Roll over

PETER RAYNEY examines how incorporating a company can lend itself to further tax savings.

We have now entered the era of super tax rates which means that many successful sole traders and partners are exposed to a top rate of 51% (including 1% National Insurance) on a large slice of their profits. To put it another way, this means that only £49 out of every £100 of profit earned will be available for personal drawings or reinvestment within the business.

It is not surprising then that we have seen many highly profitable sole traders/partnerships/limited liability partnerships rushing to incorporate. The obvious tax carrot being offered with a company is that profits can be retained at relatively low tax rates, which is particularly good news for businesses that plough back a large part of their profits as working capital. Furthermore, in most cases, the incorporation itself can provide an opportunity for creating further tax savings, and this is the primary focus of this article.

Unless stated otherwise, all statutory references are to TCGA 1992.

Traditional strategies

The legal mechanics of incorporation tend to be heavily influenced by capital gains tax considerations. The transfer of chargeable assets, such as trading premises and goodwill, will often generate capital gains by reference to their market value (s 17 and s 18). There are two main methods which have traditionally been used to avoid a capital gains tax liability when a business is transferred to a company.

In brief, the standard incorporation relief in s 162 secures a rollover of the gains against the market value of the consideration shares issued in return for the transfer of the assets. Effectively, the incorporation gains are deferred until the shares are sold. Where the relevant conditions are satisfied, the application of s 162 relief

KEY POINTS

- Deferring capital gains on incorporation.
- Entrepreneurs' relief and goodwill.
- Care must be taken in valuing goodwill.
- Intangibles related-party rules may apply.
- No time like the present.

Getty.com

is mandatory. However, it requires *all* the business assets to be transferred to the company (with the possible exception of cash).

Consequently, if the business has valuable property, a stamp duty land tax liability will be triggered on the transfer based on its market value. Furthermore, the value of the transferred business is effectively 'locked in' as share capital (although private companies are now able to reduce their share capital under the Companies Act 2006, s 654 as long as the directors provide a declaration of solvency and the company can distribute the resultant profit to shareholders)

Section 162A contains a useful election to disapply the s 162 rollover. This might be helpful, for example, if the newly incorporated company is sold shortly after the incorporation. Since there is no reading back for the 12-months share ownership under the entrepreneurs' relief legislation, entrepreneurs' relief would not be available on the share sale. However, by electing to disapply the s 162 rollover, the shares will have a market value basis, equal to the value of the net assets, including goodwill, transferred. The incorporation

gains should qualify for entrepreneurs' relief, giving an effective 10% capital gains tax rate on most of the business value .

The second route using the 'gifts of business assets' relief under s 165 tends to be more user-friendly. Section 165 relief does *not* require all the assets to be transferred to the company, although goodwill will invariably follow the trade. The trading property can therefore be retained by the sole trader/partners, hence avoiding any stamp duty land tax cost, and let to the company. The rent can subsequently provide a useful way of extracting income from company in a National Insurance-free form.

With s 165, the goodwill (and possibly the property) is gifted *or* sold at an undervalue to the company. The relevant gains are then held over against the company's deemed market value purchase consideration, thus eliminating the sole trader/partners' capital gains tax liability. This means that the company effectively acquires the assets at their base cost. Because this is the overall tax effect, Statement of Practice 8/92 enables both parties to elect to dispense with a formal market value of goodwill etc.

Sell at market value?

In recent years, many unincorporated businesses have ignored these traditional methods of incorporating, preferring instead to sell the goodwill to the company at its fair market value and pay the appropriate capital gains tax. Although this seems at first glance to be counter-intuitive, it can be a very attractive option. In essence, the sale of the goodwill would be credited to the owner-manager's loan account with the company, which can be repaid over a suitable period, possibly in lieu of highly taxed salaries or dividends. In some ways, this might be viewed as fiscal alchemy – converting income to capital gains.

Provided the 12-month ownership test is satisfied, entrepreneurs' relief should be available on the chargeable assets, such as goodwill and property, sold to the company under s 169I(2)(a). The loan account credit for goodwill would only cost tax of some 10% on the gain (not bad eh?). Clearly, no holdover under s 165 is available since full consideration is being given by the company. With the prospect of an increase in the headline capital gains tax rate possibly just around the corner, those contemplating incorporation will need to act pretty quickly to obtain the certainty of an effective 10% tax rate.

In my view, provided the goodwill consideration is left outstanding as a simple debt, there should be no possibility of the transaction falling within the transactions in securities rules in ITA 2007, s 698. On the other hand, the issue of a formal loan note instrument (security) evidencing the debt might cause the transaction to fall within the rules.

With proper implementation, the sale of goodwill should enables funds to be withdrawn from the company (in the form of loan account repayments) at an effective tax cost of around 10%. ***Example 1: 'Market value' sale*** illustrates how this might work in practice.

All this sounds relatively simple but, as with most tax strategies, there are a number of potential pitfalls that must be avoided.

EXAMPLE 1: 'MARKET VALUE' SALE

Roy has operated a successful marketing business as a sole trader since June 1999. In June 2010, he was advised to transfer his business to a new limited company, Roy's Marketing Ltd (RML).

