Make it a partnership

In this back to basics article Nicole Neville explains what partnerships are for tax purposes and how different taxes treat partnerships differently.

© iStockphoto/AlisaRut

I woke up and the sun was shining! After endless days of rain, this was a welcome sight. How to celebrate? I decided to start the day with a run around the park and then buy myself a smoothie from 'Smooth Operators' on my way home.

So, 30 minutes later having worked up a sweat, nay, glow, I was walking into 'Smooth Operators' looking forward to my banana-berry smoothie.

I was met by Brenda Blender (who set up the business with Lucy McJuicy and Terry Yaqui). Brenda was looking troubled. 'Everything ok?' I enquired.

'Not really' she responded: 'Our accountant slipped on a banana skin and has informed me he is out of action for the foreseeable future.' Brenda continued. 'I am an expert smoothie maker but when it comes to partnership tax, I haven't got a clue!' And of course, we are still coming to terms with Terry's retirement from the partnership. He plans to set up a sushi shop.'

Well, with a name like Terry Yaqui I was surprised he had ever considered joining the 'Smooth Operators' partnership. But given Brenda's obvious dismay, I thought it wise to keep that thought to myself. She was joined by Lucy (the other partner) who gave her a sympathetic smile and then turned to me and said: 'You know a bit about tax, I'll whip you up a smoothie and you can help us out!'

Before I knew it a smoothie was thrust in my hand and Brenda and Lucy were looking at me expectantly. 'Assume we know absolutely nothing about the taxation of partnerships,' said Lucy encouragingly. 'Take us back to basics!' added Brenda.

Key points

- The need for a partnership agreement.
- The partners are not employees and a partner's 'salary' actually represents an initial allocation of profit.
- Interest on capital is an initial allocation of profit before the general sharing ratios apply.
- The profit shares are the amounts to be shown on a partnership's tax return.
- The partnership does not pay tax – the partnership return records partners' profits. They settle their own taxes based on their self-assessment return.
- There are National Insurance contributions and capital gains tax consequences to consider.

What is a partnership?

The three of you – Brenda, Lucy and Terry – set up a business in partnership. This involved the three of you working together in a business with a view to making a profit. If the business does well you share profits and if the business does poorly you share losses.

Partnerships ideally should have a partnership agreement. This should be drawn up at the commencement of a partnership and details the partners' understanding of how they see the partnership working. Points to include in an agreement – and these are by no means exhaustive – would be:

- how the profits and losses of the partnership are going to be shared;
- rules on admitting a new partner to the partnership;
- the retirement of a partner. This may include notice periods or some partnerships even have compulsory retirement when you reach a certain age;
- rules on the conduct of the partners;
- the ownership of assets which are not always owned equally between the partners – some more senior partners may have a greater share in, say, the property; and
- rules on the resolution of disputes.

'Oh yes – we do have a partnership agreement', says Lucy. 'And I have a copy of it right here!' As she pulls it out of the pocket of her apron, I take a long sip of my smoothie and swallow with a cough and splutter!

'It's one of Lucy's new recipes,' says Brenda sympathetically, 'It's called EnerJuicer, a mix of kale, spinach and leek.'

'Here we go,' interrupts Lucy. 'Our partnership agreement states that profits and losses should be shared equally between the three of us; and assets are also owned equally.

Retiring partners have to serve a six-month notice period, which is exactly what Terry did before leaving at the end of August 2020.

How is a partnership's income taxed?

'So please explain to us how partnerships are taxed?' asks Brenda, subtly swapping my EnerJuicer for a FunkiFruiti.

'In fact, I just happen to have our most recent set of accounts right here. You can help us calculate our tax liabilities!'

With this, they talked me through the relevant information in their accounts.

Lucy, Brenda and Terry set up in partnership five years ago making up accounts to 31 March each year. The accounting profit for the year ended 31 March 2021 is £181,000 after charging the following expenses:

- Depreciation: £1,000.
- Gift of a smoothie maker to a regular customer on her 90th birthday. The smoothie maker had the 'Smooth Operators' logo on its base: £250.
- On 31 May 2020 the business purchased some new kitchen equipment: £10,855.

