

Introduction

A partnership is a relationship between two or more people who are in business together with a view to making a profit. The existence of a partnership is a question of fact. There does not have to be a written partnership agreement, but it is preferable to formalise the relationship between the partners in a written agreement to avoid future disputes, which sadly are all too common with partnerships. A written agreement is also useful in cases where HM Revenue and Customs (HMRC) disputes that a partnership exists.

A partnership is not a legal entity in England and Wales, unlike a company. It cannot exist separately from its members. Even where it is, for many tax purposes it is treated as being 'transparent'. Every partner is jointly and severally liable for all debts and obligations of the partnership while they are a partner.

However, tax on partnership profits is not a joint liability of the partnership. Instead, each partner is taxed individually on their share of profits and is liable only for the tax and national insurance on that share.

A limited liability partnership (LLP) is a separate legal entity that combines the organisational flexibility of a partnership with the limited liability of a company. The profits of an LLP are taxed largely in the same way as those of a conventional partnership.

The income tax, capital gains tax (CGT), inheritance tax (IHT) and value added tax (VAT) rules for partnerships are broadly similar to those for sole traders. There are special stamp duty land tax (SDLT) rules that deal with certain partnership transactions involving land.

This section outlines the key issues that are peculiar to partnerships.

Types of partnership

Types of partner

There are five main types of partner in a conventional partnership:

- A *full partner*, also known as an equity partner, is a partner in every sense of the word. Such a partner shares the profits or losses, is liable for all partnership debts and takes part in the management of the business.
- A *salariated partner* is normally an employee of the partnership and pays tax under the PAYE system.
 - Salaried partners often appear as full partners to outsiders. However, they are generally employees whom the firm wishes to promote but who are not yet ready for the benefits and liabilities of full partnership.
 - Salaried partners can be taxed on a self-employed basis if they are in effect full partners. Key indications of this would be having capital at risk and acting with full authority, rather than under the direction and control of other partners.
- A *limited partner* cannot take part in the management of the partnership. As the name suggests, the liability of that partner for partnership debts is limited.
 - A limited partner is not to be confused with a partner in an LLP (see page 3, "Limited liability partnership (LLP)").
 - A limited partner is a member of a conventional partnership in which at least one other member is a full partner.

- The tax rules restrict the partnership trading losses that limited partners can reclaim against their other income to the amount of their capital at risk.
- Any excess losses can be carried forward and set against the individual's share of profits from the partnership in subsequent years.
- A limited partner's share of profits is treated as unearned income rather than earned income.
- The main effect of this is that the profit share is not treated as relevant UK earnings for the purpose of supporting pension contributions.
- A *sleeping partner* has unlimited liability for the debts but is otherwise treated for tax purposes as a limited partner.
- A *corporate partner* is a partner that is a limited company. Such a partner pays corporation tax on its share of profits computed, broadly, using corporation tax rules.

Husband and wife partnership

Where a spouse would otherwise have little or no income, a couple could achieve substantial tax savings if business profits can be shared rather than taxed as the income of one spouse only. For this reason, HMRC will sometimes look closely at a husband and wife partnership. It is important to be able to demonstrate that a partnership is genuine and not simply a way of transferring income between spouses.

- General points that can help in establishing that a genuine partnership exists include:
 - A deed of partnership expressing the intention to carry on the business with a common view to profit, and giving details of the way in which profits are shared.
 - Accounts prepared in accordance with the agreement.
 - The introduction of capital by the new partner, if a spouse joins an existing business of the other spouse. The capital introduced could be either cash or assets.
 - Bank account mandates, VAT registration, business stationery, etc, showing the names of both partners.
- Introducing a spouse as a partner is not always possible or desirable.
 - In some professions, all members of a partnership must be suitably qualified.
 - The husband or wife could instead be an employee, which could also provide tax-saving opportunities, but care must be taken to ensure that the salary paid is not excessive for the work done.
 - There is also a national insurance cost if the salary is more than the national insurance earnings threshold (£110 a week in 2009/10).
- HMRC tried to use the old income settlements anti-avoidance legislation to attack various arrangements for transferring income from a working spouse to a non-working spouse. HMRC argued that where a non-working spouse receives a disproportionate share of profits compared to the contribution made to the partnership, the working partner may be taxed on the non-working partner's profit share. The House of Lords rejected this principle for an arrangement in which a limited company paid dividends equally to a working husband and lowly paid wife who handled administrative matters only. It is not known whether the courts would take the same view towards a partnership. The government stated its intention to introduce legislation to prevent individuals gaining a tax advantage by 'income shifting'. However, the plans have been delayed indefinitely.

