Transfer of a business to a company

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At a time when personal income tax rates are in excess of 50% now is an opportune time for sole traders to consider incorporating their businesses. We will look at the tax implications of doing so but apart from tax there are other reasons to incorporate a business, namely:

- Limited liability – the shareholders liability is limited to the amount of share capital contributed by them
- Separate legal entity – a company is a distinct legal entity, separate to its shareholders
- Continuity – a company continues to trade irrespective of director or management changes until the company is wound up and dissolved
- Pension Planning – It is often more advantageous to have a company pension plan than a personal one
- The registered Business Name of a sole trader is not protected against duplication, the name of a limited liability company is protected
- Finance - Greater ability to raise finance by the issue of shares and debentures.

There are disadvantages to trading as a company, which includes:

- The filing of sometimes sensitive commercial financial information with the Companies Registration Office which is openly available
- Business losses may not be set against personal income
- The possibility of further taxation on capital gains if appreciating assets are withdrawn from the business at a later date.
- The need for accounts to comply with Companies Acts together with auditing and accounting standards

From a taxation point of view there are several advantages from trading through a limited company;

- Profits are taxed at 12.5%
- Shareholders taxed on what they take from the company. Sole traders are taxed on their profits regardless of whether they take them as drawings or not
- Passive income is taxed at only 25%
- Sale of subsidiary companies can often avail of an exemption from CGT.

As you can see there are considerable advantages in trading through a limited company. So, what are the implications if an individual decides to change from a sole trader to a limited company?

The transfer of assets from a sole trader to a company constitutes a disposal for CGT purposes and if gains arise, they will be taxable. However, there is a relief which defers the tax payable to the extent that the consideration is taken in the form of shares in the company.

Any shares received as consideration for the transfer are referred to as “the new assets”. In effect, the gain on the transfer is apportioned between the consideration received in shares and any cash payment. The part of the gain attributable to the shares is deducted from the allowable cost of the shares in computing the gain on a future disposal of the shares.

This relief is not available unless the transfer is effected for bona fide commercial reasons and does not form part of a tax avoidance scheme (**Section 600(6)**).

For such transfers by an individual or partnership, the net gains on transfer of the assets to the company are to be computed in the normal way and the proportion appropriate to any consideration other than shares is charged to CGT immediately.

Where a business is transferred to a company and part of the consideration consists of a credit balance on loan or current account due by the company to the transferor, the amount of the loan, etc., should be treated as consideration other than shares.

The amount of the total gain (see below) arising on the transfer of the business to the company which is to be deducted from the "cost" of the shares acquired wholly or partly in exchange for the business is that proportion of the total gains which the value of the shares received bears to the value of the whole of the consideration for the transfer of the business.

The total gain arising on the transfer is the sum of the net chargeable gains (chargeable gains less allowable losses).

Liabilities of the business included in the transfer rank as consideration for the transfer because the discharge of liabilities of the transferor by the transferee is equivalent to the payment of cash by the transferee to the transferor.

In practice, however, where an individual transfers a business to a company, in exchange for **shares only** and assets exceed liabilities, bona fide **trade creditors** taken over will not be treated as consideration.

The term “bona fide trade creditors” means genuine creditors who supply goods or services to a business. An example of a trade creditor is a supplier of food to a restaurant. Liabilities of a business such as bank loans or tax liabilities taken over by the company are not trade creditors and, if taken over, are to be included as consideration for the transfer of a business.

Example 1(a)

A transfers his business to a company. Assume that in consideration for the transfer he receives €200,000 in shares in the company. Trade creditors of €20,000 are also taken over by the company. The gain on the transfer is calculated at €250,000.

Shares	€200,000
Trade creditors	€ 20,000

By concession, the trade creditors are not treated as consideration for the transfer. Accordingly, the gain of €250,000 on the transfer is deferred.

Example 1(b)

The facts are the same as in Example 1(a) except that the company also takes over a bank loan relating to the business and tax liabilities of the transferor amounting to €30,000.

The gain on the transfer is €250,000, which is attributable proportionately as follows:

Shares	€200,000
Trade creditors	€ 20,000
Bank loan/tax Liabilities	€30,000

The concession does not apply in this example because in addition to the trade creditors, a business bank loan and tax liabilities are taken over by the company. Accordingly, only the proportion of the gain attributed to the shares can be deferred.

The following example illustrates the application of **Section 600**:-

Example 2.

A person transfers his business with all its assets except the cash to a company and gets 30,000 shares and €200,000 in cash.

The balance sheet of the business is -

Stock in trade	€100,000
Goodwill	20,000
Premises	70,000
Cash	60,000
Total assets	€250,000
Less:	
Creditors	40,000
Capital and reserves	€210,000

During the negotiations, the following were agreed market values -

Stock in trade	€120,000
Goodwill	50,000
Premises	130,000
	€300,000
Creditors	40,000
Net value of assets transferred	€260,000

The 30,000 shares and €200,000 cash which the person receives for the transfer are worth €260,000 so that the value of the shares is €60,000 (i.e. €260,000 less €200,000).

The gains are -

Stock (not chargeable)	Nil
Goodwill	€30,000
Premises	60,000
Total Gain	€90,000

The consideration received was -

Value of shares (as mentioned already)	60,000
Cash	200,000
Creditors (a liability taken over – see note 1)	40,000
Total consideration	€300,000

Amount of gain not to be charged to CGT

The amount of the gain not to be charged to CGT is the part of the total net gain on the assets transferred which is attributable proportionately to the shares received in exchange for the business.

€60,000/€300,000 = 1/5

The cost of the new assets (i.e. the shares) is €60,000.

Calculation of gain on transfer

Chargeable gain in respect of all assets transferred	€90,000
Less Amount not chargeable (1/5th)	€18,000
Amount chargeable	€72,000

Cost of shares for future disposals

The cost of the shares in the event of a future disposal of those shares is €42,000 (i.e. €60,000, which is the value of the shares, less €18,000, which is the amount of the gain attributable to the shares that is not charged to CGT).

Note 1: In this example, the creditors taken over **are** included as consideration for the transfer other than shares, **as the total consideration does not consist only of shares**.

The Relief from Incorporation is a valuable relief which all students should be aware of. In practice it a relief that is widely used as alloy of small businesses start of as sole traders and then as they grow they transfer their business into a limited company.