CHAPTER 21

PARTNERSHIP LOSSES

Statutory references are to ITA 2007 unless stated otherwise

21.1 Introduction

There is no change to the basic partnership principles we adopt if the partnership makes a loss. We still **adjust** the accounts for tax purposes to arrive at a tax adjusted loss. We then **allocate** the loss between the partners in accordance with the profit sharing ratios for that accounting period. Once the allocation is complete, we **treat the partners as individual sole traders**.

ITTOIA 2005, s. 849

If the partnership makes a loss, once the loss has been allocated, **each partner** is then able to **claim loss relief based on his or her own personal circumstances. There is no concept of a "partnership loss" – the loss belongs to the partners** and loss relief claims are made **individually**. They could claim:

ITTOIA 2005, s. 850

a) S.64 relief – losses set against net income of the year of loss and/or the preceding year (and thereafter a claim could be made to carry the loss back a total of 3 years against trading income if the loss relates to either the 2008/09 or 2009/10 tax year).

b) S.71 and s.261B TCGA 1992 relief - losses set against capital gains in the year, after a s.64 claim has been made.

c) S.83 - losses carried forward against future profits from the partnership.

d) A new partner could claim s.72 relief – a loss of any of the first 4 tax years of trade is carried back against net income of the 3 preceding years.

e) A retiring partner could claim terminal trade loss relief under s.89.

Illustration 1

John and Matt are in partnership sharing profits and losses equally. In the year to 31 December 2010 the partnership had an adjusted loss of £30,000. Partnership profits in the previous year were £4,000. John has annual income of £20,000 from the letting of a freehold property he bought 10 years ago. Matt has a small investment portfolio which realises £2,000 of income every year.

We will consider the optimum loss claims in these circumstances.

Initially we allocate the loss in the loss sharing ratio. John and Matt share losses equally, so they are deemed to have a trading loss for the year ended 31 December 2010 of £15,000 each. This is a loss of the tax year 2010/11.

John could carry his loss of £15,000 forward against profits from the same trade, i.e. from the partnership. As an alternative he could claim s.64 relief. The year of loss is 2010/11, so s.64 relief could be claimed against other income for 2010/11 and/or the preceding year, 2009/10.

When dealing with losses, we should assume that individuals want relief **as soon as possible**. In John's case he has partnership profits of £2,000 in 2009/10 - i.e. 50% of £4,000. He has no trading profits in 2010/11 because the partnership made a loss. John also has property income of £20,000 each year.

	2009/10	*2010/11*
	£	£
Trading Income	2,000	Nil
Property Income	20,000	20,000
Net Income	22,000	20,000
Less: S.64 losses	(15,000)	or (15,000)
Revised Net Income	7,000	5,000

It is therefore possible for John to submit a s.64 loss relief claim for 2010/11 and/or 2009/10. If John made a s.64 current year claim against his rental income in 2010/11, this would reduce his income for the year to £5,000. Alternatively, John could claim s.64 loss relief against his income for 2009/10. This would reduce his income in 2009/10 to £7,000.

The latter (carry back to 2009/10) would probably be the preferred claim. John receives his **loss relief sooner**, and he also has **full utilisation of his personal allowances in both tax years**. If John were to claim s.64 current year relief in 2010/11, he would waste some of his personal allowance.

Alternatively **s.83** (carry forward) **could be claimed if John believes that partnership profits will increase significantly** in the year to 31 December 2011. It could be that the partners expect their profits to be in the higher rate band in that year, and consequently a s.83 claim may be preferable in those circumstances. Whatever claim John decides to make, he is **not bound by the other partners' loss claims.**

Matt has the same loss, £15,000. He too could carry it forward under s.83, or he could also claim s.64 relief for 2010/11 and/or 2009/10. Matt's tax position is slightly different to John's in that he has no significant other income. There should be no s.64 loss claim for Matt as his income is already covered by his personal allowance – a s.64 relief claim would waste his personal allowance.

Matt would be **best advised to carry his loss forward under s.83.** Losses would reduce Matt's share of partnership profits in 2011/12. The loss is not carried forward in the partnership - it is carried forward by Matt to set against his own partnership profits.

21.2 New partners and losses

When a new partner joins a partnership, he is subject to the **commencement rules** as we saw in the previous chapter. If the partnership makes a loss and consequently a loss is allocated to the new partner, then he will be treated as a sole trader who commences his business and makes a loss in his early years. Consequently **s.72 early trade loss relief is available to this partner in addition to relief under s.64 (current year /carry back), s.83 (carry forward) and s.71 (capital gains)**.

