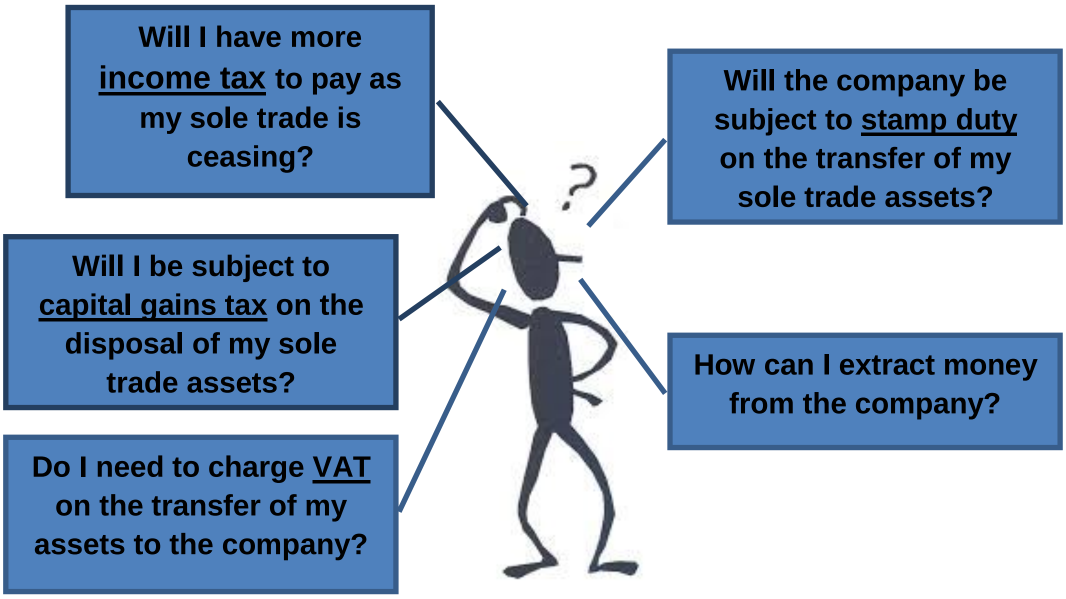
**Taxation considerations on the incorporation of a sole trade**

***By: Claire Scott McAteer, BSc, MSc Advanced Accounting, ACA, AITI, CTA, Examiner in Professional 2 Advanced Taxation***
***and Niall McAteer BSc, PGDip Advanced Accounting, ACA***

When advising on the transfer of a sole trade business to a limited company, a number of taxes need to be considered both from the sole trader's and the new company's perspective. This article outlines the income tax, capital gains tax (CGT) and VAT implications and the tax reliefs available for the sole trader who is incorporating his/her business. In addition, this article considers the stamp duty implications of the incorporation as the company will be acquiring the sole trade assets.




This article is of interest to students of Professional 2 Advanced Taxation.

**Section 1 Tax considerations for the sole trader**

1.1 Income tax implications on the transfer of a sole trade to a company

When a sole trader transfers his/her trade to a company, the sole trade will cease and the income tax cessation provisions (section 67 Tax Consolidation Act 1997) will apply. These cessation provisions require a penultimate year review to take place. Where the actual profits for the penultimate year are higher than the profits originally assessed, additional income tax will be due.

As a result of the cessation of the sole trade, possible balancing charges may arise in respect of tangible movable assets such as plant & machinery and fixtures & fittings. Such balancing charges could increase the income tax due for the sole trader but Section 312 of the Tax Consolidation Act 1997 provides for an election which can be made where the assets are transferred to a company controlled by the transferor. Where the election is made, the assets are deemed to have transferred to the company at their tax written down value. Therefore, no balancing allowance or charge will arise.

In certain circumstances it may be advantageous not to make the above election. For example, if a sole trade business has losses which will absorb the balancing charge there will be no additional income tax cost while at the same time, the base cost of the assets to the company for capital allowances purposes will be increased.

Where a loss is incurred by the sole trade business in the 12 months to cessation, a terminal loss relief claim may be made. It should be noted that any unutilised trading losses of a sole trade business cannot be carried into the company on incorporation.

1.2 CGT implications on the transfer of the sole trade assets to a company

As a company is a separate legal entity from its shareholders, the sole trader will be deemed to have disposed of his/her trade to the company. The trade assets being transferred may include: business premises; goodwill; inventory and trade receivables/debtors. CGT needs to be considered where the transfer of the trade includes chargeable assets such as business premises and goodwill. Inventory and trade receivables/debtors are non-chargeable assets for CGT purposes.

It is common practice that the sole trader will be a shareholder in the company which is taking over the trade. Where this is the case, the disposal of the sole trade assets will be treated as being between connected persons and therefore market value must be used when computing any liability to CGT.

On the incorporation of a sole trade, an individual may claim **Transfer of Business Relief** (Section 600 Tax Consolidation Act 1997). This relief effectively enables the individual to defer any CGT arising on the disposal of business assets to the extent that the market value of the assets transferred are exchanged for shares in the new company. The deferred CGT liability will crystallise on the disposal of the shares by the individual who transferred the assets to the company, as the base cost of the shares is reduced by the total gain deferred on the transfer of the assets.

