

A medical examination

HEATHER MILLER works through some calculations where a partnership takes in new members.

Nobody likes going to the doctors. As if sitting in an overly-heated reception with all the other sickly members of the local community isn't bad enough, there's the steely glare of the receptionist and the drafting of the obligatory 'I've got a doctor's appointment so I need to leave early' email to your boss to suffer as well. All in all, it's an experience to be avoided where possible; far better to struggle through like the martyr that you are and spread your lurgy to everyone at the office instead.

In all this abject self-pity, it is easy to overlook the fact that your GP is an actual human being too (albeit with a seemingly cast iron immune system) and has probably got his own problems ... not least, the possibility that he's about to pay tax twice on his overlap profits because having previously been trundling along happily as a self-employed practitioner or perhaps even an employee, he is now joining the partnership that also runs out of the health centre.

Taking the recent Readers Forum query, 'Practice mergers' (*Taxation*, 17 November 2011, page 24) as its inspiration, this article will discuss the practicalities of partnerships and sole traders operating from the same premises in respect of their basis of assessment. It will also discuss the implications of a brand new partnership being formed and how the change in status from sole trader to partner affects the amounts on which tax is due in each tax year. The focus is on the basis of assessment only, and so any other tax implications – National Insurance or capital gains tax, for example – have not been considered here.

The Waltons Surgery

Let's imagine a situation in which both a partnership of three GPs and two separate sole trader GPs are working alongside

KEY POINTS

- Tax calculations relating to an employee joining a partnership.
- Overlap profits and top rates of tax.
- Understanding basis periods and change of accounting date.
- Sole traders joining a partnership.
- Is there a continuing business or a new one?



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each other from the same health centre building. To the outside world they are simply the local surgery, but on the inside they could well be paying tax by reference to different periods, and on different amounts.

We'll call this health centre, and the medical partnership within it, The Waltons Surgery, and the partnership has a year end of 31 December 2011. The three partners – Dr Zhivago, Dr Who and Dr Watson share profits equally and have operated from the practice together for the last five years. In the year ended 31 December 2011, the partnership made tax adjusted profits of £500,000. The sole traders – Dr No and Dr Jekyll – each made £150,000 from their individual practices in the same year.

All five practitioners will be on the 'current year basis' of assessment as in ITTOIA 2005, s 198(1): 'The general rule is that the basis period for a tax year is the period of 12 months ending with the accounting date in that tax year'.

Waltons 1 shows the amount of profits assessable on each practice member.

So far, so simple. But supposing the partnership also employs another GP, Dr Seuss (okay, so I'm running out of famous doctors) at a salary of £80,000 per annum. However, they are so impressed with him – he has a particular gift when it comes to cheering up children, you see – that they make him an offer to join the partnership on 1 September 2011, at which point they will share the profits equally among the four partners. In this case, for 2011/12, Dr Seuss will have been an employee of The Walton Surgery for five months and a partner thereafter. See **Waltons 2** for the effects of this on the three original partners.

WALTONS 1

Year ended 31 December 2011, falling in the 2011/12 tax year	GP	Profits assessable in 11/12
The Waltons Surgery Partnership:		
<i>Dr Zhivago</i>		
1/3 p'ship profits		$500,000 \times 1/3 = 166,667$
<i>Dr Who</i>		
1/3 p'ship profits		$500,000 \times 1/3 = 166,667$
<i>Dr Watson</i>		
1/3 p'ship profits		$500,000 \times 1/3 = 166,667$
Sole traders:		
<i>Dr No</i>		
Sole trade profits		150,000
<i>Dr Jekyll</i>		
Sole trade profits		150,000

The admission of a new partner has not affected their basis of assessment, only the level of profits on which they are assessed.

As an aside, and given that by 1 September 2011 the partners will not yet have paid payments on account of the 2011/12 tax year (the payments are due on 31 January 2012 and 31 July 2012), is it worth revisiting the amounts they should pay in light of their newly-reduced profit share?

