Taxation of Partnerships

A Practical Guide

1st Edition

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4. Capital gains and partnerships

4.1 Introduction

4.1.1 Capital gains tax – an outline

Capital gains tax (CGT) is charged on gains accruing on the disposal of assets by individuals and trustees. Although companies pay corporation tax rather than CGT as such, CGT principles are also applied in relation to companies, with certain variations as mentioned below.

CGT applies to the disposal of most assets, although TCGA 1992 includes a number of exceptions (e.g. motor vehicles), and there are special rules for a number of types of asset, (e.g. shares and securities, and chattels).

Essentially, the gain is computed as the difference between the proceeds and the base cost, with relief also available for incidental costs of purchase or sale.

CGT applies primarily to UK residents, but there are some important exceptions that broaden this scope for certain transactions. Non-residents are subject to CGT on gains on the disposal of UK real estate, and on certain transactions involving the disposal of assets used for the purposes of a trade carried on in the UK through a branch or agency. CGT also applies where an individual makes certain gains while temporarily non-UK resident.

For most purposes, chargeable gains and losses are computed in the same way for individuals and for companies, but there are some reliefs, for example transfers within a group or the substantial shareholding exemption, which apply only to companies. These differences need to be borne in mind when a partnership has corporate members.

Gains and losses accruing in a tax year (for individuals) or accounting period (for companies) are aggregated. Net losses are carried forward, and although the basic rule is that they are set against gains in future years, there are some important modifications to this rule both for individuals and for companies.

For individuals, losses are carried forward (although there is a carry-back facility for losses incurred in the year of death) and set off against future gains after taking into account the annual exempt amount for the year. Losses accruing on the disposal of assets to connected persons can only be set off against gains on disposals to the same person.

Losses accruing to companies are carried forward to future accounting periods and can be set off against future capital gains. However, from 1 April 2020 companies have a deductions allowance which enables them to offset losses in full against the first £5m of profits and gains. Above that figure, only 50% of the remaining gain can be relieved by losses. The allowance of £5m is shared between group companies. The allowance is reduced *pro rata* for accounting periods of less than 12 months. Where a company has a one-day accounting period only by virtue of the gain, the £5m allowance can be used in full.

Capital gains are computed on the difference between the proceeds less the original cost of the asset (or March 1982 value, if appropriate), together with any improvement costs and incidental costs of sale.

There are a number of CGT provisions and reliefs that are particularly common in the context of partnerships, including:

- transfers at undervalue and between connected persons;
- gift relief;
- replacement of business assets; and
- entrepreneurs' relief.

These will be considered in more detail once we have looked at the basis on which capital gains are computed and charged in relation to partnerships.

Law: TCGA 1992, s. 15, 17, 18, 152, 165, 169K, 171, 272 and Sch. 7AC

Guidance: CG 16200C, 60250C, 63950P, 66450C

4.1.2 How are partnership gains taxed?

Partnership gains are dealt with succinctly in TCGA 1992, covered by a single section, s. 59. There is a further section, s. 59A, dealing with LLPs. Most of the detail in relation to CGT and partnerships is addressed in a statement of practice first published in January 1975, SP D12, together with supplementary statements of practice 1/79 and 1/89. There have been suggestions that SP D12 should be put on a statutory footing, but in view of the complexities of doing this, the idea has been put to one side.

Essentially, partnerships, and LLPs for most purposes, are treated as transparent so that a partner's share of partnership gains, and gains accruing to partners in relation to their partnership dealings, are reported on the partner's tax return and treated as his gains and losses, and aggregated with his other gains and losses in the year of assessment.

This is set out in s. 59:

> "(1) Where two or more persons carry on a trade or business in partnership –
>
> (a) tax in respect of chargeable gains accruing to them on the disposal of any partnership assets shall, in Scotland as well as elsewhere in the United Kingdom, be assessed and charged on them separately, and
>
> (b) any partnership dealings shall be treated as dealings by the partners and not by the firm as such."

This wording is almost the same in s. 59A(1) dealing with LLPs, although there are some important exceptions to this basic position in relation to CGT and LLPs (see **4.2.7**).

Law: TCGA 1992, s. 59, 59A

Guidance: CG 27000

4.2 HMRC guidance and practice

4.2.1 Statement of Practice D12

Statement of Practice D12 (SP D12) considers a range of scenarios that are commonly encountered in relation to gains accruing to partners, both in relation to partnership gains and in relation to transactions by the partner on disposal of partnership interests and changes in capital-sharing ratios. It should be remembered that SP D12 does not have any statutory basis, but it has, over the last 40 years, become accepted practice in relation to partnership capital gains. It is, essentially, a non-statutory extension to sections 59 and 59A(1).

The Office of Tax Simplification carried out a review of the taxation of partnerships, and concluded that SP D12 provided a reasonable result in most circumstances, but that parts of it should be rewritten to replace out-of-date language and obsolete content. The current version of SP D12 has taken into account those recommendations.

Guidance: SP D12; CG 27250

4.2.2 Basis of valuation of partnership assets

SP D12 starts by considering the basis of valuation of a partner's share in a partnership asset. Although each partner is treated as owning a fraction of each partnership asset, the valuation is taken as a fraction of the total value of that asset without applying a discount for the size of the partner's share. This is an important distinction when compared with the valuation of a minority interest in the share capital of a company, where the discount for a small minority interest can be as high as 70% or 80%.

Guidance: SP D12; CG 27250

4.2.3 Distribution of partnership assets to the partners

Where assets are disposed of by the partnership, each partner will be treated as disposing of his fractional share in the asset. The disposal proceeds will be allocated according to how they are dealt with by the partnership, which will usually be in accordance with an agreed capital-sharing ratio, or in accordance with the normal profit-sharing ratio. However, if there is no formal agreement on how profits are to be shared, the default *Partnership Act* position is to share profits equally. If there is an agreement outside the accounts as to how the proceeds on a disposal are to be shared, that will be used as a basis for computing the gain for each partner.

Where assets are distributed to the partners, often on dissolution of the partnership, partners who do not receive a share of the asset on distribution will be treated as making a disposal for CGT purposes. The partners who receive a share of the asset on distribution will be treated as having acquired the asset with a base cost that is made up of their own share of the original base cost, plus the aggregate market