

4.3

Taxation Aspects of Flotation

Maurice Fitzpatrick and Jay
Sanghrajka
Tenon Group

The object of this chapter is to examine the principal tax implications of a flotation, concentrating for the most part on the personal tax position of the owners of the company being floated.

The first part of the chapter will act as a 'tool kit', by briefly setting out those aspects of capital gains tax (CGT) and inheritance tax (IHT) that may be relevant in terms of understanding the CGT and IHT implications of the flotation on the owners of the company. The second part of the chapter will briefly set out a number of relevant tax planning areas for further consideration. Needless to say, professional advice should always be sought regarding the impact of the flotation on the IHT and CGT positions of the shareholders of the company being floated, particularly as the flotation may well represent the largest single financial transaction in which the shareholders will ever be involved.

'Tool kit' regarding relevant tax parameters

CGT

There are three main areas to bear in mind:

- hold over relief (HOR);
- retirement relief;
- tax complications of taper relief.

Each of these is now looked at in turn, in the context of a company being floated, E Co.

Hold over relief (HOR)

Prior to the flotation of E Co it would normally have been possible for the company's shareholders to gift shares without incurring a CGT liability based on the market value of the shares at the time they were given away. This would have been achieved by the shareholder who had made the gift (the donor), and the recipient of the gift, jointly electing for HOR to apply to the gift, with the result that (broadly) the recipient inherited the CGT base cost of the donor of the gift. After flotation, the ability to make an HOR election may be lost, unless either:

- the flotation concerned is on the Alternative Investment Market (AIM) or OFEX; or
- even after flotation, the shareholder making the gift broadly owns at least 5 per cent of E Co.

Retirement relief

After the flotation of E Co, those shareholders who would previously have qualified for retirement relief (which in the current 2001–02 tax year can exempt up to £100,000 gain from CGT altogether, and can halve the rate of tax payable on up to a further £300,000 chargeable gain) may find that they are denied retirement relief on disposal after flotation, unless, as for the ongoing availability of HOR:

- the flotation concerned is on AIM or OFEX; or
- even after flotation, the shareholder concerned broadly owns at least 5 per cent of E Co.

Retirement relief is gradually being phased out and will be abolished altogether in respect of disposals after 5 April 2003.

Taper relief

Taper relief was introduced in 1998 and subsequently changed in 2000. There are two types of taper relief: standard taper relief (STR) and the

more valuable business taper relief (BTR). STR will apply wherever BTR does not apply.

STR operates so as to exempt a proportion of the gain made on the disposal of a 'non-business' asset. Up to 40 per cent of such a gain can be excluded from the charge to CGT, although this 40 per cent reduction is only achieved once the asset concerned is deemed to have been held for at least 10 years at the time of disposal. This will give a maximum rate of CGT of 24 per cent. In terms of computing how long the asset has been held at time of disposal, for the purposes of computing the rate of STR, the acquisition date is taken as:

- (i) the actual acquisition date if the asset was acquired after 5 April 1998; or
- (ii) in the case of assets held on Budget Day 1998 (17 March 1998), 6 April 1997.
- (iii) in the case of assets acquired in the period 17 March 1998 to 5 April 1998, 6 April 1998.

BTR is much more valuable to the taxpayer than STR; BTR is available on business assets. Under current legislation, under BTR 75 per cent of the gain is exempt from CGT once the asset has been held for more than four years at the time of disposal. This will give a maximum rate of CGT of 10 per cent. In the case of disposals after 5 April 2000, and purely in terms of computing how long the asset has been owned at the time of disposal for the purposes of computing the rate of BTR, the acquisition date of the asset is the later of the actual acquisition date or 6 April 1998.

In terms of shares in a company, such shares will qualify as a business asset in the hands of the shareholder for the purposes of BTR, provided certain conditions are satisfied, as follows:

- (a) the company concerned must be either a trading company or the holding company of a group of trading companies. In each case the trading company concerned, or the group, must not carry on to any substantial (not defined in the legislation) extent activities carried on otherwise than in the course of a trade; and
- (b) one of the following conditions must be satisfied:
 - (i) the company is unlisted (companies whose shares are dealt with on AIM or OFEX are regarded as unlisted); or

- (ii) the shareholder is an employee (full-time or otherwise) of the company; or
- (iii) the shareholder concerned broadly owns at least 5 per cent of the company.

