

# Loss adjustments

## GLENN COLLINGBOURNE

obtains HMRC's agreement to a new interpretation for restricted loss relief.

Readers will be aware that, from 6 April 2013, previously uncapped income tax reliefs have been restricted. This restriction was innocuously entitled "Limit on Step 2 deductions" and is found in ITA 2007, s 24A. HMRC refer to it as a "limit on income tax reliefs" but, for many tax practitioners, a "restriction on sideways loss relief" is a more accurate description.

All references in this article are to ITA 2007. I will focus on trade and property losses, but the restriction also applies to other reliefs and deductions, which are listed in s 24A(6) and s 24A(7). Generally, where a deduction or relief already has an inbuilt restriction, s 24A does not apply. For example, the effectiveness of pension contributions is already reduced by the annual allowance excess charge, and enterprise investment scheme (EIS) and seed enterprise investment scheme (SEIS) are limited by their respective investment caps.

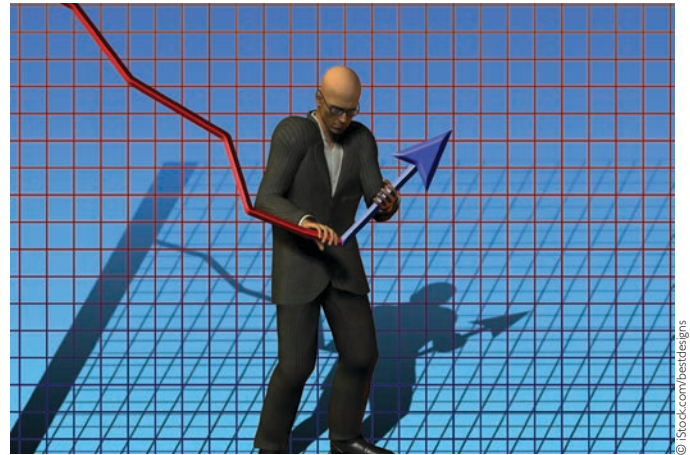
It is important to note that the use of trade losses is restricted only when they are set against total income. Loss relief is unlimited when it is set against earlier or future profits of the same trade. Further, if surplus trade losses are "converted" to capital losses, no restriction applies to how much may be set against capital gains of the current or previous year.

## The restriction in practice

The restriction appears to be straightforward: the loss available for sideways relief is limited to the *maximum* of £50,000 or 25% of the "adjusted total income" (more on this later). See **Luciano**.

### KEY POINTS

- Restricted loss relief applies only to those reliefs that are not already subject to restrictions.
- How do brought-forward losses interact with claims to sideways relief?
- There is an apparent difference between legislation and HMRC guidance.
- Advisers should be aware that tax software may not give the expected result.
- HMRC agree that there needs to be clarification in the *Helpsheet 204* worksheet.



However, if we look again at the example of **Luciano**, what would happen if there were property income losses brought forward from earlier years? Are brought-forward losses deducted before calculating the adjusted net income? This distinction is important; see **Rolando** for what *may* be the case if an adjustment is included for brought-forward losses from a rental business.

This real-life example of **Rolando** relates to 2015/16. As a result of a one-off event, his trade suffered significantly, but it is expected to recover in future. His pension income is the value of pension savings after receiving his 25% tax-free lump sum. He wanted to draw down the whole pension and mitigate the tax by using trade losses. This will help the trade survive the impact of an important transaction going wrong.

Most tax advisers will use third-party software to prepare and file their clients' income tax returns. We use a well-established tax software provider, and inputting the relevant figures produced the bad news shown in **Rolando**. However, on closer inspection, s 24A gives him a glimmer of hope.

### LUCIANO

Details	£
Rental profits	500,000
Plus: Pension income	<u>120,000</u>
Total income	<u>620,000</u>
25% of total income	155,000
Trading loss	200,000

Because 25% of total income £620,000 is greater than £50,000, it is possible to use loss relief to reduce total income by £155,000. £45,000 of the £200,000 loss for the year is unrelieved and may be carried back against total income or carried forward and used against future profits of the same trade.

## ROLANDO

Details	£	£
Rental profits	500,000	
Less: Losses brought forward	<u>500,000</u>	
Rental profits taxable		0
Pension income		<u>120,000</u>
Total income		<u>120,000</u>
25% of total income		30,000
Trading loss		200,000

If brought-forward losses are deducted before applying the 25% restriction the trading loss relief is capped at £50,000, meaning Rolando will have to look to next year or the previous year for tax relief, if appropriate.

