EXPLANATORY MEMORANDUM TO THE

PARTNERSHIPS (RESTRICTIONS ON CONTRIBUTIONS TO A TRADE) REGULATIONS 2005

1. This explanatory memorandum has been prepared by HM Revenue & Customs and is laid before the House of Commons by Command of Her Majesty.

This memorandum contains information for the Select Committee on Statutory Instruments.

2. Description

These Regulations apply to individual partners in limited partnerships, limited liability partnerships, partners who spend less than 10 hours per week actively carrying on a partnership trade, and to any partners who have claimed film related losses . They exclude limited recourse or non-repayable loans, or other reimbursable amounts, from being treated for tax purposes as part of the partner's contribution to a trade, thereby preventing that partner from benefiting from loss relief in excess of the actual amounts lost or at risk.

3. Matters of special interest to the Select Committee on Statutory Instruments

These Regulations have retrospective effect from 2 December 2004. The powers to make the retrospective provision are conferred by section 118ZN(3)(a) of the Income and Corporation Taxes Act 1988 and section 122A(3)(a) of the Finance Act 2004, which were inserted by sections 73 and 79 of the Finance Act 2005. They give effect to anti-tax avoidance measures announced by the Chancellor on 2 December 2004 and described in a Technical Note entitled Tax Avoidance Using Film and Partnership Reliefs published by the Inland Revenue on the same date.

4. Legislative Background

4.1 The powers to make these Regulations are conferred by section 118ZN of the Income and Corporation Taxes Act 1988 and section 122A of the Finance Act 2004, which were inserted by sections 73 and 79 of the Finance Act 2005. This is the first 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 (commonly called "sideways loss relief"). The restrictions are (broadly) that losses are restricted to the individual's capital contribution to the relevant trade. Section 119 of the Finance Act 2004 imposes a charge to income tax where an individual has claimed film related losses in excess of his capital contribution to the trade.

4.3 Sections 73 and 79 of the Finance Act 2005 supplement 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.

4.4 These Regulations exclude amounts in two situations.

- The first is where the individual takes out a loan to finance a contribution to a trade, and the loan is on limited or non-recourse terms, or in the event, the cost of repaying the loan is borne, assumed or released by someone else (see Conditions 1 to 3 in Regulation 4). There is a backup test where the individual's actual loan repayment costs over any period of 5 years are less than they would be on arm's length commercial terms (see Condition 4 in Regulation 4).

- The second is where arrangements are made so that the financial cost to the individual of making a contribution to a trade can be reimbursed by someone else (see Regulation 5).

4.5 The Regulations include specific exemptions to ensure they cannot apply where financial costs are met by another person in the normal course of social, personal or family relationships, where a person becomes insolvent, or where the costs borne by another person are taxed as income of the individual (Regulation 6).

5. Extent

5.1 This instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

The Paymaster General has made the following statement regarding Human Rights:

In my view the provisions of the draft Partnerships (Restrictions on Contributions to a Trade) Regulations 2005 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 that 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, complex tax avoidance schemes were devised in which the partners' capital contributions were boosted by amounts the cost of which they did not have to bear, most commonly in the form of limited recourse or non-repayable loans. Finance Act 2005 included provisions to prevent this in sections 73 to 79. These provisions gave Her Majesty's Revenue and Customs powers to make these regulations to exclude certain amounts from being treated as part of a partner's capital contribution.

7.4 The purpose of the legislation is to prevent individuals benefiting from sideways loss relief in excess of amounts which they actually lose or are at risk of losing.

7.5 Specific exemptions are included in the regulations to ensure that the regulations cannot apply to individuals not involved in tax avoidance.

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

Graham Dean at HM Revenue & Customs Tel: 020 7147 2568 or e-mail: graham.dean@hmrc.gsi.gov.uk can answer any queries regarding the instrument.