3. Partnership losses

3.1 Approach to claiming income tax losses

3.1.1 Overview

Relief is available for trading losses incurred by a partnership, but the process of establishing the loss and how that loss can be used has become very complex as a result of a number of anti-avoidance provisions that have been introduced, often in response to tax schemes that made use of partnership losses.

It is best to approach a loss claim by following a series of steps. Broadly, these are as follows:

- Establish the allocation of losses between the partners.
- For mixed-member partnerships, consider whether the anti-avoidance provisions in relation to excess allocation of losses to non-corporate partners apply.
- Establish what options are available to a partner for using his or her share of loss: sideways loss relief, carry-forward relief, terminal loss relief.
- Where sideways loss relief is contemplated, consider whether any partnership restrictions apply, principally in relation to limited partners, non-active partners, LLPs or capital contributions.
- Consider whether any of the broader anti-avoidance provisions for tax-generated losses apply.
- Consider the overriding restriction on deductions against income applying to sideways loss relief, which is broadly the greater of £50,000 and 25% of adjusted total income.

Law: ITTOIA 2005, s. 849B; ITA 2007, s. 116A; Pt. 4, Ch. 2, 3; Pt. 13, Ch. 5

3.1.2 Establishing the loss for each partner

When a partnership makes a loss (as adjusted for tax purposes), that loss is allocated to the partners. If, after that allocation, some partners have a loss, but others have a profit as a result of priority allocation of salaries or notional interest, a second allocation is required for tax purposes so that all partners show a nil allocation or a loss. The second allocation of the loss is done in proportion to the loss initially allocated to each of the loss-making partners.

Example

Christine, Etienne and Jacques are in partnership. They have agreed that Christine would have a prior allocation of profits of £30,000, and thereafter the profits are to be shared Christine 30%, Etienne 30% and Jacques 40%. The partnership makes a loss for the year of £17,500.

The initial allocation produces the following result:

	Christine £	Etienne £	Jacques £	Total £
Salary	30,000			30,000
Balance of loss	(14,250)	(14,250)	(19,000)	(47,500)
Total	15,750	(14,250)	(19,000)	(17,500)

As a result, Christine has a profit, whereas Etienne and Jacques have a share of loss that exceeds the total loss for the partnership. The loss allocation must be recomputed in proportion to the losses initially allocated to Etienne (14,250/33,250) and Jacques (19,000/33,250).

The revised allocation is:

	Christine £	Etienne £	Jacques £	Total £
Net allocated	15,750	(14,250)	(19,000)	(17,500)
Allocation ratio	Nil	14.25/33.25	19/33.25	
Reallocated	Nil	(7,500)	(10,000)	(17,500)

This allocation is only for tax purposes, so the allocation in the accounts will follow the agreed profit/loss sharing ratio. Although Christine is allocated a profit, she will not pay tax on her share of profit. Conversely, Etienne and Jacques will have tax losses that are smaller than their allocated loss.

Law: ITTOIA 2005, s. 850B

Guidance: BIM 82245; PM 163050

3.1.3 Overview of losses available

Individuals who are partners in a partnership or LLP can claim trading loss relief, making use of the same provisions as are available to a sole trader. References to a loss in a trade are treated as references to a partner's notional trade. With a small number of exceptions, trading loss relief will apply to professions and vocations as well as trades. In outline, these reliefs are:

- trade loss relief against general income either of the year of loss or of the previous tax year, or both;
- trading loss treated as a capital loss and set against capital gains;
- early-years trade loss relief, which allows losses incurred in the first four years of trade to be set against general income of the three years preceding the year of the loss;
- carry-forward trade loss relief, where losses not otherwise used against general income (sideways loss relief) can be carried forward and set against future profits from the same trade;
- carry forward of trading losses where a trade is transferred into a company in exchange for shares, and set against income from the company; and
- terminal loss relief, where losses incurred in the 12 months to permanent cessation can be set off against profits of that trade in the three previous tax years.

However, the availability of sideways loss relief (the first three bullet points above) is subject to complex anti-avoidance rules that apply to certain types of partner, and which impose restrictions based on the capital contributed to the partnership.

Losses for corporate partners follow the normal rules for corporate loss relief. In outline these reliefs are:

- relief for trade losses against total profits of the company in the accounting period of the loss or of the preceding 12 months, so long as the trade was being carried on in that previous period;
- terminal loss relief, where losses incurred in the final 12 months of trade can be set off against total profits of the

previous three years so long as the trade was carried on in those earlier periods;

- carry forward of trading losses. Losses incurred in an accounting period beginning before 1 April 2017 can be set off only against future profits from the same trade; later losses can be carried forward and set against the company's total profits (subject to special rules for profits over £5m, where there is a restriction to the amount of losses that can be set off);
- group relief and consortium relief, which allow losses to be surrendered to other group or consortium companies.

There are some anti-avoidance rules in relation to losses for corporate partners, but these are straightforward by comparison to those that apply for income tax purposes. At the end of this chapter we will look at the restrictions specific to corporate partners, but a closer look at corporate loss relief is beyond the scope of this book.

There are also special provisions that apply to farming and market gardening for both income tax and corporation tax losses.

Law: ITA 2007, Pt. 4; CTA 2010, Pt. 4, 5
Guidance: BIM 85000; CTM 04000

3.2 Sideways loss relief

3.2.1 Trade loss relief against general income

Sideways loss relief under ITA 2007, s. 64 can be claimed against general income of the year of the loss, or by reference to general income of the year preceding the year of the loss. A supplementary claim can be made to extend the loss relief to chargeable gains.

The claim must specify the years for which the loss is to be used. The claim can be:

- for the loss-making year;
- for the previous tax year; or
- for both tax years.

If a claim is being made for both years, it must specify which year is being used first, and income for that year must be exhausted before setting losses against the other year. It is not possible to make partial claims for both years.

Example

Jacques's share of losses is £10,000 for the year 2022-23. He also has rental income of £20,000 in 2022-23 and £6,000 in 2021-22.

The following sideways loss relief claims are possible:

- Offset the £10,000 against the rental income of £20,000 in 2022-23.
- Offset £6,000 against income in 2021-22 and carry forward the balance of £4,000.
- Offset £6,000 against income in 2021-22, and £4,000 against 2022-23, leaving £16,000 chargeable in 2022-23.

He could not make a partial claim for both years.

Jacques would probably take the first option, as this would enable him to use his personal allowance in both years to reduce his tax liability to nil.

Section 64 relief is subject to a number of restrictions:

- where the trade is uncommercial (see **3.2.2**);
- in relation to farming and market gardening (see **3.2.3**);
- for tax-generated losses (see **3.2.4**); and
- where the cash basis is used (see **3.2.5**).

The restrictions on trade loss relief for certain partners also need to be considered (see **3.4** below).

Law: ITA 2007, s. 64, 71; TCGA 1992, s. 261B
Guidance: BIM 85015