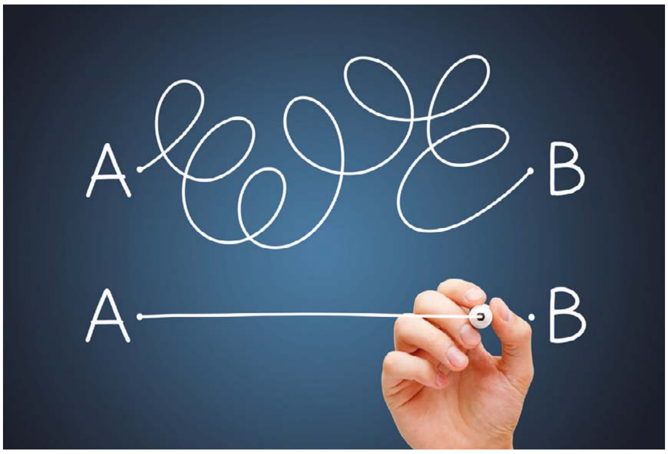
Easy as ABC

The partnership is an important medium for carrying on business in the UK. Debbie Bray explains some basic principles aimed at those who may have to answer exam questions on this topic.



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Partnerships are an important business medium which is why they often feature in the ATT and CTA examinations. Partners in a partnership may be individuals or they may be companies, but here we look at several aspects of general partnerships in which all of the partners are individuals.

> "From an income tax point of view, we treat a partnership in the same way as a sole trader but with one additional step."

Income tax

In essence, a partnership comprises two or more individuals who own and run the business together. From an income tax point of view, we treat a partnership in the same way as a sole trader but with one additional step: we must share the tax adjusted profits or losses for the accounting period between the partners before we can allocate them to tax years for each partner.

Let's assume Ade, Bret and Chetna have been trading as the ABC Partnership for some years, preparing their accounts to 31 December each year. The facts are as follows.

Key points

- Partners are taxed in the same way as sole traders on their share of adjusted profits or losses.
- Partners' salaries are a means of allocating profits or losses between the partners.
- Disallowed expenditure added back to calculate the tax adjusted profit or loss should include private expenses.
- If the partnership as a whole had made a loss, a partner cannot be allocated a profit.
- Loss relief is claimed by individual partners and they may make different claims.
- Calculating capital gains on a transfer of partnership property.
- To achieve a high score in exams, question practice and good exam technique are key.

- The partnership agreement states that Ade is entitled to an annual salary of £10,000, Bret £20,000 and Chetna £50,000. Any remaining profits and losses are shared equally.
- The partnership has incurred a tax adjusted trading loss for the year ended 31 December 2018 of £40,000.
- Bret retires from the partnership on 31 December 2018. He has £5,000 of unrelieved overlap profits from when he joined the partnership.
- The ABC Partnership jointly owns an office which it bought for £210,000 in October 2014. When Bret retires, the partnership transfers ownership of the office to him. The office has a market value of £600,000 on 31 December 2018.
- Dieter, who was formerly an employee of the ABC Partnership, becomes a partner on 1 January 2019.
- Chetna is the nominated partner of the partnership.

Tax adjusted profit or loss

The partnership's tax adjusted trading loss for the year ended 31 December 2018 will have been arrived at using the same approach we follow for sole traders as summarised below. The amounts of the pre-capital allowances profits and those allowances are unimportant for the purposes of this article.

Year ended 31 December 2018	£
Tax adjusted profit/loss before capital allowances	X/(X)
Less: Capital allowances	(X)
Tax adjusted trading loss of the partnership for y/e 31 December 2018	(40,000)

We should note the following points when arriving at the tax adjusted trading profit or loss.

- The disallowed expenditure added back in arriving at the tax adjusted profit or loss before capital allowances includes any private expenditure incurred by any of the partners and any partners' salaries that may have been incorrectly expensed in the profit and loss account.

A partner's salary is merely a pre-allocation of the tax adjusted profits and losses to that partner, it is not a true salary and is not a deductible expense for the partnership.

- The capital allowances calculations include private use asset columns for any asset used partly for business and partly for private purposes by any of the partners. Only the business use percentage of the first-year allowance, annual investment allowance and writing down allowance is taken across into the capital allowances column and is actually deductible.
- If the accounting period is not exactly 12 months long, we have to be careful in the calculation of the maximum annual investment allowance and ensure the writing down allowances are time apportioned for the length of the accounting period.

Allocation between the partners

In ***Profit or Loss Allocation***, we will now allocate this loss between the partners using their agreed profit sharing arrangements.

The salaries are just a means of allocating any profits or losses between the partners. As can be seen in ***Profit or Loss Allocation***, we still allocate out the partners' salaries even when the partnership has made a loss. The salary allocations simply increase the total loss that has to be shared out between the partners using the profit-sharing ratio (PSR).

Again, watch out if the accounting period is not exactly 12 months long – the annual salary figure would need to be time apportioned by reference to the length of the accounting period in the calculation of the profit or loss allocation.

