Looking at a loss

For those studying for tax exams, ARPITHA AJIT summarises the loss relief options that are available for companies and sole traders


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Companies and sole traders are not always profitable; they may make losses too. However, there are options available to use trading losses for both types of business, although the reliefs differ.

It is easy to think that if a business makes a loss relief for this will be obtained by setting it against future profits and that, even if sideways or carry-back options are considered, it's a case of 'six of one, half a dozen of the other'. That is not always the case. Even if tax rates are static, a tax repayment now rather than a tax reduction later can provide crucial funds to a business – especially a loss-making one. If the tax rates are falling, an earlier deduction can be more remunerative. So, when considering losses, a more than cursory glance at the options can be beneficial.

Company's trading losses

Let's see what options a company has when it makes a trading loss. Here we are considering singleton companies rather than groups or consortia. The rules for corporate losses can be found in CTA 2010, Pt 4 ch 2 and references below are to that legislation.

Current year claim

A company can set off the loss against 'total profits' (all types of income and gains before deducting qualifying charitable donations) in the period it makes the loss. It's an 'all or nothing' claim. This means that the available loss must be used in full against other profits or all of the available profits must be eliminated. Only in the latter event can the unused losses be used elsewhere – a company cannot relieve only a part of the loss against current year profits and choose to set the balance against other income (s 37(3)(a)).

Carry-back claim

The loss can be carried back and set off against the total profits of the previous 12 months. Again, this is an all-or-nothing claim. However, the current year claim must be made first (s 37(4)). The loss must be set against current year profits before it can be set against those of the previous 12 months (s 37(3)(b)).

Carry forward

Unrelieved trading losses are automatically carried forward to future years and are set off against the first available trading profits of the same trade. So, if no other claims are made, the full trading loss will be carried forward. If they are made, any loss remaining will be carried forward (s 45).

Terminal loss relief

Finally, if a company ceases to trade and makes a trading loss in its final 12 months it can consider terminal loss relief. The trading loss of that final year can be carried back against the total profits of the previous three years. The loss must be set against profits of later years before earlier ones – commonly known as a LIFO (last in, first out) basis. Again, the loss must be offset against total profits of the current accounting period before being carried back and is an all-or-nothing claim (s 39, s 41).

Sole trader's trading losses

A sole trader making a trading loss also has options available to them, although the reliefs are different from those to which a company is entitled. The legislation on loss relief for sole traders and partnerships is at ITA 2007, Pt 4 ch 2. Again, unless mentioned otherwise, references below are to that legislation.

KEY POINTS

- Losses may be set against income of different years.
- Corporate losses are set against total profits, namely all types of income and gains before deducting qualifying charitable donations.
- Treatment for losses of sole traders differs from corporate loss relief.
- Trading losses can also be set against capital gains.
- Non-tax considerations may be relevant when allocating losses.

TRADING LOSS & CAPITAL GAIN

Murray has carried on a trade for some years, preparing accounts to 30 June each year. For the year ended 30 June 2016 he makes a trading loss of £17,000. His assessable profit for 2015-16 is £5,000, and his other income for both 2015-16 and 2016-17 amounts to £2,000. He makes a capital gain of £15,900 and a capital loss of £1,000 for 2016-17 and has capital losses brought forward of £11,000. Murray claims for loss relief against income of 2015-16 and income and gains of 2016-17 under ITA 2007, s 64(2)(b), s 64(2)(a) and TCGA 1992, s 261B.

	£	£
Calculation of 'relevant amount'		
Trading loss – year ended 30 June 2016		17,000
Relieved against other income for 2016-17 (ITA 2007, s 64(2)(a))		(2,000)
Relieved against income (£5,000 + £2,000) for 2015-16 (ITA 2007, s 64(2)(b))		(7,000)
Relevant amount		£8,000
Calculation of 'maximum amount'		
Gains for 2016-17		15,900
Deduct: Capital losses for 2016-17		(1,000)
Unrelieved capital losses brought forward		(11,000)
Maximum amount		£3,900
Relief under TCGA 1992, s 261B		
Gains for the year		15,900
Losses for the year	1,000	
Relief under TCGA 1992, s 261B	3,900	
		4,900
Gain (covered by annual exemption)		£11,000
Capital losses brought forward and carried forward		£11,000
Loss memorandum		
Trading loss – year ended 30 June 2016		17,000
Claimed under ITA 2007, s 64(2)(a)		(2,000)
Claimed under ITA 2007, s 64(2)(b)		(7,000)
Claimed under TCGA 1992, s 261B		(3,900)
Unused loss		£4,100

Note

In this example, £100 of the capital gains tax annual exemption of £11,100 is wasted, but the brought-forward capital losses are preserved to carry-forward against gains of future years. If Murray had not made the claim under TCGA 1992, s 261B, his net gains for the year of £14,900 would have been reduced to the annual exempt amount by deducting £3,800 of the losses brought forward. Only £7,200 of capital losses would remain available for carry-forward against future gains and a further £3,900 of trading losses would have been available to carry forward against future trading profits. So the effect of the claim is to preserve capital losses at the expense of trading losses.

