

## Uncertainties in relation to the application of ESC D32

### Submission by the Chartered Institute of Taxation

#### 1 Summary

- 1.1 The Chartered Institute of Taxation (CIOT) is the leading professional body in the UK for advisers dealing with all aspects of taxation. We are a charity and our primary purpose is to promote education in taxation with a key aim of achieving a more efficient and less complex tax system for all. We draw on the experience of our 19,000 members, and extensive volunteer network, in providing our response.
- 1.2 This submission concerns the uncertainties in relation to HMRC's application of ESC D32 on the incorporation of a business, where an individual transfers the whole of the assets and liabilities to a company for consideration consisting wholly of the issue of shares by the company, relying on incorporation relief under TCGA 1992 s 162.
- 1.3 Following the House of Lords decision in *R (on the application of Wilkinson) v Inland Revenue Commissioners* [2005] UKHL 30. HMRC undertook a review of its published concessions. Where HMRC concluded that a concession exceeded the scope of the discretion of the judgment in Wilkinson, concessions were put on a legislative basis where appropriate. ESC D32 was retained and remains in force. We assume HMRC's position remains that ESC D32 is *intra vires*.
- 1.4 We suggest that the guidance in the Capital Gains manual dealing with ESC D32<sup>1</sup> needs updating and supplementing to reflect modern commercial practice by lenders to include—
  - Examples of 'business liabilities' for the purposes of ESC D32 and whether 'business liabilities' may include property mortgages where the property letting activities are sufficient to amount to a business for incorporation relief purposes, and
  - Examples of scenarios where HMRC accepts that business liabilities have been 'taken over' by a company.
- 1.5 We would be pleased to contribute to the development of any new guidance that removes these uncertainties.

---

<sup>1</sup><https://www.gov.uk/hmrc-internal-manuals/capital-gains-manual/cg65745>

- 1.6 We note also that there are wider issues with section 162 relief that cause issues in practice. We would be pleased to discuss these issues in more detail if that would be helpful.

## **2 About us**

- 2.1 The CIOT is an educational charity, promoting education and study of the administration and practice of taxation. One of our key aims is to work for a better, more efficient, tax system for all affected by it – taxpayers, their advisers and the authorities. Our comments and recommendations on tax issues are made solely in order to achieve this aim; we are a non-party-political organisation.
- 2.2 The CIOT's work covers all aspects of taxation, including direct and indirect taxes and duties. Through our Low Incomes Tax Reform Group (LITRG), the CIOT has a particular focus on improving the tax system, including tax credits and benefits, for the unrepresented taxpayer.
- 2.3 The CIOT draws on our members' experience in private practice, commerce and industry, government and academia to improve tax administration and propose and explain how tax policy objectives can most effectively be achieved. We also link to, and draw on, similar leading professional tax bodies in other countries.
- 2.4 Our members have the practising title of 'Chartered Tax Adviser' and the designatory letters 'CTA', to represent the leading tax qualification.

## **3 Introduction**

- 3.1 We outline the background to ESC D32, and areas of concern, interpretation, and use of ESC D32 in practice that are giving rise to the uncertainties.
- 3.2 Our stated objectives for the tax system that are relevant to this submission include:
- Greater simplicity and clarity, so people can understand how much tax they should be paying and why.
  - Greater certainty, so businesses and individuals can plan ahead with confidence.
  - A fair balance between the powers of tax collectors and the rights of taxpayers (both represented and unrepresented).
  - Responsive and competent tax administration, with a minimum of bureaucracy.

## **4 Background to ESC D32**

- 4.1 The general position where an individual transfers their business to a limited company that they own is that the disposal is deemed to be at market value for CGT purposes, subject to the availability of any reliefs.
- 4.2 Where all of the assets of the business are transferred to the company for consideration consisting wholly of the issue of shares in the company, incorporation relief under TCGA 1992, s 162 should apply, such that

(broadly) the gain on the disposal of the sole trade business is rolled over and deducted from the base cost of the shares for CGT purposes.

- 4.3 Strictly, the chargeable gain on incorporation should be apportioned pro-rata between the shares issued by the company and any ‘other consideration’—
- The gain attributed to the shares is rolled over and deducted from the base cost of those shares under TCGA 1992, s 162, and
  - The gain attributed to any ‘other consideration’ (such as the assumption of business liabilities) is chargeable to CGT.
- 4.4 The original enactment of the relief in FA 1965, Sch 7, para 8(3) specifically stated that business liabilities assumed by the company would be treated as ‘other consideration’ for the purposes of the original incorporation relief (see Appendix 1).
- 4.5 However, the legislation was rewritten by FA 1969, Sch 19, para 15 and the reference to business liabilities was removed from the legislation entirely (see Appendix 2). It is noted that para 15 is written in broadly the same terms as TCGA 1992, s 162 and its predecessor, CGTA 1979, s 123.
- 4.6 After incorporation relief was revised in FA 1969 to remove the reference to business liabilities, the Inland Revenue appeared to acknowledge that the amendment would not strictly disregard any business liabilities taken over by the company as representing ‘other consideration’, thus failing to ensure full rollover where the business liabilities taken over are less than the base cost of the assets of the sole trader<sup>2</sup>.
- 4.7 The Revenue published Statement of Practice (SP) D22 (see Appendix 3 ) on 10 September 1971, which stated that—
- ‘Where business liabilities are taken over by a company on the transfer of a business to the company, it is the practice of the Revenue for the purposes of the roll-over provision in [TCGA 1992, s 162] (transfer of a business to a company) not to treat such liabilities as consideration; if therefore the other conditions are satisfied, no capital gain arises on the transfer.’*
- 4.8 The wording of SP D22 was republished by HMRC almost verbatim, save for updated statutory references, as extra-statutory concession (ESC) D32 in 1995.

