TaxZone Newthwire

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Introduction

A principle of tax law is that trading profits are taxed. This used to be dealt with under the old Schedular system of Schedule D, Cases I or II, but this has now been replaced as regards many transactions by The Income Tax Trading and Other Income Act 2005 (ITTOIA).

Logic and fairness prescribe that trading losses should also be allowed for taxation purposes. On the whole, this has become part of tax legislation, although there are certain conditions and time-limits, which we shall explore in this wire.

1. Underlying legislation

The underlying legislation dealing with trading losses is still contained in Chapter I of part X of the Taxes Act 1988, comprising sections 379A - 392. Superficial and other minor changes have been made by section 882 of and paras. 156 to 169 of Schedule 1 to ITTOIA 2005, and the basic law regarding a trading loss is set out in section 26, ITTOIA.

The subject also merits substantial coverage in HMRC Business Income Manual at BIM 75000 – BIM 75760.

Summaries of about 15 tax cases are also included in *Tolley's Tax Cases*.

2. Methods of relief

There are five main ways in which trading losses are dealt with, as follows:

Set-off of loss against other income (section 380, ICTA 1988).

Carry forward of loss to be set against future profits (section 385, ICTA 1988).

Carry back of losses in early years of trade (section 381, ICTA 1988).

Carry back of terminal loss where business or trade has ceased (section 388, ICTA 1988).

Set-off against capital gains where income in the year is not sufficient (section 72, Finance Act 1991).

Each of these scenarios will be considered in turn.

Planning point

Accountants should be conversant with the different types of loss claim that can be made.

3. Allowance against income

The time-limit for a claim against other income in the same year or year preceding the loss is 12 months after 31 January following the year of assessment. Where a claim is made in this way under section 380, it embraces both the allowance of the loss against income in the current year and the preceding year, but the current year takes precedence. The following example illustrates the procedure:

Example one

Strickland makes up his accounts to 5 April each year. His profits and losses are:

http://www.accountingweb.co.uk/photolib/example1_a.gif

He makes a claim under section 380, and the loss will be allowed as follows:

2005/2006 £8,000 against other income
2004/2005 £12,000 against profits

Strickland's amended income for the two years then becomes:

http://www.accountingweb.co.uk/photolib/example1_b.gif

Planning point

Practitioners should be conversant with a section 380 claim, and the relevant time-limit.

4. Losses carried forward

Any balance of trading loss not set off against other income or a capital gain, or carried back in the early years of business or treated as a terminal loss may be carried forward without time-limit as a set off against the first following profits of the same business by the same owner (section 385, Taxes Act 1988). This applies even if the loss would have been covered by the personal allowance in a subsequent year, in which case that allowance may be lost. A loss must be claimed within five years of 31 January following the year of assessment in which it was incurred but, when carried forward, is relieved automatically without any further claim being made.

Certain investment income which, had it not been taxed at source, would have been regarded as trading income, is regarded as an addition to profits, and a loss set against such income may produce a tax repayment.

In the case of a partnership, the share of loss belongs to the partner personally, and is carried forward against his or her share of future assessable profits. It should be noted that, on retirement or death, any unexhausted share of loss lapses.

Planning point

It should be noted that a loss claim must be made initially, even if the loss is subsequently carried forward.

5. Losses in early years of trade

If an individual (including a partner) sustains a loss in a trade, profession or vocation in any of the first four years of assessment from commencement of trading, he or she may claim relief for that loss against other income of the preceding three years, earlier years first. There is no relief where the trade was previously carried on by the spouse earlier than the three years of assessment preceding the loss. Any change in a partnership is disregarded for an individual who is engaged in the trade immediately before and after that change.

The following conditions and obligations, *inter alia*, apply:

Claims must be made in writing twelve months after 31 January following the year in which the loss occurred. There is no statutory mechanism for a late claim under either section 380 or 381, but it may be allowed if it was due to HMRC error, based on an informal claim notified to HMRC or the taxpayer was prevented from making a timeous claim by reasons beyond their control.

The loss claimed cannot be claimed under any other relieving provision.

Capital allowances are automatically included the claim, in that they increase the amount of loss claimed.

Example two

Kingston commenced in business on 6 April 2001. His profits and losses for the first four years of the business are:

http://www.accountingweb.co.uk/photolib/example2.gif

He has no other income, and the loss is allowed against existing profits as follows:

2001/2002 £20,000 – reducing the profits to nil
2002/2003 £30,000 – reducing the profits to nil
2003/2004 £30,000 – reducing the profits to £10,000
2004/2005 Nil assessment

Planning point

Accountants should be aware of the existence of a loss claim in the early years of a business, its mechanism and the time-limit involved.