Limited liability partnership (LLP)

In a conventional partnership, partners, other than limited partners and most salaried partners, have joint unlimited liability for business debts. Although insurance provides some protection, partners are at risk of having to forfeit personal assets if a claim against the firm exceeds the partnership assets plus its insurance cover. An LLP provides a means of restricting that liability.

- An LLP is a separate legal entity, which is liable for business debts up to the value of its assets.
- Claims can normally be made only against the LLP, not against the individual partners.
- An individual partner could still have personal liability, but this is likely to occur only where a partner has been negligent and had assumed personal responsibility for the advice.
- Other partners cannot normally be made liable for the consequences of one partner's negligence.
- Although LLPs are of most interest to larger partnerships, any partnership of two or more people can register as an LLP by submitting an incorporation document to Companies House.
- An LLP's accounts must be lodged with Companies House, so that anyone can check on the partnership's financial position.
- In contrast, such information about an ordinary partnership is only available to outsiders with the partners' permission.
- Partners in an LLP are taxed on their profits and gains on disposals of partnership assets in the same way as partners in a conventional partnership.
- Although the LLP is a separate legal entity, it is not taxed as such, except after it goes into liquidation. At that point it is taxed as a company.
- There is a restriction on loss relief for members of an LLP carrying on a trade, and some tax exemptions and reliefs are not available to members of a property investment LLP or an investment LLP.

Personal service partnerships

A partnership can be taxed as an intermediary under the personal service company legislation commonly known as the IR35 rules. The rules come into play where a partnership provides the services of one or more individuals to a client in such a way that if the individual worked directly for the client under the same terms, they would be taxed as an employee under the normal rules for distinguishing employment and self-employment. Such contracts are called relevant engagements.

The intermediary partnership has to operate PAYE on income received from a 'relevant engagement', minus some very limited expenses, where:

- The worker (on their own or with relatives) is entitled to 60% or more of the profits, or
- Most of the profits of the partnership come from work for a single client, or
- The individual's income from the partnership is based on the income generated personally from relevant engagements.

The amount that is subject to PAYE is called the deemed payment.

- The deemed payment plus the employer's national insurance contributions (NICs) on it is the income from relevant engagements less the permitted expenses.
- The amount of the deemed payment is not included when computing the individual's share of partnership profits.

In practice most partnerships, other than those where the partners are close relatives, will not fall within these rules. For example, a partnership will be outside the rules if it has two unrelated partners who share profits equally, and it does not receive most of its profits from one client. Where a partnership would fall within the rules, there may be scope for ensuring that the terms of contracts under which work is carried out takes them outside the definition of 'relevant engagement'.

Partnership tax return

- Under self-assessment, the partnership must submit an annual partnership tax return showing:
 - Full details of all partners.
 - The computation of partnership trading or professional income and details of income from other sources.
 - The allocation of income among the partners.
- A nominated partner, selected by the partnership, is responsible for filing the return. HMRC can substitute a different partner if the nominated partner fails to complete the return.
- Partnerships with a turnover in excess of £15 million must submit full accounts and tax computations. They do not have to complete the tax return boxes for details of income and expenses and the balance sheet summary.
- Partnerships with a turnover of £30,000 or more, up to £15 million, must give standard accounts information in the tax return, although they can submit accounts as well if they wish.
- Partnerships with a turnover of less than £30,000 need only show gross income, total allowable expenses and net profit.
- The return includes a partnership statement, which shows each partner's share of profits, losses, income, tax deducted at source, charges and proceeds of disposals of partnership chargeable assets. Chargeable assets are those that can give rise to a CGT liability. The partnership return does not include a computation of chargeable gains; partners have to show a computation of the chargeable gain on their own share of the asset on their personal tax return.
- Filing and payment dates are the same as for individuals.
 - A partnership tax return should be submitted by 31 January following the end of the tax year (the year to 5 April) if it is filed online.
 - If a partnership return is filed on paper, it must be submitted by 31 October after the end of the tax year.
 - If a return is issued within the three months before the filing date for the chosen method of filing, it must be submitted by three months after the issue date.