Any of the above claims could be made by a new partner - it is entirely up to him or her which claim to make. Remember s.72 claims can be made where a loss is incurred in any of the first 4 tax years of a business. The loss is carried back against net income of the 3 years preceding the year of the loss on a FIFO basis, and the loss is set against the earlier years first.

Illustration 2

Matilda and Grace are in partnership sharing profits and losses equally. On 1 July 2009, Linda joined the partnership and profits and losses continued to be shared equally. In the year to 30 June 2010 the partnership made a loss of £33,000. There was a profit of £60,000 in the preceding year. Matilda and Grace have no other income, but prior to joining the partnership Linda earned £50,000 per annum as a client manager in a recruitment agency.

The partners share the losses equally, ie, £11,000 loss to each partner for the year ended 30 June 2010. Matilda and Grace have been partners for many years so for 2010/11 they have losses of £11,000 each. Linda however, joined the partnership on 1 July 2009, therefore she is subject to the opening year rules.

In the year to 30 June 2009, Matilda and Grace had profits of £30,000 each. There are no trading profits in the year to 30 June 2010.

	2009/10	*2010/11*
Trading Income	£	£
Y/e 30.6.09	30,000	
Y/e 30.6.10		Nil
S.64 carry back loss relief	(11,000)	—
Revised net income	19,000	Nil

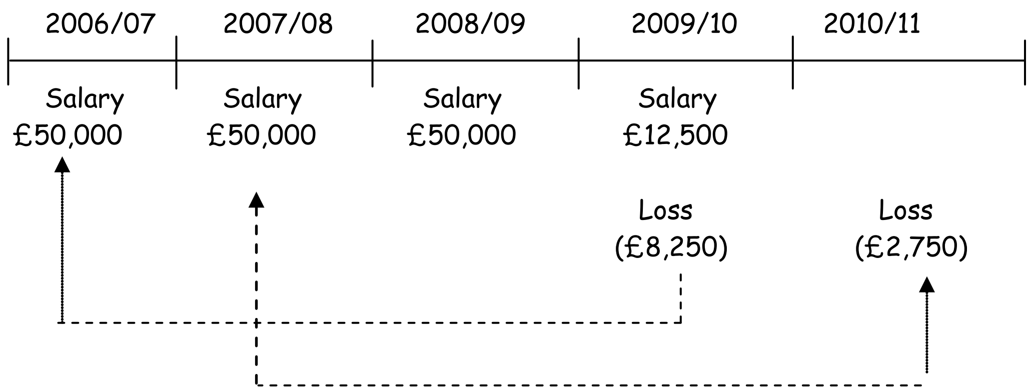
The partners have the option of making a s.64 claim against net income for 2010/11 and/or 2009/10. There is no point in making a s.64 current year claim for 2010/11, as there is no income in 2010/11 to offset the loss against. The partners will instead claim s.64 carry back loss relief for 2009/10. This reduces their profits in 2009/10 to £19,000. The loss would therefore have enjoyed relief at 20%.

If Matilda and Grace feel that partnership profits are likely to suffer higher rates of tax in future years they may consider a s.83 carry forward claim instead. Alternatively, Matilda could opt for a s.64 claim whilst Grace may choose a s.83 claim or vice versa - it is entirely their **own decision**.

Linda on the other hand has a different set of CYB rules to consider. In the year ended 30 June 2010 she also made a loss of £11,000. Linda joined the partnership on 1 July 2009 - therefore 2009/10 is her year of commencement. Opening year rules will apply to determine the losses to be allocated to the relevant tax years:

2009/10:	
1.7.09 – 5.4.10	
9/12 x (11,000)	(8,250)
2010/11:	
12m to 30.6.10	(11,000)
Less: allocated to 2009/10	8,250
Loss of 2010/11	(2,750)

In the years up to joining the partnership Linda earned £50,000 per annum. We have determined that Linda has a loss in 2009/10 of £8,250 and a loss in 2010/11 of £2,750.



S.72 carry-backs

Dealing with the earlier loss of 2009/10 first, Linda has many options. She could simply carry forward under s.83 against her first available profits from the partnership. Alternatively, she could claim s.64 current year loss relief against her income in 2009/10 (£12,500) and/or s.64 carry back loss relief claim against her employment income of £50,000 in 2008/09.

Linda also has the option of claiming s.72 relief against her employment income of £50,000 in 2006/07, that being the earlier year of the 3 preceding years. In this example Linda **may well choose to make a s.72 claim** in preference to any other claim. It gives her relief **earlier** and leaves the later years, 2007/08 and 2008/09 in tact for any future s.72 claims should the partnership continue to make losses. The loss would obtain relief **at 40%** in 2006/07.

