

Share reorganisations, company takeovers and Capital Gains Tax

This Help Sheet discusses share reorganisations involving shares held by individuals, personal representatives and trustees. It explains the basic rules that apply to disposals made during the tax year 2008-09.

Please read it in conjunction with Help Sheet 284 *Shares and Capital Gains Tax*, which explains the basic rules applying to the acquisition and disposal of shares. Both Help Sheets assume the capital gain or loss will be calculated using the actual costs of acquisition and the actual disposal proceeds. Pages CGN 4 and CGN 5 of the *Capital gains summary notes* explain the circumstances in which market value must be substituted for actual cost or disposal proceeds.

This Help Sheet explains only the basic rules, as they apply in simple cases. If you are in any doubt about your circumstances, you should ask your tax adviser. We will also be pleased to help. You can also consult our Capital Gains Manual, which explains the rules in more detail, at www.hmrc.gov.uk

This Help Sheet explains:

- what a share reorganisation is
- what information is available about share reorganisations
- how the Capital Gains Tax rules deal with share reorganisations
- how you deal with share reorganisations involving different classes of share
- the special rules for stock dividends
- the special rules for demergers
- the special rules for takeovers if the company making the takeover issues shares and/or securities.

It will help you fill in the *Capital gains summary* pages of your Tax Return.

The general rules described in this Help Sheet may not apply to any shares which you acquired under the Enterprise Investment Scheme (EIS), or to shares in a Venture Capital Trust (VCT). For general information on EIS and VCT shares, see Help Sheet 297 *Enterprise Investment Scheme and Capital Gains Tax* and Help Sheet 298 *Venture Capital Trusts and Capital Gains Tax*, available from the Orderline or www.hmrc.gov.uk

Ask us or your tax adviser if you need detailed information on the rules for EIS or VCT shares.

What is a share reorganisation?

A share reorganisation is a general term used to describe certain transactions in which:

- new shares are issued to the shareholders in a company, or
- the rights attaching to shares are altered, or
- a company's share capital is reduced.

The most common share reorganisation transactions are bonus issues and rights issues. In both cases, new shares are allotted to some or all of the existing shareholders in proportion to their shareholdings. In a rights issue the allotment is provisional until the shareholder accepts he or she will pay for the shares. There are other transactions, such as open offers, which may be treated as share reorganisations where new shares are issued to existing shareholders in proportion to their shareholdings.

Other examples, not involving an issue of shares, include capital reorganisations and an alteration of the rights attached to shares.

Example 1

Examples of share reorganisations which do not involve an issue of shares are:

- five 10p ordinary shares may be consolidated into one 50p ordinary share
- ordinary shares with no voting rights may be given the right to vote.

What information is available about share reorganisations?

This Help Sheet is concerned primarily with share reorganisations involving listed companies. If a listed company makes a share reorganisation it will almost always issue a circular or prospectus to its shareholders. This will include the company's explanation of the tax treatment. Often it will be followed up with more detailed advice. For example, the counterfoil attached to a new share certificate may give details of the allowable cost for a stock dividend. You should keep this information. It will help you complete your Tax Return.

How are share reorganisations dealt with for Capital Gains Tax purposes?

The basic Capital Gains Tax rules that apply to share reorganisations are:

- the issue of any new shares is not treated as an acquisition
- the loss or alteration of any old shares is not treated as a disposal.

Because a share reorganisation is not treated as an acquisition, any new shares of the same class that you receive are added to the holding in respect of which they were issued.

Example 2

You own 1 000 shares in JKL plc. JKL plc makes a bonus issue of one new share for every two shares you hold. You receive 500 further shares and now have 1,500 shares in JKL plc. If you make a disposal of only some of those shares you use the share identification rules as described in Help Sheet 284 *Shares and Capital Gains Tax* to establish the cost of the shares you have sold.

Because you are not treated as acquiring the new shares, the same day rule and the bed and breakfasting rule (see the section 'How to identify the shares disposed of' in Help Sheet 284 *Shares and Capital Gains Tax*), do not apply.

Example 3

On 6 May 1998 you buy 1,100 shares in LMN plc.

On 4 February 2009 you sell 200 shares reducing your holding to 900 shares.

On 3 March 2009 LMN plc makes a bonus issue of one share for every three shares held and you receive 300 further shares.

The bonus issue is a share reorganisation so your 300 further shares are not treated as acquired on 3 March 2009 but on 6 May 1998.

