CHAPTER 39

PARTNERSHIP CAPITAL GAINS – ASSET REVALUATIONS

39.1 Introduction

In this chapter we shall look at how to calculate capital gains where assets are **revalued in the partnership accounts**, and at some point after the revaluation there is a **change in capital sharing ratios**.

Firstly, let us consider what we mean by a revaluation.

Illustration 1

Bob and Mike carry on business in partnership and share capital profits and losses equally.

The partnership owns a building which cost £100,000. The building is now worth £400,000 and the partners decide for commercial reasons to reflect the building in the accounts at the current value of £400,000. The building will be included in the balance sheet at £400,000

The surplus on the revaluation ie £400,000 - £100,000 = £300,000 will be credited to the partners' capital accounts as follows:

Bob	£300,000 @ 50%	= £150,000
Mike	£300,000 @ 50%	= £150,000

It is important to appreciate that the revaluation itself has no tax effect. No capital gains calculations are required when the revaluation takes place, because no disposal has occurred. It is a subsequent change in the partnership sharing ratio that gives rise to an acquisition and disposal.

Where there is a change in the partnership sharing ratio after a revaluation, the disposal is **not** a "no gain no loss" disposal. Instead a chargeable gain – or allowable loss – will accrue to the partner or partners whose shares **decrease** as a result of the change in sharing ratios. These rules are dealt with in Paragraph 5 of SP D12. SP D12 Para 5

39.2 Revaluation

Before we look at the tax implications of revaluation, it is worth exploring the effect of a revaluation a little more. A revaluation may take place for commercial reasons. In addition, it may take place when a new partner joins an existing partnership.

Illustration 2

Assume that we have 2 partners – Lisa and Marie – sharing income and capital profits equally. Their only partnership asset is goodwill acquired on 1 January 2008 with a base cost of £40,000.

On 1 January 2011, Nigel joined the partnership and was awarded a 20% interest in the partnership assets. Lisa and Marie's share in the partnership goodwill has fallen by 10% each.

The goodwill was valued at £140,000 when Nigel joined the partnership but was not revalued in the accounts.

Assume that the partners sold the goodwill on 31 March 2012 for £200,000. The gains would be as below:

Gains:	*Lisa (40%)*	*Marie (40%)*	*Nigel (20%)*
	£	£	£
Proceeds	80,000	80,000	40,000
Less: cost	(16,000)	(16,000)	(8,000)
Gain	£64,000	£64,000	£32,000

In this case, Lisa and Marie make a capital gain of £64,000 and Nigel makes a capital gain of £32,000. Nigel has therefore made a significant profit, even though he has only held an interest in the asset for just over a year.

Lisa and Marie would probably want to ensure that Nigel was only entitled to 20% of the increase in value **since** he joined the partnership. This could be achieved by revaluing the goodwill in the accounts before Nigel was admitted.

Up to 31 December 2010, the goodwill increased in value by £100,000. This increase would be credited to Lisa and Marie's respective capital accounts on the revaluation. For the accountants among you, the "double entry" here is to increase the assets on the balance sheet by £100,000 to reflect the revised value of the goodwill, and to subsequently increase the liabilities of the partnership – i.e. the partners' capital accounts – by the same amount. Lisa and Marie would make this adjustment to reflect the fact that their business had increased in value by £100,000 as a result of their own efforts - they therefore take credit for their respective halves of this capital increase.

The goodwill of the partnership increased in value by a further £60,000 between 1 January 2011 and the date of sale. As Lisa and Marie were entitled to 40% of the capital profit, the respective credits to their capital accounts would have been £24,000 each. Nigel's capital profit would be 20% of this subsequent increase, being £12,000.

If a revaluation took place the position would be:

Actual profits:	*Lisa (40%)*	*Marie (40%)*	*Nigel (20%)*
	£	£	£
Up to 30.12.10	50,000	50,000	
1.1.11 – 31.3.12	24,000	24,000	12,000
Credit to capital accounts	£74,000	£74,000	£12,000

This reflects fairly the gains belonging to each partner.

