CHAPTER 17

GILTS AND QCBs

17.1 What is a QCB?

A QCB or **"qualifying corporate bond"** is a type of security. These are also referred to as **loan stock or debentures.**

If an individual invests money into in a company, he will either be buying shares or some sort of loan stock – i.e. securities. If the investor acquires shares in the company, he has a stake in the company and a say in how the company is run. In return for his investment, the shareholder will receive dividends and rights to vote at shareholder meetings.

If an investor acquires loan stock in a company, this can be thought of as an "IOU". The investor is simply lending money to the company, and this money will be paid back at a future date. If a company issues loan stock to an investor, the company will pay the investor interest on the loan as opposed to dividends.

The attraction of loan stock is that it is usually less risky than holding shares. The share price is far more likely to fluctuate than the value of the loan stock. The disadvantage of holding loan stock, is that there is less opportunity to make a substantial profit and the stockholder usually has no voting rights.

For loan stock to satisfy the definition of a QCB, it must satisfy three conditions: TCGA 1992, s. 117

(i) The loan stock must have been issued **after March 1984**; and
(ii) The loan stock must be expressed in **sterling**; and
(iii) The loan stock **cannot be converted** into any other currency.

If the terms of the loan are expressed in such a way that the security can be converted into another currency, it will not satisfy the definition of a QCB.

When a UK company pays interest on loan stock to its investors, assuming those investors are individuals, it will **withhold 20% tax at source**. The investor will therefore receive the interest net of tax.

17.2 Gilts

TCGA 1992, Sch 9

A gilt-edged security is another example of loan stock, but this time the stock is **issued by the Government** rather than by a company. Examples of gilt-edged securities are UK Government Treasury Stock, Exchequer Stock or 3½% War Loan.

All gilt-edged securities will be denominated in Sterling and are non-convertible. Gilts carry a **fixed rate of interest** from the date of acquisition through until the date of redemption. For example, if a taxpayer acquires 8% Treasury Stock 2013, he has lent the money to the Government on which they will pay interest at a fixed rate of 8% per annum, until the loan is repaid by the Government in 2013. Because an investor is lending money to the UK Government, this is an extremely safe investment and for this reason gilts are quite popular.

Interest on gilts is generally paid to investors every six months. Interest paid on gilts is paid gross.

17.3 CGT treatment of gilts and QCBs

TCGA 1992, s. 115

Gilts and qualifying corporate bonds are **exempt assets** for CGT. Therefore if a taxpayer sells a gilt or QCB and makes a profit, the gain will not be charged to tax. Similarly, **losses** on gilts and QCBs are **not allowable.**

These rules only apply for individuals – they do not apply for companies. If a **company** sells a gilt or QCB and makes a profit or loss, the resulting profit or loss is dealt with under the loan relationship rules.

17.4 CGT treatment of non QCBs

If a security does not satisfy the definition of a QCB, it is a chargeable asset for CGT purposes. For instance, loan stock or debentures issued by a company which are expressed in US Dollars are not QCBs. Remember QCBs must be denominated in Sterling and are not convertible.

If an investor holds a **non-QCB,** we **treat this in exactly the same way as a share** for capital gains tax purposes. The same pooling & matching rules will apply, and any gains will be chargeable and any losses allowable.

There are anti-avoidance rules to prevent a company converting a non-QCB into a qualifying corporate bond, or vice versa. If a **non-QCB converts** to a qualifying corporate bond, we pretend that the non-QCBs have been **disposed of at their market value** at the date of conversion. This produces a **capital gain**. This gain is not charged to tax immediately, but is instead **brought into charge when the QCB is eventually sold**. This rule was introduced as an anti-avoidance provision, to prevent taxpayers from converting what were essentially shares into QCBs in order to take advantage of the CGT exemption. TCGA 1992, s. 132(3)(a)(ia)

17.5 QCBs and takeovers

TCGA 1992, s. 116

A QCB may be offered by a company as part of the consideration on a takeover. As well as offering new shares and cash for the vendor's old shares, the issuing company also offers loan stock which satisfies the definition of a QCB.