Therefore the 200 shares sold on 4 February 2009 are not matched with 200 of the new shares under the 30 day bed and breakfasting rule but are 200 of your original 1,100 shares.

The 300 further shares and the 900 shares remaining, after the sale of the 200 shares, comprise your new holding of 1,200 shares.

There are special rules that deal with any amounts you have to pay on a share reorganisation, such as when you take up a rights issue. These are explained below. There are also special rules which apply to the taxation of any amounts you receive other than the issue of new shares. These are explained in the section on takeovers on page 7.

If the shares you acquire on the reorganisation are not of the same class, they will form a separate holding. The cost of the original shares is apportioned (see the section on 'Share reorganisations involving different classes of shares' on page 5).

If the share reorganisation is a bonus issue there is no allowable expenditure to add to the actual cost of the original shares. If the share reorganisation is a rights issue, you add the cost of the further shares acquired in the rights issue to the cost of the original shares.

Example 4

In April 1996 you buy 1,000 shares in OPQ plc for £7,000.

On 26 May 1997 OPQ plc declares a one for five rights issue at a price of £9 per share. You take up your full entitlement to 200 shares and pay £1,800 for them.

On 2 June 2008 you sell 300 shares for £12 per share.

Following the steps in the paragraph headed 'How to work out the gain for shares in a Section 104 holding' on pages 3 and 4 of Help Sheet 284 *Shares and Capital Gains Tax*, you work out the gains as follows.

Step 1	Number of shares	Pool of actual cost
April 1996 The pool is formed	1,000	£7,000

Step 2

May 1997

Add the cost of the new shares $200 \times £9 = £1,800$ to the pooled cost

Add cost of new shares	<u>200</u>	<u>£1,800</u>
	1,200	£8,800

Step 3

June 2008

Calculate the gain or loss. **First**, calculate the allowable cost. Multiply the pool of cost by:

$$\frac{\text{Number of shares sold}}{\text{Total number of shares in the pool}} = \frac{300}{1,200}$$

$$\text{Allowable cost } £8,800 \times \frac{300}{1,200} = £2,200$$

Second, calculate the gain or loss

Disposal proceeds	£3,600
minus allowable cost	<u>£2,200</u>
Chargeable gain	£1,400

Third, adjust the holding of shares remaining

	Number of shares	Pool of actual cost
Brought forward	1,200	£8,800
	minus <u>300</u>	minus <u>£2,200</u>
Carried forward	900	£6,600

Share reorganisations involving different classes of shares

The shares issued on a share reorganisation may be of a different class from the shares you already own. Because the shares are of different classes you cannot identify the allowable cost of the shares using the number of shares disposed of. Instead, you identify the allowable cost from the respective values of the shares using the formula:

$$\text{Cost x} = \frac{\text{Value of shares disposed of}}{\text{Value of shares disposed of} + \text{value of shares still held}}$$

The time at which you determine the cost of the different classes of share depends on whether or not any of the shares are listed on the Daily Official List of the Stock Exchange, or any other recognised Stock Exchange, within three months of the reorganisation taking effect:

- **listed shares** - you value the different classes of share on the first day when values are listed for the shares in the reorganisation
- **unlisted shares** - you wait until you dispose of some of the shares before splitting the cost. The values you use in the formula are the values of the shares at the time of the disposal.

Example 5

In May 1986 you buy 1,000 £1 ordinary shares in FGH plc, a listed company, for £1,800.

In March 1995 FGH plc makes a rights issue of one £1 'A' ordinary share for every four £1 ordinary shares held at a price of £2.50 per share. You take up your full entitlement of 250 £1 'A' ordinary shares at a cost of £625.

On the day after the share reorganisation, the £1 ordinary shares had a value of £8 per share, and the £1 'A' ordinary shares a value of £2.60 per share.

If you sell the ordinary or the 'A' ordinary shares you split the cost between the different classes of share as follows.

Step 1

Calculate the cost up to and including the share reorganisation.

