



FACT SHEET NO. 9

PARTNERSHIPS

INFORMATION

i A partnership is defined as ‘two people carrying on a business in common with a view to profit’. The word ‘firm’ denotes the people who constitute the partners.

ESTABLISHING WHETHER A PARTNERSHIP EXISTS

The terms and formation of a partnership may be evidenced by a partnership agreement setting out the rights and responsibilities of each partner.

However, a partnership can also be established by oral and other methods e.g. admission by a person in a court action or in an income tax return.

It is advisable that a written agreement should be prepared by a solicitor with partners signing the partnership agreement.

Any written agreement should include the following points:

- how profits or losses are to be shared;
- who has the authority to enter in to contracts on behalf of the firm;
- whether salaries will be paid;
- under what circumstances the business will be dissolved.

ADVICE

“ ” In the absence of a written agreement the Partnership Act 1890 will apply.

In the absence of a written agreement it can be difficult to establish whether the partnership

exists. A common example would be in the case of husband and wife or couples running a business together. Complications arise when some of the bills and accounts of the business are in sole names and some in joint names. In this case it is important then to establish the intention of the parties involved and the evidence submitted by the parties suggesting the business is run on a partnership status.

LIABILITY ISSUES

Partners share equally in the profits and losses of the business unless otherwise agreed.

Partners are jointly and severally liable for the firm’s debts. In other words, partners can be sued jointly or individually for all of the partnership’s debts irrespective of any agreement between them stating the opposite. If one partner ends up paying more than their agreed share to a firm’s creditor then they are entitled to seek redress from the other partner through the courts if necessary.

However, in the case of income tax liabilities there is no joint or several liability and the partner merely has to pay tax on their own share of the profits to the Inland Revenue.

An incoming partner is not liable for the existing debts of the partnership unless the remaining partners and creditors agree otherwise.

An outgoing partner could be liable for subsequent partnership debts unless proper notice is given to the creditors and his/her name is removed from the firm’s style.

The estate of a partner who dies or becomes bankrupt is not liable for subsequent partnership debts.

Anyone representing themselves to a third party as a partner can also be liable.

Every partner is an agent of the firm and therefore an act done by any partner within the scope of their actual or implied authority makes the other partners liable. All partners have implied authority to do anything within the ordinary course of the partnership business, e.g. order supplies and take credit.

Sometimes a partner is a 'sleeping partner' who is not actually involved in the running of the business. Nevertheless a sleeping partner is still jointly and severally liable for the partnership debts.

TAXATION PRINCIPLES

Under the partnership taxation rules a partnership is not regarded as a separate entity for the purpose of taxation and assessments are not raised on the partnership itself. Instead the profits of the partnership are allocated between the partners and assessments are then raised on the partners as an individual.

The Inland Revenue must be notified of the existence of the business and tax returns must be submitted each year.

The tax return provides information on the profit or loss for a period of account ending in the tax year and gives details of the profit-sharing agreement.

The tax return is also used to:

- claim capital allowances;
- claim relief for any business expenses incurred by the partners individually.

Notional profit and losses

Sometimes there are occasions where partners salaries and expenses may end up with that partner being allocated a loss even though the partnership overall made a profit. In these circumstances the partner who made a 'notional loss' will show 'nil' on their tax return and that loss is then allocated to the other partners in proportion to their original profit share percentage.

The partner can also allocate a 'notional profit' to the partnership in the event the partnership as a whole sustained a loss. This is in effect a tax minimisation tactic on the part of the individual partner.

Change in partnership composition

This occurs when a partner joins a partnership or a partner dies or leaves the partnership.

When a partner joins the partnership he/she has effectively commenced trading and is therefore subject to the commencement rules of taxation e.g. notifying the tax authorities of a liability for tax to be charged.

When a partner leaves the partnership he/she will in effect have ceased trading and is therefore subject to the cessation of trade rules e.g. notifying the tax authorities on their tax return the date they left the partnership.

Non partnership trading income

Sometimes the partnership may have income which is not related to trade purposes. This income may be 'taxed' or 'untaxed'.

Taxed income is defined as income from which tax has already been deducted at source and dividends. The taxed income can be divided between the partners in accordance with the profit sharing agreement and each partner will then be assessed to tax individually during the

period in which the taxed income was received. Some taxed income may have to be grossed up as in the case of dividends and bank/building society income in order to calculate the partner's individual tax liability correctly.

Untaxed income is defined as non-trading income which is not taxed at source. The untaxed income arising in a trading year can be allocated between the partners in the profit sharing agreement and each partner again is assessed to tax individually.

TRADING LOSSES: RELIEFS

In the event that a partner incurs a loss he/she is entitled to structure their tax affairs to minimise their tax liabilities. In the case of partnerships, loss relief is available in the same way as sole traders.

The loss relief available is as follows:

Section 385 Income and Corporation Taxes Act 1988.

The trading loss may be carried forward and set off against the future profits of the same trade as and when they arise.

The partner must maximise the relief taken in each year until the loss is fully relieved. However Section 385 may not always constitute the best way to relieve the loss as:

- relief is delayed until the partner actually makes a profit in subsequent years if they ever do;
- the partner does not have control over the amount of relief he/she wishes to use in each year as the maximum amount has to be taken thereby restricting the effective use of personal allowances;
- future tax rates may fall and the relief may be given at a lower rate.

Section 380 Income and Corporation Taxes Act 1988

The trading loss may be relieved against the statutory total income of the partner for a period of up to two years; either

- in the tax year in which the loss is incurred; or
- the previous tax year; or
- both tax years.

The maximum amount of relief must be taken for the whole of the trading loss.

The partner must claim for Section 380 relief by 31 January in the second tax year following the tax year in which the loss was incurred. For example if the partner incurred a loss in 2003/04 a Section 380 claim must be made by 31 January 2006.

Section 387 Income and Corporation Taxes Act 1988

This section relates to trade charges which can be set against the future profits in the same way as under Section 385.

Section 381 Income and Corporation Taxes Act 1988

This allows partners who have incurred a loss in any of the first four tax years to be set against the statutory total income of the three previous years beginning with the earliest year.

Section 381 applies to all three previous years to the loss making year.

The partner cannot choose the years in which he/she wishes to claim the relief nor can they choose the amount of relief they want to take in each year. Only the maximum possible relief is available even if it results in personal allowances being wasted.

Relief must be given against income in order which results in the lowest tax liability.

A claim under Section 381 must be made by 31 January in the second year following the year in which the loss was incurred.

Section 388 Income and Corporation Taxes Act 1988

Section 388 provides relief known as 'terminal loss relief' when trade ceases.

Section 388 allows a trading loss incurred in the last 12 months of trading to be set against the partners profits of the tax year in which cessation occurred plus the previous three tax years.

Relief must be given in later years first.

The partner cannot specify how much relief is to be given in each year and therefore the maximum possible relief must be used each year.

Section 72 Finance Act 1991

Following a Section 380 claim the partner can also reduce his/her tax liability under Section 72 for any unrelieved loss which allows it to be set against the partner's capital gains for the year.

Making a claim under Section 72 is done in the same way as under Section 380.



WARNING

Issues around taxation can be very complicated so if you are in any doubt about the information in this fact sheet then please consult a tax specialist or accountant. You may be able to get assistance from TaxAid, a UK charity who give free, independent and confidential tax advice to people who cannot afford to pay a professional advisor. See www.taxaid.org.uk or **phone us for advice.**

Remember: You can always contact us for advice about any difficulty you have in dealing with your debts.

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