

Relief for early year losses

Many businesses make losses in the early years as they struggle to become established. The tax system provides various ways for relieving losses generally, with additional help available where the loss is incurred in the early years.

Option 1: relief for losses in early years of a trade

Unincorporated businesses with losses in the first four years of trade are able to carry the loss back against total income of the three years preceding the loss. The loss is set against income of the earliest year first – the individual does not get to choose the year against which the loss is relieved.

This can be useful if, say, an individual has been employed and then starts a business making an initial loss, as carrying the loss back may generate a tax refund. However, if income in the preceding years is low, carrying the loss back may not be the best option if this leads to personal allowances being wasted.

The special relief for losses made in the early years of a trade is not available where a business prepares accounts under the cash basis.

Option 2: sideways relief

A trading loss can be relieved against general income of the year of the loss and/or against general income of the year preceding the loss. The taxpayer can choose whether to relieve the loss against the general income of the current or the preceding year, and which is to take priority where a claim is to be made for both years. However, it is an all or nothing claim and it is not possible to tailor the claim to use only part of the loss so as to preserve personal allowances, for example.

Where the individual does not have sufficient income to offset the loss in full, the relief may extend to capital gains.

Where a loss is made in the early years of the trade, relief can be claimed under these provisions rather than under the special provisions outlined above for applying to losses in the early years. As with early years relief, sideways relief is not available where the accounts are prepared under the cash basis.

Option 3: carry forward

Carrying the loss forward for relief against future profits from the same trade is essentially the default option and can be used if it is neither possible nor desirable to carry the loss back (under early year rules) or sideways.

Best option

In ascertaining the best use for a loss, the aim is generally to get relief at the best possible rate as early as possible. However, what is the best strategy will depend on an individual's circumstances and the extent that other income is available to mop up a loss. For example, it may not be desirable to carry a loss back or sideways if that results in personal allowances being wasted – in which case carrying the loss forward will be preferable. However, going back or sideways when this triggers a tax refund will generally be advantageous.

It is also necessary to be aware of the cap of reliefs, set at the higher of £50,000 and 25% of adjusted net income.