	Number of shares		Pool of actual cost
	ord	'A' ord	
May 1986	1,000		£1,800
March 1995 - rights issue		250	£625
Holding at March 1995	1,000	250	£2,425

Step 2

Split the cost of the two pools of expenditure. The amount allocated to the £1 ordinary shares is given by the formula

$$\frac{\text{Value } \text{£1 ord}}{\text{Value } \text{£1 ord} + \text{Value } \text{£1 'A' ord}} = \frac{1,000 \times \text{£8}}{(1,000 \times \text{£8}) + (250 \times \text{£2.60})} = \frac{8,000}{8,650}$$
$$\text{Pool of actual cost} \times \frac{8,000}{8,650} = \text{£2,243}$$

At March 1995 you have a holding of £1 ords:

Number of shares	Pool of actual cost
1,000	£2,243

and a holding of 'A' ords:

Number of shares	Pool of actual cost
250	£182

If the company had not been a listed company you would split the cost of the shares in the same way but using the value of the shares when the disposal that caused the calculation to be required was made.

Stock dividends

In a stock dividend, the company paying a dividend gives its shareholders the option of taking the dividend in the form of new shares rather than cash. It is a form of bonus issue as the shareholders do not pay for the new shares. Shareholders who take shares are taxable on the dividend. They are treated as having received an amount called 'the appropriate amount in cash', which attracts Income Tax.

For Capital Gains Tax purposes, shareholders are treated as though they paid the appropriate amount in cash for the new shares. In other words, the appropriate amount in cash is the allowable expenditure on the new shares.

If a stock dividend is paid by a listed company, that company will usually explain the tax treatment and tell you the value of the appropriate amount in cash.

This explanation may not apply to stock dividends received by trustees, so please ask us or your tax adviser for details.

Demergers

A demerger in which a company distributes shares in a subsidiary to its shareholders may be treated as a share reorganisation. Because the shareholder will then own shares in the original company and the subsidiary, this is a share reorganisation involving different classes of share. It is therefore necessary to apportion the allowable cost of the shares using the rules explained in the section 'Share reorganisations involving different classes of shares' on page 5. A listed company making a demerger will usually tell its shareholders whether the demerger is a share reorganisation.

Takeovers

When a company takes over another it may issue its own shares and/or securities in payment or part payment for the shares it is buying. Under certain conditions this is treated as a share reorganisation. If the takeover is by a listed company, the information you receive about the takeover will usually say whether these conditions are met. The payment can consist of a mixture of cash, shares and securities. The treatment of these different elements is described below.

All shares

If the company making the takeover only issues shares, you are treated as though you acquire the new shares at the same time and at the same price as the old shares. You may already own shares in the company making the takeover. If you do, the new shares and the existing holding will be merged.

Example 6

You have the following holdings of shares:

	Shares	Cost
KNO Ltd	5,000	£6,000
RST Ltd	2,000	£8,000

RST Ltd takes over KNO Ltd and issues five RST Ltd shares for every one KNO Ltd share held. You get 25,000 RST Ltd shares in exchange for your KNO Ltd shares. You are treated as having acquired these shares at the same cost (or 31 March 1982 value) as the KNO Ltd shares they replaced.

The holding of RST Ltd shares now becomes:

	Shares	Cost
RST Ltd	27,000	£14,000

Shares and cash

If the company making the takeover gives you cash and shares, you may have to pay Capital Gains Tax on the cash you receive. If the amount of cash you receive is 'small' compared with the value of your shares in the original company immediately before the takeover, there may be no immediate liability. In that case if the allowable cost of your original shares is more than the cash received, you simply reduce the cost by the amount of the cash receipt and use the reduced amount of cost to work out your gain or loss on a later disposal of the new shares you received in the takeover. If the cash received is more than the allowable cost, you reduce the cost to nil for later disposals of the new shares and have an immediate gain equal to the excess of the cash over the cost.

We accept that a cash receipt on a takeover is 'small' if **either** it is less than £3,000 in total, **or** it is not more than 5% of the value of the shares in the original company immediately before the takeover. If the cash you receive is not 'small', you will need to work out your gain or loss on the cash received by apportioning the allowable cost of the shares in the original company between the cash received and the shares received. You do this by reference to the value of what you receive. The formula is:

$$\frac{\text{Value of cash received}}{\text{Value of cash received} + \text{value of shares received}}$$

Example 7

You have a holding of 20,000 shares in CDE Ltd that cost £3 each.

On 17 March 2009 CDE Ltd is taken over by WXY Ltd.

WXY Ltd pays £4 in cash and issues two of its own shares for each share in CDE Ltd, so you received £80,000 in cash and 40,000 WXY Ltd shares.

On 17 March 2009 each WXY Ltd share is worth £6.

The holding of CDE Ltd shares was:

Number of shares	Pool of actual cost
20,000	£60,000

The receipt of the cash on the takeover is treated as involving a disposal of an interest in the CDE Ltd shares.

