B9.112 Incorporation relief—conditions for relief

Simon's Taxes > Business tax > Part B9 Incorporation and disincorporation > Division B9.1 Incorporation > Incorporation—capital gains tax aspects

Incorporation relief is available where:

- a person who is not a company transfers to a company a business as a going concern
- that person transfers it together with the whole assets of the business, or together with the whole of those assets other than cash, and
- the business is transferred wholly or partly in exchange for shares issued by the company to the person transferring the business

'Company' includes any body corporate or unincorporated association but does not include a partnership.

Any shares received by the transferor in exchange for the business are referred to in the legislation as 'the new assets'.

The transferor

The transferor must be a person who is not a company. This could include an individual, two or more individuals in partnership, trustees or personal representatives.

Partnerships

Whilst relief is generally available to individuals who are members of a partnership, even if one of the partners is a company, it is not available where a partnership or limited liability partnership (LLP) incorporates into an existing corporate member. The relief is precluded in the latter case because the requirement that the whole of the business is transferred to the company in exchange for shares has not been met; part of the business is already owned by the company.

Where relief is available it is computed separately for each individual partner. The relief is not precluded where one or more of the other partners receive cash or a combination of shares and other consideration.

For an example showing how the relief applies on the incorporation of a partnership see B7.529.

The transferee

There is no requirement for the transferee company to be specially formed for the purpose of the transfer. The provisions are therefore relevant, for example, where an established company acquires a further business in exchange for shares. There is also no requirement that the transferee company should be resident in the UK or otherwise liable to tax. This is logical since the rolled over gains reduce the base cost of the shares held by the transferor rather than the cost of the transferee company's assets.

Transfer of a business

The provisions apply where a business, rather than simply a trade, is transferred as a going concern. The word 'business' is not defined in the capital gains tax legislation.

HMRC interprets the term 'business' according to its normal meaning. It accepts that business includes, but is not restricted to, trading, and the terms 'business' and 'trade' are not synonymous. Each case must be judged on its own facts.

There is a stronger presumption with a company than with an unincorporated person (who is the transferor for the purposes of the relief under TCGA 1992, s 162) that a business is being carried on, since a company is specifically incorporated for the purpose of making profits for its shareholders.

HMRC highlights the case of *Ramsay*, in which the Upper Tribunal held that the letting of flats in a large house qualified as a business for the purpose of TCGA 1992, s 162. The UT reversed the First-tier Tribunal decision because it had relied too much on cases relating to the definition of business in other contexts. Berner J confirmed that the word 'business' should be afforded a broad meaning for these purposes. He noted that it should be considered whether:

> 'activities were a “serious undertaking earnestly pursued” or a “serious occupation”, whether the activity was an occupation or function actively pursued with reasonable or recognisable continuity, whether the activity had a certain amount of substance in terms of turnover, whether the activity was conducted in a regular manner and on sound and recognised business principles, and whether the activities were of a kind which, subject to differences of detail, are commonly made by those who seek to profit by them.'

In addition the UT found that:

> 'it is the degree of activity as a whole which is material to the question whether there is a business, and not the extent of that activity when compared to the number of properties or lettings. If an individual undertaking the letting of properties increases his portfolio, and as a result increases activities of a business nature in relation to his properties, those activities will not be prevented from being a business merely because the activity has only proportionally increased along with the enlargement of the portfolio, and so can be described as commensurate with the property holdings.'

Mrs Ramsay had worked on the property for about 20 hours per week which was found to be sufficient to indicate the carrying on a business and it is this benchmark which HMRC advises its staff to use in accepting that an activity is indicative of a business for incorporation relief. Other cases are open to consideration.

HMRC had previously stated that the passive holding of investments or an investment property did not amount to business so this change of approach following the *Ramsay* case is helpful to unincorporated property lettings businesses which wish to incorporate. From 6 April 2017 tax relief for interest and other finance costs on let residential properties is being restricted for unincorporated businesses (see B6.202F) so such businesses may wish to consider incorporating to be able to access full relief for the interest and finance costs. This could, however, present a problem with the transferring of liabilities and this is discussed in B9.114.

Transfer of a business as a going concern

To be eligible for incorporation relief, the business must be transferred as a going concern. HMRC states that this requirement indicates that there must be a transfer of something more than a mere collection of assets. Whether a business is transferred as a going concern is a question of fact. In *Kenmir Ltd* it was held that an important factor was whether the transaction put the transferee in possession of a going concern, the activities of which he could carry on without interruption. Furthermore, the business must be transferred as a going concern at the time of the transfer. In *Roelich* it was held that the taxpayer did carry on a business and it was capable of being transferred as a going concern. His business consisted of advising on projects involving property development, and HMRC had argued unsuccessfully that the transfer was that of an income stream, and that the taxpayer's activities included the exploitation of professional knowledge personal to him and so incapable of being transferred to the company. This is similar to HMRC's views on goodwill (see B9.120).

