CHAPTER 19

OPTIONS & OTHER INTANGIBLE ASSETS

19.1 Intangible assets

An intangible asset is one that cannot be seen, touched or moved. The most common types of intangible assets are **shares** and **leases**. We have looked at the special rules for these assets in previous sessions.

Goodwill is another intangible asset. Goodwill is the **difference between the value of the business as a whole and the value of the tangible business assets**. Goodwill is the "intangible" or "inherent" value of the business. Goodwill is a chargeable asset for CGT purposes and the sale of a business by an individual gives rise to chargeable gains on assets such as land and buildings and the goodwill.

For the majority of this session we shall look at capital gains arising on the grant, exercise and disposal of **options**. We shall also look at how we deal with other intangible assets such as **debts, loans** and **patent** rights.

19.2 Options

TCGA 1992, s. 144

An option is a right to buy or sell an asset for a specified price within a specified time period. A share option is a right for an employee to buy shares in his employer company within a specific time window at a fixed price. In this chapter we shall look at options over other assets and will consider the CGT implications of options being granted, exercised and disposed.

19.3 Disposals of options

The tax position on the disposal of an option depends on whether the option has a useful life more or less than 50 years.

(i) **Non-wasting assets**
If an option has a useful life of 50 years or less, the option is a "wasting asset". If the option can last for more than 50 years, the option is a "non-wasting" asset. If a non-wasting asset is sold, normal CGT rules apply. We simply deduct cost from proceeds in the usual way.

TCGA 1992, s. 44

(ii) **Wasting assets**
If a wasting asset is sold, special rules apply to calculate the gain.

When a wasting asset is sold, the **allowable costs** for CGT purposes are **deemed to waste away** over the useful life of the asset. This means that allowable expenditure in the CGT computation is restricted.

TCGA 1992, s. 46

The capital gains computation is as below:

	£
Proceeds on disposal of option	X
Less: base cost	
Cost of option x $\frac{\textbf{Life remaining}}{\textbf{Useful life}}$	(X)
	X

Effectively there is a straight-line depreciation of the cost of the asset over time. The closer we get to the end of the useful life of the asset, the smaller the proportion of the base cost is allowable for CGT.

Illustration 1

A taxpayer owns an option. The option cost £10,000 in January 2002 and can be exercised at any time in the following 10 years. The option will therefore expire and become worthless in January 2012, and will be a wasting asset for CGT purposes. In July 2010, the taxpayer sells the option. Sale proceeds are £8,000. From this we deduct the allowable cost.

The gain is as follows:

	£
Proceeds on disposal of option	8,000
Less: base cost	
£10,000 x $\frac{1\frac{1}{2}}{10}$	(1,500)
Gain	£6,500

19.4 Abandonment of an option

TCGA 1992, s. 144(4)

Whilst the disposal of an option may give rise to an allowable loss, the **abandonment of an option will not produce a loss**. Therefore if an option becomes worthless, and is subsequently abandoned without either being sold or exercised, no allowable loss will accrue.

19.5 Granting an option

TCGA 1992, s. 144(1)

Illustration 2

Assume that Fred, who is a higher rate taxpayer, grants an option to Barney. The option gives Barney the right to buy Fred's house at any time in the next 5 years for the fixed price of £100,000. Fred is the "grantor". Barney is the "grantee".

Barney pays Fred £5,000 for the option. If house prices rise, Barney will exercise his option and buy Fred's house for £100,000. If house prices fall, Barney will not exercise his option and Fred will have the best of the deal. Fred and Barney are effectively having a bet on the movement in house prices.

For CGT purposes, the grantor (ie Fred) is deemed to have sold an asset (the option) at the date of grant for £5,000. As the option has a base cost of zero, the proceeds of sale will be equal to the chargeable gain. A gain of £5,000 will therefore be chargeable in the year the option is granted. Fred may receive relief for incidental selling expenses such as legal fees etc.

At any time until the expiration of the option, the grantee may exercise his right to either buy or sell. In this example, if Barney exercises his option, he is accepting the offer to buy Fred's house for £100,000. If Barney exercises his option, the transaction that subsequently takes place will be the disposal of the house by Fred and the acquisition of the house by Barney. We will therefore calculate a capital gain for Fred.

Under S.144 TCGA 1992, the **grant** and the **exercise** of the option must be treated as **one transaction** for CGT purposes. This means that the sale proceeds charged to CGT on Fred when the option is exercised, are not just the £100,000 that Barney pays for the house, but also the £5,000 Barney paid to Fred when the option was originally granted.

TCGA 1992, s. 144(2)

Fred's capital gain will therefore be:

	£
Sale proceeds	
On grant	5,000
On exercise	100,000
	105,000
Less: cost of house (say)	(40,000)
Gain	65,000

We will aggregate this with Fred's other gains in the year, and deduct the annual exemption, to give Fred's taxable gains. Because Fred is a higher rate taxpayer, he will pay CGT at 28%.

