The Chartered Institute of Taxation

Application and Professional Skills

Taxation of Owner-Managed Businesses

May 2026

Suggested answer

Report to James Blackwood

Subject: Recommendations related to incorporating the sole trade

Introduction

As agreed at our meeting of 18 April 2026, this follow up report discusses and makes recommendations relating to tax considerations arising from the planned incorporation of Blackwood Trading at the end of the 2026/27 tax year. In particular, it covers:

- The timing of the purchase of the new machinery.
- The mechanism, and potential Capital Gains Tax (CGT) reliefs, of the incorporation – taking into account your decision to retain personal ownership of the trading premises.
- Provision of a modest income for Danielle, keeping in mind your intentions for the business.
- Sundry matters and other taxes.

The report is based on the information provided by you (James Blackwood) and the accounts for the tax year to 5 April 2026. The report and advice is intended for you only and we do not accept liability for any third parties who may wish to rely on this report.

The report is based on the legislation as at today's date. There may be changes in the future, for example in a Budget or in your circumstances, in which case you should contact us to clarify if there is any impact on the advice and recommendations.

Morgan & Mitchell Chartered Accountants

30 April 2026

Executive summary

We make the following recommendations:

1. If you purchase the new machines before incorporating on 1 April 2027, the purchase will occur in the year that Blackwood Trading (BT) permanently ceases trading for Income Tax purposes and the annual investment allowance (AIA) will not be available. We recommend selling both the existing and new plant and machinery to Blackwood Trading Limited (BTL) for a nominal £1 amount per pool to realise a large balancing allowance. This will mean a significant trading loss arises in 2026/27, eradicating your Income Tax and Class 4 National Insurance liability for the year. You will also be able to claim an Income Tax refund of £76,446 for the previous three tax years using terminal loss relief.

2. The incorporation will mean a significant capital gain of approximately £295,000 is realised. Several reliefs are potentially available. As you want to retain personal ownership of the trading premises, we recommend a sale of the trade and other assets to BTL. As the company will not have the funds to pay you the market value of the assets transferred, you will have a substantial credit of £300,002 on a director's loan account (DLA) which you can draw down free of Income Tax and National Insurance over several years, giving you a cash flow boost.

3. In order to provide Danielle with a modest income of £10,000-£12,000 each year, we recommend making her a director and paying her a small salary. This fits well with her intention to become involved with the business in the future, your own willingness to allow her an increasing level of authority, and with your wish to retain full control. It is also more tax efficient than paying dividends due salary payments being a deductible expense for BTL.

Matter 1: New and existing plant and machinery: timing of purchase and transfer to BTL

There are several considerations regarding Capital Allowances to look at. There are brought forward pool balances of £68,880 and £27,260 in the main and special rate pools respectively. There are no writing down allowances available in the year a business permanently ceases, so there will still be a positive balance in both pools at the planned incorporation date.

Transfer of existing assets

Incorporating the sole trade will mean the sole trade ceases for Income Tax purposes. A value needs to be brought into account for the assets that are being transferred to Blackwood Trading Limited (BTL), e.g. the machinery. As you and BTL will be connected, if there are no proceeds this will be for the market value, which could lead to a balancing charge if the assets are worth more than the pool balances. This would be added to your trading income for 2026/27. To avoid this, you could make an election (jointly with BTL) to transfer the assets at their Tax Written Down Value instead of market value. BTL would then have opening pool balances equal to the transferred balances, i.e. it would simply pick up where Blackwood Trading (BT) leaves off.

However, it is also possible to sell the capital assets to BTL for a specific amount. If you opt to sell them for £1 per pool, a large balancing allowance of £96,138 would be deducted from your profits for 2026/27, leaving a small trading loss of £6,138 (assuming the profits before the deduction are £90,000 as forecast). This will save approximately £26,500 in 2026/27.

New machinery

A crucial consideration regarding the timing of the purchase of the new machinery is that no annual investment allowance (AIA) – which is currently £1 million - can be claimed in the year of permanent cessation of a trade. While the trade will be continuing in BTL, for Income Tax purposes an incorporation is treated as a cessation of the sole trade.