A number of conditions need to be satisfied for full transfer of business relief to apply:

- There must be a transfer of a business by an individual to a company;
- The business is transferred as a going concern;
- The transfer is affected for bona fide commercial reasons and does not form part of any arrangement or scheme of which the main purpose or one of the main purposes is avoidance of liability to tax;
- All of the assets of the business (excluding cash) are transferred; and
- The consideration is comprised wholly or partly of shares in the company.

Where an individual intends to claim transfer of business relief, the gain on the transfer of chargeable assets to the company is calculated as normal. The proportion of the gain attributable to any cash/deemed cash consideration is assessed to tax immediately.

The amount to be deferred is calculated as follows:

$$\frac{\text{Consideration in the form of shares}}{\text{Total value of gross assets taken over}} \times \text{chargeable gain}$$

The following are deemed to be cash payments by the company to the individual who is transferring his/her trade to the company:

- Any liabilities of the sole trade business taken over by the company. However, in practice, the Irish Revenue Commissioners will treat the trade creditors/payables as not being consideration other than cash if the only consideration received by the individual for the transfer of the trade is the shares in the limited company and the taking over of the trade creditors/payables;
- The creation of a loan account in the company in favour of the individual (i.e. a director's loan account); and
- The payment by the company of pre-incorporation taxation/other personal liabilities of the transferor.

It is important to note that transfer of business relief is not available unless **all** of the assets of the trade (excluding cash) are transferred to the company as a going concern.

**Case study**

Sinead has been operating as a publican for 15 years. As at 31 March 2014, her assets were valued at €2,000,000 and comprised of the pub premises, goodwill and inventory. She also had trade creditors of €50,000. Sinead incorporated a new company into which she transferred her publican trade in exchange for 50 €1 ordinary shares. The potential chargeable gain on the pub premises and the goodwill is €150,000.

Based on the above, the trade is valued at €1,950,000. If she claims transfer of business relief, she will not have to pay CGT on the €150,000 chargeable gain as it will be fully deferred. The base cost of her shares will be €1,800,000 (that is €1,950,000 - €150,000).

Where transfer of business relief is not available or it is not desirable to claim it, the availability of **Retirement Relief** (Section 598 Tax Consolidation Act 1997) should be considered. This article is not intended to provide an in-depth discussion on retirement relief but where a sole trader is aged 55 or more and where he/she has been trading for at least 10 years, any CGT arising on the transfer of assets to the company may be fully relieved, subject to conditions.

## 1.3 VAT implications of the transfer of the sole trade assets to a company

Normally, VAT would be chargeable at 23% on the transfer of most movable assets (such as plant & machinery) and goodwill. VAT at a rate of 13.5% would normally arise on the transfer of business premises that are subject to VAT. However, where **VAT Transfer of Business Relief** applies (Sections 20 and 26 VAT Consolidation Act 2010), the transfer of assets is deemed not to be a supply for VAT purposes and therefore is exempt from VAT.

For the transfer of business exemption to apply, the following conditions must be satisfied:

- The transferred assets must constitute an undertaking or part of an undertaking capable of being operated on an independent basis.
- The purchaser is VAT registered.
- The purchaser must be entitled to full input credit.

## Section 2 Tax considerations for the company acquiring the trade

2.1. Stamp duty implications on the transfer of the sole trade assets to the company

There are no specific exemptions or reliefs available on the transfer of assets on incorporation of a business. Assets transferred will be subject to ad valorem duty. Certain assets, such as plant & machinery, may pass by delivery and hence not be subject to stamp duty.

Therefore, where a company issues shares in exchange for the assets of a sole trade business (that is, where transfer of business relief is claimed), stamp duty is payable on assets such as goodwill, business premises and trade debtors/receivables.

2.2 Corporation tax

The impact of close company provisions should be considered as the company, which has taken over the trade, will be closely held if it is owned by the sole trader or his/her family.

The Start-up Company Exemption from corporation tax is not available on the incorporation of a sole trade. The exemption specifically excludes any trade which was previously 'carried on by another person or formed part of another person's trade'.

## Section 3 Other tax considerations on incorporation

3.1 Appreciating assets

An individual incorporating his/her sole trade may need to consider whether appreciating assets used for the trade, such as the business premises, should be transferred to the company or should they be held personally by the individual and then be rented to the company.

Where such premises are not transferred to the company, transfer of business relief will not be available. However, the transfer of the business premises to the company could lead to an effective double charge to CGT when the company eventually disposes of the assets. That is, the company will be subject to CGT on the disposal and then each shareholder will suffer additional tax if he/she wishes to extract the proceeds of the sale from the company.

Where the individual retains the premises in his/her own name and rents the premises to the company, then income tax will be payable on any rental income profit earned.

3.2 Cash extraction

When an individual operates their business in a sole trade capacity, any profit generated by the sole trade belongs to the individual. This is not the case where an individual operates their business through a limited company. Any profits earned by the company belong to the company and therefore tax on cash extraction needs to be considered. Where a company is continuing to trade, the most common forms of cash extraction are salary and dividends. Both forms of income will be subject to income tax. Benefit-in-kind (BIK) rules also need to be considered. Specific statutory valuation rules must be used to determine the taxable value in relation to benefits provided to an individual from a company such as the free use of a company car or the provision of an interest free/preferential loan.