Dr Seuss, however, has a more complicated position in the 2011/12 tax year. Not only will he be assessed on his employment income from April 2011 to August 2011, he will also be subject to the 'opening year rules' on his profit share as found in ITTOIA 2005, s 199(1). 'The basis period for the tax year in which a person starts to carry on a trade:

- begins with the date on which the person starts to carry on the trade, and
- ends with 5 April in the tax year'.

The rules are such that Dr Seuss will be taxed on his actual profit share from his date of commencement in the partnership (1 September 2011) to the 5 April 2012. As the partnership has a December year end, he will be assessed on a proportion of the profits from the 2011 and 2012 year ends in his first tax year as

WALTONS 2

Year ended 31 December 2011, falling in the 2011/12 tax year	Profits assessable in 2011/12		
Accounts	<i>Dr Zhivago</i>	<i>Dr Who</i>	<i>Dr Watson</i>
1/3 p'ship profits in 8 months to 31 August 2011 $500,000 \times 8/12 = 333,333$ $\times 1/3 =$	111,111	111,111	111,111
1/4 p'ship profits in 4 months to 31 December 2011, $500,000 \times 4/12 =$ $166,667 \times 1/4 =$	41,667	41,667	41,667
	152,778	152,778	152,778

DR SEUSS

Entries for the 2011/12 tax return:	
<i>Employment income</i>	
$5/12 \times \text{£}80,000$ salary	33,333
<i>Partnership</i>	
Actual. 1 September – 31 December 2011 $4/12 \times \text{£}500,000 \times 1/4$	41,667
Estimated. 1 January 2012 – 5 April 2012 $3/12 \times \text{£}600,000$ (estimate y/e/ 31.12.12) $\times 1/4$	37,500
	79,167
Total assessable in 2011/12	112,500

a partner. On a practical level, it is very unlikely that the 2012 partnership accounts will be ready in time to provide an accurate profit share for the 2011/12 tax return – there is just one month between the year end date and 31 January 2013 tax return filing deadline – so an estimate will be required, see **Dr Seuss**.

Although Dr Seuss will undoubtedly be delighted to have been made a partner, these numbers aren't great for him. First, he has found himself at the upper end of the unpleasant £100,000 to £114,950 net income bracket (assuming he didn't already have other income that pushed him over £100,000) which means he will suffer a withdrawal of his 2011/12 personal allowance of £1 for every £2 over £100,000. This gives him an effective tax rate of 60% on £12,500 of his income and, to add insult to injury, it's likely that a personal allowance was included in his tax code in the five months that he was still an employee (HMRC are many things, but they are not, nor should we expect them to be, mind-readers) leaving him with insufficient PAYE having been deducted at source. Lovely.

And it gets worse, when we take into account opening year rules in respect of 'Year 2' of the process as shown in **ITTOIA 2005, s 200**.

ITTOIA 2005, S 200

- 200(1). The basis period for the second tax year in which a person carries on a trade is determined as follows.
- 200(2). If in that tax year: the accounting date falls less than 12 months after the date on which the person starts to carry on the trade; and the person does not permanently cease to carry on the trade; the basis period is the period of 12 months beginning with the date on which the person starts to carry on the trade.
- 200(3). If in that tax year:
- the accounting date falls 12 months or more after the date on which the person starts to carry on the trade; and
 - the person does not permanently cease to carry on the trade; the basis period is that given by the general rule in section 198.
- 200(4). If in that tax year:
- there is no accounting date; and
 - the person does not permanently cease to carry on the trade; the basis period is the same as the tax year.'

DR SEUSS – OVERLAP

<i>Year 1 (2011/12) – as in Dr Seuss.</i>	
Partnership share – actual	
1 September – 31 December 2011 (4 months)	
$4/12 \times £500,000 \times 1/4$	41,667
1 January 2012 – 5 April 2012 (3 months)	
$3/12 \times £600,000 \times 1/4$	<u>37,500</u>
Total partnership profits assessable in 11/12	<u>79,167</u>
<i>Year 2 (2012/13)</i>	
Year ended 31 December 2012	
$£600,000 \times 1/4$	<u>150,000</u>
Total partnership profits assessable in 12/13	<u>150,000</u>
<i>Overlap profits</i>	
3 months (1 Jan – 5 Apr 2012)	37,500

As The Waltons Surgery will indeed have an accounting period of 12 months or more falling within the 2012/13 tax year, Dr Seuss will be taxed on his full profit share for the year ended 31 December 2012. Let's assume that the £600,000 estimate was correct; see **Dr Seuss – overlap** below for the consequences.

