

Maximising the efficiency of income and capital tax losses

Make sure your tax advantages don't disappear unused, advises *Julie Butler*

The recent Budget has drawn attention to the importance of the review of tax loss claim compliance and planning. Legislation will be introduced in the Finance Bill 2008 as follows:

- to counteract the use of contrived arrangements that generate trade losses that may be claimed as sideways relief or capital gains relief ('sideways loss relief') by an individual, other than a partner, carrying on a trade in a non-active capacity; and
- to amend the definition of a non-active partner for the purpose of restrictions to sideways loss relief and introduce an annual limit of £25,000 on the total amount of sideways loss relief that an individual may claim from trades carried on in a non-active capacity.

These changes took effect from 12 March 2008, and will affect individuals who carry on a trade but spend an average of under 10 hours a week on commercial activities of that trade.

It is fair to say that this recent decision invites the tax adviser to review all basic planning in respect of tax loss reliefs.

The basic principle of claiming tax losses is that the taxpayer will receive a refund of tax paid or a reduction of tax that is payable. Allowing a tax refund is something that HMRC do not accept lightly. Basic tests must be achieved – commerciality, time limits, validity and of course supporting contemporaneous evidence. Clearly *ITA 2007*, s. 64 shows the power of the current year loss, as this can be set against total income – the 'sideways loss relief'.

The test of commerciality

A tax loss is not available for relief unless, for the accounting period in question, the trade was carried on on a commercial basis and with a view to the realisation of gain either in the trade itself or in any larger undertaking it was a part of.

A trade carried on so as to afford a 'reasonable exception of gain' is treated as carried on with a view to the realisation of gain.

The tax loss is subject to a validity test, which is set out in *ITA 2007*, s. 74 (formerly s. 381(4)): when looking at losses in the early

years of trade it must be shown that profits could reasonably be expected to be realised within the relevant period or within a reasonable time after the end of the period. This test supports the need for profit projections and forecasts clearly showing that a profit could have been achieved, even if it never was.

Under the direction of the recent Budget, the taxpayer must therefore now prove that not only is the business commercial, but also that the partner is active for 10 hours a week.

Losses in early years of trade and pre-trading expenses

There is a beneficial relief for losses sustained by individuals in the early years of a trade, ie, the years of assessment in which the trade commenced, or in any of the next three years of assessment. Losses may be carried back against total income for the three years preceding the year of loss, with application against income of an earlier year, before that of a later year (*ITA 2007*, s. 72, formerly *TA 1988*, s. 381). The emphasis here is total income, and this is one of the sideways loss relief claims.

There is relief for pre-trading expenditure, ie,

expenditure incurred seven years before trading commenced. Under *ITTOIA 2007*, s. 57, the tax relief is given as if spent on first day of trading.

Trading loss allocated against capital gain

FA 1991, s. 72 provides that any trading loss that is potentially allowable against total income under the terms of *ITA 2007*, s. 64 (formerly *ICTA 1988*, s. 380) can be offset against a capital gain where the loss exceeds the taxpayer's total income for the year. It is necessary, however, for the trading loss first to exhaust the income; thus, personal allowances are wasted, and this is a tax planning point for consideration.

The maximum amount of trading loss that may be relieved against capital gains is restricted to the total net capital gains for the year. This is a notional amount comprising the current year gains after deduction of current year losses, less capital losses brought forward from earlier years. This may result in the annual exempt amount for capital gains tax being wasted.

Company loss claim plus late claims

A company that 'carries on the trade' within Schedule D, Case I may claim that losses incurred in that trade be set off against other profits (including chargeable gains) of the

Section	Class of relief (individuals)	Period to be taken
Sideways loss relief		
<i>ITA 2007</i> , s. 64, formerly <i>TA 1988</i> , s. 380	Set off against <i>total income</i> of tax year or of preceding year	Accounting year ending in the year of claim
Carry-forward loss relief		
<i>ITA 2007</i> , s. 83 or for companies <i>TA 1988</i> , s. 385	Carry forward against subsequent <i>profits</i> of the same trade	Accounting period showing a loss
Terminal loss relief		
<i>ITA 2007</i> , s. 89 or for farming <i>TA 1988</i> , s. 388	Terminal loss relief, on cessation applied against earlier profits and against profits for year of assessment in which cessation occurs	Loss in the year of assessment in which the trade is permanently discontinued, plus loss in that part of the preceding year beginning 12 months before the date of cessation

same accounting period [*ICTA 1988*, s. 393A(1)(a)]. Claims must be made within two years of the end of the accounting period in which the loss is made, or within such further period as HMRC may allow (*ICTA 1988*, s. 393A(10)). In practice, HMRC's approach to late claims is that later claims will only be admitted where they could not have been made in time for reasons beyond the company's control, eg, where, at the date the time limit expired, the company or its agents were unaware of profits against which relief for losses could be claimed, or the amount of such profits or losses was under discussion with HMRC (and delay was not substantially the company's (or the agents') fault).

Property income tax losses

An excess of property expenses over rents creates property losses. The use of these losses is restricted to current or future property income. For a company, property income losses do not include finance costs, capital allowances or the costs of managing the company.