Looking at ***Profit or Loss Allocation***, we can see that Ade has been allocated £30,000 of the partnership loss and Bret has been allocated £20,000 of the loss, but Chetna has been allocated a £10,000 profit.

Profit or Loss Allocation

Year ended 31 December 2018	Total £	Ade £	Bret £	Chetna £
Tax adjusted loss	(40,000)			
Less: Salaries	(80,000)	10,000	20,000	50,000
	(120,000)			
* PSR 1:1:1	120,000	(40,000)	(40,000)	(40,000)
	Nil	(30,000)	(20,000)	10,000

Notes: * PSR = profit-sharing ratio

If the partnership has made a loss, each of the partners must either be allocated a loss or nil for tax purposes. We refer to Chetna's £10,000 profit as a 'notional profit' – in other words it is not a real profit for tax purposes and consequently we must reallocate it between the other partners based on their total shares of the loss so far as shown in ***Reallocation***.

In the same way, note that if the partnership had made a profit, each of the partners must either be allocated a profit or nil amount for tax purposes and any 'notional loss' would need to be reallocated between the other partners.

Allocation to tax years

Because Ade and Chetna have been in the partnership for several years, their tax adjusted results for the year ended 31 December 2018 will be assessed in the tax year 2018-19 on a current year basis. This gives Ade a loss of £24,000 which is allocated to 2018-19 and Chetna's assessment for 2018-19 is £nil.

Reallocation

Year ended 31 December 2018	Total £	Ade £	Bret £	Chetna £
Tax adjusted loss of partnership	(40,000)			
Less: Salaries	(80,000)	10,000	20,000	50,000
	(120,000)			
Apply PSR: 1:1:1	(120,000)	(40,000)	(40,000)	(40,000)
	Nil	(30,000)	(20,000)	10,000
				Notional profit
Reallocate to Ade:				
$\frac{(30,000)}{(30,000) + (20,000)}$ x 10,000		6,000		(6,000)
Reallocate to Bret:				
$\frac{(20,000)}{(30,000) + (20,000)}$ x 10,000			4,000	(4,000)
Tax adjusted trade losses per partner		(24,000)	(16,000)	Nil

Bret leaves the partnership on 31 December 2018 so we use the closing year rules for Bret. Bret's loss allocated to 2018-19 is as follows.

	£
Tax adjusted loss of y/e 31 December 2018	(16,000)
Less: Unrelieved overlap profits (given)	(5,000)
Bret's loss allocated to 2018/19	(21,000)

When Dieter joins the partnership on 1 January 2019, we will use the opening year rules to allocate the tax adjusted profit or loss of the year ended 31 December 2019 to tax years for Dieter.

Loss relief

It is up to each individual partner how they obtain relief for their trading losses; a particular loss relief claim by one partner has no effect on the claims available to the others.

Ade's trading loss of £24,000 in 2018-19 could be used in the following ways.

- It could be set against his net income of either 2018-19, 2017-18 or both of these tax years starting with whichever tax year he wants (under ITA 2007, s 64).
- Some of his unrelieved trading loss could be converted into a 'pretend' current year capital loss in the same tax year as he has made his claim against net income to get relief against chargeable gains (under ITA 2007, s 71).
- Any unrelieved loss could be carried forward against his trading income in 2019-20 and future tax years until all of the loss is relieved (under ITA 2007, s 83).

> "It is up to each individual partner how they obtain relief for their trading losses; a particular loss relief claim by one partner has no effect on the others."

Chetna has no loss to relieve for tax purposes.

Bret's trading loss is £21,000 in 2018-19, his final tax year of trade. Bret has the same options for using this trading loss as Ade, except that he cannot carry the loss forward against his future trading income from the partnership because he is no longer a partner.

Instead, Bret could make a terminal loss relief claim (under ITA 2007, s 89) to set this loss against his trading income of 2017-18, 2016-17 and 2015-16 in that order.

The terminal loss is that of the final 12 months of trade – because Bret's final accounting period, the year ended 31 December 2018, was 12 months long the closing year loss allocated to 2018-19 and his terminal loss will both be the same – £21,000.

Ade and Bret can each choose to make completely different loss relief claims.

If the partnership continues to make trading losses in the year ended 31 December 2019, Dieter will be able to claim to set his share of any losses incurred in any of the tax years 2018-19 to 2021-22 (the first four tax years of his trade) against his net income in the three previous tax years (under ITA 2007, s 72). This would enable Dieter to obtain relief for his trading losses against other income including his previous employment income.

Capital Gains Computation

	Ade £	Bret £	Chetna £
Sale proceeds = market value	200,000	200,000	200,000
1/3 x £600,000			
Cost			
1/3 x £210,000	(70,000)	(70,000)	(70,000)
Gains	130,000	130,000	130,000
		↓	
		Notional gain	

Capital gains tax

The partnership owns the office building which is transferred to Bret's sole ownership on 31 December 2018. In the absence of any information on capital-sharing ratios, we assume that the partners own the office in the same shares as the profit-sharing ratios. In this case, Ade, Bret and Chetna own the office equally.