- The automatic penalty for filing a partnership tax return late is £100 a partner (rather than £100 for the return), with a further £100 a partner if the return is more than six months late. There is no provision to reduce total penalties if the amount of tax is less.
- From a practical point of view, the partnership tax return needs to be completed as quickly as possible, as individual partners cannot complete their own returns accurately until they know the profit and income shares shown in the partnership return.

Assessment of profit

Change from cash basis

Partnership profits must be computed using an accounting basis that gives a true and fair view, subject to specific adjustments provided by tax law. This requires debtors, creditors and work-in-progress to be taken into account.

- This rule applies to accounting periods beginning after 6 April 1999. Before then, some professional partnerships used a cash basis, which ignored debtors, creditors, accruals and work-in-progress, or a hybrid basis that ignored some of these.
- The change from a cash basis to a full accruals basis produced a 'catch-up' adjustment, because the first accounts on the new basis included figures for opening debtors, work-in-progress, etc, that had not appeared in the previous accounts.
- Normally, one-tenth of the catch-up charge was taxable each year, on the anniversary of the day on which it first arose.
- The final year was normally 2008/09, in which the balance of the catch-up charge was taxed.

Work-in-progress

At the time of the change from the cash basis, accounting principles required that work-in-progress should be valued at the lower of cost or net realisable value. In March 2005, the Accounting Standards Board issued a new guidance note, entitled UITF Abstract 40, which changed the valuation method.

- Businesses that provide services performed over a period must now value work-in-progress at full billable value at their accounting date.
- Both staff and partners' time must be included.
- Businesses must value work-in-progress on this basis whether they bill clients by reference to time spent or for a fixed fee.
- Work-in-progress must be valued on this basis for all accounting periods ending after 21 June 2005.
- The change to valuing at full billable value generally resulted in an uplift in profits in the accounting period in which the business adopted the new basis. Businesses were able to spread the extra tax over three or, in certain cases, up to six years.
- Most businesses will benefit from minimising their work-in-progress by issuing regular bills to clients, perhaps even monthly.

Tax provisions

Partners are personally liable for tax on their own share of profits, income and gains. In principle, partnerships do not need to retain a tax reserve to meet future tax liabilities on profits. Instead,

partners could maintain their own savings out of drawings to meet their tax or pay tax out of current income – a risky strategy, which causes difficulty when partnership profits fall and when a partner leaves.

- However, many partnerships prefer to retain profits in the partnership and provide the cash to pay partners' tax liabilities when they arise. The partnership can then use the cash as working capital until the tax payment date.
- The fact that the partnership has retained the 'tax money' does not absolve individual partners from responsibility if the partnership cannot meet the liability.
- The computation of tax reserves can be problematical where individual partners have significant other income.

Basis of assessment

Partnerships can draw up their accounts to any date in the tax year, and can change that date subject to certain conditions. The profits of an accounting period are allocated to tax years in the same way as for sole traders, but with special rules for when partners leave or join a continuing firm.

Partnership profits

For established businesses, tax is assessed on the profits of the accounting period ending in the tax year. For example, the profits of the year ended 31 December 2009 are taxed in 2009/10 (year ended 5 April 2010) and have to be shown on the 2009/10 partnership tax return.

Opening years

There are special rules for the first two tax years in which the partnership carries on business. These adjustments are not shown on the partnership return. They are calculated for each partner individually, based on that partner's profit share, and shown on the partner's personal tax return.

- The first year's tax assessment is on the profits earned from the start of trading to the following 5 April.
- The second year's assessment is normally on:
 - The profits of the 12 months ending on the chosen accounting date in that tax year.
 - The profits of the first 12 months of trading where the accounting date is less than 12 months after the start of the business.
 - The profits of the tax year itself, where there is no accounting date ending in that year. This can occur if a partnership starts near the end of a tax year and has a long first accounting period. For example, a partnership that starts on 1 March 2009 and prepares its first accounts to 30 April 2010 has no accounting date ending in 2009/10.

