CHAPTER 29

INCORPORATION RELIEF

29.1 Introduction

Where a sole trader transfers his **business to a limited company,** and thereafter trades via the medium of a company, he is said to have "incorporated" his business. In this chapter, we shall concentrate on the capital gains tax implications of a transfer of business assets by an individual to the company, but before we do so, let us spend a few moments looking at other tax issues which should be considered on incorporation.

29.2 General tax implications of incorporation

Where a sole trader starts to run his business through a company, there is a **cessation of his trade** for income tax purposes. As you will see when you have studied the business income tax course, there are many income tax issues to be considered on the cessation of trade.

ITTOIA 2005, s. 202

Incorporation will bring about a change of status for the individual concerned. For example, the taxpayer is no longer a sole trader whose profits are taxed as trading income, he will now **be an employee of the newly formed company** and any salaries etc., which he draws from the company are taxable as earnings.

There is also a **change of status for National Insurance purposes**, as employees pay NIC under Class 1 whereas the self-employed pay NIC under Classes 2 and 4.

Incorporation involves the transfer of business assets by a sole trader to another person – i.e. to a limited company. Where an individual disposes of business assets, there are capital gains tax implications, and these will be considered in detail in this chapter. Finally having started to trade via the medium of a limited company, there will obviously be **corporation tax implications**. For example, the limited company will have to pay corporation tax on any profits it makes.

29.3 CGT implications

A sole trader, Brian, owns a number of assets which he uses for the purposes of his trade. His main assets are his land and buildings and the goodwill of his business. Brian also owns some plant and machinery and has certain current assets on hand such as stock, debtors and cash.

Brian decides that he no longer wishes to run his business as a sole trader, but instead wishes to incorporate by trading through a company called Brian Limited. Having set up the company, Brian transfers all of his business assets over to Brian Limited. In return for these assets, the company **issues shares** in Brian Limited to Brian. At this point, the company owns all of the assets and Brian now has shares in the company.

The transfer of business assets by an individual to a company is a **disposal** for capital gains tax. The disposal takes place with **proceeds deemed to be market value**. Brian will therefore have capital gains on the chargeable assets. The transfer takes place at market value, because Brian and Brian Limited are **"connected persons"** for capital gains tax purposes. Brian will therefore be left with a capital gain at the point of incorporation. As we shall see, this can be wholly or partly deferred by incorporation relief.

TCGA 1992, s. 18

Incorporation relief is a CGT deferral relief which works in a similar way to rollover relief or gift relief. The first thing we need to do, is to calculate the capital gains on the transfer of business assets by the individual to the company.

TCGA 1992, s. 162

In the majority of instances, gains will typically arise on the gift of land and buildings and the gift of goodwill by the individual to the company. The transfer of plant and machinery will not usually give rise to a capital gain, as such assets generally depreciate in value. The transfer of current assets such as stock or debtors is outside the scope of CGT.

Having arrived at the capital gain on the gift of business assets, we then consider incorporation relief.

29.4 Incorporation relief

Incorporation relief is calculated by taking the capital gain, and multiplying it by a fraction as follows:

TCGA 1992, s. 162 (4)

Gain on gift of land and buildings	X
Gain on gift of goodwill	X
Gains	X
Less: incorporation relief	
$\text{Gains} \times \dfrac{\text{Value of shares received}}{\text{Total consideration}}$	(X)
Gain	X

Because incorporation relief is a deferral relief, we must do something with this deferred gain. Here the **deferred gain is rolled over and set against the base cost of the individual's shares** in the company. Therefore this gain will be charged when the individual eventually sells the shares.

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Base cost of shares in Brian Ltd

	£
MV of shares at incorporation	X
Less: incorporation relief	(X)
Base cost of shares	X

If you consider the incorporation relief fraction, you will see that if the value of shares received is the same as the total consideration received by the individual from the new company, this fraction will be one. In this instance the whole of the gain will be deferred and no gain will remain chargeable. Therefore, a **chargeable gain will only arise** if the **company pays** for the business assets **with something other than shares**.

Illustration 1

Brian incorporates his sole trader business by transferring assets to a company called Brian Limited. The assets transferred are a shop, goodwill, machinery and current assets, which in total are worth £500,000. To ensure that this is a fair exchange, the company will effectively pay Brian £500,000 for these assets.

As the company has no cash, it will pay for these assets by issuing a combination of shares and loan stock. Here the consideration is split so that Brian receives £450,000 worth of shares and £50,000 of loan stock.

For capital gains tax purposes, Brian has disposed of his shop, his goodwill, his machinery and his stock. Capital gains will therefore arise on the chargeable assets which, in this instance, will be the shop and the goodwill. Assume that Brian makes a gain of £130,000 on the shop and £120,000 on the goodwill. Brian's total gains on incorporation, before any reliefs, are therefore £250,000. We need to consider the amount of incorporation relief available to Brian.

