**Transfer of a Business to a Company**

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When a business transfers its operations from that of a Sole trader, to continue operations as a company, then Capital Gains tax liabilities are triggered. Why? Because, when a sole trader transfers his assets to the newly formed company, that transfer is deemed to be a disposal for Capital Gains Tax purposes. The value of the assets being transferred will be at Market Value. The company will pay for these assets by either by the issuing of shares in the company or a combination of shares and cash/cash equivalents. Cash equivalents would include director's loans or the company taking over the liabilities of the sole trader.

There are several reasons why a sole trader may choose to transfer his business to continue operations as a company:

- Limited liability
- Lower corporation tax rate
- Increased pension options
- Raise funds through EIIS
- Lump sum payments on retirement
- Increased borrowing capacity / favourable interest rates
- Increased capacity to raise finance through selling shares in the company.

The capital gains tax liabilities primarily arise upon the deemed disposal at market value (MV) of:

- Premises
- Land
- Goodwill.

Plant and machinery or Fixtures and Fittings do not normally give rise to capital gains tax as they usually transfer at Tax Written Down Value (TWDV).

Goodwill is a very important and sometimes an overlooked asset. Goodwill which may not be evident in the balance sheet will in most cases, appear for the first time upon the disposal by the sole trader to the company.

***The relief available is the deferral of a portion of the gain (and the resulting tax liability) arising on the transfer. The amount deferred is in direct proportion to the amount that the share value compares to the assets transferred.***

In other words, if the consideration given for the transfer is €250,000 and the value of the shares in the new company is €100,000, the proportion of the gain deferred is:

$$\text{GAIN AS COMPUTED} \times \frac{€100,000}{€250,000}.$$

The problem that usually arises for students is being able to **identify the value** of the shares. THIS MUST BE WORKED OUT. It is <u>not</u> the nominal value of the shares that is given in the question.

The value of the shares is obtained by comparing the market value of the assets transferred against the consideration (i.e. cash received and the trade liabilities discharged) that is given for the transfer. The share value will be the "missing" figure.

Let's look at the following scenario and work out both the share values and the relief available. <u>There are 4 straightforward steps</u> that when followed, will give both the share values and the relief.

*Fiona has carried on her fashion boutique business successfully as a sole trader for the last eleven years. She has become increasingly concerned about the whole issue of her personal liability exposure. Fiona transferred her entire business from that of a sole trader to a company on 1 August 2016 and then continued operating under the protection of limited company status.*

*The consideration on transfer was that Fiona was issued with 10,000 shares in the new company who also took over her non-trade creditors and she received €80,000 cash.*

*Fiona's Balance Sheet as at 31 July 2016 reveals the following:*

| | | ***Cost*** | ***Depreciation*** | ***NBV*** |
|---|---|---|---|---|
| | | **€** | **€** | **€** |
| *Premises* | *[a]* | *70,000* | *24,000* | *46,000* |
| *Fixtures and Fittings* | *[b]* | *10,000* | *4,000* | *6,000* |
| *Stock* | | | | *7,500* |
| *Debtors* | | | | *4,000* |
| *Bank* | | | | *1,500* |
| *Trade Creditors* | | | | *( 7,500)* |
| *TOTAL NET ASSETS:* | | | *57,500* | |
| | | | ===== | |

**Notes:**

[a] This was purchased in August 1991.

[b] These were purchased in November 1996. The TWDV as at date of transfer was €4,000.

The following were the agreed market values of the assets:

| | **€** |
|---|---|
| Premises | 200,000 |
| Goodwill | 8,000 |
| Fixtures and Fittings | TWDV |
| Stock | NBV |
| Debtors | NBV |

Fiona discharged her trade creditors prior to the transfer taking place.

**STEP 1:**

Identify the market value of the assets taken over. This is always GIVEN in the question:

The agreed market values of the assets as at date of transfer were:

| | **€** | |
|---|---|---|
| Premises | 200,000 | |
| Goodwill | 8,000 | |
| Fixtures and Fittings | 4,000 | (TWDV) |
| Stock | 7,500 | (NBV) |
| Debtors | 4,000 | (NBV) |
| | 223,500 | |
| | ====== | |

