CHAPTER 38

PARTNERSHIP CAPITAL GAINS – FURTHER ASPECTS

38.1 Introduction

In the previous chapter we looked at the capital gains tax treatment under SP D12 where a partnership disposes of an asset to an unconnected third party and where a partnership asset is distributed to a partner. In this chapter we will deal with how a change in profit sharing ratio is dealt with under SP D12, where the assets have not been revalued in the accounts.

However, before we look at the rules in relation to a change in profit sharing ratio, we will look in a little more detail at what happens when a partner joins or leaves a partnership.

38.2 Joining a partnership

When an individual joins a partnership, he may well be expected to introduce funds to the partnership.

There are **no capital gains tax consequences** if an incoming partner **introduces cash** which is credited to either his current or capital account. Although the new partner will obtain a fractional interest in the partnership assets when he joins the partnership, the cash introduced by him to the partnership is not treated as the cost of acquisition of the fractional interest.

If the incoming partner **transfers an asset** to the partnership by way of a capital contribution, the partner is treated as having made a **part disposal** of the asset. So, if the new partner is entitled to 10% of the capital profits of the partnership, he will have given up a 90% share in the asset he transfers to the partnership and is therefore treated as disposing of 90% of the asset. HMRC Brief 3/08

The consideration for capital gains tax purposes will be the relevant proportion of the consideration paid by the partnership for the asset. The consideration paid by the partnership is taken to be the amount credited to the partner's capital account. The cost to be taken into account will be calculated using normal part disposal rules.

Illustration 1

Fred and George are in a partnership, sharing income and capital equally. On 1 August 2010, Henry joins the partnership. He introduces cash of £20,000 which is credited to his capital account and also transfers a building which he owns to the partnership. £350,000 is credited to his capital account in respect of this transfer, being the market value of the building at this time.

Henry had bought the building for investment purposes in July 2002 for £130,000.

After Henry joins the partnership, the income and capital profits are allocated 50% to Fred, 40% to George and 10% to Henry.

The introduction by Henry of the cash of £20,000 to the partnership has no capital gains tax consequences.

However, Henry is treated as disposing of 90% of his interest in the building he transfers to the partnership and will have a chargeable gain in respect of this disposal. The deemed proceeds will be 90% of the consideration credited to his capital account in respect of the transfer:

	£
Proceeds (90% x £350,000)	315,000
Less: cost	
£130,000 x A/A + B	
X 315,000/315,000+35,000	
	(117,000)
Gain	£198,000

In effect, Henry made a profit of £220,000 when he transferred the building to the partnership, being the consideration of £350,000 credited to his capital account, less the cost of the asset of £130,000. However, as he retained a 10% interest in the asset, he is only charged on 90% of the gain, being £198,000.

Fred has acquired a 50% interest in the building. His cost is equivalent to 50% of the consideration paid for the building ie £350,000 @ 50% = £175,000.

George has acquired a 40% interest, giving him a cost of £140,000 ie £350,000 @ 40%.

Henry's base cost is the remainder of his original cost of acquisition ie £130,000 - £117,000 (used in the part disposal) giving £13,000.

Note that the same calculation would apply if an existing partner transferred an asset wholly owned by him to the partnership.

When a new partner joins a partnership, he will acquire an interest in the existing assets of the partnership. We will look at this situation in the section of this chapter dealing with change in profit sharing ratios.

38.3 Leaving a partnership

When a partner leaves a partnership, there are **no capital gains tax consequences** when the partner **withdraws cash from his capital account**. He is simply withdrawing what belongs to him.

We looked at what happens when an asset is distributed to a partner in the previous chapter.

An outgoing partner will give up his interest in assets which are remaining partnership assets. We will look at this situation in the next section.

38.4 Changes in partnership sharing ratios

HMRC's practice on changes in sharing ratios is dealt with in SP D12, paragraphs 4 and 5. In this session we shall concentrate on paragraph 4 of the Statement of Practice. We will deal with paragraph 5 in the next chapter. SP D12 Paras 4 & 5

There are a number of events which could cause there to be a change in the capital sharing ratio of a partnership. If a partner leaves a partnership – for example on retirement or death – his share will naturally **decrease** and the share of the remaining partners will **increase**. The converse will happen when a new partner joins a partnership. Lastly the partnership composition could remain unaltered, but the existing partners could simply decide to change the partnership agreement and allocate capital surpluses in different proportions.