The tax written down value of assets for tax purposes at 1 April 2020 was a general pool of £30,000 and a car (carbon dioxide emissions 102g/km) at £18,000. The car is provided to Lucy and is used 50% privately.

Annual salaries are: Lucy £25,000; and Terry £24,000. The appropriate amounts have been included in wages expenses when calculating the accounting profit.

Terry had a capital account of £50,000 and received 3% interest on capital. The appropriate amount of interest was deducted in arriving at the accounting profit.

Step 1: adjust the accounting profit for tax purposes

The first step in calculating the partnership's tax liability is to adjust the accounting profit to arrive at the tax adjusted profits for the year ended 31 March 2021 as follows:

	£
Profit per the accounts:	181,000
Add: Disallowed expenses	
Depreciation:	1,000
Gift to customer (cost > £50):	250
Salaries £25,000 + (£24,000 x 5/12):	35,000
Interest on capital (3% x £50,000 x 5/12):	625
Less:	
Capital allowances (see computation):	(17,875)
Adjusted profits for year ended 31 March 2021:	£200,000

'The partnership has accounts for the year ended 31 March 2021 which show a profit of £181,000. Initially we adjust this accounting profit to arrive at taxable profits. For example, expenses which are not allowable for tax such as depreciation and the gift to the customer are added back and capital allowances are deducted.'

Brenda interrupts me: 'Can you explain the adjustment for salaries, what is that about?' Her tone takes a confrontational turn. 'We are not employees. This business is not run through a company. We are in partnership.'

Capital allowances for year ended 31 March 2021

	AIA @ 100% £	General pool £	Private use car £		Total CAs
WDV b/f		30,000	18,000		
Additions:					
Kitchen equipment	10,855				
AIA@100%	(10,855)				10,855
WDA@18%		(5,400)			5,400
WDA@18%			(3,240)	x 50%	1,620
					£17,875

I take a long sip of my FunkiFruiti. It tastes incredible and gives me the fortitude to continue. 'Do not be confused by the word "salary" here. Such payments are not taxed as employment income. As partners, you are self-employed – you are not employees. Though this is often referred to as a partner's "salary", this actually represents an initial allocation of profit.'

'That makes sense.' Lucy interjects 'We all agreed that Terry and I would get a 'salary' because we are prepared to work the evening shifts allowing Brenda to have her evenings free to pursue her beetle herding hobby.'

Beetle herding – really?

I resist the urge to ask Brenda about her hobby and I take another sip of my FunkiFruiti. It is truly sublime! I continue: 'Interest on capital is treated in exactly the same way as partners' salary. Again, it is just an initial allocation of profit before the general sharing ratios apply. Do not be confused by the term "interest". It is not really interest as we know it – it is just a chunk of advance profit paid to Terry based on the balance he held on his capital account. We simply treat his "interest" as a share of trading income.'

Brenda nods and confirms that when the partnership was set up, Terry contributed £50,000 to the partnership to help towards the cost of working capital. This amount was credited to his capital account.

I clarified that, when I adjusted the profits for Terry's salary and interest on capital, I prorated the annual amounts as Terry was only in the partnership for the first five months of the accounting period as he left on 31 August 2020.

STEP 2: allocate adjusted profits

The second step is to allocate the adjusted profits to the partners.

I explain that as a result of Terry leaving the partnership, the profit-sharing ratio has changed. The partnership agreement states that profits are to be shared equally between the partners. While Terry is a partner, profits are split in the ratio 1:1:1 (one-third each). But when Terry leaves the partnership, the profits are shared between Brenda and Lucy in the ratio 1:1, (one-half each). So we need to split the accounting period around the date Terry leaves, 31 August 2020. We then deal with these periods separately and use the ratios applying for that particular period to determine the profits to be allocated to

Allocating adjusted profits

Y/e 31 March 2021	Total (£)		Brenda (£)	Lucy (£)	Terry (£)
First 5 months					
5 months of 'Salary'	20,417			10,417	10,000
5 months of 'Interest' on capital	625				625
	21,042				
Balance (1:1:1)	62,291		20,764	20,764	20,763
5 months of adjusted profit	83,333	83,333			
Last 7 months					
7 months of 'Salary'	14,583			14,583	
Balance (1:1)	102,084		51,042	51,042	
7 months of adjusted profit	116,667	116,667			
TOTAL FOR THE YEAR		200,000	71,806	96,806	31,388

each partner. The combined profit from those split periods will give us the allocation for the whole of the accounting period.