6. Losses set of against capital gains

Where a claim has been made under section 380, and trading losses cannot be set off against income for the current year or any other year, then a claim can be made under section 72, Finance

Act 1991 for the losses to be set off against capital gains. A claim under section 72 may be made where there is no income in the year of the claim to justify making a claim under section 380.

A claim under section 72 will be accepted where:

Relief under section 380 had previously been claimed and a claim under section 72 could have been made.

A separate claim under section 72 is made within the time limits for the original section 380 claim.

After the section 380 relief there is a balance of unrelieved trading losses.

All other conditions for a section 72 claim are satisfied.

Losses claimed under this section are relieved in priority to allowable capital losses brought forward. The section 72 relief is applied before any taper relief is granted or the CGT annual exemption is taken into account. An election may also be made within the section 380 time limits for a trading loss to be relieved against capital gains for both the current year and preceding year.

Example three

Percival has made trading losses of £20,000 in year 2004/2005. He has no other income or trading profits in 2004/2005 or 2003/2004, but has made capital gains (pre-taper relief) of £12,000 in 2004/2005 and £35,000 in 2003/2004. He makes a claim under section 72, within time-limits and the relief is given as follows.

2004/2005 £12,000
2003/2004 £8,000

This results in Percival's income and capital gains becoming nil for 2004/2005 and capital gains of £27,000 (pre taper relief) being assessed for 2003/2004.

Planning Point

Practitioners should be aware that trading losses can be set against capital gains in certain circumstances, and inform their clients accordingly.

7. Terminal losses

Where a trade is discontinued permanently, unrelieved losses incurred within the final 12 months may be carried back and set against the profits of the trade made during the three years of assessment before the year of discontinuance. Relief is given firstly against profits for the latest of those years and so on.

Example four

Herbert makes his accounts up to 5 April each year. He discontinues business on 5 April 2006, and the profits and losses for the final four years are:

Year to 5 April 2003 Profits - £25,000
Year to 5 April 2004 Profits - £30,000
Year to 5 April 2005 Profits - £35,000
Year to 5 April 2006 Loss -(£50,000)

Herbert makes a terminal loss claim under section 388, and this extinguishes the profit of £35,000 for 2004/2005 and reduces the profits of 2003/2004 to £15,000.

Planning point

The opportunity to make a terminal loss claim should be something that every accountant is aware of.

8. Farming

Section 397, ICTA 1988 restricts the right of losses to be claimed in connection with a business of farming or market gardening in some instances. This section denies relief where losses (excluding capital allowances) were incurred in each of the five years of assessment preceding the year of claim.

However, this disallowance does not apply where the farming or market gardening activities are carried on in such a way that might reasonably be expected to produce profits in the future, and the activities in the preceding five years could not reasonably have been expected to become profitable until after the year under review.

This section was drafted in order to counteract ‘hobby farming’ where landowners with other employment or trading income made continued losses on their farm or market garden and claimed them against other income.

Planning point

Practitioners with farming clients need to make their clients aware of the need to trade in a commercial way with an expectation of profit, and that loss relief can be denied in certain instances.

9. Furnished holiday lettings

Where a furnished holiday letting is treated as a commercial enterprise under section 323, ITTOIA and is taxed as trading income, losses may be claimed as trading losses under the provisions of sections 380-390, ICTA 1988, as described above. This includes set off against other income, carry forward, carry back in the early years, set off against capital gains and terminal losses.

Loses which are deemed to arise from ‘non-commercial lettings’ can only be set off against profits from the same source in subsequent years.

Planning point

Accountants who have clients with furnished holiday lettings need to make sure in which category the business fits, and the different approaches to loss claims.

10. Other property income

Exceptionally, profits from furnished lettings are treated as commercial profits and are assessable as trading income, with the advantages of the various claims under sections 380-390 as set out above.

It is more likely that the income from furnished and unfurnished lettings will be treated as income from property under what used to be Schedule A, but is now described in section 308, ITTOIA. In such circumstances relief for losses can only be obtained by carrying forward the loss to be allowed against future property profits. Losses from commercial property income and commercial lettings assessable as trading income cannot be set against other non-trading income from lettings, and the reverse also applies.

Planning point

Practitioners need to inform their 'letting' clients of the restrictions on the allowance of non-commercial letting losses.