In 2013/14, Dr Seuss would at long last be taxed on the current year basis of assessment, and things would hopefully be

CHANGE OF ACCOUNTING DATE

ITTOIA 2005, s 217 states.

- (1) The conditions in this section are met if:
 - (a) the person carrying on the trade gives appropriate notice of the change of accounting date to an officer of Revenue and Customs (see subsection (2));
 - (b) the 18-month test is met (see subsection (3)); and
 - (c) either condition A or B is met (see subsections (4) to (6))
- (3) The 18-month test is met if the period of account ending:
 - (a) with the new accounting date in the tax year in which the change of accounting date occurs; or
 - (b) if there is no new accounting date in that tax year, with the new accounting date in the first tax year in which accounts are drawn up to the new accounting date; is not longer than 18 months.
- (4) Condition A is that, in the five tax years immediately before the tax year in which the change of accounting date occurs, there has been no change of accounting date that counts for the purposes of this condition.
- (5) A change of accounting date counts for the purposes of condition A if it results in the basis period for the tax year in which the change occurs ending with the accounting date in that tax year.
- (6) Condition B is that:
 - (a) the change of accounting date is made for commercial reasons (see s 218); and
 - (b) the notice under subsection (2) sets out the reasons for the change.

CESSATION OF TRADE

ITTOIA 2005, s 205 states:

- (1) If a person permanently ceases to carry on a trade in a tax year, a deduction is allowed for overlap profit in calculating the profits of the trade of the tax year.
- (2) The amount of the deduction is calculated as follows.
 - Step 1.* Add together the overlap profits arising in all overlap periods.
 - Step 2.* Subtract from that any deductions for overlap profit made under section 220 (deduction for overlap profit on change of accounting date).
 The balance is the amount of the deduction allowed under this section.

a lot more straightforward. But this doesn't negate the fact that he has paid tax on £37,500 twice, and ITTOIA 2005, s 205 and s 217 offer very limited circumstances as to when he can get relief for the tax paid.

This will either be on the **Cessation of Trade** or on a **Change of Accounting Date**, although whether that relief will be at a tax rates as high as the, perhaps 60% he may have effectively paid on part of it now will remain unknown until that time.

Now, I'm sure you're wondering what exactly has happened to Dr No and Dr Jekyll, who seem to be ambling along quite nicely and been completely unaffected by The Walton Surgery partnership upheaval. It's time to shake things up a bit and consider the prospect of one large partnership being formed, a super-partnership if you will, which involves all four existing partners and Dr No and Dr Jekyll.

But how? Should Dr No and Dr Jekyll simply join The Walton Surgery partnership, or should that partnership cease and a new one be started from scratch? Here's how these two possibilities could pan out.

Joining the existing partnership

It is agreed that Dr No and Dr Jekyll will join The Waltons Surgery on 1 January 2013, sharing profits equally.

For the existing partners, and after all the commotion of admitting Dr Seuss 16 months previously, this is certainly the most straightforward option for the existing partners of the surgery.

Dr No and Dr Jekyll are joining at the start of a new accounting period, meaning the only effect for the four original partners (Zhivago, Who, Watson and Seuss) is a reduction in their profit share from one-quarter to one-sixth; although it must of course be remembered that these will be lower proportions of partnership profits that will be boosted by the earnings of the two incoming partners.

