EXPLANATORY MEMORANDUM TO

THE DRAFT PARTNERSHIPS (RESTRICTIONS ON CONTRIBUTIONS TO A TRADE) REGULATIONS 2006

SI 2006 No.

1. Introduction

This explanatory memorandum has been prepared by Her Majesty's Revenue and Customs and is laid before Parliament by Command of Her Majesty.

2. Description

These Regulations apply to individual partners in limited partnerships, limited liability partnerships, and partners who spend less than 10 hours per week actively carrying on a partnership trade, who have claimed film related losses.

3. Matter of Special Interest to the Select Committee on Statutory Instruments

None.

4. Legislative Framework

4.1 The powers to make these Regulations are conferred by section 122A of the Finance Act 2004, which was inserted by section 79 of the Finance Act 2005. This is the second use of the powers conferred under those sections.

4.2 Sections 117, 118ZB and 118ZE of the Income and Corporation Taxes Act 1988 contain restrictions on the extent to which limited partners, members of a limited liability partnership and non-active partners can set off their share of a partnership's trading losses against their other income or gains

4.3 Section 79 of the Finance Act 2005 supplements these provisions by giving the Commissioners of Inland Revenue a regulatory power to exclude amounts of any description specified in the regulations when computing the individual's capital contribution to the trade, in respect of a film-related loss.

4.4 These Regulations have retrospective effect from 20 December 2005. The powers to make the retrospective provision are conferred by section 122A(3)(a) of the Finance Act 2004, which was inserted by section 79 of the Finance Act 2005. They give effect to anti-tax avoidance measures announced by the Chancellor on 20 December 2005 and described in a Technical Note entitled Tackling Avoidance - Manipulation of Film Tax Reliefs published by Her Majesty's Revenue and Customs on the same date.

4.5 These Regulations apply where, on or after 20 December 2005:

- a relevant partner has disposed of his rights which arise from the trade of the partnership (see Regulation 3(a));

- the rights of the relevant partner to share in the subsequent profits of the partnership are reduced or extinguished, or his share of the losses arising from the trade is increased (see Regulation 3(b));
- a new partner is admitted into the partnership (see Regulation 3(c)); and
- the new partner contributes capital to the partnership (see Regulation 3(d)).

4.6 Where these conditions are met:

- Regulation 4(a) apportions the capital contributed by the new partner between the relevant partners who were in the partnership immediately before the new partner was admitted to the partnership, according to the profit-sharing arrangements which were in place at that time;

- Regulation 4(b) excludes the amount apportioned to the relevant partner under Regulation 4(a) when computing their contribution to the trade (but not to the extent that this gives rise to a contribution which is less than nil) at the time when the latest of the events referred to in Regulation 3 occurs; and

- Regulation 4(c) provides for the recalculation of the relevant partner's contribution to the trade for determining, at the time of that event, whether it is an exit event within the meaning of section 119(2)(b) or (c) of the Finance Act 2004 and the amount chargeable for the purposes of section 119(5) of that Act.

Extent

This instrument applies to all of the United Kingdom.

6. European Convention of Human Rights

The Paymaster General, Dawn Primarolo M.P, has made the following statement under section 19(1)(a) of the Human Rights Act 1998:

In my view the provisions of the draft Partnerships (Restrictions on Contributions to a Trade) Regulations 2006 are compatible with the Convention rights.

7 Policy Background

7.1 Individual partners carrying on a trade in partnership are able to set their trading losses against their other income and gains (sideways loss relief). The Income and Corporation Taxes Act 1988 included provisions to prevent limited partners from claiming losses in excess of their capital contribution to the trade. Similar rules were introduced in 2001 for members of limited liability partnerships. Finance Act 2004 extended these rules to inactive partners in all partnerships in the first 4 years that they carry on the trade.

7.2 Finance Act 2004 also included rules to prevent individuals who claimed loss relief from a trade that had benefited from the film tax reliefs from exiting from that trade with losses in excess of their capital contribution.

7.3 Following this, tax avoidance schemes were devised which sought to produce a permanent tax advantage for such individuals by avoiding both the tax charge on income in later years and the income tax charge which arises under anti-avoidance legislation introduced in the 2004 Finance Act when individuals exit from a film business. Under these schemes, most of the income from the film-related trade in later years was allocated to a new partner who is admitted, and contributes capital, to the partnership carrying on the trade.

7.4 The new legislation will ensure that an individual partner who claims sideways loss relief for film-related losses is subject to an income tax charge when partnership changes are made as a result of which the individual may not pay tax on an appropriate share of the profits of the film-related trade in later years.

8 Impact

A Regulatory Impact Assessment has not been produced for these Regulations as they are part of anti-avoidance rules which simply ensure that existing legislation is applied in the way that was intended by Parliament and it is not anticipated that they will affect those individuals that make genuine business losses.

9 Contact

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