On 31 December 2018, when the office is transferred to Bret, we have to calculate the gain that would have arisen if the partnership had sold the office on that date for its market value. See ***Capital Gains Computation***.

Ade and Chetna have each made a chargeable gain of £130,000 in 2018-19 which will go into their capital gains tax computations. Assuming they have no other chargeable gains or capital losses in that year, they will each deduct their annual exempt amount and tax their taxable gain at 10% or 20% depending on how much taxable income they each have.

Bret's gain is a notional gain. It is not a real chargeable gain because he has not disposed of a chargeable asset, instead he now owns 100% of the office himself.

Bret is deemed to have acquired the office for its market value of £600,000 on 31 December 2018. We deduct his notional gain of £130,000 from the market value of the office to give us his base cost of the office for any future disposal as follows.

	£
Market value of office	600,000
Less: Notional gain	(130,000)
Base cost of office for Bret	470,000

National Insurance

Each partner is liable to class 2 National Insurance contributions at the relevant flat weekly rate for the number of weeks for which they have traded (in other words, the time they have been in the partnership) during the tax year.

However, if a partner's trading profits are below the 'small profits threshold' (£6,205 for 2018-19) no class 2 contributions are due. Hence neither Ade, Bret nor Chetna will be liable to any class 2 NIC for 2018-19. Before claiming exemption, they should consider the effect on their entitlement to state benefits, such as the retirement pension.

The trading income assessment for Ade, Bret and Chetna will also be nil in their income tax computations for 2018-19. It is this trading income figure that is used to calculate their class 4 National Insurance contributions for 2018-19 and therefore none of the partners will have any class 4 liability for that year either. However, Ade can carry his trade loss of £24,000 forward to set against his trading income in 2019-20 onwards for the purposes of calculating his class 4 liability. This is regardless of whatever claim he makes to use this loss for income tax purposes.

On the other hand, if Bret claims terminal loss relief for his £21,000 terminal loss, this will also reduce his trading income for class 4 purposes in 2017-18, 2016-17 and 2015-16 resulting in a repayment of the overpaid Class 4 contributions.

When Dieter joins the partnership on 1 January 2019, he will start to pay class 2 and class 4 contributions. For 2018-19, his first tax year of trade, he will pay class 2 for the number of weeks in 2018-19 that he was a partner which will be about 13 weeks. His profits for class 4 purposes will be his trading income assessment for 2018-19.

Administration

The ABC Partnership does not pay tax on its profits. Instead the partners must file their individual self-assessment tax returns and pay over their tax due as normal.

As the nominated partner, Chetna should have submitted a partnership return to HMRC showing how the trading loss had been allocated between the partners for the year ended 31 December 2018 and the chargeable gains for each partner on the disposal of the office to Bret.

Because the partnership has traded for a number of years, the partnership self-assessment tax return relates to the tax year 2018-19. The due date for this partnership return is 31 January 2020, being 31 January following the tax year to which the partnership return relates.

If Chetna files the partnership return late, *each* partner is liable to the following maximum penalties:

Delay	**Penalty per partner**
	£
Late	100
Three months late	£10 a day (for a maximum of 90 days)
Six months late	£300
12 months late	£300

Planning point

Each partner has control over how they obtain relief for any trading losses. A loss relief claim by one partner has no effect on the way in which claims are made by the other partners.

As can be seen from the previous table of delays and penalties, no tax geared penalties apply to a late filed partnership return because the partnership itself does not pay tax on its profits.

Each partner who was a member of the partnership for the period covered by the return is also liable to penalties for errors in the partnership return – the maximum penalty ranging from 30% to 100% of the error in the partnership return for each partner.

It is also worth noting that an enquiry into the partnership return extends to an enquiry into each individual partner's self-assessment return as well.

Other points

The following additional points should be noted when dealing with partnerships.

- If the ABC Partnership is VAT registered, Bret leaving and Dieter joining the firm will have no effect on its VAT registration.
- As a retiring partner, Bret should ensure that all creditors of the ABC Partnership are made aware that he is no longer a partner. This prevents Bret from remaining jointly and severally liable for any debts incurred by the ABC partnership after 31 December 2018, when his involvement ceases.
- If Dieter takes out a bank loan to make his capital contribution to the partnership when he becomes a partner, any interest he pays on this loan is allowed as a deductible payment in his income tax computation.
- A partnership comprising only individuals may also be eligible to use the cash basis of accounting. Remember that if a cash basis election is made, the individual partners can only make claims to set their trade losses against trade income (either under ITA 2007, s 83 or s 89).
- A partnership made up of individuals only may also claim to use simplified expenses for motoring expenses and business use of home.

Summary

The approach to an exam question on partnerships is similar to that for a sole trader question, with, potentially, a few additional points to watch out for as highlighted in this article. As always, question practice and good exam technique on the day are key to achieving a good score on a question relating to the taxation of partnerships.

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