## Adjusted total income

Adjusted total income is the starting point for the restriction and **ITA 2007, s 24A(8)** sets out its definition in four helpful steps. Step 1 begins with “total income”, and the subsequent steps make adjustments for payroll giving and pension contributions in their various guises. What then is total income?

Readers will be familiar with income tax calculations. In law, it all begins in Part 2, Ch 3 “calculation of income tax liability”. The definition of total income is found in s 23, which is organised into a seven-step process. It explains at Step 1 that the taxpayer needs to “identify the amounts of income on which the taxpayer is charged to income tax for the tax year...[and]...the sum of those amounts is ‘total income’.”

## ITA 2007, S 24A(8)

The taxpayer’s “adjusted total income” for the tax year is calculated as follows.

- **Step 1.** Take the amount of the taxpayer’s total income for the tax year.
- **Step 2.** Add back the amounts of any deductions allowed under ITEPA 2003, Part 12 (payroll giving) in calculating the taxpayer’s income which is charged to tax for the tax year.
- **Step 3.** If the taxpayer is given relief in accordance with FA 2004, s 192 (pension schemes: relief at source) in respect of any contribution paid in the tax year under a pension scheme, deduct the gross amount of the contribution. The “gross” amount of a contribution is the amount of the contribution before deduction of tax under FA 2004, s 192(1).
- **Step 4.** If the taxpayer is entitled to a deduction for relief under FA 2004, s 193(4) or s 194(1) (pension schemes: excess relief under net payment arrangements or relief on making a claim) for the tax year, deduct the amount of the excess or contribution (as the case may be).

The result is the taxpayer’s adjusted total income for the tax year.

This is the figure that needs to be multiplied by 25% to calculate the maximum restriction as adjusted for payroll giving and pension contributions. Brought-forward losses do not affect total income because they are deducted at Step 2 of s 23. Section 24(1)(b) also clearly states that carry-forward property loss relief is dealt with at Step 2. In the absence of anything to the contrary, the interaction of legislation is considered to take place in the order it is presented, so Step 2 should not be read back to Step 1, particularly given that the product of Step 2 is to be called “net income”. Readers wishing to refer in more detail to the calculation of income tax liability could refer to Julie Cameron’s article “Seven Steps to Heaven” (*Taxation*, 14 May 2015, page 10).

With this issue resolved, my client cashed in his pension, I told the software provider that its programme did not work properly, and all was well in the world.

## HMRC’s tax calculation notes

As summer began I received a reply from the technical team of our software provider explaining the mechanism behind its calculation and this referred me to HMRC’s working sheet. With the advent of self-assessment in 1997, HMRC had to provide a means for an unrepresented individual to calculate his or her tax and, before online filing became available, the working sheet was the step-by-step guide for individuals to do so. The 2014/15 working sheet (<http://tinyurl.com/sk7ft>) is 44 pages of boxes and cross-references, and any reader who would like an insight into why the work of LITRG and TaxAid is so valuable to the unrepresented taxpayer need prepare only one tax return using this guidance. (I did this once myself early in my career – it took a day.)

Reference also needs to be made to HMRC’s *Helpsheet 204: Working Sheet 1*. At first sight, it looks the same as s 24A but, rather than start with total income, it begins with box A59 from SA110. Box A59 is described on the working sheet as “total income” but, if the calculation of this figure is traced backwards through the various sub-totals and references, it will take you to

## WORKING SHEET 1

Total income for the year	SA110 Notes, Tax calculation summary notes, box A59	A	£
Amount of payroll giving	SA101 <i>Additional information</i> pages, page Ai3 (Income tax losses and limit on income tax relief), box 6	B	£
	Box A + box B	C	£
Pension contributions	SA100 <i>Tax Return</i> , page TR4 (Tax reliefs) boxes 1+2+3+4	D	£
Adjusted total income	Box C minus box D	E	£
	Box E x 25%	F	£
Revised limit on income tax reliefs	Higher of box F and £50,000	G	£

box 40 of the tax UK property pages (SA105), which crucially is after brought-forward losses have been deducted. This is critical for Rolando and relates to his property rental losses, but the same treatment is accorded to the self-employment pages.