For Dr No and Dr Jekyll, rather conveniently they have both been preparing accounts to a 31 December year end. In this case, they will cease to trade on 31 December 2012 and begin trading as partners on 1 January 2013. Their sole trade profits for the year ended 31 December 2012 were £180,000 each and will be subject to the closing year rules under ITTOIA 2005, s 202(1), which states that 'the basis period for the tax year in which a person permanently ceases to carry on a trade:

DR NO AND DR JEKYLL

<i>Income assessable in 2012/13</i>	
Sole trade income – closing year rules	
Year ended 31 December 2012	180,000
Less overlap (see note 1):	<u>(25,000)</u>
Net taxable	155,000
Partnership profit share	
Estimated profits for the year ended 31 December 2013	700,000
1 January 2013 – 5 April 2013	
3/12 x £700,000 x 1/6	<u>29,167</u>
Total income assessable in 2012/13	<u>184,167</u>

Note 1: As Dr No and Dr Jekyll have ceased to trade, the overlap profits originally taxed as a result of their December year ends (say £25,000 each) are relievable against the trading profits of the final period.

- (a) begins immediately after the end of the basis period for the previous tax year; and
 (b) ends with the date on which the person permanently ceases to carry on the trade'.

They will also be subject to the opening year rules on profit share from 1 January 2013 to 5 April 2013, see **Dr No and Dr Jekyll** for how this might look.

The 2013/14 tax year will bring similar problems for Dr No and Dr Jekyll in terms of overlap profits as those shown in Dr Seuss above, in that the three months' profit from January to March 2013 will be taxed again in line with the opening year rules.

A new partnership

Perhaps Dr No and Dr Jekyll aren't keen on joining an existing partnership and manage to persuade the other partners to form a brand new one from scratch, sharing all profits equally. Perhaps there is a reputational issue regarding the old partnership or they

may be concerned about historic liabilities. By the time they've thrashed out this decision, however, it's half way through the year already! Unsurprisingly, the formation of a new partnership means that The Waltons Surgery partnership will cease as at 30 June 2013 and Dr No and Dr Jekyll will cease their sole trades on the same date.

It seems that the only clear way to show the effects of this super-partnership is by way of a super-computation. Let's assume that projected profits of the new Super Surgery partnership for the first year ended 30 June 2014 are £1,000,000 and that all the prospective partners (apart from Dr Seuss, whose overlap we have already calculated) have overlap profits of £25,000 available. See **Super Surgery**.

Conclusion

Although on first glance it seems like a handy way to relieve historic overlap profits, it is very much a case of out of the frying pan into the fire. In 2014/15 all six partners will be taxed on their total share of profits from the year ended 30 June 2014; this leaves them with nine months (1 July 2013 – 5 April 2014) of overlap profit totalling £125,000. Ouch.

But what a difference a date makes. If Super Surgery commences trade on 1 April 2013, the cessation of the The Waltons Surgery partnership and the sole trades of Dr No and Dr Jekyll will fall in the 2012/13 tax year. Continuing with the estimated Waltons profit of £600,000 for the year ended 31 December 2012, the situation is shown in **Super Surgery 2**, which can be found on Taxation.co.uk.

As a final point, there seems to be rather a lot of overlap relief floating around regardless of which of these scenarios is used. A change of accounting date at some point in the not too distant future, provided it meets the criteria laid out in ITTOIA 2005, s 217, could be the answer if our doctors are finding the double taxation about as palatable as a barium enema. ■

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SUPER SURGERY

The total assessable profits for all partners in the 2013/14 tax year will be as follows.

	Dr Zhivago	Dr Who	Dr Watson	Dr Seuss	Dr No	Dr Jekyll
Profits on cessation of The Waltons Surgery p/ship 6 months ended 30.6.13 = £400,000, 1/4 x £400,000 each	100,000	100,000	100,000	100,000		
Sole trade profits In 6 months to 30.06.13					90,000	90,000
Less: overlap	<u>25,000</u>	<u>25,000</u>	<u>25,000</u>	<u>37,500</u>	<u>25,000</u>	<u>25,000</u>
Net assessable	75,000	75,000	75,000	62,500	65,000	65,000
Profits – The Super Surgery Partnership y/e 30.06.14 (estimated) £1,000,000						
Assessable – opening year rules, 1 July 2013 to 5 April 2014 9/12 x £1m x 1/6 each	<u>125,000</u>	<u>125,000</u>	<u>125,000</u>	<u>125,000</u>	<u>125,000</u>	<u>125,000</u>
Total assessable in 2013/14	200,000	200,000	200,000	187,500	190,000	190,000