The income tax regime treats property investment losses differently from corporation tax. Income tax applies to individuals, trustees and non-resident investment companies (ie, those non-resident companies not carrying on a trade in the UK through a branch or agency). Corporation tax applies to UK-resident companies.

For individuals, trustees and non-resident investment companies, property expenses including finance costs and capital allowances can be deducted from rental income of the property activity. Any surplus expenses are available to carry forward against future property income. There is no general offset against other income, except for some limited scope in respect of surplus capital allowances. No successor to the property can inherit any entitlement to unrelieved expenses or allowance, and should be taken into consideration on disposal.

Utilisation of capital losses

Capital losses can be used against current period capital gains or carried forward indefinitely against future capital gains.

If an individual or company realises a loss on the disposal of a capital asset in a year of assessment or accounting period, this loss can be offset against any chargeable gain arising in the same year. Unused capital losses can be carried forward against future capital gains but never carried back, except on the taxpayer's death, when a three-year carry back is allowed (*TCGA 1992*, s. 2(3)).

In a year when a chargeable gain is likely to arise, it may be appropriate to review other assets to see whether there might be potential

for realising any capital losses.

Tax planning can include quoted shares, which might be showing a loss; they could be sold and subsequently reacquired. However, there are anti-avoidance rules to inhibit 'bed and breakfast' arrangements where shares are bought and sold within 30 days.

In the case of the outright sale of any asset standing at a loss in the period in which a capital gain is likely to arise, the sale must be to an unconnected party. A capital loss realised on a sale to a connected party can only be offset against gains from disposals to the same person (*TCGA 1992*, s. 18).

Both individuals and companies can carry a capital loss forward to set against future capital gains (*TCGA 1992*, s. 2(2)(b)). It is important, therefore, that a log of unused capital losses is maintained with current tax information.

Capital tax loss on disposal to a connected person

Where a capital tax loss arises on the disposal of an asset to a connected person, that loss can only be relieved against gains that arise on disposals to the same connected person (*TCGA 1992*, s. 18(3)). If there are no other disposals to that particular connected person in the year in which the loss-making disposal occurs, the loss is carried forward to the first subsequent year in which a disposal is made to that particular connected person.

Negligible capital value

If the value of the asset has become negligible, a claim can be made so that the asset is treated as having been sold and immediately reacquired for an amount equal to the value specified in the claim (*TCGA 1992*, s. 24). Although the term 'negligible' is not defined by statute, 'small' is taken as 5%, so negligible can be assumed to be considerably less than that. HMRC's view is that the term means 'worth next to nothing'.

A condition of relief is that the claimant must show that the asset has 'become' of negligible value. Examples of assets are investments that have become worthless (including shares in an associated company), a property interest that has become worthless or farming quotas that no longer have a value.

There is no time limit for making a negligible value claim. However, *TCGA 1992*, s. 24(2) provides that a claim can be made so that the date of disposal is treated as having been made on any date specified during the period from 24 months before the beginning of the fiscal year in which the claim is actually made.

HMRC have an official list of quoted companies that they have deemed to have become of negligible value. The list can be found at www.hmrc.gov.uk/cgt/negvalist.htm.

Relief for capital loss by carry-forward

The offset of a current year capital loss is made before considering the annual exempt amount and, commonly, part of the loss is wasted by reducing net chargeable gains; below that amount, losses brought forward from a previous year are only relieved insofar as they bring the net gains to the amount specified as the annual exempt amount (*TCGA 1992*, s. 3(5A)).

Where the loss brought forward exceeds the excess of gain over the annual exempt amount, the unrelieved loss is carried forward to the next year, and so on, until the loss is fully relieved. There is no limit to the number of years an unrelieved loss can be carried forward.

'Terminal'/'deathbed' tax loss planning

Where, at death, an asset's market value is less than the deceased's acquisition cost, no allowable loss arises as *TCGA 1992*, s. 62(1)(b) deems the asset to have been acquired by the personal representatives without the deceased having made a disposal.

However, the deceased may have made disposals prior to his or her death. Any allowable losses that arise from disposals made by the deceased in the fiscal year in which he or she dies are first set against chargeable gains for that year. Any excess is put against chargeable gains in the previous three years, later years being counted before earlier years (*TCGA 1992*, s. 62(2)).

Losses may only be offset in previous years to the extent that the net gains before taper relief are reduced to the annual exempt amount for that year (*TCGA 1992*, s. 3(5A), (5B)).

Therefore there is scope, when a business ceases or a taxpayer dies, to ensure that the loss is carried back.

If the tax adviser takes this one stage further, there is scope before the 'death' of the business or the 'death' of the taxpayer for the adviser to see what carry-back planning can be undertaken.

Action points:

- keep income and capital tax loss memoranda;
- review assets for negligible tax loss claims;
- review tax planning in respect of 'anticipated' tax losses;
- look at 'deathbed' loss planning – before the asset dies or the business dies, (and to be brutal and insensitive) before the taxpayer dies, what carry-back tax planning is available?

Whoever said tax planning involved sensitivity?

Julie Butler runs her own practice, Butler & Co: telephone 01962 735544, email j.butler@butler-co.co.uk