Linda also has a loss of £2,750 in 2010/11, which again she could carry forward against future profits from the partnership. Alternatively she could claim s.64 relief against net income in 2010/11 and/or the preceding year 2009/10. There is no other income in 2010/11 so the only viable s.64 claim is against the employment income of £12,500 in 2009/10. A claim under s.64 would not therefore be relieving at the highest rates.

A more efficient claim for Linda would be under s.72 against the income of 2007/08, that is the earliest year of the 3 preceding years. Such a claim would achieve **40% loss relief** on the £2,750.

We can see that a **new partner** joining a practice is **treated exactly like a new sole trader.** Effectively **there are no new rules to learn for partnerships.** We know the sole trader rules so therefore we know the partnership rules - they are the same.

21.3 Retiring partners

A retiring partner who leaves the partnership will be subject to the CYB cessation rules. The partnership will continue as normal, but the individual partner who is retiring will be **subject to CYB cessation rules.** If a loss arises in the year of retirement, s.89 **terminal trade loss relief is available.** This is **in addition to normal loss relief** under s.64. Under s.89, the loss in the **final 12 months of trading** is deducted in calculating a person's trading income in the tax year of cessation and the previous **three years** on a **LIFO basis**, so later years would utilise the losses first.

Illustration 3

Mark, Tara and Roger are in partnership sharing profits and losses equally. In the year to 30 September 2010 the partnership made a loss of £60,000. Roger retired from the partnership on 30 September 2010.

The partnership had previously been profitable making tax adjusted profits of £90,000, £30,000 and £12,000 for 2007, 2008 and 2009 respectively. The partners had no other income. Roger had overlap profits brought forward of £6,000.

The accounting profits have already been adjusted. The next step is therefore to allocate the profits or losses. Once allocated we treat the partners as individuals. In this case as Roger has retired from the partnership, this will be treated as a CYB cessation.

The allocation is simply a one-third split of the total partnership profit or loss in each year. This is made easier because Roger retired on the final day of the accounting period so we do not need to split the period either side of the change in ratios.

Roger:	Profit/(Loss)	Overlap	
	£	£	
Y/e 30.9.10	(20,000)	+ (6,000) =	(26,000)
Y/e 30.9.09	4,000		
Y/e 30.9.08	10,000		
Y/e 30.9.07	30,000		

Roger retired from the partnership on 30 September 2010, which is in the tax year 2010/11. On a cessation, overlap relief is available. £6,000 of overlap profits are **added** to the final loss. Roger's loss is therefore £26,000 for 2010/11.

Roger's trading profits for 2007/08, 2008/09 and 2009/10 are as follows:

	2007/08	*2008/09*	*2009/10*	*2010/11*
	£	£	£	£
Trading income	30,000	10,000	4,000	Nil

For the £26,000 loss of 2010/11, Roger has the option of claiming s.64 carry back loss relief in 2009/10. The trading profits allocated to Roger in 2009/10 were only £4,000. Therefore there is **no point in making a s.64 claim** in 2009/10 as profits are **covered by personal allowances.** We should therefore look at terminal loss claims under s.89.

S.89 losses are offset in the year of the loss (2010/11) and then are carried back 3 years on a LIFO basis against trading income.

As Roger's final accounting period is exactly 12 months long, his terminal loss will be the same as the amount of loss allocated to 2010/11, which in this case is £26,000.

Loss Memo	£
Terminal loss	(26,000)
2010/11	Nil
2009/10	4,000
2008/09	10,000
2007/08	12,000
	-

£4,000 of the losses must be relieved in 2009/10. Personal allowances are lost in 2009/10, but that is the price that Roger must pay for being able to carry back the loss to earlier years. He cannot "opt out" of 2009/10.

We next carry £10,000 of losses back to wipe out profits in 2008/09. The remaining losses (£12,000) are used in 2007/08.

21.4 Notional losses

In some cases, **profit allocations may create a loss** for a partner in a year when the **partnership as a whole made a profit**. This could arise where the partners have agreed high salaries, but in a particular year, profits may be low. Where salaries exceed profits, losses will be created within the partnership. These losses are known as "**notional losses"** – i.e. no loss exists in real terms but one has been artificially created because of the way salaries have been allocated. The partnership as a whole makes a profit, but an individual partner may be showing a loss.