Overlap profits

The rules for the first two years can result in some profits being taxed twice. These are known as overlap profits. The overlap profits belong to the individual partners. Each partner can claim relief for their overlap profits at the earliest of:

- When the partnership ceases business.
- When the partner leaves the partnership.
- On a change of accounting date that results in more than 12 months' profits being taxed in one tax year. The amount of overlap profits that is relieved depends on the excess length

(over 12 months) of the accounting period being taxed compared to the period for which the overlap profits arose.

Relief for this double taxation will not normally be given until the business ends. However, a change of accounting date could result in earlier relief for overlap profits.

Example

Brown & Daughter started trading on 1 October 2009, making up accounts to 30 September. Mr Brown and his daughter share profits equally.

The trading profits are:

Year ended 30 September 2010	£32,000
Year ended 30 September 2011	£36,000
2009/10 assessment for each partner:	
1.10.09 to 5.4.10: $6/12 \times £32,000/2$	£8,000
2010/11 assessment for each partner:	
12 months to 30.9.10	£16,000

- So each partner has been taxed on £24,000 in respect of the £16,000 profit share of the first year. This means that there are 'overlap profits' of £8,000 for each partner, which are carried forward.

Closing year

Businesses closing down are taxed on the profits from the end of the last period taxed to the cessation of trade. The assessment can therefore be on more than 12 months' profits. For example, a partnership makes up its accounts to 30 June each year and stops trading on 31 January 2011.

- Each partner's assessment for the tax year 2009/10 will be on that partner's share of profits of the year ended 30 June 2009.
- In the final tax year, 2010/11, each partner's tax assessment will be on that partner's share of profits of the period 1 July 2009 to 31 January 2011, the whole 19 months since the end of the accounting period taxed in the previous year.
- Partners might have overlap profits to deduct. However, where the profits earned early in the business were comparatively small, the overlap relief will also be small, leaving a large assessment for the final year.

Partners joining and leaving a continuing business

New partners joining an existing partnership are individually taxed under the 'new business' rules for their first and second (and possibly third) years.

Example

Mr Singh becomes a partner in a firm of accountants on 1 January 2010. The firm prepares its accounts to 30 November.

- Mr Singh must include his share of profits from 1 January to 5 April 2010 in his 2009/10 tax return. If he files online, the return must be submitted by 31 January 2011, but the partnership accounts to 30 November 2010 are unlikely to be ready by that date.
- Mr Singh can use an estimated figure for his profit share and must amend his tax return as soon as the correct figure is available.
- For 2010/11, Mr Singh is taxed on his first 12 months' profit share under the rules for the second tax year, because the first accounting date is less than 12 months after he joined. The return must be submitted by 31 January 2012. If, as is likely, the accounts to 30 November 2011 are not ready by that date, he will have to include an estimated figure for his profit share for December 2010, his twelfth month as a partner.
- Mr Singh is taxed on the normal basis in 2011/12, namely the profits of the accounting period ending on 30 November 2011.
- Mr Singh will have overlap profits for the period 1 January to 5 April 2010 (taxed in 2009/10 and 2010/11) and for December 2010 (taxed in 2010/11 and 2011/12).

Likewise, partners leaving a partnership are taxed on their profit share under the closing year rules in the year of leaving.

- If a partnership does not use 31 March or 5 April as its accounting date, new partners might have to use estimated figures in their personal tax returns.
- Partners who leave a partnership that does not use a 31 March or 5 April accounting date can be taxed on profits of more than 12 months in the year in which they leave.

Other partnership income

Partnerships may receive other income such as savings income, income from letting property or income from a separate overseas trade.

- All income received with tax deducted at source is taxed on a tax year basis. For example, if a partnership receives bank interest from which tax has been deducted at 20%, the amount to be shown on the 2009/10 partnership tax return is the interest credited in the period 6 April 2009 to 5 April 2010.
- All other income is taxed on an accounts year basis. So if the partnership prepares accounts to 31 December, the 2009/10 partnership tax return will show untaxed interest and income from property earned in the accounting period to 31 December 2009.
- Each partner is then taxed on their share of those figures.

