CHAPTER 18

INTRODUCTION TO PARTNERSHIPS

18.1 Definition of a partnership

A partnership is "two or more individuals working together in a business with a view to making a profit". The strict definition is within the Partnership Act 1890 which defines a partnership as the relationship which exists between persons **carrying on a business in common with a view to profit.**

One of the individuals does not employ the other. Partners work together and if the business does well they will **share profits,** and if the business does poorly they will **share losses**. It is important to realise that **joint ownership is not sufficient to create a partnership** – the individuals must actually be carrying on a business in common with a view to profit.

18.2 Partnership agreement

Partnerships ideally should have a partnership agreement. Not all partnerships have such a formal agreement, but this is far from ideal. The partnership agreement should lay out the partners' understanding of how the partnership should be governed. The agreement should cover, amongst many other things, **how the profits and losses of the partnership are going to be shared.** Profits could be shared equally, they could be 60:40 or some other split – it is whatever the partners decide.

The agreement will set out the rules on **admitting a new partner** to the partnership. Individuals could set up a partnership and they may decide to take in somebody else further down the line. The partnership agreement should address how this is to be accommodated.

The partnership agreement should also address the **retirement of a partner.** This may include notice periods, or some partnerships even have compulsory retirement when a partner reaches a certain age. There may also be detailed calculations of goodwill payments for the retiring partner.
The agreement will also cover the **conduct of partners** and the **ownership of assets.** Assets are not always owned equally between the partners – some more senior partners may have a greater share of the assets. The agreement should also cater for the **resolution of disputes**.

The partnership agreement should be drawn up at the commencement of a partnership and will detail the partners' understanding of how they see the partnership working. When partnerships commence it is normally on good terms, and therefore this is an ideal opportunity to draw up the partnership agreement.

As the partnership progresses, relations between partners may deteriorate and in these cases the partnership agreement becomes vital. The partners will be bound by the agreement they signed on commencement.

18.3 Types of partner

Full partners are those who share in the profits and losses of the partnership and who play an active part in running the business. These are sometimes referred to as **Equity Partners**. If the partnership does well, these partners make a good living. If it does poorly, they will not.

Salaried partners are partners who, to the outside world, appear to be partners. They appear on the letter-head as a partner but within the internal structure of the partnership they are effectively a **senior employee**.

Salaried partners would normally have a **fixed salary** and will therefore **not participate in the profit share** of the partnership. Likewise if the partnership makes a loss, they will not bear any of the loss. Their salary is taxed as employment income, as is the case for other employees of the firm. Salaried partners are effectively a **cost** for the equity partners. In practice, becoming a salaried partner is normally a stepping stone for senior managers to obtain equity status. They become a salaried partner first and then prove themselves or serve their time as a salaried partner, and at some point they may be invited to become an equity partner in the practice.

Sleeping partners are partners who **share the profits and losses** of the partnership but **play no part** in the running of the business.

Limited partners also play no part in the running of the business and share in the profits and losses. One peculiar point about limited partners is that should the partnership make a loss the limited partners' share is **restricted to the capital he or she introduced to the business** – they effectively have limited their exposure to losses.

Corporate partners are partners who are a corporate body. It is quite common to have a limited company as a partner for various tax planning possibilities.

18.4 Tax treatment

In looking at the tax treatment of partners, we are only considering **full equity partners**. Salaried partners would not affect this position at all.

ITTOIA 2005, s. 848

The first step is to **adjust the accounting profit** to arrive at the taxable trading income. If a partnership has accounts for the year ended 31 March 2011 which show a profit of £110,000, initially we must adjust this accounting profit for any Trading Income adjustments, capital allowances etc to arrive at taxable profits.

ITTOIA 2005, s. 849

Here Trading Income adjustments of £10,000 are added back in respect of expenses which are not allowable for tax (depreciation, client entertaining etc). Capital allowances of £5,000 are claimed on plant and machinery used in the partnership, to give tax adjusted profits for the year ended 31 March 2011 as follows:

y/e 31 March 2011	
	£
Accounts profit	110,000
Disallowable expenses	10,000
	120,000
Capital allowances	(5,000)
Tax adjusted profits	115,000

The next step is **to allocate the tax adjusted profits to the partners**. The partners may allocate the profits of the practice in whatever proportions they agree. Profits are allocated according to the **profit sharing ratios for the accounting period**.

