

Loss relief on business incorporation (Lecture P1338 – 9.48 minutes)

Background

The incorporation of a business involves the cessation of a former sole trader or partnership. There are many possible reasons why sole traders or partners may wish to transfer the trade or business to a company, which might be tax-related, commercial or both.

There is a specific relief from capital gains tax (CGT) on the incorporation of a business, where certain conditions are satisfied. This form of rollover relief of gains against the base cost of the former business owner's shares in the company (in TCGA 1992, s 162) is relatively well-known and widely used, particularly in recent years on the incorporation of rental property businesses.

However, there is a less well-known tax relief when a business is transferred to a company. This income tax relief (in ITA 2007, s 86) allows losses of the unincorporated business owner to be carried forward and offset against income that the individual receives from the company. This income tax relief, like CGT incorporation relief, is subject to certain conditions.

Relief conditions

The relief may be claimed if four conditions are all met:

1. A trade is carried on by an individual, either as a sole trader or by individuals in partnership.
2. The trade is transferred to a company.
3. The consideration for the transfer is wholly or mainly the allotment of shares to the individual or individuals. However, HMRC's position is that where the consideration is expressed in the vending agreement to be cash, but the whole amount is subscribed for shares in the company, the shares may be regarded as the consideration for relief purposes (see HMRC's Business Income manual at BIM85060).
4. In the case of any individual to whom shares are allotted, that individual's total income for the relevant tax year includes income derived from the company.

If these conditions are all satisfied, for the purposes of carry-forward trading loss relief, the individual's income from the company is treated as trading profits of the relevant tax year carried on by the individual; or if the trade was carried on by the individual in partnership, their income from the company is broadly treated as the individual's partnership profit share.

The legislation states that the income derived from the company may be dividends on the shares or otherwise. The reference to 'or otherwise' is taken to mean remuneration, interest or rent, in addition to dividends.

The relief is available for the tax year in which the trade is transferred, if the individual is the beneficial owner of the allotted shares and the company carries on the trade up to 5 April in that tax year. Loss relief is also available in subsequent tax years if the same conditions are satisfied throughout the tax year.

Strictly speaking, all the allotted shares need to be retained. However. HMRC guidance states that in practice, relief should not be refused so long as the individual keeps shares representing more than 80% of the consideration received for the business.

It is helpful to note that this income tax loss relief applies not only to trades, but to businesses which are not trades (e.g., rental property businesses); so the relief is more flexible than the normal carry-forward trade loss rules (in ITA 2007, s 83), which apply to the offset of trading losses against income from the same trade carried on by the same person.

Having said that, the loss relief rules where a business is transferred to the company are concise and fairly prescriptive

Conditions not met

In *Davis v Revenue and Customs* [2022] UKFTT 274 (TC), the taxpayer carried on a sole trade of providing finance for second-hand car sales. The only customer of the sole trade was named Dickinson. The sole trade operated by the taxpayer provided funds to Dickinson, who acquired second-hand cars. When a car was subsequently sold, Dickinson repaid the loan for buying the car and shared the profit on sale with the taxpayer.

A company ('USL') was incorporated in September 2005 and started trading in October 2005. The taxpayer made a cash subscription for 100 shares at £1 per share on the incorporation of USL. However, the shares were not issued to the taxpayer in consideration for the transfer of a trade to USL, and at the time of incorporation no physical assets were transferred from the taxpayer to USL. The final transactions in the taxpayer's sole trade were with Dickinson in November 2007 (i.e., more than two years after USL started to trade).

The trade carried on by USL related to the purchase and sale of second-hand cars, but the business structure was different from the taxpayer's trade, as USL bought the cars directly. The cars were then sold on to consumers by a range of third-party garages. When a car was sold, USL received the original purchase price of the car and a share of the profit made on the sale. Dickinson was never a customer of USL.

The taxpayer's loss arose because Dickinson defaulted on the contractual arrangements with the taxpayer on a number of occasions going back to 2002, whereby Dickinson would not pay the taxpayer either the capital or profit, or would only pay partially.

HMRC enquired into the taxpayer's tax returns for 2016/17 and 2017/18, and subsequently refused the taxpayer's claims to offset losses from his sole trade against income derived from the company (under ITA 2007, s 86).

On appeal, the First-tier Tribunal (FTT) found that no trade was transferred from the taxpayer to USL. The tribunal also found that the taxpayer's existing trade, being the second-hand car financing activities with Dickinson, continued to be operated by the taxpayer for two years after USL was incorporated. On the relief condition that the consideration for the transfer was wholly or mainly the allotment of shares, the taxpayer conceded that the shares were subscribed for by him in cash, and were not issued in consideration for the transfer of the trade. The taxpayer's appeal was dismissed.

Alternative argument

On the facts, the taxpayer's case was seemingly doomed. However, an interesting postscript to Davis is that the taxpayer's representative put forward an alternative argument, which was broadly that the tribunal should take a purposive approach to interpreting the loss relief provisions and allow relief on that basis. This was a kind of 'reverse Ramsay' approach. The 'Ramsay principle' is relatively well-known and is broadly concerned with taking a purposive approach to countering tax avoidance.

Unfortunately for the taxpayer, whilst this argument by Mr Davis's representative was innovative, the tribunal held that the facts did not match up with such an approach, because no trade was actually transferred.

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