39.3 Changes following a revaluation of the asset

SP D12 Paragraph 5, deals with the capital gains tax implications where a partnership asset is **revalued** in the accounts, and **after the revaluation there is a change in the capital sharing ratios**.

It is important to remember that the disposal arises at the **date that the capital sharing ratios change,** and not at the date that the asset is revalued. A simple revaluation of a partnership asset within the accounts is not a disposal for capital gains tax purposes, as no capital asset has been disposed of. We need to consider the capital gains tax implications on the subsequent change in partnership sharing ratio.

We apply the same rules that we looked at in the previous chapter. There will be a disposal for the partner or partners whose share is decreasing. The proceeds will be the relevant fraction of the current balance sheet value but remember this will be the **revalued amount**. The cost will be the relevant fraction of the original cost. Therefore where there has been a revaluation, **a chargeable gain** (or allowable loss) will accrue on a change in partnership sharing ratio as the proceeds figure will not be the same as the cost figure. After a revaluation, there will not be a no gain, no loss disposal. We will therefore revisit the example of Lisa, Marie and Nigel and apply the provisions of SP D12, Paragraph 5.

Illustration 3

Lisa and Marie are in partnership and share capital profits equally. The only asset of the partnership is goodwill which had a base cost of £40,000. On 31 December 2010 Lisa and Marie revalued the goodwill within the partnership accounts at £140,000 and duly took a credit of £50,000 each to their respective capital accounts. Nigel joins the partnership on 1 January 2011. With effect from 1 January 2011, Lisa and Marie are entitled to a 40% share of the profits and Nigel is entitled to a 20% share. The goodwill is sold for £200,000 on 31 March 2012.

There are no capital gains tax consequences on the revaluation on 31 December 2010.

As Lisa and Marie's entitlement decreases by 10% when Nigel joins the partnership, **each of them are deemed to have disposed of a 10% interest** in the partnership goodwill. However, because this was **preceded by a revaluation** of the partnership asset within the accounts, the disposal does not take place at no gain no loss. The disposal takes place for a percentage of the current balance sheet value (ie the **revalued amount)** giving both Lisa and Marie an actual capital gain.

Disposal at PSR change (1.1.11):	*Lisa*	*Marie*
	£	£
Proceeds (10% x £140,000)	14,000	14,000
Less: cost (10% x 40,000)	(4,000)	(4,000)
Gains 2010/11	£10,000	£10,000

For entrepreneurs' relief purposes, a disposal by a partner of an interest in the partnership's assets is treated as a disposal of the whole or part of the partnership's business. Therefore Lisa and Marie could claim entrepreneurs' relief in respect of their gains if they wished. TCGA 1992, s.169I(8)

As Nigel's share in partnership assets goes up from 0% to 20%, he is deemed to have made an **acquisition for CGT purposes**, and the consideration he is deemed to have paid is equal to **20% of** the revalued goodwill. This value is £28,000. It makes sense that Lisa and Marie's proceeds of sale for CGT purposes in 2010/11 should be equal to Nigel's deemed acquisition cost.

Moving now to the **sale** of the goodwill on 31 March 2012.

The surplus of £60,000, being the proceeds of £200,000 less the revalued amount of £140,000, will be credited to the partners' capital accounts in accordance with the capital sharing ratios at the date of disposal.

For capital gains tax purposes, the proceeds are split using the capital sharing ratios at the date of disposal – i.e. 40:40:20.

For Lisa and Marie the goodwill has a base cost of £16,000, being 40% of the original base cost of £40,000. Nigel's base cost is £28,000. The gains are therefore:

Disposal of goodwill (31.3.12):	*Lisa*	*Marie*	*Nigel*
	£	£	£
Proceeds (40:40:20)	80,000	80,000	40,000
Less: cost	(16,000)	(16,000)	(28,000)
Gain	£64,000	£64,000	£12,000

Entrepreneurs' relief may be available to reduce these gains.

We can now see that Lisa and Marie have made total chargeable gains of £74,000 each, whilst Nigel has a chargeable gain of £12,000.

