

Incorporation relief: A debt trap (Lecture P1409 – 7.46 minutes)

In November 2023, HMRC commenced a 'One to Many' campaign, targeting taxpayers who incorporated their property businesses in the tax year 2017/18 but reported no capital gains tax (CGT) liability in their tax returns on the basis that 'incorporation relief' (TCGA 1992, s 162) applied in full.

How the relief works

In the legislation, the relief in TCGA 1992, s 162 is headed 'Roll-over relief on transfer of business.' In practice, it is commonly referred to as incorporation relief.

Incorporation relief is mandatory if certain criteria (in section 162(1)) are met. These are:

- A person who is not a company (i.e., a sole trader or individual partner) transfers to a company a business as a going concern;
- The whole assets of the business (or possibly the whole assets of the business excluding cash) are transferred to the company; and
- The consideration for the transfer is satisfied wholly or partly by the issue of shares in the company to the person transferring the business.

Broadly, the base cost of the shares is reduced by the capital gains on the disposal of chargeable assets of the unincorporated business. Those gains are therefore 'rolled over' on incorporation. The gains are effectively deferred until a later disposal of the shares.

There are provisions for apportionment where the consideration is not wholly in shares, such as the creation of a director's loan account with an amount being credited to it (TCGA 1992, s 162(4)).

Transfer of liabilities

The former sole trader or partner is not required for incorporation relief purposes to transfer business liabilities to the company. However, in practice they will often do so.

In strictness, business liabilities taken over by the company represent additional consideration for the transfer, which means that incorporation relief ought to be restricted. However, an extra-statutory concession (ESC D32) enables business liabilities taken over by the company to be ignored for the purposes of quantifying any consideration received for the business other than the shares.

As indicated, the cost of the shares to the former sole trader or individual partner is the value of what was given for them; in other words, the value of the business. In essence, the value of the business is the difference between its assets and liabilities.

Anything to declare?

In its 'One to Many' campaign, HMRC is sending out 'nudge' letters to taxpayers who claimed incorporation relief in respect of a property business in 2017/18. Those taxpayers are being asked to check certain aspects of their incorporation relief claims.

These include:

- Checking that the capital gain on incorporation was not greater than the value of the property business that was transferred; and
- When calculating the incorporation relief available, that the amount of any gain held over did not exceed the value of any shares received.

What HMRC are seeking to check is that the capital gains held over have not exceeded the base cost of the shares. If they have, incorporation relief will be subject to possible restriction.

Dangerous assumption

HMRC's 'nudge' letter seems to suggest some taxpayers have automatically assumed that because incorporation relief is available, there is no residual gain. However, as indicated situations can arise where all the assets are transferred, and only shares are issued, but a gain still arises.

HMRC's 'One to Many' campaign concerns property businesses, which will normally be ineligible for business asset disposal relief. However, had it been (for example) a manufacturing business instead, there may be other assets transferred upon incorporation not included on the balance sheet, but which would increase the net assets of the business, most commonly goodwill. In addition, business asset disposal relief would potentially be available, resulting in a CGT rate of 10%. The former sole trader or business partner's annual CGT exemption may be available too.

Nevertheless, if there is a high level of debt in the business, and the debt is being transferred to the company along with the assets of the business, advisers should consider the level of potential capital gains arising, and forecast the company's opening position, in advance of the incorporation taking place. As indicated, it is not a requirement of incorporation relief that liabilities of the business are transferred to the company; but not doing so will have other tax implications, such as in respect of interest relief on the borrowings, and there would also be commercial considerations such as the borrower no longer having rental income from which to repay the borrowings and loan interest.

Be careful

Care is needed if debt is being refinanced through the company. For example, if the company takes on fresh debt and uses the proceeds from those borrowings to repay borrowings of the sole trader or partner, that could cause a restriction in incorporation relief on the basis that the repayment represents consideration other than in the form of shares, which is not covered by incorporation relief. So, this could give rise to a large and unexpected CGT liability.

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