**STEP 2:**

Identify the consideration given for the transfer. This, too is always GIVEN in the question e.g:

| | **€** |
|---|---|
| Cash | 80,000 |
| 10,000 €1 shares | ? |

**STEP 3:**
Calculate the market value of the shares:

IT FOLLOWS THAT THE MARKET VALUE OF THESE 10,000 SHARES IS:

| | € | |
|---|---|---|
| Assets taken over | 223,000 | |
| Less: cash consideration | ( 80,000) | |
| Value of shares | 143,000 | Balancing figure. |
| | ======== | |

**STEP 4:** Work out the capital gains:

Capital Gains now arise on the transfer of the following assets:

| | € |
|---|---|
| **Premises @ MV** | 200,000 |
| 91/92 Cost €70,000 x | |
| Index 1.406 | ( 98,420) |
| GAIN | 101,580 |
| | ====== |
| | |
| **Goodwill @ MV** | 8,000 |
| Cost | ( Nil ) |
| GAIN | 8,000 |
| | ===== |

Note that plant and machinery and fixtures and fittings will rarely, if ever, give rise to a capital gain. They will usually transfer at TWDV. Any different transfer value (e.g. NBV ) will give rise to a balancing charge/allowance in Income Tax.

Stock, debtors and cash are not chargeable assets for capital gains tax purposes.

| | € |
|---|---|
| TOTAL GAINS: | 109,580 |
| | ====== |

Now, **provided the following conditions are met**, Transfer of Business to Company relief can be claimed and part of the gain deferred.

* The relief is only available to individuals. (This includes individuals in a partnership). A company cannot avail of the relief.
* The business must be a Going Concern.
* All assets except cash must transfer.**
* Some of the consideration given by the company MUST be in the form of SHARES in the company.

As Fiona clearly meets all of these conditions, she may claim the relief.

**Revenue have issued a precedent that trade creditors do not constitute cash. The academic treatment is that trade creditors do form part of the other consideration. Both methods are equally acceptable in an exam situation.**

**THE RELIEF:**

| | | | € | | | € |
|---|---|---|---|---|---|---|
| **Gains** €109,580 | **x** | **Value of shares** i.e. | 143,000 | = | **Gain deferred** | 70,112 |
| | | **Assets transferred** | 223,500 | | | |

As €70,112 of the total gain is being deferred, the balance is taxable now:

| | € | | | € |
|---|---|---|---|---|
| Total gains | 109,580 | | | |
| (amount deferred) | (70,112) | | | |
| Net gain | 39,468 | | | |
| Annual exemption | ( 1,270) | | | |
| Taxable | 38,198 | @ | 33**% | 12,605 |
| | ====== | | | ===== |

** Fiona may qualify for the 20% rate of tax under the Entrepreneur Relief.

Deferment is always achieved by reducing the base cost of the replacement asset (i.e. the shares) in the event of their future disposal. This will result in more tax being paid in the future rather than now. Reducing this replacement asset base cost is achieved through reducing the base cost of the shares. The following **final small calculation** completes the answer:

| | **€** |
|---|---|
| Share value | 143,000 |
| Amount deferred | ( 70,112) |
| Share Value for future disposal | 72,888 |
| | ====== |

I stated at the beginning of this article that plant and machinery / fixtures and fittings usually transfer at Tax Written Down Value (TWDV).

To demonstrate the effect of this transfer at **TWDV** we will look at the case of Fiona above:

**CAPITAL GAINS TAX:**

| | **€** |
|---|---|
| **Fixtures & Fittings @ TWDV** | 4,000 |
| Cost (actual) | ( 10,000) |
| LOSS | ( 6,000) |
| Adjust by Capital Allowances granted | 6,000 * |
| | Nil |
| | ====== |

* €10,000 @ 15% = €1,500 x 4 years

If the assets transfer however at a different value e.g. NBV, a balancing charge or allowance may arise in Income Tax e.g.

| | **€** |
|---|---|
| **Deemed sales proceeds (NBV)** | 6,000 |
| TWDV | ( 4,000) |
| Balancing Charge | 2,000 |
| | ====== |

Transfer business to company relief is not purely claimed when a sole trader decides to incorporate his business. It can also be claimed when, for example, a company decides to make a take-over offer to a sole trader for his business. The sole trader may wish to accept the offer. Provided that the four conditions are satisfied, the sole trader may avail of the relief.

Students should note that Transfer Business to Company Relief does not affect a Retirement relief claim in the future (e.g. if the individual sells his shares in the Company a few years after the transfer takes place) as the period of ownership of the assets by a sole trader is also taken into account in determining the length of ownership of the assets.