

INCOME TAX (TRADING AND OTHER INCOME) ACT 2005

EXPLANATORY NOTES

COMMENTARY ON SECTIONS

Part 9: Partnerships

Overview

3149. This Part of the Act contains the rules that apply to partnerships.
3150. Section 1 of the Partnership Act 1890 defines partnership as “the relation which subsists between persons carrying on a business in common with a view of profit”. Section 4 of the Partnership Act 1890 explains that “firm” is the term used for the purposes of that Act for persons in partnership.
3151. The sections in this Act follow the Partnership Act 1890 and refer to the partners collectively as a “firm”. But the word “partnership” is commonly used as a synonym for “firm”. So the title of the Part and some of the titles of the sections use the word “partnerships”, again following the lead of the Partnership Act 1890.
3152. The rules in this Part of the Act determine each partner’s share of the income of the firm. That income share is then charged under the normal rules for the type of income concerned.

Section 846: Overview of Part 9

3153. This section introduces this Part of the Act. It is new.

Section 847: General provisions

3154. This section introduces the concept of a “firm”. It is based on section 111 of ICTA.
3155. *Subsection (2)* adopts the same approach as the trading income Part of this Act. Most of the Chapters in the trading income Part of the Act have a rule that the trading income rules apply to professions and vocations as they apply to trades. The rules themselves refer only to trades. The sections in this Part refer to trades. They apply also to professions (but not to vocations, which cannot be carried on in partnership). Paragraph (a) of the subsection ensures that there is no need to repeat the phrase “trade or profession”. If the firm has other income, there are special rules for assessing it. The sections then have to deal with businesses other than trades or professions - paragraph (b) caters for that possibility.

Section 848: Assessment of partnerships

3156. This section makes it clear that, for income tax purposes, a firm is not an entity distinct from the partners in the firm. It is based on section 111(1) of ICTA.

3157. In the case of firms established under English law this provision merely confirms their position under that law. But Scottish firms, for example, are legal entities. This provision ensures that all firms are treated in the same way.

Section 849: Calculation of firm's profits or losses

3158. This section contains the basic rules for calculating the profits of a firm. It is based on section 111 of ICTA.
3159. If some of a firm's partners are resident in the United Kingdom and some are not, the profits of the firm's trade must be calculated on different bases. For the resident partners, the calculation includes profits arising outside the United Kingdom; for the non-resident partners, the calculation is restricted to profits arising in the United Kingdom.
3160. Section 111 of ICTA is not explicit that the profits may have to be calculated on more than one basis. This section brings together the rules for resident and non-resident partners. *Subsection (1)* introduces the idea that more than one calculation may be needed.
3161. The source legislation refers to the computation of the profits from the actual trade "for any period". Profits are calculated for a period of account. So subsections (2) and (3) make it clear that the section applies to a period of account. It is possible for a partner to be both resident (for one tax year) and non-resident (for another) within a single period of account. In such a case, the firm's profit has to be calculated twice to arrive at the partner's share of the profits.
3162. *Subsection (2)* sets out the normal basis for calculating the profits, for an individual resident in the United Kingdom. The profits are calculated as if the firm were an individual resident in the United Kingdom.
3163. *Subsection (3)* sets out an additional basis for calculating the profits. If the partner (who may be a non-resident company liable to income tax) is not resident in the United Kingdom the profits of the firm are calculated as if the firm were an individual not resident in the United Kingdom.

Section 850: Allocation of firm's profits or losses between partners

3164. This section is the link between the firm's profits and the amounts assessable on the partners. It is based on section 111(3) of ICTA.
3165. *Subsections (2) and (3)* set out what happens if the calculation of a partner's share of the firm's profits under subsection (1) produces a loss, even though the overall result for the firm is a profit. This is most likely to arise when one or more partners are entitled to a salary or interest on the firm's capital. The "loss" determined under subsection (1) is reallocated to the other partners, to reduce their shares of the profit. See *Change 143* in Annex 1.
3166. It is also possible for the calculation of a partner's share under subsection (1) to produce a profit, even though the overall result for the firm is a loss.
3167. *Subsections (4) and (5)* set out what happens in the case of an overall loss. The "profit" determined under subsection (1) is reallocated to the other partners, to reduce their shares of the loss. See *Change 143* in Annex 1.
3168. *Subsection (6)* contains definitions. If at least one of the partners in the firm is liable to corporation tax, the firm's profit (FP) or loss (FL) will include part of the profits or losses allocated to the partner liable to corporation tax, even though that part of the profits is not charged to income tax. So it is necessary, in the reallocation of the profits under subsection (3) or losses under subsection (5), that the total profits (TP) or losses (TL) include those allocated to the partner liable to corporation tax. The definition of

