

Tax Losses

1st Edition

Katherine Ford

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About the author

Katherine Ford BCom FCCA CTA is the manager of the direct tax telephone advice team at Abbey Tax Protection, where she has worked since 2007. She has dealt with over 22,000 calls from accountants, tax advisers and business owners covering all areas of UK direct taxes and stamp duties. She also provides training at client seminars and to colleagues. Katherine has a particular interest in business taxes, partnerships, capital gains tax and residency and domicile issues.

After a brief spell working for an insolvency firm after graduation, Katherine worked for over six years in the private client department of Deloitte, dealing with a variety of self-employed and high-net worth clients and complex professional partnerships.

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Abbreviations

AIA	Annual investment allowance
ATED	Annual tax on enveloped dwellings
BIM	Business Income Manual
BPRA	Business premises renovation allowances
CA	Capital Allowances Manual
CAA 2001	Capital Allowances Act 2001
CFM	Corporate Finance Manual
CG	Capital Gains Manual
CGT	Capital gains tax
CIR	Commissioners of Inland Revenue
CIRD	Corporate Intangibles Research and Development Manual
CT	Corporation tax
CTA 2009	Corporation Tax Act 2009
CTA 2010	Corporation Tax Act 2010
CTM	Company Taxation Manual
DE	Deductions from earnings
DOTAS	Disclosure of tax avoidance schemes
ECJ	European Court of Justice
EEA	European Economic Area
EIM	Employment Income Manual
EIS	Enterprise investment scheme
ESC	Extra statutory concession
EWCA	England and Wales Court of Appeal
FA	Finance Act
FHL	Furnished holiday lettings
FYA	First-year allowance
GAAR	General anti abuse rule
HMRC	Her Majesty's Revenue & Customs
HS	Helpsheet
IBA	Industrial buildings allowance
IHTA 1984	Inheritance Tax Act 1984
INTM	International Manual
ITA 2007	Income Tax Act 2007
ITEPA 2003	Income Tax (Earnings and Pensions) Act 2003
ITTOIA 2005	Income Tax (Trading and Other Income) Act 2005

LLP	Limited liability partnership
NIC	National Insurance contributions
NIM	National Insurance Manual
NRCGT	Non-resident capital gains tax
NTLRD	Non-trading loan relationship deficit
PA	Personal allowance
PE	Permanent establishment
PIM	Property Income Manual
PPR	Principal private residence
Pt	Part
R&D	Research and development
SAIM	Savings and Investment Manual
Sch	Schedule
SEIS	Seed enterprise investment scheme
SI	Statutory instrument
SME	Small or medium sized enterprise
SP	Statement of practice
SSCBA 1992	Social Security Contributions and Benefits Act 1992
SSE	Substantial shareholdings exemption
STC	Simon's Tax Cases
TC	Tax Chamber
TCC	Tax and Chancery Chamber
TCGA 1992	Taxation of Chargeable Gains Act 1992
TE	Taxable earnings
TMA 1970	Taxes Management Act 1970
TSEM	Trusts, Settlements and Estates Manual
UKFTT	United Kingdom First-tier Tribunal
UKSC	United Kingdom Supreme Court
UKUT	United Kingdom Upper Tribunal
UTR	Unique taxpayer reference
VCM	Venture Capital Schemes Manual

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3. Partnership loss restrictions

3.1 Overview

In recent years, partnerships have been a commonly-used vehicle for tax avoidance. Film partnerships were often used to create tax losses where no economic loss had been made by the partner. The *Limited Liability Partnerships Act* of 2000 made partnerships very attractive vehicles and “mixed partnerships”, i.e. those with a mixture of individual and corporate members (with the corporate often owned by the individual), became commonplace. Typically, profits went to the corporate members as corporation tax rates were lower and losses went to the individual members who then received higher rates of income tax relief – and why wouldn’t you if you can?!

Early restrictions targeted film partnerships, limited partners and non-active partners. *Finance Act* 2013 brought in an annual cap for individuals for sideways loss relief (and qualifying loan interest) against income (but not gains) of the higher of £50,000 or 25% of adjusted total income (see **1.3.1**). However, it was not until *Finance Act* 2014 that HMRC brought in some really effective partnership restrictions, particularly regarding the profit and loss allocations for mixed LLPs, as well as applying the loans to participator charges and reclassifying salaried partners in LLPs as employees in some cases.

Throughout the legislation and guidance for individuals, the term “sideways loss relief” is used. For an individual, this means (per ITA 2007, s. 103) loss relief against his or her total income under s. 64 (against net income of the current and/or previous year) or s. 72 (early years’ losses). HMRC also use the term “capital gains relief” which refers to trade losses set against capital gains under TCGA 1992, s. 261B (for which a s. 64 claim must be made first). See **Chapter 1** for further details of these reliefs. For ease of reference, sideways loss relief in this book means all of the above. For a company, the restrictions apply to losses set against total profits (CTA 2010, s. 37) or to group relief claims (CTA 2010, Pt. 5).

