Ltd shares has already been used in the part disposal that took place at takeover due to the cash consideration.

16.4 Different classes of shares

You may come across takeovers in which the vendor receives different classes of shares in the new company.

The shares we have looked at so far have been ordinary shares. **Ordinary shares** generally carry voting rights – i.e., they usually give the shareholder the right to vote at company meetings. If a shareholder has more than 50% of the ordinary shares of the company, he will generally control the company by being able to exercise more than half of the voting rights.

A shareholder could also be given **preference shares** in the company. Preference shares do not usually carry voting rights, but instead a preference shareholder will have a preferential right to a dividend. Dividends are generally paid to preference shareholders in priority to ordinary shareholders.

It may be that on a takeover, the acquiring company – i.e. in our example Big Co Plc – would not want to give Terry the right to vote at a shareholders meeting. Big Co Plc may therefore offer Terry preference shares rather than ordinary shares.

For CGT purposes, it makes no difference whether the vendor receives ordinary shares or preference shares. Both types of shares are chargeable assets, so we calculate capital gains on sale in the normal way. It is not uncommon for different types or different classes of shares to be included within a takeover offer.

Illustration 3

Malcolm bought 10,000 shares in White Ltd for £20,000 in May 1989. White Ltd was taken over by Black Plc on 1 July 2010. In return for his old White Ltd shares, Malcolm received a mixture of new shares and cash.

For every White Ltd share he held, Malcolm received:

2 Black Plc ordinary shares (MV £5.50 per share)
1 Black Plc preference share (MV £7.50 per share)
£1.50 cash

We need to consider Malcolm's capital gains tax position on the takeover in July 2010.

We need to establish what Malcolm has after the takeover. He started with 10,000 White Ltd shares which cost £20,000 in May 1989.

After the takeover Malcolm has:

	Value £
Black Plc ordinary shares	
20,000 x £5.50	110,000
Black plc preference shares	
10,000 x £7.50	75,000
Cash	
10,000 x £1.50	15,000
	£200,000

In this situation, there have been **two share for share exchanges**. This means that the receipt of the ordinary shares and the preference shares will not give rise to a disposal for CGT. However, because part of the consideration has been paid in cash, Malcolm will have an **immediate gain on the cash element,** and to calculate the gain we use the part disposal rules.

Gain on receipt of cash:	£
Proceeds	15,000
Less: cost	
$20{,}000 \times \frac{15000}{200000}$	(1,500)
Chargeable gain	£13,500

After the takeover, Malcolm has 20,000 Black ordinary shares, 10,000 Black preference shares, and £15,000 cash. Malcolm originally spent £20,000 in acquiring White Ltd shares in May 1989. This is his total base cost. We have already allocated £1,500 of this base cost to the cash element.

To arrive at the base cost of the ordinary shares and the preference shares, we do exactly the same exercise.

	Base cost £
Black Plc ordinary shares	
$\frac{110000}{200000} \times 20{,}000$	11,000
Black Plc preference shares	
$\frac{75000}{200000} \times 20{,}000$	7,500

Malcolm sells the Black Plc ordinary shares for £125,000 on 31 March 2011.

Malcolm's gain is calculated as follows:

	£
Proceeds	125,000
Less: cost (May 1989)	(11,000)
Chargeable gain	£114,000

16.5 Interaction with entrepreneurs' relief

Where shares in one company are exchanged for shares in another on takeover, the "share-for-share" rules apply automatically. There is no disposal for CGT purposes and therefore no gain at the time of the takeover. The "new" shares inherit the base cost of the "old" shares.

TCGA 1992, s.127

However, since the introduction of entrepreneurs' relief from 6 April 2008, it is possible for a taxpayer to **make an election to disapply the share-for-share rules** on a takeover. This is to enable taxpayers to make full use of entrepreneurs' relief in the tax year of the takeover if they wish. The election must be made by the anniversary of the 31 January following the year of disposal – ie, by 31 January 2013 for disposals in 2010/11.