Partnership trading losses

A trading loss is shared among full partners in a similar way to the way in which profits are shared. There are five ways in which partnership losses can be relieved. Each partner can claim the relief that suits them best. All loss claims can result in wasted personal reliefs, because it is not possible to restrict the loss claim to avoid this.

Partners who do not spend a significant amount of time in running the trade can only claim relief against other income or capital gains for an amount of losses up to the amount of capital they have contributed to the partnership. The restriction applies only to losses that arise in the first four tax years that the partner carries on the trade. The rule was introduced to combat certain tax avoidance schemes that create loss relief greater than the partner's real liability.

Relief against general income

In general, a partner's share of a trading loss can be set against other income of the tax year in which the loss occurs, or carried back against income of the previous (one) tax year, or both.

- A temporary extension to this relief allows partners and sole traders to carry back losses for up to three years, with later years' profits being relieved first.
- Only losses of the tax years 2008/09 and 2009/10 can be carried back more than one tax year. The amount of losses that can be carried back to the immediately preceding year is unlimited. After carry-back to that year, a maximum of £50,000 of any unused losses is available for carry-back to the earlier two years.
- For established partners, the loss is treated as occurring in the tax year in which the accounting period ends.
- Losses of opening and closing years are calculated in the same way as profits under the self-assessment rules, except that special rules prevent the same loss being in effect relieved twice by being included in the calculation for two tax years.

Relief carried forward

If a partner's share of loss is not relieved against other income, it can be carried forward and set against their share of the first available profits of the same trade, but not against other income.

Relief carried back – opening years' losses

Losses incurred in any partner's first four tax years as a partner can be carried back against that partner's other income of the three tax years before the loss was incurred, using the income of the earliest year first.

Terminal loss relief

Where a partner has a loss incurred in that partner's final 12 months as a partner, it can be carried back against partnership profits from the same trade. The set-off is against the tax year in which the cessation occurs and the three preceding years, taking the latest year first.

Relief against capital gains

An individual partner can set trading losses against capital gains. The loss can be claimed against gains of the same year, and of the preceding year. The claim is an extension to a claim to offset losses against total income.

- There is no prohibition on offsetting the loss against a gain arising in the year before the trade started.
- The gains can be from the disposal of any assets, not just business assets.
- Claiming the relief may waste the annual exemption for CGT, because the relief cannot be restricted to avoid this.

Limited partners

A limited partner, however actively involved in the trade, can set off partnership trading losses against other income and capital gains only to the extent of the partner's contribution to the

partnership capital. The restriction also applies to losses in the opening years, but not to losses carried forward against partnership profits or claimed as terminal loss relief.

LLPs

The restrictions on relief for trading losses apply to members of LLPs in a similar way as to limited partners. There are special rules for calculating a member's capital contribution to the partnership.

The restriction does not apply to losses in a partnership that carries on a profession, only to partnerships that carry on a trade. Provided that the normal conditions for relief are otherwise met, a member of an LLP that carries on a profession is entitled to loss relief against other income.

Personal expenses

Individual partners can claim tax relief for expenses they incur personally for the purposes of the business. For example, partners might own and run their own cars and claim tax relief for the costs of driving on partnership business.

- Such personal expenses must be included as expenses within the partnership return. They therefore reduce the profit for the whole partnership.
- Partners can get the benefit of their own expenses if the taxable partnership profit before personal expenses is allocated in accordance with the normal profit-sharing ratios and each partner's expenses are then deducted from their profit share.

Example

A two-partner firm has profits of £100,000 shared equally.

Partner A has personal expenses of £3,000 and partner B has expenses of £5,000.

The partnership profits are £92,000 (£100,000 – £3,000 – £5,000).

Partner A's profit share is £47,000 (£100,000/2 – £3,000).

Partner B's profit share is £45,000 (£100,000/2 – £5,000).

- Individual partners' capital allowances claims, for example, on the business use proportion of the capital cost of a car, can be dealt with in the same way. Capital allowances are generally deducted from business profits in the same way as business expenses.
- Partners cannot claim tax relief for personal business expenses and capital allowances in their personal tax returns, except for certain loan interest (see "Relief for interest paid" on page 11).