This means that if you purchase the new machines before incorporating you will not be able to claim the AIA and instead would need to pool the cost in the main pool.

If you wait until after incorporating to purchase the machines, BTL will be able to claim the AIA which will lead to a trading loss of £170,000 for Corporation Tax purposes in its first accounting period to 31 March 2028. This would be fully relieved after two further years, assuming profits before salaries of £180,000 and would save £64,574 in Corporation Tax.

You have stated that you think gaining further new contracts is highly unlikely, so on the face of it there appears to be no commercial reason to buy the machines early. However, doing so would present a planning opportunity.

If you purchase the machinery prior to incorporation, it will increase the balance on the main pool by £350,000. In the same way as the existing machinery, you can then sell the assets to BTL for £1 per pool. This will augment the loss (see above) so that your overall position for 2026/27 will be a loss of £356,138.

<u>Using the losses</u>

You can take advantage of terminal loss relief to generate a significant Income Tax and Class 4 National Insurance refund. This relief allows you to offset losses arising in the final 12 months of trading against profits from the three previous tax years on a last-in first out basis. The loss would reduce your profits for 2023/24, 2024/25 and 2025/26 to nil, and mean a refund of £76,446 (in addition to the £26,500 saving already discussed for 2026/27 – see above). As this loss claim is "all or nothing" it does unfortunately lead to wasting the personal allowances for those years; however, it is almost £12,000 better than relieving the capital expenditure in the company (see above).

There will be an unused loss of £96,016 after the terminal loss relief claim. As you have no other income, it is possible to make a claim to offset the remaining loss against capital gains arising in the same year (see Matter 2 below).

Recommendation

We recommend you purchase the new machinery prior to incorporation, then transfer the new and existing capital assets to BTL for £1 per pool to realise a large balancing allowance and a trading loss. You can then utilise terminal loss relief to generate a refund of Income Tax and Class 4 National Insurance. The remaining losses can be used against capital gains in the same year.

The advantage of this option is that the Income Tax and Class 4 National Insurance refund will be sufficient to cover the remaining capital gains tax (CGT) charge (after the offset of losses) that will arise if you follow our recommendation regarding incorporation (see Matter 2 below). This avoids unexpected outgoings, in line with your expressed wishes.

Matter 2: the incorporation and CGT considerations

There are several options for incorporating BT. Broadly, you could:

1. Sell the trade and assets to BTL for cash consideration (left owing – see below).
2. Sell the trade and assets in exchange for shares in the new company.
3. Gift the trade and assets to the new company.

All of these options will trigger a gain of approximately £295,000 which would be charged to CGT. However, there are reliefs available depending on which option you choose. Let's consider each in turn.

Note. We assume that you will remain personally liable for the outstanding loans/creditors as it is unlikely the other parties will accept these becoming subject to limited liability.

<u>Option 1</u>

A sale of the trade and assets would be deemed to take place at market value, due to you and BTL being "connected". The only relief we could potentially claim would be business asset disposal relief (BADR), which would restrict the rate of tax charged to 18%. In principle, BADR would be available due to BT being a trading business that you have owned for more than two years. You have not made any previous disposals, so you have a full lifetime allowance of £1 million for BADR.

Unfortunately, BADR will not apply to the value of the goodwill, which is the only chargeable asset being transferred (as you are retaining the business premises). This is due to a block on BADR applying where the sole trade and the new company are connected, and the sole trader will own at least 5% of the shares.

The £295,000 gain on the goodwill will be charged at the upper main CGT rate of 24%. Note that the loss on the machinery will not affect this as you have claimed Capital Allowances on their cost – the loss is therefore not a deductible loss.

If we assume the company pays you the market value of the goodwill and current assets, and assuming you follow the recommendation regarding the plant and machinery (see Matter 1 above), the amount owed to you will be £300,002. Of course, these are estimated figures at present but should give you a reasonable idea of the position.