ITTOIA 2005, s. 850

For example, assume that for the year ended 31 March 2011, A, B and C agree to share profits £40,000 to A, £45,000 to B and £30,000 to C. This is an allocation based on the accounting year – it has nothing whatsoever to do with the tax year. Once allocated, these profit shares would be **shown on the partnership tax return** for 2010/11. The accounting year to 31 March 2011 falls within the current year basis of assessment for 2010/11, hence a partnership return is required for 2010/11.

Once the allocation and partnership return are completed, we need to refer to the **individual's self assessment returns**. Partners A, B and C need to prepare individual self assessment returns for 2010/11. The profits they need to put on their individual returns should be **identical to those recorded on the partnership return**.

Partner A will therefore have £40,000 of partnership profits in his 2010/11 self assessment return, and he will show this as profits earned for the year ended 31 March 2011. Similarly Partner B must show £45,000 on his self assessment return and Partner C must show £30,000 on his return.

It is then the **individual partners who must pay tax based on the profits** recorded on their self assessment returns. The **partnership does not have a tax liability** – the partnership simply records the individual partners' profits and then the individual **partners settle their own taxes**.

Illustration 1

Albert, Billy and Clare are in partnership sharing profits equally. The partnership profits for the year ended 31 December 2010 are £160,000. The accounts include depreciation of £10,000 and customer entertaining of £5,000. The tax written down value of the general pool at 1 January 2010 was £42,500.

The first step in partnership computations is always to **adjust the accounting profit** for tax purposes.

	£
Profit per accounts	160,000
Add: Depreciation	10,000
Entertaining	5,000
	175,000
Less: Capital allowances	
(£42,500 x 20%)	(8,500)
Adjusted profit	166,500

The adjustments are the same as we make in a sole trader's tax computation.

Once we have the adjusted profits, we then move on to step 2 – the **allocation.** We allocate profit for the **accounting year based on the profit sharing ratio (PSR) that the partners will have previously agreed**. Here they agreed to equal shares, ie £55,500 per partner. Therefore on the partnership return, the profit allocation will be shown as £55,500 to each of Albert, Billy and Clare.

The final step is to look at the **individual partners' self-assessment returns.** If we just consider Albert, the partnership return shows that he is entitled to profits of £55,500 for the year ended 31 December 2010. Under current year basis, this year falls in the tax year 2010/11. Therefore on Albert's self-assessment return for 2010/11, he records £55,500 as his partnership profit. This is then treated as Trading Income and taxed in the normal way.

So in summary there are **three steps** to partnership computations:

(i) **adjust** the accounts for tax purposes;

(ii) **allocate** the trading income between the partners based on the profit sharing ratio for the accounting period; then

(iii) **deal with the individual partners as though they were sole traders** (ie taxing their profit share on a current year basis).

Remember that a partnership is required to complete an **annual return**, but it is not a taxable entity in itself so there is **no concept of a partnership tax liability**. It is the individual partners who pay the tax.

TMA 1970, s. 12AA

18.5 Sharing profits - terminology

Let us now look at terminology in a partnership situation. **Drawings** are simply the amount that partners draw on account of their profit share. Partners do not know how much they have earned until the end of the accounting year, but they cannot expect to wait until the end of the accounting year to take their money.

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Therefore during the year they draw amounts, normally monthly, on account of their profit share. As the partners are taxed on their profit share, their periodic **drawings should be ignored** in the tax computation. Normally profit per the accounts excludes any reference to drawings. Drawings normally appear on the balance sheet. They have no effect on profit and they should not appear anywhere in our computations.

Some partnerships may agree that certain partners are entitled to an initial allocation of profit. They may refer to this as a "**partner's salary"**. Do not be confused by the word "salary". Such "salary" payments are **not taxed as employment income as the partners are self employed – they are not employees**.

The partners are simply saying "before we allocate profit, Joe is entitled to an initial allocation of £5,000". This may be for a number of reasons. It might be seniority, for example the senior partner gets an initial share of £5,000 with the balance being shared equally between the partners. It may be that a certain partner works longer hours or a certain partner brings more work into the partnership. A "salary" is **just a way of giving a partner a priority allocation of the Trading Income.**

Interest on capital may be paid to partners under the terms of the partnership agreement. This is treated in exactly the same way as partners' salary. Again it is just an **initial allocation of profit** before the general sharing ratios apply. Do not be confused by the term "interest". It is **not really interest as we know it** –it is just a chunk of advance profit based on balances the partners hold on their capital account, or amounts otherwise loaned by the partners to the partnership. We simply treat such "interest" as a share of Trading Income.