To calculate the relief we take the gains of £250,000 and multiply by the value of the shares received by Brian divided by the total consideration paid by Brian Limited. The value of the shares received by Brian was £450,000, out of a total of £500,000 paid to him by the company. Because some part of the consideration was paid in non-share form, the incorporation relief will not be enough to wipe out this capital gain.

	£
Gain on transfer of shop	130,000
Gain on transfer of goodwill	120,000
	250,000
Less: incorporation relief	
$\text{Gains} \times \dfrac{\text{Shares received}}{\text{Total consideration}}$	
$250{,}000 \times \dfrac{450000}{500000}$	(225,000)
Gain	£25,000

After the incorporation, Brian has two assets. He has shares in Brian Limited, plus an IOU from the company for £50,000. The shares in Brian Limited are worth £450,000 at the date of incorporation. The way incorporation relief works, is by taking the deferred gain of £225,000 and deducting it from the base cost of Brian's shares in the company.

Base cost of Brian's shares = 450,000 - 225,000 = £225,000.

This deferred gain will effectively become chargeable when Brian sells his shares in Brian Limited.

As you will see incorporation relief works in a very similar way to gift relief or rollover relief, as the deferred gain is rolled over and reduces the base cost of another asset.

29.5 Conditions for the relief

TCGA 1992, s. 162(1)

As is the case for all CGT reliefs, there are certain conditions to be satisfied before the relief will be given. Here there are three.

Firstly the business transferred must be a **"going concern"** – i.e. Brian must have been running a solvent business in order to benefit from incorporation relief.

The most important condition to be satisfied, is that **all assets of the sole trader must be transferred** to the company to obtain the relief. The **only exception** to this, is that any **cash** held by the sole trader need *not* be transferred. This means that if the sole trader wishes to retain any assets – such as land or buildings – outside the company, he will not be given incorporation relief.

The final condition is that the **consideration** paid to the individual by the company, must be **wholly or partly in shares**.

Incorporation relief is **automatic** and no formal claim is necessary.

29.6 Interaction with entrepreneurs' relief

In the above illustration, after incorporation relief, Brian was left with a chargeable gain of £25,000. This gain is a gain on a material disposal of business assets for entrepreneurs' relief purposes, so provided Brian has owned the business for one year, a claim for entrepreneurs' relief can be made.

Illustration 2

Brian, from Illustration 1, had a gain after incorporation relief of £25,000. If the gain arises before 23 June 2010, and Brian claims entrepreneurs' relief, his CGT liability for 2010/11 will be:

	£
Gain after incorporation relief	25,000
Less:	
Entrepreneurs' relief ($\frac{4}{9}$ x 25,000)	(11,111)
Gain	13,889
Less: annual exemption	(10,100)
	£3,789
CGT @ 18%	£682

Note that the claim for entrepreneurs' relief applies after incorporation relief has been calculated.

Illustration 3

Suppose that in Illustration 2, Brian's gain on incorporation arose later, on or 23 June 2010. If Brian claims entrepreneurs' relief, his CGT liability for 2010/11 will be:

	£
Gain after incorporation relief	25,000
Less: annual exemption	(10,100)
	14,900
CGT @ 10%	£1,490

Entrepreneurs' relief again applies to the gain after incorporation relief but of course the method of obtaining entrepreneurs' relief has changed. For disposals on or after 23 June 2010, relief is not given as a deduction in arriving at the chargeable gain. Instead the taxable gain is taxed at the special rate of 10%.

29.7 Maximising relief

It is not possible for the taxpayer to restrict his incorporation relief so as to make sure he uses his annual exemption etc. However as we shall see in the next illustration, it is possible for the taxpayer to **manipulate the figures by taking some consideration other than in shares,** so as to make sure his annual exemptions etc., do not go to waste.

Illustration 4

Michael is planning to incorporate his business by transferring all the assets to Michael Ltd, making total gains before any reliefs of £500,000. From this we will deduct incorporation relief. We calculate the incorporation relief by taking the capital gain, and multiplying it by the value of shares received divided by the total consideration paid. Michael will receive total consideration of £950,000, the value of the assets transferred.

Having calculated the gain after incorporation relief, Michael will deduct his annual exemption of £10,100 to arrive at a taxable gain. Presumably Michael does not want to pay any CGT, so he would like his taxable gains to be zero.

Ideally therefore, Michael would like his gains after incorporation relief to be £10,100.

Therefore if Michael can claim **incorporation relief** of **£489,900**, he will be left with a gain of £10,100, (500,000 – 489,900) which will be reduced to nil by the annual exemption.

However, incorporation relief is automatic, and the amount of relief given by HMRC depends entirely on the value of the shares issued by the company to the individual. Therefore Michael **can take a certain amount of non-share consideration** – i.e. a certain amount of loan notes – **such that a gain of £10,100 will arise**.

In this instance, if Michael takes shares worth £930,810 and loan stock worth £19,190, the amount of the capital gain to be deferred will be exactly £489,900. If you do the sum on your calculator, you will see that £500,000 multiplied by 930,810 over 950,000 gives us incorporation relief of £489,900.