“partner” for the purposes of the section makes it clear that partners liable to corporation tax are part of the picture.

Section 851: Calculations etc. where firm has other income or losses

3169. This section sets out the rule for a firm’s non-trading income. It is based on section 111(7) of ICTA.
3170. Section 847(2)(a) of this Act applies to this section but section 847(2)(b) does not. So the reference to a “trade” in subsection (1)(a) of this section is to be read as including a profession but not a business.
3171. A trading firm may have income that does not arise from the trade or from a business. Such income is calculated and allocated to the partners in the same way as trading income, in accordance with sections 849 and 850. Each partner’s share is assessed using the basis period rules set out in section 854.

Section 852: Carrying on by partner of notional trade

3172. This section gives the rules for determining when a partner’s notional trade starts and ceases. It is based on sections 110, 111 and 112 of ICTA.
3173. *Subsection (1)* introduces the “notional trade” carried on by each partner. This phrase is used instead of the “deemed trade or profession” in section 111(4) of ICTA. The basis period rules in Chapter 15 of Part 2 of this Act apply to the notional trade carried on by each partner.
3174. *Subsection (2)* deals with a partner joining the firm. The general rule is that the notional trade starts when the partner joins the firm. The subsection makes it clear that the notional trade may start when the firm starts to trade. This is merely implicit in section 111 of ICTA.
3175. *Subsection (3)* is an exception to the general rule. If a firm is formed by a sole trader taking another person into partnership to carry on the same trade, the original trader is treated as starting to carry on a notional trade at the start of the actual trade. This provides continuity of treatment for the original trader.
3176. *Subsection (4)* deals with a partner leaving the firm. The general rule is that the partner ceases to carry on the notional trade when the partner leaves the firm. The subsection makes it clear that the notional trade may end when the firm ceases to trade. This is merely implicit in section 111 of ICTA.
3177. *Subsection (5)* is an exception to the general rule. If a firm is dissolved and its trade is continued by a sole trader, the continuing partner’s notional trade is treated as ceasing only when the actual trade ceases. This provides continuity of treatment for the continuing trader.
3178. *Subsection (6)* is the equivalent for partners of the general rule for individuals in section 17 of this Act.
3179. Section 112(1B) of ICTA operates by treating a partner who changes tax residence as ceasing to be a partner. That triggers a cessation of the deemed trade or profession in accordance with section 111(4)(e) of ICTA. This subsection says directly that a continuing partner who becomes, or ceases to be, resident in the United Kingdom is treated as ceasing to carry on one notional trade and starting another.
3180. *Subsection (7)* preserves the partner’s right to carry forward trading losses even if the notional trade is treated as ceasing by subsection (6).

Section 853: Basis periods for partners' notional trades

3181. This section sets out the rules for determining the basis periods for the assessment of each partner's share of the firm's profits or loss. It is based on section 111 of ICTA.
3182. *Subsection (1)* sets out the general rule that the basis periods for the partner's notional trade are determined by reference to the accounting dates of the firm's actual trade. The subsection repeats the assumption in section 111(2) of ICTA that the notional trade is carried on by an individual.
3183. Section 111(4)(c) of ICTA ensures that, in most cases, the basis period for the partner's deemed trade or profession is determined by reference to the same periods of account as are used by the firm. Section 111(4)(d) of ICTA also ensures that, even if the firm has a change of accounting date, the general rule usually still applies.
3184. This result is stated explicitly in subsection (1)(b) of the section.
3185. *Subsection (2)* deals with an exception to the general rule.
3186. Section 111(5) of ICTA applies if the firm has an "ineffective" change of accounting date. In that case, the basis period rules are applied as if the accounts were drawn up to the old accounting date. The description of the change as ineffective does not appear in the source legislation or elsewhere in the text of this Act. But it appears in the heading to section 219 of this Act and is used here in conjunction with a cross-reference to section 216.
3187. *Subsection (3)* sets out how a firm can give the notice required by section 217 of this Act. It goes on to set out how the firm can appeal against a notice by the Inland Revenue under section 218.
3188. *Subsection (4)* is a special rule to deal with the case of enterprise allowance received by an individual partner. It explains how section 207 of this Act operates so that the allowance is taxed only once.