One of the fundamental principles of partnership capital gains is that each partner is deemed to own a **fractional share in each partnership asset**. Remember that for CGT purposes, the concept of a partnership does not exist and each partner is treated as owning a share of each asset in his or her own right. Therefore when a partner becomes entitled to a **greater share** in a partnership asset – for example on joining the partnership, or on a change of partnership agreement – this is treated as an **acquisition** of an asset for CGT purposes.

Conversely, if a partner's share decreases – for example on leaving the partnership or on a change in the partnership agreement – this is treated as a **disposal** for capital gains tax purposes. In certain instances, a change in partnership sharing ratios will give rise to a CGT liability in the hands of the partner or partners whose share in partnership assets goes down.

It is important to distinguish this situation from the previous chapter, where the asset ended up being wholly owned by one person. Here the asset is remaining a partnership asset. There is merely a change in the proportions owned by the respective partners.

38.5 Changes with no revaluation of the asset

SP D12 Para 4

Paragraph 4 of SP D12 deals with a change in partnership sharing ratios where there is **no revaluation of the asset in the partnership accounts** prior to the change in partnership sharing ratios. In other words, the asset is reflected in the balance sheet at original cost and not at market value at some later date.

On a change in partnership sharing ratios, the disposal consideration for the partner giving up a share of the asset, will be the relevant fraction of the

current balance sheet value of the asset. Where there has been **no adjustment** through the partnership accounts, a change in partnership sharing ratios is therefore a "**no gain no loss**" disposal by the partner whose share in the partnership assets goes down. This is because the cost available to set against the proceeds will be the same amount as the proceeds figure, as the asset is reflected in the balance sheet at original cost.

Essentially the partner whose share **decreases,** is treated as having sold his share to his or her fellow partners for an amount such that neither a gain nor a loss will accrue. This will however have the effect of **decreasing his base cost** for CGT purposes in the event of a subsequent disposal of the asset outside the partnership.

It stands to reason where one partner's share in partnership assets goes down, another partner's share will go up. The partner or partners whose profit shares **increase**, are treated as making an **acquisition** for CGT purposes, and this will **increase their base costs** in the event of a subsequent disposal.

Illustration 2

Alan and Brian are in partnership sharing income and capital equally. The only partnership asset is goodwill, which was acquired by the partnership on 1 July 1999 for £100,000. On 1 January 2011 the partners decide to change the income and capital sharing ratios. From January 2011, income and capital profits will be allocated 40% to Alan and 60% to Brian.

Alan's share of the partnership goodwill has gone down from 50% to 40%. Alan is therefore treated as having made a **disposal of a 10% interest** in the goodwill. Brian is similarly treated as having **acquired an additional 10% share** in the partnership goodwill.

The partners **do not revalue the goodwill** within the partnership accounts at 1 January 2011. Paragraph 4 of SP D12 will therefore apply. The disposal by Alan will therefore take place at no gain, no loss.

Alan disposes of a 10% share in the partnership goodwill at 1 January 2011. The partnership paid £100,000 for the goodwill in July 1999. For CGT purposes, Alan is deemed to have sold his 10% interest in the goodwill to Brian for £10,000 ie 10% of the balance sheet value. As Alan is disposing of a 10% share, his base cost of this share will be £10,000.

Disposal on 1.1.11:	Alan
	£
"Deemed proceeds" (10% share)	10,000
Less cost (£100,000 x 10%)	(10,000)
Gain	NIL

It is only fair that Alan should not be taxed on a gain at this point because he has not made any actual profit. Although his share in the goodwill has decreased, he has not received value in excess of original cost in respect of giving up part of his share.

Brian is deemed to have bought Alan's 10% share in the goodwill from him on 1 January 2011 for £10,000. This £10,000 can therefore be treated as **enhancement expenditure** incurred by Brian.

The change in capital sharing ratios will affect the base costs of Alan and Brian.