For example, assume a taxpayer owns shares in Old Ltd. Old Ltd is taken over by New Co Plc. New Co Plc offers the shareholder cash plus shares in New Co Plc in exchange for the Old Ltd shares. As part of the consideration, New Co Plc also offer loan stock in New Co Plc. This loan stock satisfies the definition of a qualifying corporate bond. We have to consider how each element of the consideration is treated for CGT purposes.

Because the shareholder has received part of his consideration in cash, a chargeable gain will arise calculated using the part disposal rules. The share for share exchange will not give rise to a disposal for CGT purposes so no gain will arise. However, the share for share exchange rules cannot apply to the QCB, as it is not a share for CGT purposes.

On the **receipt of a QCB on takeover**, we assume the shareholder has received an amount of cash equal to the value of the QCB. We therefore **calculate the capital gain** that would have arisen on the receipt of this "pretend cash". However, because the shareholder does not physically have the cash in his possession, we **do not charge this gain immediately**. Instead, we **"freeze" it.**

This "frozen" gain is eventually **charged** to tax when the shareholder **disposes of his QCB** sometime in the future. If the investor sells part of his QCB, only part of the frozen gain becomes taxable.

Illustration 1

Michael owns 1,000 shares in Mike Ltd which he bought in January 2006 for £30,000. In November 2010, Mike Ltd is taken over by Giant Plc. The terms of the takeover are that Michael will receive total consideration of £150,000 split as follows:

	Value
	£
1,000 ordinary shares in Giant Plc	100,000
£10,000 of loan stock in Giant Plc	15,000
Cash	35,000
Total	£150,000

Note that £10,000 of loan stock is not necessarily worth £10,000. Here it is worth more. The £10,000 is the "nominal value" of the stock – i.e. this is the amount on which interest is calculated. Loan stock could be worth more or less than its nominal value depending on interest rates and on the strength of the company.

We need to calculate the capital gains arising at the point of takeover. Because part of the consideration has been paid in cash, a **chargeable gain will arise on the cash element**. To calculate the gain, we use the part disposal rules as follows:

Gain on cash received:	£
Proceeds	35,000
Less: cost $\times \frac{A}{A+B}$	
£30,000 $\times \frac{35000}{150000}$	(7,000)
Chargeable gain	£28,000

Part of Michael's consideration has been paid in the form of a **QCB**. We calculate the gain by pretending that the £15,000 of loan stock received is cash. This **gain will then be "frozen" until the QCB is eventually sold**.

The proceeds are the market value of the loan stock at the date of the takeover, being £15,000.

Gain on QCB received:	£
Proceeds (MV at takeover)	15,000
Less: cost $\times \frac{A}{A+B}$	
£30,000 $\times \frac{15000}{150000}$	(3,000)
Gain	£12,000

This gain of £12,000 is then frozen. The gain will "crystallise" when the QCB is eventually sold.

For example, assume Michael sells half of his loan stock in July 2011 for £18,000 to an unconnected third party. As Michael is **disposing of <u>half</u> of his QCBs**, he will **crystallise <u>half</u> of the frozen gain** in the year in which the QCBs are sold – in this case in 2011/12.

Frozen gain (Nov 2010)	£12,000
50% crystallises	£6,000

This is taxed in 2011/12

As the **QCB itself is an exempt asset**, the sale of the QCB will not give rise to a chargeable gain or an allowable loss, so the proceeds figure of £18,000 in this example is irrelevant.

17.6 Practical points

The issuing company often prefer to include QCBs as part of the takeover consideration, as this means that they do not have to find the cash to pay to the shareholder. Paying the vendor in the form of a QCB, simply means that money is being left outstanding by way of a loan.

As far as the vendor shareholder is concerned, if he takes QCBs instead of cash, he will not pay capital gains tax until such time as he sells the QCB. Taking loan stock on a takeover is therefore a way in which the vendor can defer a capital gain.

If a vendor has a frozen gain on the receipt of a QCB, it is common tax planning for the vendor to **dispose of a small part of his QCB each tax year, in order to crystallise a gain equal to the annual exemption**. If the taxpayer has no other disposals and therefore does not utilise his annual exemption year on year, by redeeming his QCBs in regular small amounts, he can turn the loan notes into cash without having to pay capital gains tax.