While a definition of substantial is not contained in the tax legislation, it is generally interpreted by the Inland Revenue as meaning more than 20 per cent of the overall activities of the company or group concerned.

The 2001 Finance Act has introduced a further situation in which an asset can be regarded as a business asset for the purposes of BTR. Specifically, employees who work for non-trading companies (such as property investment companies) can regard shares that they own in their employer company as a business asset for BTR purposes, subject to certain conditions.

Finally in connection with BTR, the Treasury announced in June 2001 that the period of ownership required to achieve the 75 per cent reduction in a chargeable gain as a result of BTR will be reduced from four years to two, following the March 2002 Budget. The precise effect of the legislation enacting any such change will need to be looked at when it is published in April 2002.

The above conditions apply in determining whether shares qualify for BTR for the period since 6 April 2000. In respect of the period prior to 6 April 2000, the conditions which had to be met in order for the shares to qualify for BTR were more onerous (see Note 1 at the foot of this chapter).

In any event, it follows from the above that some or all of the shareholders of E Co may lose BTR in respect of their post-flotation periods of ownership. Specifically, shareholders of E Co who qualified for BTR prior to flotation would cease to qualify unless:

- (i) the flotation is on AIM or OFEX; or
- (ii) the shareholder remains an employee (part-time or otherwise); or
- (iii) the shareholder retains (broadly) at least 5 per cent of the company.

The implications, for the shareholder concerned, of losing BTR status on his shares in respect of his post-flotation period of ownership can be quite considerable. Where an asset has qualified for BTR during part of the period of ownership, and STR for the balance of the period of ownership, it is necessary to apportion the total gain and apply BTR

to part of the gain and STR to the balance. In other words, the total gain is hacked out into two separate gains, with taper relief on one gain (Gain A) being computed using BTR rules, and with taper relief on the other gain (Gain B) being computed with reference to STR rules.

Gain A will represent the total gain times y per cent, where y is that part of the 'relevant period of ownership' of the asset during which the asset qualified for BTR, divided by the 'relevant period of ownership'. The 'relevant period of ownership' always commences with the later of the date of acquisition of the asset and 6 April 1998, and ends with the date of disposal of the asset.

Gain B is the total gain times x per cent. x per cent equals that part of the 'relevant period of ownership' during which the asset qualified for STR, divided by the 'relevant period of ownership'. As above, the 'relevant period of ownership' always commences with the later of the date of acquisition of the asset and 6 April 1998, and ends with the date of disposal of the asset.

If the above calculation sounds somewhat complex, it is probably because it is. An example will make the position clearer. Take the position of a shareholder of E Co who first purchased some shares in E Co in 1995. The holding was such that the shares qualified for BTR until E Co floated on 30 September 2001, after which time the shares did not qualify for BTR in the shareholder's hands but merely for STR.

The shareholder then disposes of the asset on 30 September 2007, realising a chargeable gain post-indexation relief but prior to taper relief of £950,000.

The 'relevant period of ownership' is the nine and a half years from 6 April 1998 to 30 September 2007. The period within the 'relevant period of ownership' during which the shares qualified for BTR is the three-and-a-half-year period of 6 April 1998 to 30 September 2001. The period within the 'relevant period of ownership' during which the asset qualified for STR is the six years from 1 October 2001 to 30 September 2007.

Gain A will therefore be $(3.5 \text{ over } 9.5) \times$ the chargeable gain of £950,000, ie £350,000. Gain B will be $(6.0 \text{ over } 9.5) \times$ £950,000, ie £600,000.

The rate of taper relief for Gain A is calculated with reference to the rules for calculating the rate of BTR as set out earlier, and with reference (for this purpose) to the entire taper relief period of ownership of the asset (notwithstanding the fact that the asset only

qualifies for BTR for part of such period of ownership). At the time of disposal on 30 September 2007, this being a disposal for BTR purposes after 6 April 2000, the asset is deemed to have been owned for BTR purposes for nine and a half years (from 6 April 1998 to 30 September 2007) and thus qualifies for the 75 per cent taper relief available (under current legislation) for the disposals of assets owned (for BTR purposes) for at least four years.

The rate of taper relief applicable for Gain B is similarly calculated with reference to the entire taper relief period of ownership of the asset, again notwithstanding the fact that the asset only qualified for STR for part of the period of ownership, using the rules governing the rate of STR as set out earlier.