Partnership mergers and other changes

A merger of two partnerships carrying on a similar business is largely ignored for tax purposes, except that assessments will be affected if one or both partnerships change their accounting date. Apart from merging, partnerships may split up into different businesses, or expand by taking over other businesses.

Where the business carried on after any change is substantially different from the previous business, one or more or all of the previous businesses may be treated as having ceased

permanently, with a new trade or trades being set up. Whether this is the case depends on whether a going concern can be traced through the change.

Any cessation or commencement of this nature will result in the partners involved being taxed in accordance with the rules for the closing year or opening years, as appropriate.

Incorporation of a partnership into an LLP is not treated as a cessation and commencement for tax purposes and generally does not have any effect on the way in which individual partners are taxed.

Relief for interest paid

Interest on partnership borrowings for business purposes is treated as a trading expense in the usual way.

- Where individual partners borrow money in order to buy a share in, or invest it in, the partnership, they can obtain relief for the interest against their general income, including partnership profit shares. Relief is restricted if the partner recovers capital from the partnership and ceases if the partner leaves.
- They can also obtain relief for up to three years on interest on money borrowed personally to buy plant and equipment for use in the business.
- There are a number of anti-avoidance rules relating to interest relief and these need to be considered.

Restructuring borrowings

There are various reasons why partners may wish to restructure borrowings so that relief is obtained personally rather than through the partnership accounts. For example, an individual might be able to replace a home loan, which does not qualify for tax relief, or part of it, with fully allowable interest. In all cases where borrowings are restructured, extreme care is needed to ensure that tax relief is not jeopardized.

- For example, if personal borrowings have been introduced into a partnership, and any part is later withdrawn to pay off outside loans, then tax relief will not be available on the interest on the amount withdrawn, even if the same amount is reintroduced.
- Withdrawals of undrawn profits will not jeopardize the tax relief on loan interest.
- Where a partner makes withdrawals from the partnership, it is essential to be able to demonstrate that they represent undrawn profits and that the figure of borrowings introduced previously is not reduced.

There must also be sound commercial reasons for the restructuring.

Personal borrowing

A partner might have borrowed personally to buy a property for use by the business. If the business pays the interest, this is an allowable business expense of the partnership. However, it must be treated as rental income in the partner's hands, with a corresponding set-off for interest paid.

Provided the partnership does no more than pay the interest, and does not repay any of the capital sum borrowed, the individual will have no tax liability on the interest treated as rental income. However, if the partnership also makes repayments of the loan, the payments treated as the individual partner's rental income will be more than the deductible interest, and the difference will be liable to income tax. Receipt of rent after 5 April 2008 may increase the

partner's CGT liability on a later disposal of the property by restricting entrepreneurs' relief (see page 13, "Entrepreneurs' relief").

Investment LLPs

Individuals cannot claim tax relief for interest on a loan to buy into or invest in an investment LLP. An investment LLP is an LLP whose business consists wholly or mainly in the making of investments and which derives the principal part of its income from those investments.

Capital gains tax (CGT)

Partners have to calculate their own chargeable gains on disposals of partnership assets, based on their share of disposal proceeds and acquisition costs.

- They must include these gains on their own tax returns and pay the tax personally.
- The gains are calculated in the normal way.
- Individual partners can claim relief for capital losses and the annual exemption in accordance with their own personal circumstances.

Capital asset share

Each partner is treated as owning a fraction of the partnership's assets. The partnership agreement may specify the way in which gains or losses on capital assets are to be shared, but if not, the gains or losses on disposals will generally be shared in the same ratio as trading profits.

Goodwill

Partnership assets may include goodwill, the value of which may or may not be reflected on the balance sheet. However, any payments made for goodwill on the retirement of partners or the introduction of new partners are treated as disposals for CGT. The same principle applies to payments for other assets.