Section 854: Carrying on by partner of notional business

3189. This section gives the rules for determining when a partner starts or ceases to carry on a notional business. It is based on sections 111 and 112 of ICTA.
3190. *Subsection (1)* introduces the "notional business" carried on by each partner in the firm. The notional business consists of the partner's share of the untaxed income of the firm that is not trade profits.
3191. *Subsection (2)* deals with the start of the notional business.
3192. The general rule in section 111(8) of ICTA is that a partner's income from the notional business (in ICTA, "the second deemed trade or profession") is assessed using the same basis periods as those for the notional trade (in ICTA, "the deemed trade or profession") carried on by the partner. But this rule applies only if section 111(2) and (3) of ICTA apply in relation to the profits of an actual trade (see section 111(7) of ICTA). So, if a firm is formed to receive non-trading income, the general rule does not apply and the non-trading income is assessed on the usual tax year basis.
3193. A problem may arise if the members of an existing firm start trading for the first time. A strict interpretation of section 111(8)(b) of ICTA seems to require that the basis periods for each partner's notional business are determined to be the same as those for the notional trade, not only for the year in which trading starts but also for all the years since the firm was formed. Subsection (2)(b) of this section makes it clear that the partner's "notional business" does not start until the firm starts to trade. See *Change 144* in Annex 1.

3194. *Subsection (3)* makes it clear that the notional business continues even though particular sources of untaxed income may start and cease.
3195. The date on which a partner starts to carry on a notional business is determined by the date on which the partner joins a firm, or (if later) the date on which the firm starts the actual trade. It does not matter when the firm starts to receive untaxed income. Nor does it matter whether in a particular year there is income from the notional business. The basis periods for a partner's notional business may be determined before the firm starts to receive untaxed income. And, once the basis periods are established for the partner, they change only if the accounting date of the actual trade changes.
3196. *Subsection (4)* deals with the date on which a partner ceases to carry on a notional business. This happens when the partner leaves the firm or (if earlier) when the firm ceases to carry on the actual trade.
3197. *Subsection (5)* is the equivalent for partners of the general rule for individuals in section 17 of this Act.
3198. Section 112(1B) of ICTA operates by treating a partner who changes tax residence as ceasing to be a partner. That triggers a cessation of the second deemed trade or profession in accordance with section 111(8)(d) of ICTA. This subsection says directly that a continuing partner who becomes, or ceases to be, resident in the United Kingdom is treated as ceasing to carry on one notional business and starting another.

Section 855: Basis periods for partners' notional businesses

3199. This section gives the rules for determining the basis periods for the assessment of a partner's share of the non-trading income of a firm if the firm carries on a trade. It is based on section 111 of ICTA.
3200. There is no special basis of assessment for a partner's share of the taxed income of a firm, or of the untaxed income of a firm that does not carry on a trade. In those cases, the usual tax year basis applies.
3201. *Subsection (1)* gives the general rule that the basis period for the partner's notional business is the same as that for the partner's notional trade.
3202. *Subsections (2) and (3)* are similar to section 852(3) and (5), dealing with notional trades.
3203. If a firm is formed by a sole trader taking another person into partnership to carry on the same trade, subsection (2) makes it clear that the original trader's notional business starts with the formation of the firm. Similarly, if a firm is dissolved and a partner carries on the same trade alone, subsection (3) makes it clear that the continuing trader is treated as ceasing to carry on a notional business.
3204. It follows from the rules in sections 854 and 855 that the income from the partner's notional business is assessed in accordance with the commencement and cessation rules in sections 199, 200 and 202 of this Act.