HMRC **does not allow relief for these notional losses.** Consequently these notional losses must be **reallocated to the other partners** who are showing a profit. The reallocation is based on the **ratio of profit allocated** to the other partners in the year. ITTOIA 2005, s. 850A

Illustration 4

Stan, Arthur and Jake are in partnership sharing profits, 30:37:33 after charging salaries to Stan and Arthur of £15,000 pa and £12,000 pa respectively. In the year to 30 September 2010 the partnership made a profit of £20,000.

The profit for the partnership as a whole is lower than the salaries to be allocated to Stan and Arthur. Whenever this occurs there will be a **notional loss**, in this case for Jake.

We first allocate the £20,000 profit between the partners in the usual way.

The profit for the year was £20,000. Salaries were £27,000. This leaves a **residual loss** of £7,000 to be shared between the partners in the ratio, 30:37:33.

	Total	Stan	Arthur	Jake
	£	£	£	£
Y/e 30.9.10				
Profit	20,000			
Salaries	(27,000)	15,000	12,000	
Residual loss	(7,000)			
Ratio 30:37:33	7,000	(2,100)	(2,590)	(2,310)
		12,900	9,410	(2,310)
				Notional loss

Jake seems to have made a loss of £2,310 in the year. This is a **notional loss** as the partnership as a whole has made a profit. HMRC will **not allow any loss relief for Jake**. The notional loss must therefore be **reallocated to Stan and Arthur**. It is reallocated in the **proportion of Stan and Arthur's profit share** in this particular year.

For Stan that will be:

$$\frac{12{,}900}{12{,}900 + 9{,}410} \times (2{,}310) = \underline{£(1{,}336)}$$

For Arthur that will be:

$$\frac{9{,}410}{12{,}900 + 9{,}410} \times (2{,}310) = \underline{£(974)}$$

The reallocation of the notional loss will therefore be as follows:

	Total	Stan	Arthur	Jake
	£	£	£	£
Y/e 30.9.10				
Profit	20,000			
Salaries	(27,000)	15,000	12,000	
Residual loss	(7,000)			
Ratio 30:37:33	7,000	(2,100)	(2,590)	(2,310)
		12,900	9,410	(2,310)
Reallocate notional loss		**(1,336)**	**(974)**	**2,310**
		11,564	8,436	Nil

Total = £20,000

Stan and Arthur's profit share now adds up to £20,000 (the partnership profit for the year). Jake has neither a profit nor a loss.

The same principles will apply if a partnership has a **loss** for an accounting period, but due to the provision of salaries, one of the partners seems to have made a profit. **HMRC will not tax a partner on an artificial profit in a period in which the partnership as a whole has made a loss.** In this instance, the **notional profit** will be reallocated to the other partners in exactly the same way as above. ITTOIA 2005, s. 850B

21.5 Sideways loss relief – 'non-active' partners

ITA 2007, s. 103-114

Finance Act 2004 contained legislation to counter tax avoidance arrangements which exploited relief for trading losses through partnerships. The legislation took effect from 10 February 2004 and is now contained in ss.110–114 ITA 2007. The changes were introduced to tackle schemes which exploit relief for trading losses from partnerships, which individuals can claim against their other income or gains.

The rules affect "**non-active" partners** in partnerships, including LLPs. A "non-active" partner is a partner who **did not spend a "significant amount of time" working in the partnership** when the losses arose. The rules will therefore affect part-time or "sleeping" partners. ITTOIA 2005, s. 103B

"Significant" is defined as an average of at least 10 hours per week; therefore a non-active partner spends less than 10 hours per week (on average) working in the partnership.

These provisions are known as "sideways loss relief". Sideways loss relief **restricts** the total amount of **loss relief** that can be claimed by a non-active partner **under s.64, s.71 and s.72 ITA 2007** (ie. against their net income and gains). The restriction does not apply to giving relief for the loss against the profits of that same trade. ITA 2007, s. 103

The first restriction applies to the **first four tax years of trade** only. A non-active partner's **cumulative loss relief claims under s.64, s.71 and s.72 ITA 2007** in their first four tax years of being a partner is **restricted to** the amount of their **"contribution" to the partnership**. ITA 2007, s. 110, 112

For this purpose the "contribution" to the partnership is calculated as: ITA 2007, s. 111

	£
Capital introduced	X
'Undrawn' profits	X
Amount payable on a winding up of the partnership	X
	X

HMRC excludes certain capital contributions when calculating how much a non-active partner has contributed to the partnership.