Change of asset share

- When partners leave or join, or profit- or asset-sharing ratios change, but no payments are made, this is not necessarily a deemed disposal of part or all of the partnership assets. The original costs, or the 31 March 1982 values for assets acquired before that date, are simply reallocated among the current partners.
- CGT may be payable when a partner's profit share changes after partnership assets have been revalued.
 - If partnership assets have been revalued in the accounts, the capital accounts of the partners at that date will have been credited or debited with their share of the revaluation.
 - If there is a subsequent change in the asset-sharing ratios, or partners retire, those partners reducing their shares are treated as having disposed of part or all of their interest in the revalued assets.
 - Such gains may be covered by the annual exemption, or may be eligible for rollover relief.
- Withdrawal or introduction of capital is not a chargeable CGT event.

Connected persons

The general rule for CGT is that transactions between connected persons are deemed to take place at market value. This is modified for partnership transactions.

- Although partners are connected persons, transfers of shares in assets between them are not treated as disposals if they form part of genuine commercial arrangements. For example, a partner might reduce their share of profits and assets in exchange for another partner taking a larger share of the work and responsibilities.
- Where partners are otherwise connected, for example, father and daughter, transactions between them may give rise to deemed CGT disposals at market value, if the consideration would have been different in a non-family situation.

Entrepreneurs' relief

Partners can claim entrepreneurs' relief on the disposal of all or part of their interest in the business, or of business assets within three years after the business has ended or been disposed of.

- The disposal may arise when a partner withdraws from or reduces their share in the partnership, or when the whole partnership sells the business.
- Entrepreneurs' relief reduces up to £1 million of gains by four-ninths. As the CGT rate is 18%, this results in effect in gains being taxed at 10%.
- The partnership must be carrying on a trade, profession or vocation.
- The partner must have been a member of the partnership for at least a year up to the date of the disposal.
- Relief extends to a partner's disposal of an asset owned personally and used for the partnership business, where the disposal of the asset takes place in conjunction with the partner's withdrawal from the partnership.
 - Relief is restricted where the partner has received rent after 5 April 2008 for use of the asset.
 - There are some other conditions (see page 1, "Capital Gains Tax for Business Owners").

VAT

A partnership is treated as a separate legal person for VAT registration purposes.

- HMRC should be informed if there is a change in the members of a VAT-registered partnership. Notification is not needed when profit-sharing ratios change.
- Normally the same VAT registration number is kept.

If a sole trader takes a partner, or a partnership ceases and one partner continues as a sole trader, it is necessary to deregister and reregister. Technically, in these situations there is a sale of the business, which would normally be a taxable supply on which VAT would arise. However, if some conditions are satisfied, such a change is a transfer of a business as a going concern, on which there is no liability to VAT.

Inheritance tax (IHT)

The IHT provisions apply to each partner as an individual, and to their interest in the firm's assets. The transfer of a partner's interest in a partnership business, on death or where a lifetime transfer is or becomes chargeable, will normally qualify for the 100% business property relief.

- However, if the partnership agreement includes a binding arrangement for other partners to acquire the interest, the transfer will not qualify for relief.
- An option for the other partners to acquire the interest will normally preserve the relief.

Assets used in a partnership business but owned by an individual partner qualify only for 50% business property relief.

Stamp duty land tax (SDLT)

The SDLT legislation applies to partnerships and distinguishes between partnership transactions involving third parties and those where a partner or connected person is involved. Where there is a partnership transaction involving a change in a partnership share (income entitlement):

- Acquisitions by the partnership will give rise to an 'entry charge' broadly based on the share of the asset passing to partners who previously had no interest in the asset;
- Disposals by a partnership will give rise to an 'exit charge' broadly based on the share of the partnership asset ceasing to be owned by a person who was previously a partner; and
- Transfers of partnerships shares in a property investment partnership will give rise to a charge. These rules are extremely complex.

The legislation has been amended each year since SDLT was introduced in 2003, and the above is an extremely simple summary of the potential impact. As the charge to SDLT is up to 4% of the gross (market) value of the property, it is essential that the application of the legislation to the specific facts is carefully examined.

Overseas partnerships

If a partnership is managed and controlled overseas, it is deemed to be carried on by non-UK residents. Any UK resident members are liable to UK tax on their share of overseas profits under the normal rules for overseas income. Both UK resident and non-resident partners are taxable on any profits an overseas partnership makes from any trading within the UK. Such profits are taxed in the same way as any other UK trading profits.