Base costs c/f:	Alan (40%)	Brian (60%)
	£	£
Original (50:50)	50,000	50,000
Adjustment	(10,000)	10,000
New base costs	£40,000	£60,000

When Alan and Brian eventually come to sell the partnership goodwill, Alan will have a base cost of £40,000, and Brian a base cost of £60,000. Alan's base cost has decreased but of course Alan will also be entitled to less of the proceeds on a subsequent disposal of the goodwill.

Illustration 3

Clare and David are in partnership. Clare has a 60% interest and David a 40% interest. The partnership owns an office which originally cost £100,000 in September 1998.

On 1 July 2010, Ewan joined the partnership. Ewan was thereafter given a 20% profit share. David's interest remained at 40%, however Clare's is reduced from 60% to 40%.

For CGT purposes, Ewan is treated as having **acquired a 20% interest** in the office on 1 July 2010. David's share has remained **unchanged**, so therefore he makes neither a disposal nor an acquisition. Clare's interest in the partnership assets **reduces** from 60% to 40%. Therefore she is treated as having **disposed of a 20% interest** in the office as at 1 July 2010.

The partners do not revalue the property and accordingly no adjustment is made through the partnership accounts. Paragraph 4 of SP D12 will therefore apply, such that Clare's disposal takes place at neither a gain nor a loss.

Disposal on 1.7.10:	Clare
	£
"Deemed proceeds" (20% x £100,000 balance sheet value)	20,000
Less: cost (£100,000 x 20%)	(20,000)
Gain	NIL

Clare is deemed to have sold her **20% share in the office to Ewan** for £20,000. This £20,000 is Ewan's base cost for future CGT purposes.

Revised base costs:	Clare	David	Ewan
	£	£	£
Original (60:40)	60,000	40,000	Nil
Adjustment	(20,000)	______	20,000
New base cost	£40,000	£40,000	£20,000

When Clare and David come to sell their share in the office, their base cost will each be £40,000. Ewan acquired his 20% interest for £20,000 on 1 July 2010.

Assume that the partnership sells the office building for £500,000 on 31 May 2011 but continues to trade from rented premises. Where a partnership asset is sold to a third party, gains are calculated under paragraph 2 of SP D12, using the rules that we covered in the previous session. The proceeds are allocated between the partners using the capital sharing ratios at the date of disposal. The partners' respective base costs are as above.

	Clare	David	Ewan
	(40%)	(40%)	(20%)
	£	£	£
Proceeds	200,000	200,000	100,000
Less: cost	(40,000)	(40,000)	(20,000)
Gains	160,000	160,000	80,000

The amounts of the gains are equal to the amounts that will be credited to the individual partner's capital accounts.

Ewan has made a significant profit, even though he has only held an interest in the asset for a very short period.

As this may not be considered equitable, Clare and David could avoid this situation by revaluing the building in the accounts prior to Ewan joining the partnership. We will look at revaluation of assets in the next chapter.

Example 1

Harry, Ian and John are in partnership sharing profits 40%: 35%: 25%. The only partnership asset is goodwill bought in January 2000 for £60,000. On 1 December 2006 the partnership shares were changed to:

Harry (50%), Ian (40%) and John (10%).

The goodwill was not revalued at that point.

The partnership dissolved on 31 March 2011 and was sold for £800,000.

Calculate the partners' chargeable gains.

Answer 1

Disposal on 1.12.06;	*John*
	£
Deemed proceeds (15% x £60,000)	9,000
Less: cost (15% x £60,000)	(9,000)
Gain	Nil

Revised base costs:	*Harry*	*Ian*	*John*
	£	£	£
Original (40: 35: 25)	24,000	21,000	15,000
Adjustment (12/06)	6,000	3,000	(9,000)
New base costs	30,000	24,000	6,000

Sale of goodwill (31.3.11)	*Harry*	*Ian*	*John*
	(50%)	*(40%)*	*(10%)*
	£	£	£
Proceeds	400,000	320,000	80,000
Less: cost	(30,000)	(24,000)	(6,000)
Gains	370,000	296,000	74,000

Each partner will be able to claim entrepreneurs' relief as they are no longer involved in the partnership.