TCGA 1992, s.169Q

Such an election will have the following effects:

1) A gain will arise calculated as if the value of the new shares received was cash. This gain can then qualify for entrepreneurs' relief (assuming the relevant conditions are satisfied); and

2) The new shares have a base cost equal to their market value at the date of the takeover. This will reduce the gain when the new shares are eventually sold.

Illustration 4

Dan, a higher rate taxpayer, had been a director of I-Track Ltd (a computer software company) for many years, owning 10,000 (representing 10%) of the ordinary shares. He had acquired the shares from a share option scheme in March 2003 and their CGT base cost was £10,000.

In September 2010, the issued shares of I-Track Ltd were acquired by Megatron plc. Each shareholder received £10 in cash and 20 new shares in Megatron plc in return for their I-Track Ltd shares. The Megatron plc shares were quoted at £2.00 in September 2010. There are 10 million Megatron plc shares in issue.

Following the normal share-for-share rules, Dan will have a gain on the cash element of his consideration, but no gain on the shares element.

The gain arising will be eligible for entrepreneurs' relief because:

a) I-Track Ltd is a trading company; and

b) Dan works for the company; and
c) he has at least 5% of the voting rights.

The CGT position is therefore as follows:

Consideration received from Megatron plc in September 2010

	Value £	%
Cash (10,000 x £10)	100,000	20
200,000 new shares @ £2 each	400,000	80
Total	500,000	100

Gain on cash

	£
Proceeds	100,000
Less: base cost (£10,000 x 20%)	(2,000)
Gain	98,000
Less: AE	(10,100)
Taxable gain	87,900
CGT @ 10%	£8,790

Base cost of new Megatron plc shares:
£10,000 x 80% £8,000

Remember, in order for a disposal of shares to qualify for entrepreneurs' relief, the individual must own at least 5% of the company. Dan does not own 5% of Megatron plc, so any future disposal of these shares will not qualify for relief, with any gain taxed at 28% rather than 10%.

He may therefore prefer to crystallise the full gain when the share-for-share exchange takes place in order to maximise the entrepreneurs' relief available.

Now assume that Dan makes an election to disapply the share-for-share exchange rules when I-Track Ltd is taken-over in September 2010.

The revised position would be:

Gain on cash and shares

	£
Proceeds:	
Cash received	100,000
MV of shares received	400,000
	500,000
Less: base cost	(10,000)
Gain	490,000
Less: AE	(10,100)
Chargeable gain	479,900
CGT @ 10%	£47,990

Base cost of new Megatron plc shares

= MV at takeover £400,000

If an election is made:

a) Dan has a higher gain in 2010/11 on which CGT will be due; but

b) his base cost of the new shares is substantially higher, thereby reducing the gain on the eventual sale of the Megatron shares.

Remember that he will not be eligible for entrepreneurs' relief when he sells the Megatron shares, as he does not have a 5% holding.

Example 1

Dorothy bought 2,000 Oz Ltd shares in May 1981 for £5,000. The shares were worth £6,000 in March 1982. She bought another 3,000 shares in July 2006 for £12,000.

Oz Ltd was taken over by Emerald plc in July 2010. Dorothy received:

£5 cash
5 Emerald plc shares

for every Oz Ltd share.

The Emerald plc shares were worth £2 each in July 2010.

Calculate Dorothy's gain in July 2010 assuming that she has never worked for either company.

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Answer 1

Before: 5,000 shares in the S.104 pool as follows

	Shares	*Cost*
		£
31 March 1982	2,000	6,000
July 2006	3,000	12,000
Total	5,000	18,000

After:	*Value*
	£
Cash	
5,000 x £5	25,000
Emerald plc shares	
25,000 x £2.00	50,000
	£75,000

Gain on cash received:

	£
Proceeds (cash)	25,000
Less: CGT base cost	
$18,000 \times \frac{25000}{75000}$	(6,000)
Chargeable gain	£19,000

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