Consider, for example, a three partner firm where two of the partners have capital accounts of £50,000. Capital accounts are effectively undrawn profits – i.e. money the partners have left in the business to fund working capital etc. If the third partner has a capital account of £200,000, this partner has obviously contributed more to the working capital or asset base of the partnership, and therefore he should be remunerated accordingly. The way partnerships achieve this is by a **priority allocation** of profit. They will call it "interest on capital" because they have used capital balances to work out the amount. However, as far as we are concerned, it is a **priority allocation of Trading Income**. It is not taxed as Savings and Investment Income.

Illustration 2

Max and Harry are in partnership. Profits for the year to 31 October 2010 are £120,000. Max and Harry have agreed to share profits 60:40, but this is after paying a salary of £7,000 p.a. to Max because he works longer hours. Interest on capital of £3,000 p.a. is paid to Max and £5,000 pa is paid to Harry. Harry has the higher capital account, therefore his interest on capital is higher.

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During the year Max drew £50,000 and Harry drew £48,000 on account of their profit shares. Partner's drawings are shown as a reduction in their capital account and will be reflected on the partnership balance sheet.

This information on drawings is irrelevant as far as the tax computations are concerned. Max and Harry will pay tax on their profit share. When and how they draw these profits has no bearing on their tax liabilities.

The allocation of profits between Max and Harry is done based on profit sharing ratios (PSR) for the **accounting period,** ie for the year ended 31 October 2010. Trading Income is £120,000. These have already been adjusted for tax purposes, so effectively we are starting here from step 2 – the allocation.

Max has a salary of £7,000, so £7,000 is his prior allocation of profits. Partner's interest is £3,000 to Max and £5,000 to Harry - again just pre-allocations of the Trading Income. That leaves us with £105,000 of "residual profit" to share between Max and Harry in their profit sharing ratios for that accounting year. They have agreed to share profits 60:40, i.e. £63,000 to Max and £42,000 to Harry.

Y/e 31 October 2010	Total	Max	Harry
	£	£	£
Trading Income	120,000		
Partners salary	(7,000)	7,000	
Partners interest on capital	(8,000)	3,000	5,000
"Residual profit"	105,000		
Shared equally	(105,000)	63,000	42,000
		73,000	47,000

y/e 31 October 2010
∴ 2010/11

The total profit share for Max is £73,000 and for Harry is £47,500. These figures will be entered on the partnership tax return. The individual partners would show this amount on their personal returns for 2010/11, because (under CYB) the year ended 31 October 2010 falls in the tax year 2010/11.

18.6 Other partnership income

Partnership trading income is assessable as Trading Income based on the profit sharing ratios in the accounting period.

Where we have **other untaxed partnership income**, such as Property Income, Savings and Investment Income or miscellaneous income, this is **chargeable on the same current year basis** as the Trading Income.

Once we have identified the untaxed partnership income for the accounting period, we then apportion this income to the partners based on their profit sharing ratios for that accounting period. The partners are then taxed on the untaxed partnership income using CYB rules.

Other untaxed income is treated as a **second deemed trade** or profession. Therefore, **changes** in sources within the untaxed partnership income are of **no consequence.** For example, the practice may sell a specific property and therefore, rental income from that particular source will stop. This does **not create a cessation of the second deemed trade.**

However, the **normal commencement, cessation and overlap rules** will apply when **partners join or leave the practice.** For example, when a partner **joins or leaves** a partnership, their **property income will be allocated to tax years using the normal opening and closing year rules** that we apply to trading income. This can give rise to **overlap profits** in the opening years which will either be relieved when the partnership changes its accounting date closer to 5 April, or when that partner leaves the partnership.

Taxed income received by the partnership (such as bank interest and dividends), is **allocated to the partners using the profit sharing ratio of the accounting period** and is then **apportioned to the tax year**.

S.203 ITTOIA 2005 allows us to **allocate taxed income to the tax year on a time-apportionment basis.** In other words, the taxed income for the period covering the tax year from the 6th April to the following 5th April, is found by apportioning the income allocated to the partners from the set, or more likely two sets of accounts, that cover this period.

Strictly S.203 only applies if it is necessary to use a time basis. It could be argued that as taxed income such as net interest and dividends has a receipts basis, **the income should be allocated to the tax year in which it was actually received**. As the next illustration shows, different methods give us different results.

This is very different from the normal rules for assessing partnership income.

In practice the amount of partnership income which suffers tax at source is likely to be very small - bank interest is probably the most common.