In *Villar* the taxpayer was a surgeon who transferred his business to Spire Health Care Ltd for £1m. The question was whether that was a capital payment for the sale of the business as a going concern or an advance payment of income subject to the rules relating to the sale of occupation income (see DIVISION E1.12). HMRC maintained that the appellant did not have a business to sell. There was no business or practice without him. He was the practice. His personal reputation attracted patients and colleagues alike. Therefore, regardless of his intentions, the

arrangements could only amount to an agreement to use his professional skills and reputation in order to build a practice for Spire. The appellant acknowledged that his services were key to building the business and required to ensure a smooth handover to Spire, but maintained that there was a business, independent of him, consisting of the team he had built around him, the patient lists, the surgical techniques he had developed and the particular working practices he had adopted. The First-tier Tribunal agreed as a matter of fact that the appellant sold his business and that the consideration received was capital which was not treated as sale of occupation income for tax purposes. It noted that the fact that much of the goodwill was connected with the name 'Richard Villar' and the appellant continued to be known by this name did not prevent him from having parted with the goodwill. Following the sale, only the purchaser was entitled to use the name 'Richard Villar' in connection with the business. It did so, changing its name from Spire after completion. And the appellant, in accordance with the agreement, did not carry on a business under that name.

Assets transferred

Incorporation relief does not apply where the transferor retains some of the business assets, such as goodwill, other than cash. It is arguable that cash does not include balances at a bank, but, in practice, HMRC does not appear to deny relief simply because a bank deposit or current account was not transferred to the company. If other business assets are not transferred relief is not available. By concession, HMRC does not deny relief where some or all of the business liabilities are not taken over by the company (see B9.114).

There is no requirement to transfer non-business assets such as investments to the company; and as chargeable gains accruing on such assets do not qualify for relief, it is unusual to transfer them.

HMRC has been known to question entitlement to the relief if cars which are used substantially for business purposes are not transferred, even if they were not previously reflected on the sole trader or partnership's balance sheet. HMRC might, of course, just settle for an adjustment to the private use percentage in the pre-incorporation accounts.

Business premises

It is rarely considered beneficial to transfer all the business assets to the company where the business owns a property from which it carries on its business, but to not do so would preclude incorporation relief. Where there is a good commercial reason to have the premises inside the company, a compromise approach involves creating, before incorporation, a lease out of the freehold property.

As it is not possible for an individual to grant a lease to himself, it is necessary in these circumstances to rearrange matters to facilitate such a lease. Thus, it may be appropriate to remove the property from the business balance sheet and transfer a part interest in it to another person, such as a spouse. The owners can then grant a lease to the business in return for a commercial rent. When the business is later incorporated, it is the lease rather than the freehold which is assigned to the company. The freehold reversion is retained by the individuals. It is a sensible precaution to ensure that the grant of the lease takes place at least six months before the subsequent incorporation of the business.

Consideration for transfer

The business must be transferred wholly or partly in exchange for shares issued by the company to the transferor. Relief is therefore denied where the issue of shares is not in consideration for the transfer of the business (for example, where there is a separate subscription for shares, or where the shares are issued in consideration for cash left on a loan account). The legislation does not stipulate that the transferor must hold a minimum percentage shareholding or have a continued working involvement in the company. There is also no statutory time limit for the issue of the shares. While HMRC recognises that it may not always be possible for the shares to be issued immediately at the time of the transfer, it expects the issue to take place reasonably promptly after any reasons for delay have disappeared.

Particularly when incorporating a partnership, it is important to consider how many shares to issue in exchange for the business assets, as well as the proportions in which the shares are to be held. In practice, where valuations (eg of goodwill) are agreed at a later date, the shares will often effectively be issued at a premium and a non-distributable share premium account will be reflected in the company's accounts.

If there is a substantial capital account in the unincorporated business, the business owner(s) should be advised to draw this down before incorporation, otherwise that capital will be locked into the value of the shares.

Apportionment will generally be required of the aggregate consideration, even if wholly satisfied by shares, as between the various assets disposed of. That apportionment will generally be set out in the agreement for the transfer and will bind both parties. If, however, the apportionment is manifestly unreasonable, it can be challenged by HMRC on the basis of the decision in *E V Booth (Holdings)*. For further discussion on apportionment of the consideration, see 'CAPITAL ALLOWANCES—PLANT AND MACHINERY' in B9.105.

Choosing not to meet the conditions of TCGA 1992, s 162

Although it is possible to elect for TCGA 1992, s 162 not to apply (see B9.115), another way to avoid the automatic relief is to ensure that one of the above conditions is not met. Examples of ways in which this may be effected in practice are by not transferring the business premises, or not transferring any business debts to the company. In the latter case, it is usual for the transferor to appoint the company as his agent to collect the debts.