There is a downside to a vendor accepting QCBs instead of cash. If the **acquiring company** - i.e. the New Co – **goes into liquidation,** it is highly likely that it will be unable to repay the loan to the investors and the **QCBs will become worthless**. When the company is liquidated, the investors are deemed to have disposed of their QCB. As the QCBs themselves are exempt assets, any **losses** incurred on the redemption of the QCBs, **will not be allowable**.

However, when the QCBs are disposed of on liquidation, the **gain which was frozen on takeover becomes a chargeable gain.** The investor therefore has a chargeable gain, but may well have no cash to pay the capital gains tax. This problem, has come to light in many instances.

One way around this problem is for the investor to **give his loan notes to a charity.** Gifts of assets to charities do not give rise to a CGT charge, and HMRC has confirmed that such a disposal will **not crystallise the frozen gain.**

17.7 Interaction with entrepreneurs' relief

TCGA 1992, s.169R

The position in relation to entrepreneurs' relief varies depending on the date the exchange of shares for QCBs takes place.

Shares exchanged for QCBs between 6 April 2008 and 23 June 2010

Where shares are exchanged for QCBs between 6 April 2008 and 23 June 2010, **entrepreneurs' relief will be available in respect of the frozen gains that become chargeable** when the QCBs are redeemed.

Assuming that the sale of the shares meets the qualifying conditions, a claim for entrepreneurs relief is made at the time that the gains are frozen – ie, at the date of the takeover. Entrepreneurs' relief is then given by **reducing the frozen gains by 4/9ths** (within the lifetime maximum).

The frozen gain (net of 4/9^{ths} entrepreneurs' relief) will become chargeable when the QCBs are sold or redeemed. **This gain will then be taxed at 18% or 28%** depending on the date of the disposal and whether the taxpayer pays tax at the higher rate.

Do note that if the frozen gain becomes chargeable after 23 June 2010 and the taxpayer pays income tax at the higher rate, **the frozen gain will be charged at 28%.** This equates to an effective rate of CGT of 15.56% (not 10% as it was before 23 June 2010).

Illustration 2

Guy sold his shares in Newborn Ltd (a trading company) to the Elbow Group plc in May 2008. He had set-up the company with £10,000 of initial share capital in May 1999 and was managing director and sole shareholder.

The Elbow Group offered Guy total consideration of £480,000 for his Newborn Ltd shares, consisting of 300,000 Elbow Group plc ordinary shares (valued at £1 each) and £180,000 of loan notes (valued at par). The loan notes satisfy the definition of a QCB.

In January 2011, Guy sold 150,000 shares in Elbow Group plc for £195,000 and redeemed the loan notes at par. He had made no previous disposals of chargeable assets and he does not work for Elbow Group plc.

Guy is a higher rate taxpayer who uses his annual exemption every year.

We will calculate Guy's capital gains in 2010/11.

Consideration received from Elbow Group plc in May 2008:

	Value	%
	£	
300,000 ordinary shares in Elbow Group plc	300,000	62.5
£180,000 of loan stock in Elbow Group plc	180,000	37.5
Total	480,000	100

The disposal is eligible for entrepreneurs' relief because Guy sold a "material stake" in a trading company (i.e. he worked for Newborn Ltd and was able to exercise at least 5% of the voting rights).

Guy does not work for Elbow Group plc, so when he comes to sell his new shares he will not be entitled to entrepreneurs' relief. Therefore Guy can elect to disapply the share-for-share exchange rules in 2008/09 and claim entrepreneurs' relief on the exchange of the Newborn Ltd shares for shares in Elbow Group plc.

Gain on exchange of shares:

	£
Proceeds (MV of Elbow Group plc shares)	300,000
Less: base cost £10,000 x 62.5%	(6,250)
Gain	293,750
Less: entrepreneurs' relief (4/9 x £293,750)	(130,556)
Chargeable Gain	163,194
CGT @ 18%	29,375

Base cost of new Elbow Group plc shares:
(MV at date of exchange) £300,000

The gain in respect of the QCBs received is frozen until the QCBs are redeemed.