For this purpose, the asset (having been disposed of in circumstances where STR is applicable) was deemed to have been acquired (purely for the purposes for determining the rate of STR) on 6 April 1997 since it was an asset held prior to 17 March 1998.

As of 30 September 2007 the asset is deemed to have been held (purely for the purposes of computing the rate of STR) for ten and a half years and therefore qualifies for the full 40 per cent STR.

The overall calculation of chargeable gain is set out in Table 4.3.1.

Table 4.3.1 Chargeable gain for CGT

	Gain A £	Gain B £	Total £
Chargeable gain	350,000	600,000	950,000
Less taper relief 75%/40%	262,500	240,000	502,500
Taxable gain subject to annual exemption	87,500	360,000	447,500

The overall chargeable gain after taper relief is £447,500, which, using a CGT rate of 40 per cent, produces CGT of £179,000. By contrast, had the asset qualified for BTR for the whole of the relevant period of ownership, the chargeable gain would have been just £237,500, being £950,000 chargeable gain pre-taper relief less 75 per cent BTR, producing a CGT liability of £95,000.

Had the asset continued to qualify for BTR for the whole period of ownership after flotation, there would thus have been a potential CGT saving of £84,000 (ie £179,000 less £95,000).

IHT

Prior to flotation, the shares in a company being floated, E Co, would normally qualify for 100 per cent business property relief (BPR) for IHT purposes. In other words, they would be disregarded altogether in terms of valuing a person's estate on death. Broadly, IHT is payable on all but the first £242,000 of a person's estate on death. Again, in general IHT terms, gifts of an asset made more than seven years before death escape IHT, while gifts made within seven years of death may attract IHT on death. Gifts of assets qualifying for BPR made within seven years of death still escape IHT, provided (broadly) the asset concerned was still owned by the recipient at the time of the death of the donor and still qualified for BPR at the time of death of the donor.

After flotation, the shares in E Co will not qualify for BPR unless the flotation is on AIM or OFEX, and BPR status may be lost.

As a result of losing BPR status:

- gifts made by the shareholder shortly before flotation could be within the charge to IHT should the shareholder concerned die within seven years of making the gift; and
- shares owned by the shareholder at time of death (after flotation) will not qualify for 100 per cent BPR.

Planning issues

Clearly, every shareholder of a company being floated needs to consult his professional adviser and assess to what extent his CGT or IHT position is going to be affected by the flotation. If the flotation is on the main list of the Stock Exchange, with the result that certain tax reliefs previously enjoyed will cease to be enjoyed, then certain action may be considered prior to flotation, such as:

- gifting shares while they still qualify for eg CGT HOR;
- realising shares gains on which may qualify for CGT retirement relief.

In terms of taper relief, the earlier example makes it clear how valuable (in terms of minimising CGT) it is for the shares to qualify for CGT BTR even after flotation. Every effort should be made by the shareholder

concerned to ensure that the shares continue to qualify for CGT BTR (eg in the event of a full listing on the Stock Exchange) by becoming an employee (even part-time) of E Co (if he is not already, and subject of course to commercial and tax considerations).

It is apparent from the above that floating on AIM or OFEX helps to 'lock in' a range of capital taxation reliefs for the shareholder concerned, with those reliefs being potentially extremely valuable. While the overall decision as to whether to go on AIM or OFEX on the one hand, or the main list of the Stock Exchange on the other, will largely be determined by commercial factors, the tax reliefs concerned should not be ignored in terms of making the final decision.

Note 1

For periods prior to 6 April 2000, shares in a company qualify for BTR in circumstances where:

- (a) the company concerned was a trading company or the holding company of a trading group; and
- (b) either
 - (i) broadly, the shareholder owned at least 25 per cent of the company; or
 - (ii) broadly, the shareholder owned at least 5 per cent of the company and was a full-time working employee of the company.

The pre-6 April 2000 definition of shares for BTR purposes is thus considerably more restrictive than the post-5 April 2000 definition.

Thus, prior to 6 April 2000, in order for the shares to qualify for BTR the shareholder concerned either had to have a fairly significant (ie 25 per cent plus) holding in a company, or he had to have a material (ie 5 per cent plus) holding in the company and be a full-time employee. By contrast, after 5 April 2000 any size holding in an unquoted trading company/trading group qualifies for BTR, regardless of whether the shareholder is an employee or not.