It is a fundamental principle that if a partner wants to obtain sideways relief for a trading loss, there must actually be a trade (see the cases of *Ensign Tankers* and *Samarkand Film Partnership*) and that trade must be carried on on a commercial basis with a view to making a profit (ITA 2007, s. 66 – see **1.3.3**).

Cases: *Ensign Tankers (Leasing) Ltd v Stokes* [1992] STC 226; *Samarkand Film Partnership No 3 & Others v RCC* [2017] EWCA Civ 77

3.2 Types of partners

Different restrictions apply to different types of partnerships so it is essential to understand which type of partner and partnership you are dealing with:

3.2.1 Members of LLPs

HMRC's Business Income Manual at BIM 82110 provides good background notes to LLPs and the rights and responsibilities of their members.

As mentioned above, LLPs and particularly those with a mixture of individual and corporate partners, were used for perceived tax avoidance for many years. The adjustments to profit and loss allocations that are now required under ITTOIA 2005, s. 850C-D have made mixed LLPs considerably less attractive. See HMRC's guidance on mixed partnerships.

Guidance: BIM 82110, BIM 82700 onwards; www.gov.uk/government/publications/mixed-membership-partnership-aifms-and-asset-disposal-rules-legislation-day-technical-note-and-guidance

3.2.2 Limited partners

HMRC provide some useful notes at BIM 82101 as to the rights and responsibilities of a limited partner. Partners are either general partners or limited partners and the latter, as the name suggests, cannot participate in the management of the partnership and their liability is capped to their capital contribution on joining plus any undrawn profits. It is the limited partners who are subject to the partnership-specific restrictions on their loss relief.

For tax loss relief purposes, the definition of a limited partner includes an individual who is:

- a limited partner in a partnership registered under the *Limited Partnerships Act 1907*;
- a partner who seems to act as a limited partner; or
- a partner in an overseas partnership who is not allowed, under the relevant overseas laws, to participate in the management of the trade and who has limited liability for any trade debts.

Law: ITA 2007, s. 103A

Guidance: BIM 82101, BIM 82615

3.2.3 Non-active partners

A “non-active partner” is an individual who carries on a trade as a member of a partnership (including as a member of an LLP but excluding a limited partner) and who does not spend a “significant” amount of his or her time working in the trade.

“Significant” means that such partners must personally spend on average at least 10 hours a week working in the trade, throughout the basis period for the tax year. If the basis period is less than six months, then for a newly commenced trade, you consider their working time in the first six months of trading; for a trade that has ceased, you look at the work they did in the six months up to the cessation date. The trade must also be carried on on a commercial basis and with a view to making profits.

Sideways loss relief is restricted for non-active partners in the first four tax years in which they carry on the trade. See **3.3.2** and **3.3.3**.

Law: ITA 2007, s. 103B

Guidance: BIM 82640, 82645, 82650

3.3 Restrictions

3.3.1 Restrictions generally

Restrictions on the amounts of an individual partner’s trading losses available for sideways relief are applied before any general restrictions, such as the £50k/25% sideways loss relief cap (see **1.3.1**) and before any loss relief claim can be made. The restrictions affect the following types of partner:

- limited partners (under the *Limited Partnerships Act 1907*);
- members of LLPs (under the *Limited Liability Partnerships Act 2000*);
- non-active partners (typically spending less than 10 hours a week working for the partnership) in their first four tax years of trading; and
- partnerships whose trade includes the exploitation of films or licences.

Restrictions also apply to corporate partners but only in relation to the sideways relief being capped to their capital contribution.

The restrictions to sideways relief take the following forms and are applied in the following order:

- Step 1: cap the cumulative sideways loss relief to the amount of the partner's capital contribution. This is considered throughout the individual's time as a partner rather than just looking at one year in isolation (see **3.3.2** below).
- Step 2: apply the annual limit on sideways loss relief of £25,000 (see **3.3.3**).
- Step 3: consider if sideways relief needs to be denied for "tax-generated losses" (see **3.3.4** and **1.3.5**).
- Step 4: consider whether there needs to be a restriction on sideways relief for a member of a film partnership and whether there needs to be an "exit charge" for a member of a film partnership, or of a partnership that exploits licences, who has then disposed of his or her partnership share (see **3.3.5**).
- Step 5: deny loss relief altogether if an "excessive amount" of a loss is allocated to a member of any mixed partnership (see **3.3.6**).
- Step 6: apply the £50k/25% loss cap (see **1.3.1**).

NB: these loss restrictions only apply to trades (apart from losses at Steps 3 and 5 as those provisions also applies to professions or vocations) and do not apply to loss relief given against income from the same trade.

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