However, because the option proceeds of £5,000 were originally charged to tax in the year the option was granted, by including these proceeds again in calculating the gain on exercise, this £5,000 is effectively being taxed twice. Therefore, any **tax paid on the option proceeds in the year of grant, can be credited against any tax payable when the option is exercised**.

	£
Chargeable gain	65,000
Less: annual exemption	(10,100)
Taxable	54,900
CGT @ 28%	15,372
Less: tax paid at grant of option	(?)
Additional CGT due	£X

19.6 The "grantee's" position

Having considered the position of the person who granted the option (Fred) we will now consider the other side of the equation, ie the grantee's position.

The exercise of the option means that Barney will be buying Fred's house. Barney will therefore make an acquisition for CGT purposes. We therefore need to calculate Barney's base cost. The base cost is simply the amount paid (in total) by Barney to Fred to acquire the house i.e.

CGT base cost:	£
Cost of option	5,000
Cost of house on exercise	100,000
	£105,000

19.7 Options to sell ("put" options)

In the previous paragraphs, we looked at options enabling the grantee to buy an asset. These are called "call" options. Now we will look at the other side of the coin, being options which enable a grantee to sell an asset. These are called "put" options.

Illustration 3

Assume that Janet grants an option to John. The option gives John the right to sell his house to Janet at any time in the next 10 years for a fixed price of £150,000.

Janet has granted the option, so she is the "grantor". John can exercise the option, so he is the "grantee". As this option gives the grantee the right to sell, this is a "put" option.

John pays Janet £6,000 for the option.
The grant of an option is a disposal by the grantor for CGT purposes, therefore Janet makes a capital gain of £6,000 (less any selling expenses), in the year of grant. This gain will be charged to CGT in the normal way.

If John decides to exercise his option, he will be selling his house to Janet. John will therefore make a disposal for CGT purposes, whilst Janet will make an acquisition. Let's calculate John's gain first:

John's gain on exercise of option:

	£
Proceeds	150,000
Less: base cost	
Cost of house (say)	(40,000)
Cost of option	(6,000)
Gain	104,000

19.8 The "grantor's" position

We now look at Janet's position. In the case of a "put" option, the grantor will buy the asset on the exercise of the option. Section 144 tells us that the grant and exercise of the option should be **treated as one single transaction** by the grantor for CGT purposes. Therefore, Janet is deemed to have bought John's house for the exercise price of £150,000, less the £6,000 Janet received on the grant of the option.

Base cost:	£
Exercise price	150,000
Less: amount received for grant of option	(6,000)
CGT base cost	£144,000

This could again give rise to an element of double taxation, because the £6,000 Janet received on the grant of the option was charged to CGT in the year of grant. Therefore by reducing her base cost by £6,000, we are effectively taxing this amount twice.

Therefore any CGT paid on the £6,000 option proceeds in the year of grant, can be either credited or repaid when the option is exercised.

Tax year of exercise of option;	£
CGT due for year	X
Less: CGT paid on grant of option	(X)
CGT due/(repayable)	£X/(X)

If the grant and exercise take place in the same tax year, no tax is actually paid on the option proceeds and the amount received by the grantor is simply deducted from base cost.

19.9 Sale of patent rights

ITTOIA 2005, ss. 587 -590

A patent is a **right to use an invention, process or product**.

If a person – be it an individual or company – pays a patent royalty, the payment is a deductible payment for the payer and taxable income for the recipient. Such royalties are typically paid annually.

However, a taxpayer may choose to assign (i.e. sell) his patent rights to someone else. Effectively the taxpayer is selling his rights to future royalty income in return for a capital sum. If a taxpayer makes a profit on the sale of a patent right, the profit is **not chargeable to capital gains tax**, but is instead chargeable to **income tax as miscellaneous income**. The income is treated as non-savings income.

ITTOIA 2005, s. 587

The taxable profit is simply proceeds less any acquisition costs.

The taxable profit is not fully charged in the year of sale, as to do so would distort the tax computation and give an unusually excessive charge in one tax year. Instead HMRC will **spread the charge evenly over 6 consecutive tax years, starting with the year of sale.** These rules are contained at s.590 ITTOIA 2005.

The taxpayer may make a **claim to have all of the profits charged in the year in which the patent rights are sold**. This may be beneficial if the taxpayer has losses in the year of sale, or he would be paying tax at a lower marginal rate in this particular year.

ITTOIA 2005, s. 590(3)

An election for the income to be fully taxed in the year of sale should be made no later than 31 January following the anniversary of the year of sale. Therefore, for a sale in 2010/11, the election should be made by 31 January 2013.

ITTOIA 2005, s. 590(6)

Finally, if the rights to an invention are being sold by the original inventor, the profits may be treated as relevant earnings for pension purposes.