There would be a significant CGT charge. Assuming your annual exempt amount (£3,000) is available, the gain subject to CGT will be £292,000, although this can be reduced to £195,984 after the offset of losses as per Matter 1), meaning CGT of £47,036 will be payable by 31 January following the end of the tax year the incorporation takes place in.

Note. If you realise a trading loss in 2026/27 (see Matter 1), some of the gain will be taxed at 18%.

As BTL will have no initial funds, it would owe you the market value (£300,002) via a credit on your new director's loan account, or by issuing you with loan notes. You could draw funds from BTL from future profits up to this amount with no Income Tax or National Insurance consequences. We would still recommend you take a small salary each year to secure a Corporation Tax deduction and accrue National Insurance credits for State Pension purposes, but you would not need to take any dividends until the loan account is repaid.

As an illustration, if you took £12,570 as a salary each year and then drew (say) £75,000 against the loan account credit, you would have no Income Tax liability for four years, so your in-pocket position would be £87,570. Based on the illustrative calculations we provided at our meeting, this would save you £20,080 each year in tax you would otherwise pay on the dividends, so you would be in a better position than the standard salary and dividend extraction we discussed. Four years would mean a saving of 4 x £20,080 = £80,320. The tax saving in the long term is significantly more than the CGT charge of £70,080, and given that you will have an Income Tax refund to pay the CGT with so that you aren't out of pocket (see Matter 1), this is a strong option.

<u>Option 2</u>

Selling the trade and assets in exchange for consideration wholly consisting of shares in the new company would mean that incorporation relief would automatically apply. This is a form of rollover relief, which would reduce the base cost of the new shares by a corresponding amount – the gain would then be charged along with any future growth in value on a later disposal of the shares. However, this requires all assets (other than cash) to be transferred to BTL.

As you want to retain ownership of the business premises (see below), this relief cannot apply.

<u>Option 3</u>

Making a gift of the goodwill to BTL would mean that a joint election (between you and BTL) can be made to delay the charge to CGT until the goodwill is disposed of by BTL. Crucially, there is no requirement to transfer all assets to BTL for this to apply, so retaining the business premises outside BTL would not impact the relief.

There are a number of conditions that must be met for the claim to be successful.

1. The asset disposed of must be a "business asset" as defined by the relevant legislation. There are no concerns here as you are an established trader.

2. The transfer must be a gift or at less than market value. You would be transferring the trade and assets for no consideration (but see below) so this condition will be met.

3. A formal claim must be made and agreed by both the transferor and transferee. This will be a joint claim by you (personally) and BTL (you as an officer of BTL).

The amount of relief may be reduced if there is actual consideration paid. It may be worth having a small amount of cash consideration paid (owing to you on your director's loan account as discussed under option 1) to utilise your CGT annual exempt amount (currently £3,000), unless you have already made other disposals in the year that have used this.

Recommendation

We recommend that you sell the trade and assets to BTL for market value (£485,000). This will be left owing to you on a director's loan account, and will be available to draw against Income Tax and National Insurance free going forward. This will lead to savings that will exceed the CGT payable. There will be a CGT charge of £70,080, payable by 31 January 2028 (though this may be reduced by making a claim to offset some of the trading loss against the gain – see Matter 1). However, you will have an Income Tax refund (see Matter 1) that will be sufficient to pay this.

Matter 3: Income for Danielle

There are a number of options available for involving Danielle in the business. Broadly, the options are:

1. Employ her on a part-time basis;
2. Make her a director;
3. Make her a shareholder only;
4. Make her a director and shareholder.

Option 1 is the most straightforward and would allow you to pay her wages. As long as these are not excessive in relation to the work undertaken, they will be deductible for Corporation Tax purposes.

Option 2 is similar to Option 1, and is preferable given that Danielle has indicated she wants to become more involved in the business, and that you intend to have her attend client meetings and business networking. You would pay her a salary, which would be deductible for Corporation Tax purposes, again subject to not being excessive.