Illustration 3

David and Edward are in partnership sharing profits 60:40.

For the year ended 31 December 2010 results were:

		£	£
Trade profits			40,000
Rental income			8,000
Net dividends:	January 2010	180	
	August 2010	90	
			270
Total			48,270

How will the above income be taxed?

First each type of income is apportioned to each partner based on their profit sharing ratios of 60:40 as follows:

	Total	David	Edward
	£	£	£
Trade profits (60:40)	40,000	24,000	16,000
Rental income (60:40)	8,000	4,800	3,200

Both the trade profits and the rental income from year ended 31 December 2010 are then taxed on David and Edward in 2010/11 under the current year basis.

The dividends are **taxed income and are not assessed under the current year basis**. Instead the dividends are **apportioned into the relevant tax years**.

S.203 ITTOIA permits the **apportionment to be on a time basis**.

		Total	David	Edward
		£	£	£
Dividends (60:40)	Jan 2010	180	108	72
	Aug 2010	90	54	36
		270	162	108

	David	Edward
2009/10:	£	£
1 January 2010 – 5 April 2010 = 3m		
3/12 x £162 and £108	41	27
2010/11:		
6 April 2010 – 31 December 2010 = 9m		
9/12 x £162 and £108	121	81

These net amounts would then be declared on David & Edward's SA returns for the relevant years.

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However, as dividends have a receipts basis, the strict method of apportionment could also be used. This will allocate dividends to tax years based on the date the **dividends were actually received**, i.e.

	David	Edward
2009/10:	£	£
Jan 2010 dividend received	108	72
2010/11:		
Aug 2010 dividend received	54	36

Again these net amounts would be declared on David & Edward's SA returns for the relevant years.

You will see that whichever method is used, £270 of dividends are charged to tax. However, the method adopted affects both the way the income is allocated and the tax year in which the income is assessed.

In the examination, either method will be acceptable. In practice the first method of apportionment (i.e. on a time basis), is usually adopted.

Occasionally you may see employment income within a partnership situation. For example, this may occur when a partner holds a **non-executive directorship role in a client company**.

Strictly this income is taxable as employment income, but HMRC accept a request to **include income under the current year basis rules in a partnership**.

This is done under ESC A37 which grants the Trading Income treatment, provided that the directorship is a **normal incident of the profession and of the particular practice concerned.** Also the fees must only be a **small part of the profits** and these fees must be **pooled for division among the partners**.

Where partnerships are looking to apply ESC A37, they are normally expected to provide HMRC with a written undertaking that director's fees received in full will be included in the gross income of the basis period, whether or not the directorship is still held in the year of assessment and whether or not the partner concerned is still a partner.

Finally, one word of caution. Do be aware that the **IR35 rules can apply to partnerships** in very distinct circumstances. The detailed IR35 rules can be found in your personal income tax course.

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Example 1

Katie, Leo and Martha are partners and they share profits 40:30:30. In the year to 31 March 2011, the partnership showed a profit of £262,000. The accounts include depreciation of £21,000. The tax written down value on the general pool at 1 April 2010 was £40,000.

Calculate the partners' Trading Income assessments for 2010/11.

Example 2

Peter, Quentin and Rupert are in partnership sharing profits 35:25:40. Quentin is also entitled to a salary of £10,000 whilst Rupert has £4,000 as interest on his capital account. The tax adjusted profits for the year to 28 February 2011 were £190,000.

Calculate the partners' Trading Income for 2010/11.

Answer 1

Step 1 – Adjust accounts profits

	£
Y/e 31 March 2011	
Profit per accounts	262,000
Add: Depreciation	21,000
Less: Capital allowances (£40,000 x 20%)	(8,000)
Adjusted profits	275,000

Step 2 – Allocate profits

	£
Katie (40%)	110,000
Leo (30%)	82,500
Martha (30%)	82,500
	275,000

Step 3 – tax the individual partners

Y/e 31 March 2011 ends within 2010/11, so the partners are taxed on the allocated profits within Step 2 in that tax year.

Answer 2

	Total	Peter	Quentin	Rupert
Y/e 28 February 2011	£	£	£	£
Tax adjusted profits	190,000			
Salary	(10,000)		10,000	
Interest on capital	(4,000)			4,000
"Residual profit"	176,000			
Split 35:25:40	(176,000)	61,600	44,000	70,400
	Nil	61,600	54,000	74,400

y/e 28 February 2011
∴ 2010/11