The Personal Tax Planning Review

RETIREMENT RELIEF ON EXCHANGES OF SHARES FOR LOAN NOTES

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Where the consideration for a sale of shares takes the form of loan notes, the selling shareholders will often prefer the loan notes not to be qualifying corporate bonds. There are good reasons for this, namely the availability of indexation allowance on non-qualifying corporate bonds (although not to increase or create a loss) and also loss relief if the issuing company defaults or the loan notes are sold at a loss.

For selling shareholders entitled to retirement relief the position is more complicated. If the loan notes are *qualifying* corporate bonds, the provisions of s.116 Taxation of Chargeable Gains Act 1992 ("TCGA") apply, subject to s.137 TCGA, so that at the date of the exchange a chargeable gain is calculated by reference to the market value of the shares. In calculating the amount of that chargeable gain retirement relief can be deducted. Payment of tax on the chargeable gain as reduced by retirement relief is then deferred until the qualifying corporate bonds are disposed of.

If the loan notes are not qualifying corporate bonds, ss.127-131 TCGA are applied by s.135 TCGA with the result that there will be no disposal for capital gains tax purposes at the time of the sale and the loan notes will fall to be treated as the same asset acquired at the same time as the underlying shares. As the loan notes will not, in many cases, be qualifying assets for retirement relief purposes, retirement relief may not be available on a subsequent disposal of the loan notes. All is not lost, however, as shareholders can elect under sched 6 para 2(1) TCGA that s.127 TCGA should not apply to the sale, thereby triggering a disposal for capital gains tax purposes at the time of the exchange. This provision does not, however, allow for a partial election and, if a chargeable gain would be realised after deduction of the available retirement relief, any tax payable cannot be deferred. (It may be possible to get around this problem by having separate disposals of shares, although in many cases this may not be practicable.) Accordingly, where loan notes are being issued to shareholders entitled to retirement relief, it will generally be preferable for them to receive qualifying

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corporate bonds, unless an election under sched 6 para 2(1) taken with retirement relief would result in no tax being payable.

The position is more complicated where the consideration consists of a mixture of cash and loan notes. If qualifying corporate bonds are received, the tax payable on the cash element will be calculated by reference to the proportion of the overall gain (i.e., including the deferred gain) that the cash element bears to the market value of the selling shareholder's shares (s.116(12) TCGA). If non-qualifying corporate bonds are received, the maximum retirement relief available can be set off in full against the cash element of the consideration assuming no election is made under sched 6 para 2(1). Accordingly, whether or not it is preferable to receive qualifying or non-qualifying corporate bonds depends on the figures involved. To take two examples, assuming in each case that (a) the original shares have nil base cost (b) the consideration equals full market value and (c) maximum retirement relief is available:

(1) Smith receives consideration for his shares of £1m, of which £500,000 is in cash and £500,000 in loan notes.

(a) With loan notes as qualifying corporate bonds:

Gain =	£1m
Less retirement relief: 250,000 + ½(1m - 250,000) =	£625,000
Chargeable Gain =	<u>£375,000</u>
Immediately chargeable $\frac{£500,000}{1m}$(cash) x 375,000 =	£187,500
Deferred Gain =	£187,500

(b) With loan notes as non-qualifying corporate bonds and no election made under sched 6 para 2(1) TCGA:

Gain =	£500,000 (cash element only)
Less retirement relief:	
250,000 + ½(500,000 - 250,000) =	<u>£375,000</u>
Immediately chargeable gain =	£125,000
Deferred Gain =	£500,000

In this example, therefore, the immediately chargeable gain from non-qualifying corporate bonds is £62,500 less than with qualifying corporate bonds, but this is at the expense of an additional potential chargeable gain on redemption of the loan notes (ignoring indexation) of £312,500.

(2) Smith receives consideration for his shares of £3m, of which £1m is in cash and £2m in loan notes.

(a) With loan notes as qualifying corporate bonds:-

Gain =	£3m
Less retirement relief: (as in (1)(a) above)	£625,000
	£2,375,000
Immediately chargeable: $\frac{1m}{3m}$ (cash) x 2,375,000 =	£791,666
Deferred Gain =	£1,583,334

(b) With loan notes as non-qualifying corporate bonds:

Gain =	£1m (cash element only)
Less retirement relief: (as in (1)(a) above) =	£625,000
Immediately chargeable gain =	£375,000
Deferred Gain (subject to indexation) =	£2m

In this example the overall chargeable gain (ignoring indexation on the non-qualifying corporate bonds) is the same but the initial tax liability is much lower with non-qualifying corporate bonds.

A further advantage of receiving non-qualifying corporate bonds is that if they satisfy the conditions in s.165(2)(b) TCGA hold-over relief is available on transfers other than at arm's length. Transfers of qualifying corporate bonds (other than between spouses) will crystallise any tax deferred under s.116 TCGA.