Section 856: Overlap profits from partners' notional businesses

3205. This section sets out a special rule to deal with the possibility that the deduction of overlap profit may produce a loss. It is based on section 111(9) of ICTA.
3206. A consequence of the application of the trading income basis period rules is that there may be overlap profit (see section 204 of this Act) of a partner's notional business.
3207. *Subsection (1)* deals with the case where a deduction is made for overlap profit on a change of accounting date (to a date later in the tax year), in accordance with section 220.

3208. *Subsection (2)* deals with the case where a deduction is made for overlap profit on cessation of the firm's actual trade, in accordance with section 205.
3209. *Subsection (3)* gives relief for any excess of overlap profit over the income otherwise to be assessed for the year of the change of accounting date or cessation. This excess would not usually qualify for relief against total income because it is not a trading loss. But this section ensures that relief is given in that way.

Section 857: Partners to whom the remittance basis may apply

3210. This section gives a special rule for the treatment of the profits of a firm that is managed and controlled outside the United Kingdom. It is based on section 112(1A) of ICTA. The source legislation charges the remittance basis partner's share of the profits of such a firm under Schedule D Case V.
3211. In most cases, the charge under Case V rather than Case I has no practical effect on the partner's income tax liability. But, if the profits of the firm arise from the carrying on of a trade wholly or partly outside the United Kingdom, an individual who is assessed on the basis of the amount of income received in the United Kingdom (the "remittance basis") is charged only to the extent that the overseas profits are received in the United Kingdom.
3212. This result is achieved by two rules in section 112(1A) of ICTA which require:
- computation of the firm's profit as if the trade were carried on by an individual not resident in the United Kingdom; and
 - treatment of any profits arising outside the United Kingdom as arising from a "possession out of the United Kingdom".
3213. *Subsection (2)* of the section reproduces the first ICTA rule. The assumption in ICTA that the trade is carried on by a non-resident individual means that the computation of the firm's profits excludes any profits that arise outside the United Kingdom. This section does not require that assumption. Instead, this rule is directed specifically at the profits arising in the United Kingdom to produce the same result. The determination of the firm's profits in accordance with section 849 will involve subsection (2) of that section (because the partner is resident in the United Kingdom – see *subsection (1)(c)* of this section).
3214. *Subsection (3)* of the section reproduces the second ICTA rule. The assumption that the profits arising outside the United Kingdom arise from a "possession out of the United Kingdom" means that the partner's share of those profits may be assessed on the remittance basis. This section treats the profits as "relevant foreign income" for the purposes of this Act. So the remittance basis may apply.
3215. Section 112(1A) of ICTA applies if "any of the partners ... satisfies the Board that he is not domiciled in the United Kingdom...". The quoted words (introduced in 1995) are based on section 65(4) of ICTA as it was until 1996.
3216. As part of the introduction of Self Assessment, all such references to the Board being satisfied were intended to be removed – a person self-assessing could not know whether the Board were satisfied. So the words in section 65(4) of ICTA were changed, by section 134 of and Schedule 20 to FA 1996. The words became "any person who makes a claim to the Board stating that that he is not domiciled ...".
3217. The corresponding amendment to section 112 of ICTA was not made. It is clear that section 112(1A) of ICTA should apply to exactly the same category of person as section 65(4) of ICTA.
3218. This section applies if a partner is an individual who satisfies the conditions in section 831 of this Act. So the rule for a non-domiciled partner is expressed in the same way as the rule for non-domiciled individuals generally.

