CHAPTER 19

PARTNERSHIP CHANGES

Statutory references are to ITTOIA 2005 unless stated otherwise

19.1 Introduction

If there are any **changes in profit sharing ratios** in a partnership, these will affect the allocation of profits within that accounting period. The basic principles still apply for the partnership. First we **adjust** the accounting profit for tax purposes to arrive at an adjusted profit. We then **allocate** the taxable profit between the partners in the profit sharing ratios in that accounting period. ITTOIA 2005, s. 850

Having done that, we then **treat the partners as individuals** who pay their own tax through their self assessment returns.

19.2 Changes in profit ratios

Partners may change their profit allocation ratios **part way through** an accounting period. For instance, there may be an internal agreement whereby the partners feel that the profit allocations need to be adjusted to reflect the current performances of the partners.

For tax purposes, the only effect that a change in ratios has is on the **allocation step** – that is step 2.

In step 2, when we are allocating profits we need to **split the accounting period around the change** (or changes if there are more than one). We then deal with these periods separately and use the **ratios applying for that particular period** to determine the profits to be allocated to each partner. The combined profit from those split periods will give us the allocation for the whole of the accounting period.

Illustration 1

During the year to 31 December 2010, two partners initially share profits 60:40 but on 1 July 2010 they decide to change their ratio to 50:50. We therefore have a change in profit sharing ratio within the accounting period. For allocation purposes, we split the accounting period into two periods – pre change and post change. For the six months to 30 June 2010, 6/12ths of the profits will be allocated 60:40. Post change, from 1 July 2010 to 31 December 2010, 6/12ths of the profits will be allocated 50:50.

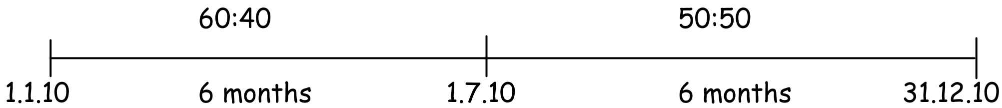

Illustration 2

Anne, Bella and Helen are in partnership sharing profits 40:30:30. In the year to 30 September 2010 the adjusted profit is £180,000. On 1 July 2010 the partners agreed to change their profit sharing ratios to 35:25:40.

In order to deal with the profit allocation for the year to 30 September 2010, we need to split the accounting period around the change and deal with the two periods separately.

	Total	Anne	Bella	Helen
	£	£	£	£
1.10.09– 30.6.10 (9m)				
Adjusted profit				
$\frac{9}{12}$ x £180,000	135,000			
Ratio 40:30:30	(135,000)	54,000	40,500	40,500
1.7.10 – 30.9.10 (3m)				
Adjusted profit				
$\frac{3}{12}$ x £180,000	45,000			
Ratio 35:25:40	(45,000)	15,750	11,250	18,000
		69,750	51,750	58,500

y/e 30 September 2010
∴ 2010/11

The partners are deemed to have the above profits for the year ended 30 September 2010 and will be taxed on these profits under CYB in 2010/11 via their self-assessment returns.

19.3 Further issues

When given partner's salaries or interest on capital, these are normally **annual figures**. Therefore if we are told that a partner is entitled to a salary of £5,000, this means **£5,000 per annum**. We know that this is not a "true" salary - it is just a prior allocation of profits.

When we are given **salaries or interest on capital in a non 12 month period**, we must **pro rate those annual figures**. When dealing with changes in ratios part way through an accounting period, you will be looking at periods which are less than 12 months. In the previous illustration, we had a 9 month period and a 3 month period making up the 12. If there were salaries paid to partners, we would need to pro rate them, ie take 9/12ths of the annual salary for the first period and 3/12ths of the annual salary for the second period. Once again if there are partner's salaries or interest on capital, these will only affect the allocation step.

Illustration 3

Jack, Kevin and Louis are in partnership and have adjusted profits for the year to 30 April 2010 of £210,000. Up to 31 December 2009, the partners shared profits equally after charging a salary for Jack of £12,000 per annum. With effect from 1 January 2010, Jack's salary is to be reduced to £9,000 per annum and Kevin is to receive interest on capital of £3,000 per annum. Residual profits are shared equally.

	Total	Jack	Kevin	Louis
1.5.09 – 31.12.09 (8m)	£	£	£	£
Adjusted profit				
(8/12 x £210,000)	140,000			
Salary (8/12 x £12,000)	(8,000)	8,000		
	132,000			
Ratio 1:1:1	(132,000)	44,000	44,000	44,000
1.1.10 – 30.4.10 (4m)				
Adjusted profit				
(4/12 x £210,000)	70,000			
Salary (4/12 x £9,000)	(3,000)	3,000		
Interest (4/12 x £3,000)	(1,000)		1,000	
	66,000			
Ratio 1:1:1	(66,000)	22,000	22,000	22,000
		77,000	67,000	66,000

y/e 30 April 2010
∴ 2010/11

The self-assessment return for the partners for 2010/11 will include their allocated profits for the year to 30 April 2010 on the current year basis. This same method would apply if there were two changes in the year – there would be two splits, so three different allocations within the same year.

Example 1

Sarah, Tim and Joe are in partnership. Adjusted profits for the year to 31 May 2010 are £300,000. Up to 31 October 2009, the partners share profits 35:30:35 after charging a salary for Tim of £12,000 per annum.

With effect from 1 November 2009, Joe is to receive a salary of £8,000 per annum and Tim's salary is reduced to £10,000 per annum. The profit sharing ratios were amended to 40:35:25.

Calculate the profit allocated to each of the partners for the year to 31 May 2010.

Example 2

Adam, Ben and Charles are in partnership and their adjusted profits for the year to 30 November 2010 were £105,000. Their profit sharing ratios are as follows:

	A		B		C
1.12.09 – 30.4.10	30	:	44	:	26
1.5.10 – 31.8.10	30	:	40	:	30
1.9.10 – 30.11.10	32	:	33	:	35

Charles is also credited with a salary of £5,000 from 1 September 2010.

Calculate the profit allocation for the partners for the year to 30 November 2010.

Answer 1

	Total	Sarah	Tim	Joe
	£	£	£	£
1.6.09 – 31.10.09 (5m)				
Adjusted profit				
(5/12 x £300,000)	125,000			
Salary (5/12 x £12,000)	(5,000)		5,000	
	120,000			
Ratio 35:30:35	(120,000)	42,000	36,000	42,000
1.11.09 – 31.5.10 (7m)				
Adjusted profit				
(7/12 x £300,000)	175,000			
Salary (7/12 x £10,000/8,000)	(10,500)		5,833	4,667
	164,500			
Ratio 40:35:25	(164,500)	65,800	57,575	41,125
		107,800	104,408	87,792

Answer 2

	Total	Adam	Ben	Charles
	£	£	£	£
1.12.09 – 30.4.10 (5m)				
Adjusted profit				
(5/12 x £105,000)	43,750			
Ratio 30:44:26	(43,750)	13,125	19,250	11,375
1.5.10 – 31.8.10 (4m)				
Adjusted profit				
(4/12 x £105,000)	35,000			
Ratio 30:40:30	(35,000)	10,500	14,000	10,500
1.9.10 – 30.11.10 (3m)				
Adjusted profit				
(3/12 x £105,000)	26,250			
Salary (3/12 x £5,000)	(1,250)			1,250
	25,000			
Ratio 32:33:35	(25,000)	8,000	8,250	8,750
		31,625	41,500	31,875