'And we must not forget to allocate "salaries" and "interest on capital" as an initial allocation of profits' points out Lucy. 'Absolutely right! And then the residual profit is split according to the profit sharing ratio,' I continue. See ***Allocating adjusted profits***.

Step 3: apply basis period rules to allocated profit share

The final step is to deal with the individual partners as though they were sole traders (ie apply the basis period rules to allocate their profit share to the relevant tax year). Continuing partners (Brenda and Lucy) are assessed by taxing their profit share under current year basis rules. However, the retiring partner (Terry) will be assessed on his profit share using the cessation rules.

Applying current year basis, Brenda will be taxed on £71,806 in her 2020-21 tax return and Lucy will be assessed on her profit share of £96,806 in her 2020-21 tax return.

Under the cessation rules, Terry's final tax year of trading is 2020-21. He is simply taxed on profits from the end of the 2019-20 basis period (1 April 2020) to the date he ceases trade as a partner in the partnership (31 August 2020). So he will include £31,388 in his 2020-21 tax return. As the partnership prepares accounts to 31 March, Terry has no overlap profits to relieve.

Brenda pipes up: 'And these profit shares are the amounts we need to show on the partnership tax return.' I nod encouragingly. Brenda and Lucy have turned out to be great students as well as great smoothie makers. I clarify that the accounting year to 31 March 2021 ends in 2020-21 and therefore the profits will be reported on the partnership return for 2020-21.

'So how do we calculate the partnership tax?' Lucy asks.

'The partnership does not actually have a tax liability. The partnership return simply records the individual partners' profits and then the individual partners settle their own taxes based on their own self-assessment return.'

What other taxes are applicable?

I take a last sip of my FunkiFruiti and prepare to leave. I have finished my smoothie and my partnership income tax tutorial! I head towards the door of the shop as another person enters. He is carrying a large platter which he places on the counter with a dramatic flourish. 'I came as soon as you called,' he said with a conspiratorial wink at Brenda and Lucy, 'And I have brought some sushi for you to sample,' he adds.

I am about to walk out the door when Lucy calls me back, 'You can't go yet, we have only discussed income tax, what about the other taxes? Can you please explain to us how our National Insurance liability is calculated? And Terry came specially to ask you about capital gains tax.'

I knew something *fishy* was going on!

Brenda is pressing a RedBerry smoothie into one hand and a plate of sushi into the other as the three of them look at me expectantly.

I resign myself to staying longer, but at least I will be well fed!

'Well once your profits for the accounting period have been allocated to you, for both income tax and National Insurance contribution purposes you are then taxed like sole traders. As sole traders you will pay class 2 NIC which is £3.05 per week for the tax year 2020-21. Class 4 NIC is calculated based on your share of the taxable trading profit of the partnership.'

Both Brenda's and Lucy's profit share is above the upper limit of £50,000 for class 4 NIC. They will pay NIC at a rate of 9% on their share of the profits between the lower profit limit of £9,500 and the upper limit of £50,000. The excess profits, above the upper limit is subject to NIC at 2%.

Brenda's class 4 NIC is:	£(50,000 – 9,500) x 9%= £3,645
	£(71,806- 50,000) x 2%= £ 436
	£4,081
Lucy's class 4 NIC is:	£(50,000 – 9,500) x 9%= £3,645
	£(96,806- 50,000) x 2%= £ 936
	£4,581
Terry's class 4 NIC lability based on his share of profits from the Smooth Operators partnership is:	£(31,388 – 9,500) x 9%= £1,970

I demonstrate my chopstick prowess as I eat a delicious piece of sushi washed down with a long sip of the RedBerry smoothie. Brenda's smoothies are incredibly tasty. Why are the ones I make at home never as good? What does she put in them, I wonder.

Capital gains tax for asset distribution

I am brought out of my culinary reverie by Terry requesting some explanation as to his capital gains tax position.