Section 858: Resident partners and double taxation agreements

3219. This section ensures that a UK resident partner's share of the income of a foreign firm remains liable to United Kingdom tax even though the income of the firm as a whole is exempt from United Kingdom tax in accordance with a double taxation agreement. It is based on section 112(4) and (5) of ICTA.
3220. The business profits article of the United Kingdom/Jersey double taxation arrangement exempts the profits of a Jersey firm from United Kingdom tax. In the case of *Padmore v CIR* (1989), 62 TC 352 CA¹, the Court of Appeal decided that the exemption extended to the share of the profits arising to a United Kingdom resident individual. The rules in section 112(4) and (5) of ICTA were enacted in 1987 to remove the exemption.
3221. *Subsection (1)* sets out the type of individual and firm with which the section is concerned. It goes on to identify the sort of exemption from tax that was considered in the *Padmore* case.
3222. For United Kingdom tax purposes, if it is necessary to consider where a firm is resident, the question is likely to be decided by the place where the firm's business is controlled and managed. But it is possible that, under foreign law, a firm may be considered to be resident elsewhere, for example, by reference to where the firm was established. So the section uses both the "control and management" test and the "resides" test.
3223. *Subsection (2)* makes it clear that the section does no more than remove any exemption under a double taxation arrangement. It does not deny other reliefs, such as tax credit relief. See *Change 145* in Annex 1.
3224. *Subsection (3)* deals with United Kingdom tax credits. A double taxation arrangement may give a non-resident person an entitlement to payment of a tax credit on a distribution by a United Kingdom company. The entitlement is restricted to the share of the distribution that arises to a United Kingdom resident partner.

Section 859: Special provisions about farming and property income

3225. This section clarifies the position of firms that carry on a farming trade or property business. It is based on sections 15 (paragraph 1(3) of Schedule A), 53(2) and 65A(4) of ICTA.
3226. In section 53(2) of ICTA there is a rule that all farming carried on in the United Kingdom by a person is a single trade. The section refers to a "particular person or partnership or body of persons".
3227. In section 15 of ICTA there is a similar rule that all property income activity carried on by a person forms a single property business. Paragraph 1(3) of Schedule A refers to a "particular person or partnership". Section 65A(4) of ICTA, which deals with overseas property businesses, also refers to a "particular person or partnership".
3228. *Subsection (1)* is the rule that all farming carried on by a firm is a single trade. The subsection also makes it clear that the firm's single farming trade is separate from any farming trade carried on personally by a partner in the firm.
3229. *Subsections (2) and (3)* are the corresponding rules for UK property businesses and overseas property businesses.

Section 860: Adjustment income

3230. This section sets out the rules for taxing adjustment income when a trade is carried on in partnership. It is based on paragraph 13 of Schedule 22 to FA 2002.

¹ STC [1989] 493

*These notes refer to the Income Tax (Trading and Other Income)
Act 2005 (c.5) which received Royal Assent on 24 March 2005*

3231. *Subsection (1)* provides that there can be a change of basis at the same time as a partial change in the membership of the firm.
3232. *Subsection (3)* ensures that the adjustment income rules are applied to the firm, rather than to the individual partners.
3233. *Subsection (7)* ensures that the special rules in this section apply instead of the main partnership rules. In particular, the income is allocated between the partners in accordance with subsection (2) instead of section 850. And the charge is on income treated as arising on the last day of the new period of account in accordance with section 232 of this Act instead of by reference to the basis period rules in sections 852 and 853.