This is what we mean by the individual manipulating the numbers so as to make sure that he maximises his reliefs.

	£
Gain before relief	500,000
Less: incorporation relief	
$500,000 \times \frac{\text{Shares}}{£950000}$	(489,900)
Gain	10,100
Less: annual exemption	(10,100)
Taxable	Nil

	£
Shares	930,810
Loan stock	19,190
Total consideration	£950,000

29.8 Election to disapply incorporation relief

If a business is incorporated on or after 6 April 2002, it is also possible to **elect to disapply** incorporation relief. If the election is made, it will mean that no incorporation relief will apply to the transfer of the business – **it is not possible to make a partial disapplication**. So either incorporation relief will apply to the total gain on the transfer of the business or it will not.

TCGA 1992, s. 162A

It may be beneficial to elect to disapply incorporation relief if, for example, an individual has capital losses to use. In addition, entrepreneurs' relief can be claimed in respect of the full gain. This would be beneficial if any subsequent disposal of the shares would not qualify for entrepreneurs' relief.

Illustration 5

Gerry has been in business for many years and incorporates his business on 31 March 2011.

If Gerry disposes of all his shares by 5 April 2012, (the end of the tax year following the tax year of incorporation), he **must elect by 31 January 2013,** (one year from 31 January following the end of the tax year of incorporation) to disapply incorporation relief.

If Gerry holds his shares until 31 March 2013 then he **must elect by 31 January 2014** (two years from 31 January following the end of the tax year of incorporation) to disapply incorporation relief. He may wish to do this if for example, he has losses to use in 2010/11.

29.9 Gift relief alternative

TCGA 1992, s. 165

There is an alternative way of obtaining deferral relief on the incorporation of a business, and that is by using **gift relief** under Section 165. You will recall, that if an individual gives away a business asset, the donor and the donee can make a **joint election** to defer the gain under the gift relief provisions in Section 165. This applies in the same way if the donee is a company.

In practice, a sole trader may consider making gift relief claims **if he does not wish to transfer all of his business assets to the company.** Remember that one of the conditions for incorporation relief to be given, is that all of the individual's business assets must be transferred to the company. Therefore, for example, if the sole trader wishes to retain an asset –for example, a building – outside the company, the only way to obtain capital gains tax deferral relief would be to claim gift relief instead. The reason a taxpayer may not wish to transfer a building to a company, is in order **to save stamp duty land tax** on the transfer.

Therefore if a sole trader gives other business assets – such as goodwill or plant and machinery – to the company, gift relief can be claimed in the normal way under Section 165. The gift of the goodwill to the company would result in a capital gain. A joint gift relief claim would be made by the sole trader and the company, to defer the gain and in all probability reduce the gain down to zero.

This deferred gain would then be rolled over and reduces the base cost of the asset in the hands of the donee – in this instance, the company. In the majority of instances, where a sole trader is transferring all of his assets to the company, it is beneficial for the sole trader to take incorporation relief as opposed to gift relief.

An overview of incorporation and the general implications across the taxes is included at the end of this chapter in addition to the summary page.

Example 1

Toby has a sole-tradership. His business assets are worth £280,000. Toby transferred his business to a new company, Belch Ltd, in January 2011 making capital gains of £100,000.

In return, Belch Ltd issued 210,000 new £1 shares and £70,000 of debenture stock to Toby.

Calculate the base case of Toby's new shares for CGT purposes, assuming Toby does not elect for incorporation relief not to apply.

Example 2

Richard transferred the assets of his sole trader business which he had owned for many years to a new company, Rich Ltd, in May 2010. He received shares and loan stock in return for his business assets.

In December 2010 Richard gave half of the Rich Ltd shares to his son Thomas. Richard bought some new shares in Kingfisher Plc (a quoted company) in January 2010.

Which of the following reliefs would Richard receive in 2010/11?

a) Rollover relief

b) Gift relief

c) Incorporation relief

d) EIS reinvestment relief

e) Entrepreneurs' relief.

Answer 1

	£
Gains on incorporation	100,000
Less: incorporation relief	
$100,000 \times \frac{210000}{280000}$	(75,000)
Gain	£25,000
Shares in Belch Ltd	
MV @ incorporation	210,000
Less: deferred gain	(75,000)
Base cost	**£135,000**

Answer 2

The reliefs available would be:

b) **Gift relief** – on the gift of unquoted shares to his son.

c) **Incorporation relief** – as he is transferring business assets to a company. This will defer only some of the gain as the consideration is a mixture of shares and loan stock.

e) **Entrepreneurs' relief** – the gain remaining chargeable after incorporation relief will be eligible for entrepreneurs' relief as it relates to a material disposal of business assets.

There is no rollover relief as he is not selling a business asset and replacing it with a new one.

There is also no EIS reinvestment relief as the shares acquired in Kingfisher plc are quoted.