Option 3 would mean issuing Danielle with shares. She could not be paid a salary but could be paid dividends. Dividends are not deductible for Corporation Tax purposes.

Option 4 is a combination of 2 and 3, and offers the greatest flexibility.

We do not recommend Option 3 or 4 as this could involve you giving away some control, which you indicate you do not want to do. This could be resolved by issuing Danielle with shares of a different class that have no voting rights, but an entitlement to dividends. However, there is little point in doing this as shares with no voting rights do not attract business asset disposal relief (BADR).

You mentioned that dividends are more tax-efficient than salary. It is true that dividends are subject to lower rates of tax than earnings:

- 0% within the dividend allowance of £500;
- 8.75% within the basic rate band;
- 33.75% within the higher rate band; and
- 39.35% at the additional rate.

Additionally, dividends are not subject to National Insurance. However, in this case, a dividend would mean a higher overall tax charge.

Danielle has no other income, and so a salary payment of £10-12,000 would be covered by her personal allowance each year. A dividend would also have no tax at that level; however, the dividend is not deductible for Corporation Tax purposes, so the salary is the more efficient option. As such, there is no tax incentive for issuing her with shares upon incorporation. If you wanted to transfer some shares to her further down the line, perhaps after she finishes university for example, you could again take advantage of the CGT holdover relief for gifts of business assets discussed in the context of incorporation above (see Matter 2).

<u>Note on fiduciary duties</u>

Directors are treated as agents of the company; which means they have the power to bind the company in the course of its business. You may wish to reserve this authority to yourself initially until Danielle is more experienced.

Directors have fiduciary duties to the company, the key ones being:

- to act within their powers within the constitution of the company;
- to promote the success of the company in good faith;
- to exercise independent judgment, as well as reasonable care, skill and diligence;
- to avoid conflicts of interest; and
- to declare any potential conflicts of interest.

Breaching these duties can have consequences – including criminal charges in the most serious cases.

Recommendation

We recommend making Danielle a director and paying her a salary as this is most efficient, and fits with your wish to retain 100% control. As an added bonus, having a second director paid an amount of at least the secondary Class 1 National Insurance threshold for a period in the tax year will mean the employment allowance is available to BTL. This will save £1,136 that would otherwise be payable on your salary (refer to my illustrative calculations from the meeting). You have indicated that you can justify this level of payment with the work you are planning to give Danielle. Finally, Danielle is likely to feel more involved in the company as a director than as a part-time employee.

Sundry matters and other taxes

The transfer will be a transfer of a going concern for VAT purposes, so BT will not charge BTL output tax. It is possible to apply to retain the existing VAT number, though this will mean BTL inherits BT's VAT history.

As you are retaining the business premises, Stamp Duty Land Tax will not be charged, saving £5,500.

The gift of the business premises to Danielle will be a Potentially Exempt Transfer for Inheritance Tax purposes, meaning that if you were to die within seven years it would be taxable in your estate. Additionally, if you were to die while owning the property, you should note that BPR would only be available at 50% on the building instead of 100% currently.

Structures and buildings allowances would technically be available on the improvement works, but this would cease at incorporation as BTL wouldn't own the building. This is unlikely to be material in any case.

You may wish to charge BTL rent for using the building. If so, we will need to revisit the profit extraction strategy discussed once the director's loan account is fully used to ensure your overall income doesn't exceed £100,000, or your personal allowance will start to be eroded. It is also worth noting that BADR is restricted where rent is paid; however, as you are planning to gift the building to Danielle this is unlikely to matter.

You could also choose to charge BTL a commercial rate of interest while the director's loan account has a credit balance. Doing so would mean you could take advantage of the savings starter rate and the personal savings allowance. This would mean £6,000 of interest could be paid to you with no Income Tax (as your income will only be £12,570 until the loan account is exhausted). The advantage of this is that it would be deductible for Corporation Tax, though the company would need to deduct 20% and pay this to HMRC. You would be able to claim a credit for this on your own tax return.

Morgan & Mitchell Chartered Accountants

30 April 2026