Section 861: Sale of patent rights: effect of partnership changes

3234. This section sets out what happens when there is a sale of patent rights by a trader and there is change in the membership of any firm that carries on the trade. It is based on section 558 of CAA.
3235. The rules for intellectual property are split:
- the rules that give capital allowances are in CAA;
 - the rules that charge non-trading profits from the sale of patent rights are in Chapter 2 of Part 5 of this Act; and
 - the special rules that apply to firms are set out in this section and section 862.
3236. If a trader receives a sum from the sale of patent rights in the ordinary course of the trade the sum is a trade receipt. In that case, it is not a “capital sum” and section 524(1) of ICTA ensures that the special rules do not apply. In this Act the treatment is the same because section 575(1) ensures that a charge under Part 2 of this Act takes precedence over a charge under Part 5 of this Act (which includes income from intellectual property in Chapter 2 of that Part).
3237. If a trader receives a capital sum from the sale of patent rights, the sum is excluded from the calculation of the trade profits by the general rule that excludes capital receipts. Instead, the sum is separately charged to income tax under section 587 of this Act. The profit on the sale is charged to tax over six years. But the seller may elect to have the sum charged in the year in which the proceeds of sale are received. Or the charge may be spread in accordance with section 591 or 592.
3238. *Subsection (2)* sets out the “tax condition” for the section to apply. The condition is that the charge on the proceeds from the sale of patent rights is spread over several tax years.
3239. *Subsection (3)* sets out the “partnership condition” for the section to apply. The condition is that the trade that gives rise to the sale of patent rights is carried on in partnership, either at the time of the sale or at any time during the tax spreading period. In this case the charge under section 524 of ICTA “falls to be made on two or more persons jointly” (section 525(3) of ICTA).
3240. *Subsection (4)* sets out the “non-cessation condition” for the section to apply. The condition is that there is not a complete change in the persons carrying on the trade. If there is such a change, section 862 applies instead.
3241. *Subsection (5)* sets out the what happens if all the conditions in the previous three subsections are met: the charge on the proceeds of sale of the patent rights is made on the current partners in the firm. This subsection is based on section 558(3) of CAA.
3242. *Subsection (6)* makes clear the assumptions on which the charge on the current partners is to be calculated. All the current partners step into the shoes of the persons who were partners at the time of the original sale.

Section 862: Sale of patent rights: effect of later cessation of trade

3243. This section sets out what happens when there has been a sale of patent rights to which the previous section applied and there is a complete change in the persons carrying on the trade. It is based on section 525 of ICTA.
3244. *Subsection (1)* sets out the conditions for the section to apply.
3245. *Subsection (1)(b)* is the condition that the current charge on the proceeds from a sale of patent rights is made on a firm. It is possible for an individual to “inherit” such a charge from a firm as a result of section 861. In that case when the individual ceases to carry on the trade the assessment of the remaining instalments of the charge is not disturbed.
3246. *Subsection (1)(d)* is the condition that there is a complete change in the persons carrying on the trade. If there is a partial change, section 861 applies.
3247. *Subsection (2)* is the main rule that when the firm ceases to carry on the trade the remaining tax charges are “rolled up” in the last year of the trade.
3248. *Subsection (3)* sets out how the “rolled-up” charge is split between the current partners on cessation of the trade.
3249. *Subsections (4) to (6)* allow an election to have the remaining tax charge spread evenly over the years since the original sale of patent rights.
3250. The time limit for the election is the same as that in section 593 and is brought into line with the time limit for other elections in this Act. See *Change 104* in Annex 1.
3251. This section does not specify that the election is to be made to “the inspector”. Section 878(4) of this Act draws attention to the rules in TMA, which apply for the purposes of this Act. Those rules require elections to be made to “an officer of the Board”.

Section 863: Limited liability partnerships

3252. This section contains the rules that treat limited liability partnerships (“LLPs”) in the same way for tax purposes as ordinary partnerships (“firms” in this Act). It is based on section 118ZA of ICTA.
3253. The Limited Partnerships Act 1907 established “limited partnership”. It built on the Partnership Act 1890 and established a class of partner whose liability for the debts of the firm did not extend beyond the partner’s contribution to the firm. But there had also to be at least one general partner whose liability was not so limited and the firm was not a separate legal person.
3254. The Limited Liability Partnerships Act 2000 created a new form of legal entity, a limited liability partnership. It is a body corporate with legal personality separate from its members. In many ways, LLPs are treated for non-tax purposes in the same way as companies. In particular, there are requirements as to accounts and audit. Members of an LLP may be subject to disqualification in the same way as directors. And various provisions relating to insolvency and winding up apply to LLPs as they do to companies.
3255. A first version of section 118ZA of ICTA was inserted by the Limited Liability Partnerships Act 2000. FA 2001 replaced it with a new section. Those Acts also introduced special rules (which are not in this Act) for:
- losses;
 - capital gains;
 - relief for interest; and
 - some types of investment vehicle.

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3256. *Subsection (3)* ensures that the basic rule in subsection (1) continues to apply to an LLP if the LLP would otherwise temporarily fail to qualify for treatment as an ordinary firm on account of the LLP:

- ceasing to carry on a trade with a view to profit; or
- being wound up.