Choosing the right one

Debbie Bray looks at the trade loss reliefs for individuals and companies examinable at ATT paper 2.

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Remembering the rules for how to relieve losses can be tricky, especially because the rules for individuals and companies are different. Things are made harder by the fact that the loss relief rules for companies have changed over recent years.

Setting up a new business can be risky. It may involve a lot of up-front expenditure such as legal and accounting advice, as well as capital investment to buy the items of plant and machinery to be used in the trade. It may take time to attract customers and for the staff to work out the most efficient ways of working. Consequently, a new business may make trading losses in its early years.

Experienced businesses may suffer trade losses too. This may happen if they lose an experienced member of staff, if there is an economic downturn, or if advances in technology render their product or service obsolete. An experienced business may be able to turn things around and become profitable again, others may fail and cease to trade.

Sole trader

Let's start by considering a business which is run by an individual as a sole trader. Individuals pay income tax so the main loss reliefs either reduce the tax payable or provide a refund of tax already paid.

By way of an example consider Blossom. She runs a business and prepares her accounts to 31 March each year. For the year ended 31 March 2020 she incurred a tax adjusted trading loss of £120,000.

Blossom is an individual, so we need to allocate this trade loss to tax years. Here the loss relates to the tax year 2019-20. Her trade profits for 2019-20 are therefore nil. In the exam we would record a trade loss of £120,000 in a working called a 'loss memo' before looking at the options available to Blossom to relieve this trade loss.

If Blossom has been trading for a while, she can choose to set this loss against the net income in her income tax computation for either:

- 2019-20 – the tax year of loss; or
- 2018-19 – the previous tax year.

There is no set order for this loss relief under ITA 2007, s 64. If Blossom wants to, she can set the loss against her 2018-19 net income only, there is no need for her to use any of it in 2019-20 first. Alternatively, she may want to set the loss against her net income in 2019-20 only, or she may want to use it against her net income of both of these tax years, in which case she can choose which of the two tax years to claim loss relief in first.

Of course, Blossom may decide that she does not want to make any claims against her net income at all.

The downside of a net income claim is that the net income must be reduced down to nil if this is possible (more on this shortly) with the result that the personal allowance may be wasted. This is often referred to as an 'all or nothing' claim.

Setting the loss against her net income will enable Blossom to relieve her trade loss against other types of income in her income tax computation.

After making a net income claim under s 64, Blossom could claim to set some of the remaining trade loss against her chargeable gains in the capital gains tax computation. This claim under ITA 2007, s 71 (and TCGA 1992, s 261B) means in effect that we 'pretend' some of her trade loss is a capital loss and has arisen from selling a chargeable asset for sale proceeds which were lower than the cost of the asset.

The loss can only be converted to a capital loss in the same tax year that a net income claim has been made under ITA 2007, s 64. In other words, if Blossom wants to convert some of

Key points

- Unexpected events can cause financial problems for businesses.
- Individual traders' loss reliefs can be used to reduce their income tax.
- Some loss reliefs can be claimed against earlier years' income.
- Terminal loss relief is calculated in two parts.
- Company loss reliefs are set against its total profits.

her trade loss to a capital loss in 2018-19, she needs to make a net income claim in 2018-19 first.

If Blossom has any unrelieved trade losses, they are carried forward and automatically set against the first available future trade profits that she makes from the same trade – regardless of whether she wants to – under ITA 2007, s 83.

See ***Loss reliefs for sole traders and partners*** for a summary of the reliefs available to any business.

Additional loss reliefs are available if the sole trader incurs a loss (see ***Other loss reliefs for sole traders and partners***):

- in any of the first four tax years of their trade; or
- in the final 12 months of their trade.

If 2019-20 was one of the first four tax years of Blossom's trade, in addition to the reliefs already mentioned, Blossom could make a claim to set the trade loss against her net income in each of the three previous tax years, starting with the oldest of those tax years first, under ITA 2007, s 72.

In this case, Blossom may relieve income she had earned before she started to trade, such as employment income.

On making this claim, Blossom would set her trade loss against her net income for 2016-17 first, then against her net income for 2017-18 and finally against her net income for 2018-19.