The cost of the CDE Ltd shares is allocated between the cash received and the shares in WXY Ltd after the takeover by reference to the value of the amount received compared to the value of WXY Ltd shares as follows:

Value of cash received	$\frac{20,000 \times £4}{(20,000 \times £4) + (40,000 \times £6)}$	=	$\frac{80,000}{£320,000}$	=	$\frac{1}{4}$
Value of cash and shares received					

Allowable cost of CDE Ltd shares allocated to cash received $£60,000 \times \frac{1}{4}$ = £15,000

Capital Gains Tax calculation:

	Disposal proceeds	£80,000
minus	Cost	£15,000
	Chargeable gain	£65,000

You now have a holding of 40,000 WXY Ltd shares.

Number of shares	Pool of actual cost
40,000	£45,000
	(£60,000 minus £15,000)

Securities

The company making the takeover may issue securities such as loan notes. This is sometimes described as a 'loan note alternative' to the cash offer. The tax treatment depends on whether the securities are Qualifying Corporate Bonds. The information given to you at the time of the takeover should say whether the securities are Qualifying Corporate Bonds. (If the securities are not Qualifying Corporate Bonds you follow the rules described in the paragraph on page 7 headed 'All shares'.)

If the securities are Qualifying Corporate Bonds the rules are as follows. You calculate the gain that would have arisen if the shares in the company being taken over were sold at their market value immediately before the takeover. That gain becomes chargeable as and when the Qualifying Corporate Bonds are disposed of. There is no separate gain on the disposal of the Qualifying Corporate Bonds themselves.

Example 8

You own 1,000 shares in JLM Ltd.

JLM Ltd is taken over by NPR Ltd which issues securities worth £5 for every share in JLM Ltd you hold. The securities are Qualifying Corporate Bonds.

Your holding of JLM Ltd shares was worth £5,000 immediately before the takeover.

If the cost of these shares was £3,500 this would give a notional gain of £1,500 immediately before the takeover.

If you dispose of half the securities that will release a gain of £750.

If you receive cash as well as Qualifying Corporate Bonds on a takeover you may have to pay Capital Gains Tax on the cash you receive, unless the amount of cash is 'small'. See the section on page 8 headed 'Shares and cash' for the meaning of small. If the cash amount is small, it is ignored and you follow the rules described in the paragraph above to calculate the gain that becomes chargeable when the Qualifying Corporate Bonds are disposed of. If the cash is not small you still calculate the gain as described above, but a proportionate part of the gain is chargeable at the time of the takeover. For example, if you received £25,000 in cash and Qualifying Corporate Bonds worth £75,000, one-quarter of the gain would be chargeable at the time of the takeover and three-quarters of the gain would be chargeable when you disposed of the Qualifying Corporate Bonds.

Cash/shares/securities

The company making the takeover may offer a combination of cash, shares and securities. You will have to apportion the allowable cost of the shares in the company being taken over between the different elements of the consideration received.

As shown in the examples above, you do this by reference to the values of what is given or received.

Earn-outs

Some company takeovers may include an earn-out right, where the amount of the consideration to be paid depends on, for example, the future profits of the company. Because the amount cannot be calculated at the time of the takeover, the value of the earn-out right itself represents disposal proceeds. However, if you receive an earn-out right which can be satisfied **only** by an issue of shares or debentures, and the right was conferred on or after 10 April 2003, the right may be treated as if it were itself a security, but not a Qualifying Corporate Bond. Then the rules for company takeovers described in the paragraph on page 7 headed 'All shares' apply to the receipt of the earn-out right. Those rules will also apply when you actually receive any shares or debentures under the terms of the earn-out.

The rules in relation to earn-outs can be a complex matter. If you receive an earn-out right you are advised to consult your professional adviser, or use our Capital Gains Manual.

If you do not want the company takeover rules to apply to an earn-out right, you may elect for it not to be treated as a security. The time limit for an election is 12 months from 31 January in the tax year following that in which the right was conferred. So if the right was conferred in 2008-09 the time limit is 31 January 2011.

If you want to make an election in respect of a right conferred in 2008-09, you should put 'X' in either box 20 or 26 (as appropriate) on pages CG 1 or CG 2 of the *Capital gains summary* pages and say in your supporting computation that an election is being made.

These notes are for guidance only and reflect the position at the time of writing. They do not affect any rights of appeal.