Frozen gain on receipt of QCBs:

	£
Proceeds (MV of loan stock)	180,000
Less: base cost: £10,000 x 37.5%	(3,750)
Gain	176,250
Less: entrepreneurs' relief (4/9 x £176,250)	(78,333)
Frozen Gain	97,917

In January 2011 there will be:

(i) a gain on the sale of the Elbow Group plc shares; and
(ii) crystallisation of the frozen gain when Guy redeems the loan notes.

No entrepreneurs' relief is available on the disposal of the Elbow Group plc shares as Guy does not work for Elbow Group plc.

Gain on Elbow Group plc shares:

	£
Proceeds	195,000
Less: cost (½ x £300,000)	(150,000)
Gain	45,000
Frozen gain now charged	97,917
Elbow Group plc shares gain	45,000
Taxable gains	142,917
£142,917 @ 28%	40,017

The frozen gain in relation to the QCBs has already received entrepreneurs' relief and therefore is also taxed at 28% (as Guy is a higher rate taxpayer).

Shares exchanged for QCBs before 6 April 2008

Entrepreneurs' relief will be available on a share-for-QCB exchange even if the original disposal in respect of which the QCBs were issued was before 6 April 2008.

Entrepreneurs' relief will be given in the above situation **only if the original sale of the shares would have met the conditions** for entrepreneurs' relief.

A claim for entrepreneurs' relief is **not made until the frozen gain comes back into charge.**

If the frozen gain becomes chargeable before 23 June 2010, the position is the same as that outlined in Illustration 2 above. The frozen gain (within the permitted maximum) is reduced by 4/9ths, and the balance of the gain is charged at 18% (to give an effective rate of 10%).

If the frozen gain becomes chargeable on or after 23 June 2010, the gain will not have been reduced by 4/9ths. Instead entrepreneurs' **relief will be obtained by charging the gain at 10%.**

Shares exchanged for QCBs on or after 23 June 2010

Where the exchange of shares for QCBs takes place on or after 23 June 2010, the position is different.

If entrepreneurs' relief is available on the disposal of the original shares, an election can be made for the gain in relation to the QCB element **not** to be deferred. Instead, the gain in respect of the QCB element will be charged at the time of the takeover.

Entrepreneurs' relief will then apply and the resulting gain (up to the qualifying maximum) will be charged to CGT at 10%.

This election effectively disapplies the "share-for-QCB rule" in the same way as the similar election does where a share-for-share exchange takes place.

The election for the gain not to be deferred must be made on or before the **first anniversary of 31 January following the tax year** of the exchange.

Note that if no claim is made to set aside the normal share-for-QCB rule, the gain on the QCB element will be frozen at the date of the takeover. When this gain eventually crystallises, **it will be charged at either 18% or 28%** depending on whether the individual is a higher rate taxpayer. No entrepreneurs' relief will be available.

Illustration 3

The facts are the same as Illustration 2, but this time we will assume that the takeover takes place in July 2010, with the subsequent sales of shares and QCBs taking place in January 2012.

Guy sold his shares in Newborn Ltd (a trading company) to the Elbow Group plc in July 2010. He had set-up the company with £10,000 of initial share capital in May 1999 and was managing director and sole shareholder.

The Elbow Group offered Guy total consideration of £480,000 for his Newborn Ltd shares, consisting of 300,000 Elbow Group plc ordinary shares (valued at £1 each) and £180,000 of loan notes (valued at par). The loan notes satisfy the definition of a QCB.

In January 2012, Guy sold 150,000 shares in Elbow Group plc for £195,000 and redeemed the loan notes at par. He had made no previous disposals of chargeable assets and he does not work for Elbow Group plc.

Guy is a higher rate taxpayer and uses up his annual exemption every year.

We will calculate Guy's capital gains in 2010/11 and 2011/12.

Consideration received from Elbow Group plc in July 2010:

	Value £	%
300,000 ordinary shares in Elbow Group	300,000	62.5
£180,000 of loan stock in Elbow Group	180,000	37.5
Total	480,000	100

As the disposal in July 2010 qualifies for entrepreneurs' relief but the later disposals will not, Guy will elect to disapply the share-for-share exchange rules. A chargeable gain will therefore arise on the exchange of the shares.