Again, this is an 'all or nothing' claim so Blossom has to use enough loss to bring her net income down to nil in each of those three tax years if possible.

The amount of loss which may be relieved against an individual's net income under ITA 2007, s 64 or s 72 may be restricted in use. There is a maximum amount of trade loss that can be set against income that is not trade income in the income tax computation in any tax year. Note that this restriction applies only to the loss used against income which is not trade income.

The maximum amount of loss relief against net income which is not trade income is the higher of:

- £50,000; and
- 25% of the adjusted total income in that tax year.

For exam purposes, the adjusted total income is the net income for that tax year less the amount of any grossed-up personal pension contributions paid in the year.

Therefore, this restriction should be considered in the exam only if both the trade loss to be relieved and the total net income in the tax year are more than £50,000.

Terminal loss

Finally, if an individual incurs a trade loss in the final 12 months of their trade, this is known as a terminal loss. An additional relief is available under ITA 2007, s 89 to s 90 for this.

The terminal loss is calculated in two parts, either side of where the tax year changes, in the final 12 months of trade. In Blossom's case however, where the final accounting period of trade is exactly 12 months long, the terminal loss will always be the same as the actual closing year loss for the final tax year of trade.

The terminal loss is carried back three years but only against trading income, starting with the most recent tax year first. In Blossom's case, the terminal loss would be set against her trade profits of 2018-19, then against her trade profits of 2017-18 and finally against her trade profits of 2016-17 if there was any unrelieved terminal loss left.

> "Instead of carrying the loss forward against future trading profits, the terminal loss is carried back against trading profits made in the past."

The logic behind terminal loss relief is that there will be no more trading profits in the future to carry the loss forward against because the business has ceased. So, instead of carrying the loss forward against future trading profits, the terminal loss is carried back against trading profits made in the past.

It is up to Blossom to decide if she wants to make a terminal loss relief claim and, if so, whether she wants to make a net income claim under s 64 before she makes a terminal loss claim or after she makes a terminal loss claim. The order in which these reliefs are claimed is flexible.

Loss reliefs for sole traders and partners

Loss relief	ITA 2007, s 64	ITA 2007, s 71 (TCGA 1992, s 261B)	ITA 2007, s 83
Available for which losses?	All trade losses	All trade losses	All trade losses
Relief in which tax year?	Loss making tax year and/or previous tax year	Loss making tax year and/or previous tax year	Future tax years
	Any order	Section 64 claim must be made first in the same tax year a s 71 claim is made	
Loss set against	Net income subject to restriction	Gains	First available future trading profits from the same trade
Claim	One year from 31 January following year of loss	One year from 31 January following year of loss	Four years from end of tax year of loss (so that HMRC know the amount of loss)

Other loss reliefs for sole traders and partners

Loss relief	Additional relief for new businesses ITA 2007, s 72	Additional relief on the cessation of a business ITA 2007, s 89 to s 90
Available for which losses?	Losses in first four tax years of trade	Trading loss in final 12 months of trade = terminal loss
Relief in which tax year?	Three years before year of loss on FIFO basis	Three years before final tax year on LIFO basis
Loss set against	Net income subject to restriction	Trading profits
Claim	One year from 31 January following year of loss	Four years from end of the tax year of cessation

Company trade loss reliefs

Current year	Against total profits 'All or nothing' (bring total profits down to nil if possible)
	Claim – two years from the end of the loss making accounting period (CTA 2010, s 37(3a))
Carry back	Against total profits of the previous 12 months, 'all or nothing', must do current year claim first (CTA 2010, s 37(3b))
	For a terminal loss (loss made in the final 12 months of trade) the carry back is extended to the previous three years (CTA 2010, s 39)
	Claim – two years from the end of the loss making accounting period
Carry forward	Pre 1 April 2017 losses: Against future profits of same trade (automatic) (CTA 2010, s 45)
	Post 1 April 2017 losses: Any amount against future total profits (requires claim) (CTA 2010, s 45A)
	Claim – two years from the end of the future accounting period

In deciding which loss reliefs to claim, factors which an individual should consider are:

- try to avoid wasting the personal allowance;
- try to use the loss in tax years where a higher rate of income tax is paid; and
- the future is uncertain, so it may be worthwhile getting relief now rather than waiting – this helps cashflow with either no tax paid now or tax from a previous tax year repaid.