'When I left the partnership in August 2020, I withdrew the cash from my capital account. The shop unit which we bought for £45,000 when we started in partnership was transferred into my sole ownership'.

'We used to trade from this unit, until we started renting our current shop which we agreed was in a better location' explained Lucy.

'But it is ideally situated for my sushi business,' interjected Terry, 'So Brenda and Lucy agreed to transfer it to me when I left the partnership.'

I turn to Terry: 'There are no capital gains tax consequences when you withdraw cash from your capital account on leaving the partnership. You are simply withdrawing what belongs to you. But there are capital gains tax consequences on the transfer of the shop unit from the partnership to Terry.'

Brenda and Lucy are treated as having each given up a one-third share of a partnership asset, this being a disposal by Brenda and Lucy for capital gains tax purposes. As far as Terry is concerned, his fractional share in the asset goes up from one-third to 100%, and therefore Terry has made a capital acquisition.

We therefore need to calculate the capital gain for Brenda and Lucy, and the new base cost of the asset for Terry.

'To calculate the capital gain and the revised base cost, there is a three-step procedure.'

I pause to eat another piece of sushi and revel in a long drink of the RedBerry smoothie. Terry, Brenda and Lucy look at me impatiently. I continue:

'Step 1 is to calculate the chargeable gains which would have arisen had all three of you disposed of your fractional shares at market value. Effectively we are calculating a capital gain in the hands of each of you, assuming the asset had been sold by you to an outside third party for its market value.'

'The market value of the shop unit at August 2020 was £150,000,' supplies Terry helpfully.

'As per the partnership agreement, we each had an equal share of the partnership asset so the gains that would have arisen had we all sold the shop unit for its market value would be as per this neat little table I've drawn up.' See ***Gains on sale of shop unit at market value***.

I continue with Step 2: The gains accruing to Brenda and Lucy (those giving up the asset) are charged to capital gains tax.

'Oh dear,' Brenda and Lucy say in unison. 'Another tax liability!'

Planning point

As a starting step, any partnership should draw up a partnership agreement setting out the way the partners envisage the partnership to function. Failing to prepare is preparing to fail.

Gains on sale of shop unit at market value

	Brenda (1/3) £	Lucy (1/3) £	Terry (1/3) £
Market value	50,000	50,000	50,000
Less: Cost	(15,000)	(15,000)	(15,000)
Gains	35,000	35,000	35,000

'But no tax liability for me,' says Terry smugly.

'That's right,' I say. 'We finish with step 3: The gain accruing to Terry, the partner receiving the asset, is only a notional gain and is not charged to capital gains tax . Instead, Terry, as the receiving partner, is deemed to have bought the asset for an amount equal to the market value of the asset, less this notional gain. In effect, the notional gain is rolled over and reduces Terry's capital gains tax base cost.'

Terry adds: 'So my base cost of the unit will be:

Market value	£150,000
Less: Notional gain	(£ 35,000)
Base cost	£115,000'

Terry is a fast learner.

Bittersweet

I am pleased that I have provided Brenda, Lucy and Terry with a good grounding in the tax rules on partnerships.

I take the final satisfying slurp of my RedBerry smoothie and eat the last slice of sushi and prepare to leave. 'Brenda – your smoothies are truly delicious. I don't know how you do it. When I try and make smoothies they never taste this good.'

Brenda beams. 'It is the secret ingredient that makes all the difference! And before you ask, I can't tell you what it is otherwise it wouldn't be a secret.'

Brenda must see the disappointment in my face because she continues, 'But I will give you a clue. It is directly related to my unusual hobby.' And all of a sudden her smile seems to take a sinister turn.

What was Brenda's hobby?

Beetle herding! ●

Author details

Nicole Neville ACA, CTA is a senior tutor at Tolley Exam Training. She can be contacted on 020 3364 4500 or examtraining@lexisnexis.co.uk. Visit www.tolley.co.uk/products-and-services/exam-training.

FIND OUT MORE
On Taxation.co.uk

- Partnership deferral of self-assessment payments: tinyurl.com/3u4bnnus
- Tax treatment of partnerships: Tax treatment of partnerships: tinyurl.com/ctze9f8a