Gain on exchange of shares:

	£
Proceeds (MV of Elbow Group plc shares)	300,000
Less: base cost: £10,000 x 62.5%	(6,250)
Gain	293,750

Base cost of new Elbow Group plc shares: (MV at date of exchange)	£300,000

Guy can also elect for the gain in relation to the QCB consideration not to be deferred.

	£
Proceeds	180,000
Less: base cost (37.5% x £10,000)	(3,750)
Gain	176,250

Both gains will be chargeable in 2010/11. As the gains are eligible for entrepreneurs' relief and the disposals take place on or after 23 June 2010, CGT is charged at a rate of 10%.

	£
Gain on shares element	293,750
Gain on QCB element	176,250
Chargeable gain	470,000
CGT @ 10% (AE used elsewhere)	£47,000

When the QCBs and the shares are sold in 2011/12, no gain will arise in respect of the QCBs as these are exempt assets for CGT purposes.

The gain on the shares will be:

	£
Proceeds	195,000
Less: base cost ($\frac{1}{2}$ x £300,000)	(150,000)
Chargeable gain	45,000
CGT @ 28% (AE used elsewhere)	£12,600

This disposal is not eligible for entrepreneurs' relief as Guy does not work for Elbow Group plc.

Example 1

Nick (a retired businessman) bought 2,000 shares in Brown plc in February 1999 for £20,000.

Brown plc was taken over by Purple plc in May 2004. Nick received:

- 1,000 new Purple plc shares (MV £120,000); and
- £75,000 Purple plc loan stock (MV £80,000)

Nick sold £50,000 of the loan stock in March 2011 for £40,000.

Calculate Nick's chargeable gain 2010/11.

Example 2

Craig was managing director and sole shareholder of Starlings Ltd (an unlisted computer games company). He had bought the shares in June 2001 for £200,000.

Starlings Ltd was taken over by Snooks plc in March 2007. In return for his original shares, Craig received:

- £3 million in cash; and
- £9 million Snooks plc non-convertible debenture stock (valued at par and redeemable in 4 years).

In March 2011 Craig redeemed £6 million of the loan stock at par. This was his only disposal in 2010/11. He is a higher rate taxpayer.

Calculate Craig's CGT liability for 2010/11.

Answer 1

Before: 2,000 Brown plc shares cost £20,000

		£
After:	Purple plc shares	120,000
	Purple plc loan stock	80,000
		200,000

May 2004 - Gain on QCB received:

	£
Proceeds	80,000
Less: cost	
$£20,000 \times \frac{80}{200}$	(8,000)
Frozen gain (May 2004)	£72,000

March 2011
Disposal of £50,000 of QCB:

Frozen gain on £75,000 of QCB	£72,000
Crystallises $\frac{50}{75}$ x frozen gain	£48,000

Answer 2

Consideration received from Snooks plc in March 2007:

	Value	%
	£	
Cash	3,000,000	25
Debenture stock (QCB)	9,000,000	75
Total	12,000,000	100

Gain on QCB element (March 2007):

	£
Proceeds	9,000,000
Less: cost £(200,000 x 75%)	(150,000)
Frozen gain	8,850,000

The disposal of part of the debenture stock in March 2011 will crystallise part of the frozen gain:

Frozen gain chargeable 2010/11:	
£8,850,000 x 6/9	£5,900,000

The original sale of the shares would have met the conditions for entrepreneurs' relief. Therefore the frozen gain will be eligible for entrepreneurs' relief.

As the gain becomes chargeable on or after 23 June 2010:

(i) the maximum amount of qualifying gain is £5 million; and
(ii) the resulting eligible gain is taxed at 10%.

	Qualifying gains	Non-qualifying gains
	£	£
Frozen gains chargeable 2010/11	5,000,000	900,000
Less: AE		(10,100)
Taxable gains	5,000,000	889,900

CGT:	£
£5,000,000 @ 10%	500,000
£889,900 @ 28%	249,172
CGT payable	749,172

Any further redemption of QCBs will not qualify for entrepreneurs' relief as the lifetime maximum has been exceeded.