FA2004, s. 189(2)

19.10 Debts

A debt is an asset which can be bought or sold. **Ordinary debts are not chargeable assets** for CGT purposes. Therefore if an original creditor assigns a debt to someone else, no gain or loss will arise.

TCGA 1992, s. 21(1)(a)
TCGA 1992, s. 251(1)

"**Purchased debts**" – ie debts not accruing to the original creditor but purchased from someone else – **are chargeable assets**, and gains or losses will accrue when those debts are either satisfied or sold on.

TCGA 1992, s. 251(2)

Illustration 4

Jack owes £50,000 to Ronald. Jack is the debtor while Ronald is the original creditor. Ronald therefore has a valuable asset being the right to obtain £50,000 from Jack.

Ronald is having problems obtaining the repayment of the loan, so he assigns the debt to Reginald for £45,000. Jack now owes £50,000 to Reginald, the new creditor. An ordinary debt is not a chargeable asset in the hands of the original creditor, so no loss will be allowed for Ronald on the sale of the debt to Reginald.

Jack eventually settles his debt by paying £50,000 to Reginald. The satisfaction of the debt is the disposal of an asset by Reginald. As Reginald is not the original creditor, he is disposing of a purchased debt. Therefore his gain of £5,000 is chargeable to CGT.

19.11 Debts on a security

A "debt on a security" is not treated in the same way as an ordinary debt for CGT purposes. There is no strict definition of a "debt on a security" – the legislation simply refers to loan stock or similar securities – therefore the definition has been largely shaped by case law. The well-known tax avoidance case of *W.T. Ramsay Ltd v CIR* (1981) centred around the definition of a debt on a security.

TCGA 1992, s. 132(3)(b)

In the *Ramsay* case, the taxpayer company entered into an elaborate tax avoidance scheme, whereby it tried to convince the Courts that a loan note did not fall within the definition of a "debt on a security", and would thereby avoid being taxed. The company failed as the Courts found that the transaction was a "fiscal nullity" and the whole scheme had no commercial justification other than the avoidance of tax. However, it did force the Courts to discuss the meaning of the term "debt on a security".

A debt on a security must be in the nature of an **investment.** The debt must carry a **commercial rate of interest**, and normally carry a premium on early repayment to compensate the lender for a loss of future interest. In the absence of an early redemption penalty, the debt must exist for a sufficiently long period to provide a commercial return. The debt must be **marketable** and usually evidenced and documented in writing. The debt must be loan stock or a security of a similar nature, and be issued by an institution, be it an independent commercial institution, a government or a local authority.

It is important to establish the existence of a debt on a security, because such debts are **chargeable assets for capital gains purposes**. Chargeable gains or allowable losses will therefore arise on disposal.

For example, loan stock issued by a company to its shareholders, which is marketable and carries a commercial rate of interest, will satisfy the definition of a debt on a security and will be a chargeable asset for CGT purposes.

If a debt on a security satisfies the definition of a **Qualifying Corporate Bond,** the asset will be **exempt for CGT purposes.** Essentially a QCB is loan stock which is **non-convertible and issued in sterling**. Therefore gilt-edged stock issued by the UK Government, although being debts on securities, will not be chargeable assets as they are exempted under the QCB legislation.

TCGA 1992, s. 115
TCGA 1992, s. 117

19.12 Loans to traders

TCGA 1992, s. 253

Relief for losses on loans to traders is given by s.253 TCGA 1992.

Relief is available if money is lent to a UK trader for use in his business, and the loan is not a debt on a security. If the capital element of a loan to a UK trader becomes irrecoverable, the amount irrecoverable can be treated as a **capital loss in the hands of the lender.** Note that relief is only available for the capital element of the loan. No relief is available for any interest which cannot be recovered.

TCGA 1992, s. 253(3)

The loss on the loan can be treated as a **current year loss either of the tax year in which the claim is made, or of any of the two preceding years** (assuming the loan was irrecoverable in those two years).

TCGA 1992, s. 253(3A)

Loss relief is also available to a person who **guarantees** a loan to a trader, and who subsequently is required to make good his guarantee.

TCGA 1992, s. 253(4)

Claims under s.253 must be made within 4 years of the end of the tax year in which the loan became irrecoverable or in which a payment under a guarantee was made.

Example 1

Luke purchases an option from Matt for £4,000 on 31 December 2000. The option gives Luke the right to buy a Lowry print from Matt for £75,000 between 2001 and 2011.

Luke exercises his option in March 2005. Luke sold the print in January 2011 for £95,000.

Calculate Luke's gain.

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Answer 1

	£
Proceeds (Jan 2011)	95,000
Less: cost of option (December 2000)	(4,000)
cost of print (March 2005)	(75,000)
Gain	16,000