Partners' retirement

Pensions

A partner's share of partnership profits from a trade or profession is relevant UK earnings for pension purposes, except for a sleeping partner.

- Partners can obtain tax relief for payments to registered pension plans up to 100% of their partnership profit share of the year of the payment, effectively, subject to a maximum overall contribution limit of £245,000 in 2009/10. However, this limit is not imposed

if 2009/10 is the year in which they draw their retirement benefits from the pension arrangements to which the contributions are made.

- Partners can usually pay up to £3,600 into pension plans regardless of the amount of their profit share.
- Basic rate tax relief is normally given by deduction from the pension payment and any higher rate relief due is given in the individual partner's self-assessment, in the same way as for any other taxpayer.
- From 2010/11, higher rate tax relief on pension contributions will be restricted for people with taxable income of £150,000 or more.
- If the pension plan started before 1 July 1988, basic and higher rate tax relief may be given in the partner's self-assessment.

Annuities

Some partnerships have agreements to provide income for their retired partners or the partner's dependants after death, by paying annuities out of ongoing profits. Such payments are tax deductible for the ongoing partners as charges on income, if they are within certain limits. The limit is broadly 50% of the average of the partner's best three years' assessed profits in the last seven years of full-time work. Increases to take account of inflation are allowed.

Partnerships and companies

For trades and some professions, there is a choice between operating as a partnership or as a limited company. Both have advantages and disadvantages.

An LLP is a sort of middle road, providing the advantage of limited liability to a great extent but not the corporation tax advantage of a company.

- The full rate of corporation tax, currently 28%, is lower than the higher rate of income tax at 40%, and a company with profits up to £300,000 currently pays corporation tax at 21%.
- These lower tax rates may enable greater profits to be retained for the use of the business.

Some professions cannot operate through a company, although this is changing. For example, chartered accountancy practices are now allowed to incorporate.

Incorporation

Incorporation of a partnership business needs careful planning, and professional advice is essential. The details are beyond the scope of this section, but the following points generally need to be considered:

- The tax effect of the closing years' assessments on the partners.
- The ways in which company profits will be extracted, for example, salaries, bonuses and dividends, and the associated tax and national insurance implications and compliance requirements.
- The expected increase in the small companies' corporation tax rate to 22% in 2010.
- The introduction of a 50% income tax rate on income above £150,000 from 2010/11.
- The CGT implications on incorporation. In principle, incorporation involves a disposal of chargeable assets from the partnership to a company. There may be significant chargeable gains, for example, on goodwill. However, if some conditions are satisfied, many of these

gains can be deferred. Also the CGT and IHT implications for the future shareholders should be considered.

- Stamp duty and stamp duty land tax (SDLT) costs. For example, SDLT on property valued at over £500,000 is at a rate of 4%. It is arguable that the partnership SDLT rules result in a zero charge in certain circumstances.
- The ownership of the company. For example, it should be possible to include a larger number and range of shareholders than members in a partnership.
- Items deductible as charges on income for partners may not be allowable for corporation tax without substantial changes.
- The effect upon customers, suppliers, lenders, etc.
- The difficulty of reversing the decision. There are tax reliefs that apply for incorporation but not disincorporation.

Service company

An alternative to incorporation could be to run a service company alongside a partnership to provide services such as staff, office equipment and plant. The arrangements between the businesses must be commercial, but they can be effective in reducing personal tax liabilities for highly profitable partnerships.

A company as partnership member

A company can be a member of a partnership. In this case, the normal rules for assessing profits are modified. The taxable profits are calculated broadly according to corporation tax rules, and the company pays corporation tax on its share of profits. Individuals in the partnership pay income tax on their share of profits.

Conclusion

The taxation of partnerships can be complex, and professional advice is essential. Partners can limit their liability by forming an LLP but there are disadvantages. LLPs do not have any tax advantages. It is important to ensure that the partnership as a whole and the individual partners comply with their tax obligations.

This guide is for general information only and is not intended to be advice to any specific person. You are recommended to seek competent professional advice before taking or refraining from taking action on the basis of the contents of this publication. The guide represents our understanding of the law and HM Revenue & Customs practice as at September 2009, which are subject to change.