Roy initially sets up RML by subscribing for all its 10,000 £1 shares at par. His business has built up substantial goodwill and has a wide client base with many 'blue chip' customers. The business also has a number of highly paid consultants who hope to receive enterprise management incentive share options shortly after incorporation.

As part of the incorporation, Roy sells the business goodwill to the company for £500,000 (supported by a professional valuation), which will be amortised over five years. The goodwill valuation was accepted by HMRC – Shares and Assets Valuation.

The other net tangible assets of the business, such as office equipment, motor cars, debtors, less trade creditors etc., were sold for a further £245,000.

Roy's capital gains tax on the sale of the goodwill in, say, June 2010 would be calculated as follows:

	£
Market value	500,000
Less: Base cost	(-)
Chargeable gain	500,000
Less: Entrepreneurs' relief – £500,000 x 4/9	(222,222)
Gain after entrepreneurs' relief	277,778
Less: Annual exemption	(10,100)
Taxable gain	£267,678
Capital gains tax @ 18%	£48,182

Roy's loan account with the company would be credited with £745,000 (i.e. £500,000 + £245,000), which could be drawn down over a several years, possibly in preference to taking bonuses or dividends. The effective tax cost of the goodwill element built into the loan account was around 9.6% (£48,182/£500,000 x 100)

Goodwill valuation

Given the potential tax breaks on offer, there may be a temptation to be a little over-optimistic with the goodwill valuation. You can expect HMRC to review goodwill valuations critically and, equally important, HMRC will seek to ascertain that the goodwill is capable of being transferred to the company.

HMRC tend to draw a distinction between personal and business goodwill (see *Tax Bulletin* 76 April 2005). The key point here is that personal goodwill (which relates to the *personal* skills, attributes and personality of the proprietor) is *not* capable of being transferred to the company. Based on HMRC's view, one-man-band businesses are unlikely to be able to realise any meaningful value for goodwill.

Problems may also arise if HMRC consider that part of the goodwill value is so-called 'adherent' goodwill. Adherent goodwill stems from operating a trade from specifically adapted premises, such as a pub or hotel. HMRC frequently contend that this element of the goodwill can only be disposed of with the premises and cannot therefore be recognised where the premises is retained personally.

On the other hand, free business goodwill is transferable and can be valued for the purposes of the incorporation. Such goodwill normally derives from a business's brand or good name, reputation, potential to generate earnings, employee expertise, customers, and client base etc. This would often be the case for a successful well-established business, where goodwill would be factored into the price for any trade sale of the company.

> ***"It is always useful to ask the owner how much they would (sensibly) be prepared to sell the business for."***

HMRC are likely to review goodwill valuations carefully to ensure they are not excessive. One of the golden rules here would be to make sure that the goodwill value used is reasonable and defensible. There is nothing worse than starting negotiations with HMRC – Shares and Assets Valuation on the back foot because of an initial over-zealous or fanciful valuation. It is therefore sensible to use an appropriate specialist to value the goodwill.

There are a number of accepted methods of determining the goodwill value. Probably the most common technique is to apply an appropriate multiple to the maintainable earnings/profits of the business, making appropriate deductions for commercial remuneration payable to the owner-manager etc. As a helpful crosscheck, it is always useful to ask the owner how much they would (sensibly) be prepared to sell the business for. The goodwill value represents the amount by which the capitalised earnings of the trade exceed its net tangible assets. Alternatively, some valuations tend to be based on accepted practice within the relevant business sector, such as using a multiple of recurring fees.

Some owner-managers may wish to obtain certainty on their goodwill valuations when they submit their tax returns by using HMRC's post-transaction valuation check service. This would entail submitting a request on form CG34 for the goodwill to be valued soon *after* the incorporation has been completed. This ought to give sufficient time to agree the valuation before the 31 January filing date.

Unravelling distributions

In some cases, HMRC may succeed in demonstrating that the goodwill valuation is excessive. The excess amount is most likely to be received by the transferor in his capacity as a shareholder of the company. This would mean that the surplus amount would normally fall to be treated as a distribution within CTA 2010, s 1000B (previously TA 1988, s 209(2)(b)). Depending on the owner-manager's marginal tax rate, they would generally suffer an effective tax rate of 25% or 36.1% on the net distribution (due to the benefit of the 10% tax credit).

However, provided there was no intention to value goodwill excessively and reasonable efforts were made to ensure that the transfer was made at market value, for example, by using a proper professional valuation, HMRC will generally permit the distribution to be unravelled (see *Tax Bulletin 76* April 2005,). Further protection may also be obtained by building an appropriate provision in the incorporation sale contract to sell the goodwill 'at the relevant amount or such value as may ultimately be agreed with HMRC – Shares & Assets Valuation'.

The owner-manager would generally unwind the distribution by agreeing to make a corresponding debit reduction in their loan account. (The *reduction* to the agreed market value would be reflected in the capital gains tax computation.) If loan account repayments have already been made, this adjustment may cause the loan account to become overdrawn. The benefit of having an interest free overdrawn loan account is likely to be treated as taxable benefit (ITEPA 2003, s 175) and the company would also suffer a 25% tax charge under TA 1988, s 419 on any amount remaining uncleared by nine months after the year-end.

