# CHAPTER 37

# PARTNERSHIP CAPITAL GAINS – BASIC PRINCIPLES

## 37.1 Introduction

The word 'partnership' is not defined in TCGA 1992, so we need to consider the definition contained in the Partnership Act 1890, which tells us that a partnership **'is the relation which subsists between persons carrying on a business in common with a view of profit'**.

Where a partnership exists, we need to be able to deal with the capital gains tax implications not only when an asset is disposed of, but also when **a partner joins or leaves the partnership** or **an asset is distributed to a partner** or there is a **change in profit sharing ratio** between existing partners.

The statutory rules relating to partnership capital gains tax are contained in **s.59 TCGA 1992**. There is also a **statement of practice** which explains the way the legislation is applied in practice.

Over the course of this and the next two chapters we will look at the various situations described above and determine the CGT treatment.

## 37.2 Section 59 TCGA 1992

TCGA 1992, s. 59

Our starting point when looking at partnership capital gains tax is s.59 TCGA 1992. S.59 tells us that "where 2 or more persons carry on a trade or business in partnership, tax in respect of chargeable gains accruing to them on the disposal of any partnership assets shall be assessed and charged on them separately".

S.59 also tells us that any partnership dealings shall be treated as dealings by the partners and not by the firm as such. Therefore by virtue of s.59, if a partnership disposes of a chargeable asset and makes a capital gain, that resulting capital gain is charged on the **individual partners** and not on the partnership itself. **Partnerships therefore do not pay capital gains tax**.

Similarly, **partnerships do not pay income tax**. If a partnership makes a trading profit, that trading profit is allocated between the partners and each individual partner pays income tax on his or her share of the partnership profits as trading income. S.59 TCGA 1992 is effectively a mirror image for capital gains tax.

If a partnership makes a capital gain, details of the gain must be disclosed on the **partnership tax return**, along with details of how that capital gain will be allocated between the individual partners. Each partner will then disclose his or her share of that gain on the individual self assessment returns.

## 37.3 Limited Liability Partnership

Under English law, a limited liability partnership is a **corporate body**, and for legal purposes it is treated in much the same way as a company. However, for tax purposes, a limited liability partnership is **taxed in the same way as a normal partnership**. This means that any partnership trading profits are assessed on the individual partners rather than on the partnership. Similarly any partnership capital gains are allocated to the partners themselves, and will be reflected on the partners' individual tax returns.

FA 2001 inserted **Section 59A** into the TCGA 1992 to specifically **deal** with limited liability partnerships. S. 59A exactly **mirrors** S. 59 in treating any dealings in chargeable assets by a **limited liability** partnership, as dealings by the **individual partners** themselves.

TCGA 1992, s. 59A

## 37.4 Statement of Practice D12

SP D12

HMRC practice in the area of partnership capital gains is summarised in **Statement of Practice D12**.

HMRC has confirmed that SP D12 **applies equally for limited liability partnerships** as it does for normal partnerships.

Over the course of the next three chapters we shall take a detailed look at SP D12, and in particular concentrating on the first five paragraphs of the statement.

## 37.5 Valuation

As we will see, a partner is treated as owning a share of the partnership assets for capital gains tax purposes.

Under paragraph 1 of SP D12, HMRC have stressed that the **value** of an individual partner's share in a partnership asset, will be taken to be a fraction of the value of the **total partnership interest** in that asset, without any "discounting".

SP D12 Para 1

**Illustration 1**

Assume that a partnership consists of four partners, each of whom is entitled to an equal share of the partnership's trading or capital profits. Assume that the partnership owns a 100% shareholding in XYZ Ltd (an investment company), the shares in total being valued at £100,000. A 25% holding in isolation is valued at £15,000.

When valuing each partner's 25% share for capital gains tax purposes, we simply take 25% of £100,000, giving £25,000.

The value of an isolated 25% holding of £15,000 is irrelevant. This is what we mean by "no discounting".

## 37.6 Disposals of assets by a partnership

Paragraph 2 of SP D12 deals with disposals of assets by a partnership to an **unconnected third party**. On the sale of an asset by a partnership, each partner is deemed to have disposed of a fractional share in the assets. Essentially assets owned in the name of a partnership are, for CGT purposes, treated as owned by the individual partners themselves, and on a disposal of that asset, each partner will make a capital gain or loss.

SP D12 Para 2

Proceeds are allocated between the partners using agreed **capital sharing ratios.** Such capital sharing ratios are normally determined by the partnership agreement.

Where the partnership agreement does not specifically lay down the allocation of capital surpluses, the proceeds of sale will be the **actual destination** of the capital surpluses as shown in the partnership accounts. It is quite common for capital sharing ratios to be the same as profit sharing ratios for Taxable Profit purposes, however this will not always be the case.