Current year claim

A sole trader can offset their trading loss against *net income* (total income less deductible payments, but before personal allowances) of the loss-making year. This is an all-or-nothing claim so, if the trading loss exceeds the net income, this is reduced to nil. It is not possible to restrict the loss relief to the taxable income – in other words retaining the benefit of personal allowances and thereby increasing the losses available to set against income in other years (s 64(2)(a)).

Carry back

As with corporate losses, a sole trader can carry back their trading loss and set it off against the net income of the previous tax year. Again, this is an all-or-nothing claim. However, a difference to the rules for corporate losses is that a sole trader can make a current year and a carry-back claim in any order or can choose to make only one of them (s 64(3)). Contrast this with a company, which *must* make a current year claim *before* making a carry-back claim (s 64(2)(b)).

> ***"As with corporate losses, a sole trader can carry back their trading loss and set it off against the net income of the previous tax year."***

Extension to capital gains

Remember that a company offsets a trading loss against total profits which includes capital gains.

We have seen that, in the first instance, a sole trader must relieve a trading loss against net income. However, if a sole trader has made a claim to set a trade loss against net income of a tax year and some loss relief remains unused, some or all of the balance can be used as an allowable loss for capital gains tax purposes for that tax year (s 71 and TCGA 1992, s 261B).

The maximum amount of the unrelieved loss that can be used against capital gains is the sole trader's net gains for the year less any capital losses brought forward. In effect, this amount of loss is treated as a current year capital loss. If the loss relief exceeds the net gains, the annual exemption will, to some extent at least, be wasted (TCGA 1992, s 261C).

As an example, see ***Trading Loss & Capital Gain***.

Carry forward

Any unrelieved trading loss is carried forward and offset against the next available profits of the same trade. This is very similar to the relief for companies, although the sole trader must make a claim to establish the amount of the loss to carry forward. The maintenance of an accurate loss memorandum is crucial to ensure that previous losses are not overlooked (s 83).

LOSS RELIEF COMPARISON

	Company	Sole Trader
Current year	■ Offset against total profits (includes gains) ■ All or nothing	■ Offset against net income ■ All or nothing ■ Can extend to capital gains
Carry back	■ Offset against total profits (includes gains) ■ All or nothing ■ Carry back to previous 12 months ■ Current year claim must be made first	■ Offset against net income ■ All or nothing ■ Carry back to previous tax year ■ Can extend to capital gains ■ Can make current year and/or carry-back claims in any order
Carry forward	■ Unrelieved loss ■ Automatically offset against first available trading profit from the same trade	■ Unrelieved loss ■ Claim to offset against first available profit from the same trade
Terminal loss	■ On cessation of trade ■ Offset against total profits of current period ■ Then carried back three years against total profits on a LIFO basis ■ All or nothing	■ On cessation of trade ■ Terminal loss offset against trading profits of tax year of cessation ■ Then carried back three years against trading profits on a LIFO basis ■ All or nothing
Early trade loss relief	Not applicable	■ Loss in the first four tax years ■ Carried back three tax years on a FIFO basis against net income

Terminal loss relief

If a sole trader ceases to operate, they can claim terminal loss relief. The loss can be offset against any trading profits of the final tax year of trade and then carried back and set against trading profits in the previous three years, taking the most recent year first (LIFO).

This is another all-or-nothing claim, the terminal loss is that arising in the final 12 months of the trade plus any overlap profits brought forward.

Note that a sole trader obtains relief for a terminal loss against trading profits as compared with a company whose terminal loss is relieved against total profits (s 89).

> ***“Another all-or-nothing claim, the terminal loss is that arising in the final 12 months of the trade plus any overlap profits brought forward.”***

Early trade loss relief

Finally, a sole trader can claim early trade loss relief. If a sole trader incurs a loss in one of the first four tax years of carrying on a trade, the loss can be carried back to the previous three tax years. Unlike terminal losses, here the claim is made on a FIFO (first in, first out) basis. In other words, against earlier years before later years and relieved against net income. Partial claims, say to maintain the benefit of personal allowances, are not permitted.

Alternatively, relief could be set against the net income of the current year and/or the previous year as a normal current year loss relief claim (s 72).

There is no such relief for a company.

Conclusion

Sole traders and companies may incur trading losses and a good understanding of how relief can be obtained for these is important to maximise both the tax and commercial benefits. It is also important to be aware of the differences in the reliefs for a company compared with a sole trader.

The ***Loss Relief Comparison*** table summarises the options that are available.

As this overview indicates, there are several routes for loss relief. When dealing with the years in which a profit falls to be taxed, there is little room for manoeuvre, but statute provides planning opportunities for a loss. Subjective judgement may also be required. Would the sole trader with a loss this year prefer to carry back and obtain relief at 20% now and an immediate repayment?

Alternatively, perhaps after a rocky start, are they anticipating greatly improved trading conditions and profits taxed at 40% or 45% a year later? For one client in this position an immediate tax refund might be the lifeline their business needs. For another, perhaps with greater capital reserves, a greater reduction in the future may be preferable. ■

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