11. Any Answers

There have been quite a few queries regarding losses in the Any Answers zone of AccountingWEB, and the following are a selection:

Relief for losses on loans
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http://www.accountingweb.co.uk/item/141054/972/973/785

Emma enquired on 13 May 2005 whether her client could claim tax relief on two loans of £5,000 each made from the client's limited company to both his father and brother to enable them to set up their own companies. Both companies failed, and the client was a shareholder (but not director) in his brother's company.

Ken Moody confirmed that the answer was in the negative, as the loans were unallowable purposes under the loan relationship rules as not being for the company's business or commercial purposes.

Letting losses against main income
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http://www.accountingweb.co.uk/item/141431/972/973/785

Roberta Penny enquired, on 24 May 2005, whether letting losses on her first home could be set against income from self-employment. Was there some way of relieving the losses when she sold the property?

Sarah F confirmed what I stated above – that letting losses can only be set against letting profits of the same type, so unless Roberta entered into property letting in the future the losses could not attract tax relief.

Corporation tax losses
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http://www.accountingweb.co.uk/item/143619/972/973/785

Stormrider produced the scenario, on 25 July 2005, of Company A, which ceased trading with unused trading losses. Company B purchased the trade and assets of Company A and paid goodwill for the use of the trading name. Company B has continued exactly the same trade as Company A under the former trading name. A and B are associated. Can B claim the unused losses of A, and if so how?

Ken Moody referred to section 343, ICTA 1988 which would allow losses to be carried forward if the two companies are 75% owned by the same person. Otherwise the losses will simply 'die' when company A cease to trade. It is noted that the companies are associated, and so must be over 50% controlled by the same person. However 75% control is required for this purpose.

0% corporation tax and losses brought forward
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http://www.accountingweb.co.uk/item/144510/972/973/785

Jules disclosed on 19 August 2005 that he had a company with a £5k profit. However, there were £20k losses bought forward. Do £5k of the losses have to be set against the current profit, thus losing the benefit of (the then) 0% rate of corporation tax? David Lochhead confirmed that this was correct.

Company losses and capital gains
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http://www.accountingweb.co.uk/item/148962/972/973/785

RT disclosed on 16 December 2005 that a company is selling a property and has brought forward trading losses. Can the trading losses bought forward be used against the capital gain?

Neil Wilson replied in the negative. Losses brought forward must be offset against the first available trading profit in the same business. Only trading losses in the same accounting period, trading losses in the subsequent accounting period, capital losses in the same period, or capital losses brought forward could be offset against a capital gain in the current year. Rachel commented to the effect that maybe capital allowances claimed in the past two years could be disclaimed in order to create a larger current year trading loss that could be offset against a current year capital gain.

Can 2005/2006 losses be declared on the 2004/2005 tax return?
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http://www.accountingweb.co.uk/item/149499/972/973/785

Paul S queried this point on 9 January 2006. This concerned a terminal loss incurred in 2005/2006, the details of which are too complex to consider here. However, as the losses were already quantified, should they be claimed on the 2004/2005 tax return to be submitted before 31 January 2006, or does the client need to wait until the 2005/2006 return is submitted to make a claim and request tax repayment. The sole trader is now trading through a limited company.

Andy B admitted that he had tried this method without success. In the end HMRC told him to submit the terminal loss claim in writing – i.e. name, UTR, cessation date, amount of terminal loss and year to set the loss against. This procedure worked, so Andy suggested that the tax return should be submitted as normal with a separate written claim. I would add that the existence of the claim should be referred to in the 'white space' of the return.

12. Conclusion

I am well aware that, in this wire, I have adopted a simplistic approach to a very complicated subject, and there are many other issues that could have been commented on. In particular, I have not dealt with company trading losses, and this could form the basis of a future wire. In some ways the legislation regarding company losses is similar to that for sole traders and partnerships.

However, the important issue for accountants to take on board is the existence of legislation regarding trading losses, the different types of loss claim and the time-limits applicable to each type of claim.

Planning point

Practitioners need to be aware of the basic legislation about trading losses, the different types of claim that can be made, and the time-limits applicable to each type of claim.

Ask a question

Readers with a current case should post their query in Any Answers.

JOHN T NEWTH
http://www.accountingweb.co.uk/premium_content/newthwire

TaxZone, 100 Victoria Street, Bristol, BS1 6HZ
Tel:+44 117 915 3344 Fax:+44 117 915 9630
http://www.taxzone.co.uk