This conflicts with the legislation already discussed but, without following the formula provided by HMRC, it is unlikely that the electronic filing of the tax return would meet the filing schema, so the tax software providers are not in a position to alter the calculation, whether they agree with it or not. It took some effort to find the correct route to raise this with HMRC, but within 10 days they replied defending their position. It was the view of HMRC's technical team that, where the legislation at step 1 of s 23 refers to income "charged to income tax", this must mean after brought-forward losses are deducted. Though their correspondence included a detailed explanation of the boxes to use in the helpsheet and an analysis of how loss relief works, it did not explain how this conclusion was reached. I can only assume it was because brought-forward loss relief is automatic (brought-forward losses are deducted as a priority) and consequently there will be no taxable rental income irrespective of sideways loss relief.

## Back to paper

Rolando's return will be filed next year using the full amount of sideways loss relief I have calculated; it is unlikely that online filing will be possible using proprietary software. It will either restrict the sideways loss relief incorrectly or, even if a manual override is allowed, fail the validation and be rejected by the HMRC portal. My recommendation will be to file a paper return and make full disclosure in the white space. When an officer of HMRC manually inputs the data no doubt a figurative klaxon will sound, and it is difficult to see how an enquiry will not follow given the amounts involved.

## A new approach

I was resigned to this approach but then, nearly one month after HMRC's first reply and just a few days before I wrote this article, HMRC's technical team sent me further correspondence completely unprompted. Highlights from that correspondence are included below (with the figures altered to fit Rolando's circumstances). All references are to ITA 2007.

"Following my response below, I can advise you that we are now looking into the issue you have raised further, and it does appear that there needs to be clarification in respect of 'Worksheet 1' referenced from *Helpsheet 204*.

Whilst the SA105 boxes are entered as detailed in my response below, there does appear to be an issue in calculating the s 24A limit on s 24 reliefs and allowances deductible at step 2 of s 23. This means that, using the example figures in your email of 10 July 2015, [it] would result in a s 24A limit of £155,000 (£620,000 (£500,000 + £120,000) x 25%). It then follows that the property rental profits would be reduced to nil, as the s 118 loss relief carry-forward is not restricted by the limit at s 24A, and £120,000 of the £200,000 trade losses could be set sideways against the [pension] income..."

## The landscape changes

For individuals who have income of more than £200,000 and substantial relievable losses, this response alters the landscape entirely. It has moved from being "my" opinion to being "the" opinion, and there are now some issues to consider for advisers affected and their clients.

Tax software has been built around a flawed protocol. Advisers who rely on the software to give them the right answer may not predict an overpayment of tax. Unrepresented taxpayers rely on HMRC to give them the right answer. It could be assumed that individuals on this level of income would have an adviser, although HMRC's online filing tools do make filing a return without the need for an agent attractive.

This is a change in interpretation, not law. Tax year 2013/14 will be affected and at present taxpayers are in time to amend it. When the 2013/14 amendment window lapses on 31 January 2016, could tax be refunded as an overpayment claim given that mistakes in claims or as a result of "generally prevailing practice" are excluded from these provisions?

When will HMRC's "clarification" change their working sheet and when will software be updated to reflect this? Paper returns will be required during the interim for individuals affected.

For now, the advice must be for all agents to review loss relief claims that were subject to the restriction for 2013/14 and be mindful of losses available in 2014/15 and thereafter.

## Conclusion

Credit should be given to HMRC's technical team, which responded quickly to a point that initially could have been seen as obscure, and in particular for "fessing up" (as my son would say) in a very short time. Soon we will see the early trial of HMRC online digital tax accounts. My concern is how errors such as this will be identified unless there are enough objective controls to monitor the implementation of new law and policy. Online digital accounts should be there to make it easy for taxpayers to manage their tax affairs and pay the correct tax – a difficult challenge with our increasingly complex tax system.

## They do listen

Since the correspondence discussed in this article, *Working Sheet 1* to *Helpsheet 204* has been adjusted so that the definition of total income for these purposes has become "... box A59 minus any losses brought forward included in that figure". This is encouraging, though it may be better worded as "... A59 after adding back any losses brought forward included in that figure" to prevent the losses being deducted twice by those not familiar with these types of calculations. It remains to be seen how software providers will identify this correction in time for the 2014/15 filing deadline, or how incorrect returns already filed will be dealt with. ■

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