The acquisition costs of assets by a partnership are allocated between the partners in exactly the same way, using the capital sharing ratios. Proceeds less cost will give **each partner a capital gain or loss** on the sale of their share of the asset. Each partner will be assessed on this gain **separately** via the individual self-assessment returns. As we have already mentioned, there is **no partnership capital gains tax liability**, although details of the gain will need to be disclosed on the partnership tax return.

**Illustration 2**

Alan and Belinda are in partnership. The partnership owns an office building, bought in January 1990 for £100,000. In July 2010, the partnership sells the office to an unconnected third party for £500,000. As per the partnership agreement, Alan is entitled to 75% of any capital profits, with Belinda entitled to the remaining 25%. We therefore need to calculate two capital gains – one on the disposal of Alan's 75% interest, the other on the disposal of Belinda's 25% interest.

| | *Alan* | *Belinda* |
|---|---|---|
| | 75% | 25% |
| | £ | £ |
| Proceeds | 375,000 | 125,000 |
| Less: cost | (75,000) | (25,000) |
| Gains | 300,000 | 100,000 |

These gains will be disclosed on Alan and Belinda's individual self assessment returns and will be separately charged to tax. As with income tax, there is **no "joint and several" liability** for capital gains tax. Therefore neither partner can be held liable for the other partner's tax. As the gains are charged on the partners separately, each partner is entitled to relief for their own losses or annual exemption if available.

The individual partners will be able to make claims for relief in respect of any gains as normal. For example, if the asset disposed of is a qualifying asset for rollover relief purposes, a claim for rollover relief can be made by an individual partner if a qualifying reinvestment is made within the normal qualifying period.

In addition, if the partnership ceases and the assets of the partnership are sold, claims could be made by the individual partners for entrepreneurs' relief, provided the normal conditions have been met i.e. the partner had been a partner for a year prior to the date of cessation and the assets are sold within three years of that date.

## 37.7 Distributions of assets between partners

Paragraph 3 of SP D12 deals with the distribution of partnership assets among the individual partners. Assets will most commonly be passed between the partners either on the dissolution of the partnership, or where one or more of the partners leave or retire, although it can occur between continuing partners.

SP D12 Para 3

It is important to appreciate that what we are looking at here is the situation where a partnership asset ceases to be owned by the partnership but is now owned wholly by an individual.

**Illustration 3**

Mike, Nigel and Ollie are in partnership and share profits 50%, 30% and 20% respectively. The partnership owns a building. Ollie retires, leaves the partnership and at this point the building is transferred to him.

© Reed Elsevier UK Ltd 2010

After Ollie's departure, Mike and Nigel continue to trade and will share profits equally. For capital gains tax purposes, Mike and Nigel are treated as having given up a 50% and a 30% share of a partnership asset, this being a **disposal by Mike and Nigel** for CGT purposes. As far as Ollie is concerned, his fractional share in the asset goes up from 20% to 100%, and therefore Ollie has made a **capital acquisition** for CGT purposes. We will therefore need to calculate the capital gain for Mike and Nigel, and the new base cost of the asset for Ollie.

Paragraph 3 of SP D12 tells us that the partner receiving the asset – in this instance Ollie – is **not** treated as making a disposal for CGT purposes, and no capital gain will therefore be charged on him. However, the partners **giving up** the asset – in this instance Mike and Nigel – are deemed to have made gains. These gains will be charged to CGT at the time that the asset is distributed. To calculate the capital gain and the revised base cost, there is a 3 step procedure.

Step 1 - calculate the chargeable gains which would have arisen had **all** the partners disposed of their fractional shares at **market value**. Effectively we calculate a capital gain in the hands of **each** of Mike, Nigel and Ollie, assuming the asset had been sold by them to an outside third party for its market value.

Step 2 - the gains accruing to the partners **giving up** the asset are **immediately** charged to capital gains tax.

Step 3 - the gain accruing to the partner **receiving** the asset, is only a **notional** gain and is not charged to CGT. Instead, the receiving partner is deemed to have **bought** the asset for an amount equal to the market value of the asset, **less this notional gain**. In effect the notional gain is **rolled over** and reduces Ollie's CGT base cost.

**Illustration 4**

Mike, Nigel and Ollie share capital profits, 50%, 30% and 20% respectively.

The partnership jointly owns a building which it bought for £100,000 in January 1987. Ollie retires from the partnership. The asset passes to Ollie and has a market value of £500,000 at the date of the distribution.

According to paragraph 3 of SP D12, we first calculate the gain that would have arisen had the partners sold the asset for its market value.

| Gains: | *Mike* | *Nigel* | *Ollie* |
|---|---|---|---|
| | 50% | 30% | 20% |
| | £ | £ | £ |
| MV | 250,000 | 150,000 | 100,000 |
| Less: cost | (50,000) | (30,000) | (20,000) |
| Gains | £200,000 | £120,000 | £80,000 |

As Mike giving up a 50% interest in the asset, he will be charged on a gain of £200,000 at the time of the distribution. As Nigel giving up a 30% interest in the asset, he will be charged on a gain of £120,000 at the time of the distribution.