However, if HMRC believe that the goodwill was deliberately over-valued or there was intentional avoidance, the distribution treatment will stand. In such cases, the transferor owner's/partner's capital gains tax would be based on market value of the goodwill, under the general rule, and the excess amount received from the company would rank as a taxable distribution. Since goodwill would normally be transferred immediately before the company starts to trade, HMRC accept that the excess amount would only rarely be treated as taxable earnings or a benefit (ITEPA 2003, s 62 or s 203).

EXAMPLE 2: CORPORATE TAX RELIEF

Based on ***Example 1***, RML would amortise the goodwill at the rate of £100,000 (£500,000/5 years) each year (subject to any impairment review), with a commensurate reduction being made in its distributable reserves.

However, under the 'related party' rules, the company cannot obtain any tax relief on the goodwill write-off, i.e. since it is related to its controlling shareholder (Roy) who carried on the trade at 1 April 2002.

Corporate tax relief

As a general rule, companies can now obtain a tax deduction for purchased goodwill, based on the amount amortised in their accounts in accordance with Financial Reporting Standard (FRS) 10. This requires goodwill and other

intangible assets to be written off over their economic life (which can only exceed 20 years in exceptional cases), and hence the tax relief is given on the same basis. The write-off of purchased goodwill on incorporation would therefore restrict the company's distributable reserves in the short to medium term, but if loan account repayments are being made to provide income for the owner-manager in place of dividends or bonuses, the overall effect should be the same.

Under the CTA 2009, Part 8 intangibles regime, there are special rules to prevent goodwill etc. being recycled under the same economic ownership. Corporate tax relief is *not* therefore available for goodwill acquired from a 'related-party' that held it on 1 April 2002 (CTA 2009, s 882(1)(c) and (5)). No tax deduction would therefore be given on the incorporation of an established trade carried on before 1 April 2002.

Broadly speaking, the transferor owners or partners are treated as related with the company under these rules if they, together with their connected persons within CTA 2009, s 843, can control it or have a major (40%) interest in it (CTA 2009, s 835 to s 838).

In some cases, for example on the incorporation of a large partnership, the related party rules do not bite, although in exceptional cases HMRC may consider using the mini general anti-avoidance rule in CTA 2009, s 864 to deny relief where the transaction was mainly motivated by tax avoidance). See ***Example 2: Corporate tax relief*.**

However, where the trade originally started after 1 April 2002, there is an added bonus since the amortisation of the purchased goodwill would normally be tax deductible under the intangibles regime (see CTA 2009, s 882(5)). In such cases, the transfer is normally deemed to take place at market value (with any excess amount being ignored). Thus, if Roy (in ***Example 2***) had started trading in, say, 2004, the company would be able to deduct the annual amortisation under the intangibles regime.

Time is tight

The LibCon coalition has marked down that capital gains tax rates will rise, although we do not know from when. There is no real precedent for changing capital gains tax rates in a tax year, but who knows?

In any case, given that we are going to have an emergency Budget, would-be incorporators should get a move on to ensure they obtain the attractive 10% entrepreneurs' relief capital gains tax rate on their goodwill. ■

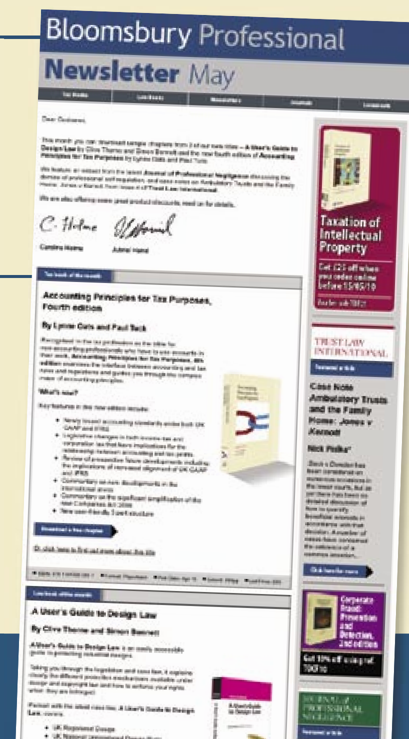
Peter Rayney FCA CTA (Fellow) TEP runs a specialist independent tax consultancy practice: Peter Rayney Tax Consulting Ltd, e-mail: peter@prtaxconsulting.co.uk. He is author of Bloomsbury Professional's *Tax Planning for Family and Owner-Managed Companies;* the 2010/11 edition will be published later this year.

Bloomsbury Professional

Sign up to our e-newsletter and receive FREE content and discounts every month

Receive sample chapters, journal articles and exclusive special offers every month when you sign up to our FREE monthly e-newsletter.

Simply complete the postcard enclosed in this issue of *Taxation* and post it back to us free of charge. Or sign up online at **www.bloomsburyprofessional.com**



We do not sell, trade or rent your email contact addresses to any third parties