## 5 Uncertainties in the application of ESC D32

- 5.1 It is unclear what is meant by ‘*business liabilities*’, and what amounts to such liabilities having been ‘*taken over by a company*’ on incorporation.
- 5.2 It would be helpful to confirm that business liabilities may include property mortgages where the property letting activities are sufficient to amount to a business for incorporation relief purposes.
- 5.3 The wording of the concession suggests that ESC D32 only applies where business liabilities are ‘taken over’ by novating the existing debt liability from sole trader or partnership to the company. However, while this

---

<sup>2</sup> TCGA 1992, s 162(4) limits the extent of the relief to the ‘cost of the new assets’, which is the market value of the shares issued to the individual.

may have been common practice in 1971, when a sole trader and their bank manager could agree to the transfer of business loans to the company, it does not align with current banking practices.

- 5.4 Our understanding is that banks and other lenders rarely allow the novation of an existing loan from sole trader to company but require a new loan agreement with the company. It is not clear that ESC D32 applies in such cases, as the company does not strictly take over the existing debt. Instead, it takes on a new debt, often on very different terms. The new borrowing is used to repay the old borrowing. The commercial outcome is an economic equivalent to that envisaged by ESC D32 – the amount of the original debt is extinguished, replaced with the same value of debt with the new company.
- 5.5 While the HMRC manual at [CG65745](#)<sup>3</sup> adds that ESC D32 is also met by the company giving the transferor an indemnity, we understand that this practice is not generally commercially acceptable to lenders, particularly on the transfer of property mortgages.
- 5.6 Leading authorities note the uncertainty, for example Simon's Taxes at B9.114 states that—
- 'The incorporation of a buy-to-let property business may involve refinancing the existing mortgages which could possibly prevent HMRC applying ESC D32. If the company does not assume the same liabilities of the transferor, but instead raises finance of its own, which is passed to the transferor to settle its debts related to the properties being transferred, there is considerable risk that HMRC might choose not to apply its concession.'*
- 5.7 Anecdotally we understand that in practice some lenders may agree to 'temporarily' novate such loans. By way of example, a lender may agree to provide bridging finance, which can be novated to Newco for a period of one month, on condition that Newco takes out new mortgages and repays the bridging finance. The aim is to achieve a 'technical' novation of the loan for a short period of time, even though there is an arrangement in place to replace the loans in short order. It is not clear whether such an arrangement would fall with the terms of the concession. We note in this context the general caveat that a concession will not be given in any case where an attempt is made to use it for tax avoidance.
- 5.8 It was previously possible to request non-statutory clearance from HMRC that TCGA 1992 s 162 and ESC D32 would apply on the incorporation of a business. However, since around April 2018, HMRC has no longer given clearance on the availability of incorporation relief (or ESC D32). Thus, any reliance on ESC D32 to depart from the strict wording of the legislation at TCGA 1992 s 162 creates uncertainty concerning the calculation of and availability of incorporation relief.<sup>4</sup>
- 5.9 We also note Spotlight 63 that considers hybrid/mixed partnership/LLP structures and also recent articles highlighting activity in relation to property incorporations that raise issues such as the transfer of a mortgage from an individual to the company and if so, whether lender consent was obtained, and whether SDLT or the equivalent was paid on the transfer. This activity seems to us, in part at least, to be driven by the uncertain application of the concession.

---

<sup>3</sup> <https://www.gov.uk/hmrc-internal-manuals/capital-gains-manual/cg65745>

<sup>4</sup> HMRC recently issued a ['one-to-many' letter to landlords](#) that included a claim for incorporation relief on their 2017/18 return. The letter does not include any reference to ESC D32, nor draw any attention to the potential for the assumption / transfer / refinancing of mortgages to be treated as additional consideration. The exact arrangements HMRC are targeting in the letter are unclear; the letter potentially adds to the uncertainty around the application of the concession.

## **6 Acknowledgement of submission**

6.1 We would be grateful if you could acknowledge safe receipt of this submission.

The Chartered Institute of Taxation

28 February 2024