The excluded capital contributions are those paid by non-active partners on or after 2 March 2007 where the main purpose for the contribution was to increase the amount of sideways loss relief that could be claimed. ITA 2007, s. 113A(1),(3)

HMRC have also introduced a second restriction which applies to trading losses sustained as a non-active partner on or after 2 March 2007. There is now also an **annual limit** for the amount of **sideways loss relief** that can be claimed by a non-active partner.

This annual limit applies **in any tax year** and not just in the first four tax years of trade. The annual limit for each tax year is **£25,000**. ITA 2007, s. 103C

This means that in each of the **first four tax years of** trade the maximum sideways loss relief which can be claimed by a non-active partner is the **lower of**:

- **£25,000; or**
- **'Unrelieved' capital contribution**

The 'unrelieved' capital contribution simply means the amount of contribution which has not already been used up by previous sideways loss relief claims.

From the fifth tax year of being in the partnership onwards, sideways loss relief claims are only subject to the **annual limit of £25,000**.

Any trading losses that can not be relieved under s.64, s.71 (s.261B TCGA 1991) and s.72 ITA 2007 due to the above restrictions are simply carried forward under s.83 ITA 2007 without restriction.

Illustration 5

Mr and Mrs Fawlty run a small bed & breakfast business in Torquay which is within its first 4 tax years of trade. They are in partnership, sharing profits 50:50. Mr Fawlty contributed £20,000 to the business, but he is employed full-time as a Chartered Surveyor and therefore only helps out in the business at weekends, spending (on average) 8 hours a week in the partnership. Mrs Fawlty runs the business full-time.

In the year to 31 December 2010, due to a rat infestation, the partnership made a loss of £64,000.

The loss is allocated as follows:

	£
Mr Fawlty	(32,000)
Mrs Fawlty	(32,000)

As Mrs Fawlty is a full-time partner, she has unrestricted use of the loss of £32,000 and can claim relief under any of the loss provisions.

Mr Fawlty wishes to move his loss "sideways" against his employment income in 2010/11 by making a claim under s.64. However, as a non-active partner, his s.64 claim is restricted to his capital contribution (ie. £20,000). The rest of the loss (£12,000) must be carried forward under s.83 against his future trading profits from the partnership.

21.6 Sideways loss relief – 'limited partners'

It is possible for one or more partners to restrict their liability for partnership debts to the amount of their agreed capital contribution, providing there is at least one general partner with unlimited liability. The **'limited partner'** cannot take part in the management of the partnership. ITA 2007, s. 103A

Similar rules apply for restricting sideways loss relief for limited partners under s64, s.71 (s.261B TCGA 1992) and s.72 ITA 2007.

For a limited partner however, sideways loss relief is **restricted in every tax year** to the 'unrelieved' capital contribution. ITA 2007, s. 104

For a limited partner the definition of 'capital contributed' is simply the capital introduced plus any 'undrawn' profit. ITA 2007, s. 105

Therefore the maximum sideways loss relief available for a limited partner equals the maximum amount the limited partner would personally stand to lose if the partnership was wound up.

As before, any unrelieved trading losses are carried forward under s.83 ITA 2007 without restriction.

Example 1

A number of options regarding losses incurred are available for a partner joining a partnership and a partner leaving a partnership.

Which of the following reliefs do you feel are appropriate for each?

	Joining Partner	*Leaving Partner*
s. 64		
s. 72		
s. 83		
s. 89		
s. 71 (s.261B TCGA 1992)		

Example 2

Paul, Allen and Gary are in partnership sharing profits 50:30:20 after charging salaries to Paul and Allen of £20,000 and £10,000 respectively. In the year to 28 February 2011, the partnership made a profit of £24,000.

Calculate the profit allocation for year to 28 February 2011.

Answer 1

	Joining Partner	*Leaving Partner*
s. 64	✓	✓
s. 72	✓	X
s. 83	✓	X
s. 89	X	✓
s. 71 (s.261B TCGA 1992)	✓	✓

Answer 2

	Total	*Paul*	*Allen*	*Gary*
	£	*£*	*£*	*£*
Y/e 28.2.11				
Profit	24,000			
Salaries	(30,000)	20,000	10,000	
Residual loss	(6,000)			
Ratio 50:30:20	6,000	(3,000)	(1,800)	(1,200)
		17,000	8,200	(1,200)
Reallocate notional loss		(810)	(390)	1,200
		16,190	7,810	Nil

Paul:

$$\frac{17{,}000}{17{,}000 + 8{,}200} \times (1{,}200) = \underline{£(810)}$$

Allen:

$$\frac{8{,}200}{17{,}000 + 8{,}200} \times (1{,}200) = \underline{£(390)}$$