Let us compare these chargeable gains with the partners' **actual capital profits**.

	Lisa	*Marie*	*Nigel*
	£	£	£
31.12.10			
Credits to capital accounts	50,000	50,000	Nil
31.3.12			
Credits to capital accounts	24,000	24,000	12,000
Actual profits	£74,000	£74,000	£12,000

You will see that the actual profits made are £74,000 for Lisa and Marie, and £12,000 for Nigel. These actual profits are exactly equal to the partners' chargeable gains.

Therefore the effect of Paragraph 5 of SP D12 is to make sure that the capital gains that are chargeable to tax are **exactly equal to the actual profits** which are allocated to the respective partner's capital accounts within the partnership.

39.4 Payments outside the accounts

This is dealt with by SP D12 paragraph 6 which says that…..

> "Where on a change of partnership sharing ratios payments are made directly between two or more partners outside the framework of the partnership accounts, the payment represents consideration for the disposal of the whole or part of a partner's share in partnership assets in addition to any consideration calculated (under paragraphs) 4 and 5….".

In other words, where one partner pays an amount directly to another partner for the acquisition of a further interest in a partnership asset, that amount is treated as **additional proceeds** in the capital gains tax computation. This applies whether or not a revaluation has taken place.

The amount paid is also treated as additional cost for the partner acquiring the increased share.

Illustration 4

John and Paul are in partnership sharing profits equally. Their only asset is the business goodwill, which they purchased in April 1990 for £100,000.

On 1 September 2010, George was admitted to the partnership and profits were thereafter split 50:40:10 between John, Paul and George.

No adjustment was made to the partnership accounts, although George made a direct payment of £35,000 to Paul for his share of the goodwill.

We will outline the CGT implications of the above.

1) George is acquiring a 10% interest in the partnership goodwill on 1.9.10.
2) Paul is disposing of a 10% interest in the partnership goodwill on 1.9.10.
3) No adjustment is made via the partnership accounts, so the transaction takes place at no gain, no loss under SPD12 para 4. Paul's CGT computation is therefore as follows;

Disposal on 1.9.10:	Paul
	£
"Deemed proceeds" (10% share)	10,000
Less: cost (£100,000 x 10%)	(10,000)
Paul's Gain	NIL

Paul is therefore deemed to have sold his 10% interest to George for £10,000.

4) As George makes a payment to Paul outside the accounts, this payment is treated as "consideration" (ie, proceeds) in addition to the deemed consideration as above. The revised capital gain is therefore;

Disposal on 1.9.10:	Paul
	£
"Deemed proceeds" (10% share)	10,000
Add: Actual payment outside accounts	**35,000**
	45,000
Less: cost (£100,000 x 10%)	(10,000)
Paul's Gain	£35,000

Entrepreneurs' relief would be available to reduce this gain.

George is deemed to have acquired a 10% interest in the goodwill on 1 September 2010 for £45,000. This is his CGT base cost.

Example 1

Valerie and Walter are in partnership sharing profits equally. The partnership trades from a shop acquired in January 1995 for £150,000.

In March 2006 the shop was revalued at £250,000, and the partnership accounts adjusted accordingly.

On 1 July 2010 the partners changed the agreement such that Valerie would thereafter receive only 35% of the profits. The shop was then worth £300,000 but no revaluation was made.

Calculate Valerie's chargeable gain in 2010/11 and the partners' base costs to carry forward.

Answer 1

1.	Revaluation followed by	Disposal for proportion of current balance sheet value (revalued amount) at date of change
2.	Change in sharing ratios	

↓

Disposal by Valerie at 1 July 2010

Gain 1.7.10	*Valerie*
	£
Proceeds (£250,000 x 15%)	37,500
Less: cost (£150,000 x 15%)	(22,500)
Gain	£15,000

Base costs carried forward	Valerie	Walter
	£	£
Cost b/f (50:50)	75,000	75,000
Disposal (15% x 150,000)	(22,500)	
Acquisition (15% x 250,000)		37,500
Costs c/f	52,500	112,500