If a partnership makes a trading loss, the loss is allocated to each partner for each accounting period. From this point, each partner is treated as a sole trader and can use loss reliefs as they wish – the loss relief claims made by their fellow partners are irrelevant.

Companies

Trade loss relief for a company is more straightforward. A company is a separate legal entity from its shareholders, so only it can use any trade losses it incurs.

Most loss reliefs for a company are set against its 'total profits' for the accounting period on the corporation tax computation. 'Total profits' are the different types of income and chargeable gains on the corporation tax computation before deducting the qualifying charitable donations.

> "There are no additional loss reliefs available for a company when it starts to trade."

If Blossom Ltd had incurred a trade loss of £120,000 for its year ended 31 March 2020, the company would, in effect, have three options to relieve the trade losses:

- Carry the trade loss forward and claim to set any amount of the loss against the total profits of the next or future accounting periods.
- Claim to set the trade loss against the total profits of the year ended 31 March 2020 (the loss-making accounting period) and then carry any unrelieved trade loss forward and claim to set any amount against the total profits of the next or future accounting periods.
- Claim to set the trade loss against the total profits of the year ended 31 March 2020 (the loss-making accounting period), then carry back the trade loss and set it against the total profits of the year ended 31 March 2019 (the 12 months before the start of the loss-making accounting period), and carry any unrelieved trade loss forward and claim to set any amount against the total profits of the next or future accounting periods.

The claims against total profits in both the loss-making accounting period and the previous 12 months are 'all or nothing' claims so Blossom Ltd must bring its total profits down to nil if it has enough loss to do so.

Conversely, the claim against total profits of future accounting periods is for any amount so tax relief for qualifying charitable donations can be preserved.

If the year ended 31 March 2020 was Blossom Ltd's first accounting period of trade, after the company has made a current year claim against total profits, all it can do is carry any unrelieved trade loss forward to set against the total profits of future accounting periods. There are no additional loss reliefs available for a company when it starts to trade.

If Blossom Ltd's year ended 31 March 2020 was its final accounting period of trade this loss is a terminal loss. The rules for the terminal loss of a company are the same as for any other loss, the only difference is that the terminal loss can be carried back against the total profits of the previous 36 months instead of against the previous 12 months.

In this case, Blossom Ltd would set its terminal loss against the total profits of the year ended 31 March 2019, then against the total profits of the year ended 31 March 2018 and finally against the total profits of the year ended 31 March 2017 having first made a claim against the total profits of the year ended 31 March 2020 (the loss making accounting period).

Unlike with an individual, there are no complicated calculations of the terminal loss for a company, it will normally be the loss of the final accounting period of trade.

If the final two accounting periods of trade for a company were, say, the nine-month period to 31 March 2020 and the year ended 30 June 2019:

- The trade loss of the nine months ended 31 March 2020 could be carried back to the years ended 30 June 2019, 30 June 2018 and 30 June 2017.
- Three-twelfths of the trade loss of the year ended 30 June 2019 would also be a terminal loss and could be carried back to the years ended 30 June 2018, 30 June 2017 and 30 June 2016. The remaining nine-twelfths of this loss would not be a terminal loss and could only be carried back 12 months to the year ended 30 June 2018.

Planning point

The claim against total profits of future accounting periods is for any amount so tax relief for qualifying charitable donations can be preserved.

The only other thing to watch out for with a company is if the trade loss was incurred before 1 April 2017. In that case, the trade loss carried forward could be set against the company's first available trade profit from the same trade only.

And that's pretty much it. See ***Company trade loss reliefs*** for a summary of the loss relief options and time limits for making each claim.

There may be a restriction in the amount of carried forward loss which can be used in each future accounting period for a company but this is not considered here because it applies only to companies with large amounts of losses and is not something that we would expect to see in an ATT paper 2 exam question.

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