However, as Ollie is not giving up a part of the asset, his "**notional gain"** of £80,000 will not be charged to capital gains tax. Ollie's interest in the partnership asset is now 100%. Ollie is deemed to have acquired the asset for its market value at the date of distribution of £500,000.

However, Ollie's CGT base cost to be carried forward is the market value of the asset, less this notional gain.

| Base cost for Ollie; | £ |
|---|---|
| Market value | 500,000 |
| Less notional gain | (80,000) |
| Base cost | £420,000 |

Effectively the notional gain is rolled against the base cost, leaving Ollie with a CGT base cost of the asset of £420,000.

## 37.8 Assets standing at a loss distributed between partners

The same principles apply if, at the date of the distribution, the asset is standing at a loss. If a loss arises on the distribution of an asset to a partner, then a partner **disposing** of his interest in the asset will have an **actual loss** which he or she will be able to set against other capital gains in the year.

SP D12 Para 3

However the partner or partners **receiving** the asset will have a "**notional loss**". This notional loss will again be **rolled over** against the CGT base cost. However whereas a notional gain decreases the base cost, **a notional loss will increase the base cost**.

**Illustration 5**

Dean, Elaine and Felicity are in partnership. Dean is entitled to 45% of capital surpluses, Elaine 35% and Felicity 20%. The partnership owns a freehold office, acquired for £500,000 in September 1988.

In March 2011, the office was transferred to Felicity when it was valued at £300,000. As this is the distribution of an asset in kind to a partner, in accordance with SP D12, we first assume that each partner had sold his or her fractional share in the building for an amount equal to its market value.

| | Dean | Elaine | Felicity |
|---|---|---|---|
| | 45% | 35% | 20% |
| | £ | £ | £ |
| Market value | 135,000 | 105,000 | 60,000 |
| Less cost | (225,000) | (175,000) | (100,000) |
| Loss | £(90,000) | £(70,000) | £(40,000) |

As the building is standing at a loss, on this deemed disposal each of the partners will have made a capital loss. As Dean is giving up his 45% interest in the partnership asset, at the date of the distribution Dean makes an **allowable loss of £90,000**. This loss is available for Dean in 2010/11, and can be set against any other gains he makes in the year, or it can be carried forward. The same applies to Elaine in respect of her loss of £70,000.

However, as Felicity is not giving up the asset, she has made a **notional loss**. Felicity's notional loss on the distribution is £40,000.

This notional loss will be **rolled over** and will act to **increase** Felicity's CGT base cost.

| | Felicity |
|---|---|
| | £ |
| Market value @ transfer | 300,000 |
| Add: | |
| Notional loss | 40,000 |
| Base cost of building for Felicity | £340,000 |

This is Felicity's base cost in the event of a future disposal of the building.

**Example 1**

Frederick and George are in partnership sharing income and gains 60:40. The partnership owns 90% of the shares of FG (Holdings) Ltd, an unlisted investment company. The shares cost £60,000 in August 2003.

The partnership sold half the shares (a 45% holding) on 1 October 2010 for £90,000.

**Calculate Frederick's chargeable gain arising on the sale.**

**Example 2**

Hayley, Imogen and Jessica are in partnership sharing income and gains 40:20:40. The partnership owns a property which cost £50,000 in September 1988.

On 1 January 2011 Jessica left the partnership. The property was worth £200,000 at that date. She took over sole ownership of the property. Jessica sold the property on 1 March 2012 for £240,000.

**Calculate Jessica's chargeable gain in 2011/12.**

**Answer 1**

| | £ |
|---|---|
| Proceeds: | |
| 60% x £90,000 | 54,000 |
| Less: Cost | |
| 60% x £60,000 x ½ | (18,000) |
| Gain | £36,000 |

**Answer 2**

1. Jessica leaving – January 2011

| | Hayley 40% £ | Imogen 20% £ | Jessica 40% £ |
|---|---|---|---|
| Market value of property | 80,000 | 40,000 | 80,000 |
| Less cost | (20,000) | (10,000) | (20,000) |
| Gains | 60,000 | 30,000 | 60,000 |
| | *Charged 2010/11* | *Charged 2010/11* | *Notional* |

| Base cost for Jessica: | £ |
|---|---|
| Market value | 200,000 |
| Less notional gain | (60,000) |
| Base cost | 140,000 |

2. Sale of property – March 2012

| | Jessica 100% £ |
|---|---|
| Proceeds | 240,000 |
| Less: base cost | (140,000) |
| Gain | 100,000 |