

A Cosmetic Exercise?

Capital Allowances Condoc

The Government has recently published its response to consultations on changes to the way in which relief will be given for expenditure on plant and machinery.¹ These changes will affect almost all taxpayers to a greater or lesser extent, with investors and property owners being particularly badly hit. By the Treasury's own admission, the principal changes will raise additional tax, by April 2010, of more than £4 billion.

The consultation process launched last July (see *The Tax Journal*, Issue 899, 20 August 2007 and Issue 901, 17 September 2007) should therefore have seen a vociferous response from businesses and their advisers, with their concerns being reflected in revisions, where appropriate, to the proposals on the table. However, whilst the number of responses received was a healthy 84, including responses from trade organisations and accountants representing many thousands of businesses, the Government intends nonetheless to proceed with its original plans, regardless of their inherent faults. One may wonder, therefore, whether the consultation process was merely a cosmetic exercise.

This article outlines the broad impact of the changes and illustrates the major anomalies. The detailed technical analysis set out in the earlier articles remains valid.

The purpose of the changes

The package of proposals is intended to raise taxes, regardless of any 'spin' to the contrary. The latest document is littered with references to making the system 'fairer', 'simpler' or more modern, to encouraging investment, and to reducing the distorting impact of tax on commercial decisions. However, the extent to which such statements cannot be taken at face value is summed up by a reference to 'a simplified capital allowances system with two main plant and machinery pools'. For

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the uninitiated, there is currently one main pool, so it is unclear how a doubling of the number is a 'simplification'.

Likewise, the claim that the proposals will encourage investment has been universally rejected by business. The reduction in the main rate of allowances will fund the cut in the main rate of corporation tax to 28%. In effect, businesses that do invest will subsidise the largest that don't. Some sectors will be particularly badly hit, for instance hospitality, already reeling from the shock announcement of the retrospective abolition of IBAs.

than £50,000 on plant in a single year. Everyone else will effectively have the allowance clawed back through reduced capital allowances, either immediately or at most within three or four years. There is no provision to carry forward unused AIA to later years.

The AIA will apply to expenditure incurred on or after 1 April 2008 for corporation tax (6 April 2008 for income tax). The same dates see the abolition of FYA for small and medium-sized enterprises. Where an accounting period overlaps the implementation dates the maximum AIA will be restricted

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Annual investment allowance

The Treasury has made a great deal of its proposed 'annual investment allowance' or AIA, to be introduced in April for the first £50,000 of expenditure on plant and machinery (other than cars). This will replace existing first-year allowances (FYA) for small and medium-sized enterprises and, it is claimed, will encourage investment. However, whilst those making the smallest investments will obtain a modest cash flow advantage, the Government accepts that larger and even moderate investors, such as purchasers of single shops, offices or pubs, will be worse off after April. The problem is that the AIA is aimed only at the smallest investments of no more

according to the proportion of the period falling after the relevant date. This will give some strange results in the coming months.

Example 1

A small company with a 30 April year end is about to spend £50,000 on plant. If it spends it in March it will qualify for a FYA of 50%, that is, £25,000. The same expenditure incurred in May (the first month of a new accounting period) will attract the full AIA of £50,000. However, if the expenditure is incurred in April there will be no FYA and the AIA will be restricted to only one twelfth of the annual amount, that is, £4,167. This means that identical transactions will be

taxed differently according to the date expenditure is incurred and the accounting date chosen.

It is questionable whether this meets the Government's stated objectives of removing investment distortions and creating a simpler, fairer tax system. Furthermore, whilst (as with the abolition of IBAs) the Government trumpets how the AIA will help business to reduce the cost of tax compliance, surely no-one seriously believes that taxpayers would rather pay more tax than go to the minor trouble of claiming a relief.

Rate of allowances

Currently expenditure on most plant and machinery may be written off for tax at a rate of 25% each year. Under HMRC's proposals, which will take effect from 1 April 2008 for corporation tax (6 April for income tax), the rate of relief will be reduced. Allowances will be given at 20% per annum for the general pool but only 10% for 'features integral to a building' and for long-life assets. In each case, as at present, allowances will be given on a reducing balance basis. Where a business makes up accounts for a period

new generally available rate of 20% pa but at only 10%. The stated logic for this is that they are assets which have a long life and do not therefore need an accelerated form of tax relief. They are described as 'features integral to a building' and comprise:

- electrical systems (including lighting systems);
- cold water systems;
- space or water heating systems, powered systems of ventilation, air cooling or purification, and any floor or ceiling comprised in such systems;
- lifts, escalators and moving walkways;
- external solar shading; and
- active facades.

Inclusion of the last two items seems little more than a gimmick to placate the 'green' lobby. Electrical and cold water systems have been included, as although the Government itself was ambivalent, the majority of respondents were in favour. This will benefit some, but not all, taxpayers.

These assets are now referred to as 'features' rather than 'fixtures', after responses pointed out that some of the

easily been resolved by using the 'short life asset' rules to accelerate relief on assets with a rapid turnover. However, the Government has chosen to exclude 'integral features' from those rules.

Example 2

Bob acquires new trading premises which incorporate an old central heating system, and agrees with his inspector to allocate £75,000 of the purchase price to that system. After five years it needs replacing, despite the fact that tax relief has only been given on 41% of the cost. Ever-diminishing allowances will continue to accrue for another 25 years or so after the scrapping of the system. If a short life asset election were permitted, tax relief would be given over the life of the system.

The problem is that the Government does not appear to understand that the term 'short life asset' is a misnomer – what the rules really deal with are assets which lose value rapidly in a particular taxpayer's hands and are sold or scrapped before full relief has been given under the conventional rates of writing down allowances. The only alternative interpretation is that the Government does understand, but is prepared to sacrifice fairness if it can increase taxes.

The 'integral features' rules will apply to expenditure incurred on or after 1 April 2008 for corporation tax, and 6 April 2008 for income tax. Where an accounting period overlaps those dates, expenditure must be split into 'pre' and 'post' elements – it is not permissible to simply time apportion the expenditure for the year. Consequently, expenditure incurred before April on relevant assets will attract a higher rate of allowances and there may be some advantage therefore in accelerating expenditure to take advantage of this. Certainly, outstanding capital allowances claims should be brought up to date.

Phasing-out of Industrial and Agricultural Buildings Allowances, including Enterprise Zones

The proposed abolition of IBAs and ABAs was to many businesses and their advisers the greatest shock of the Budget, as it is in effect a retrospective withdrawal of tax relief for transactions entered into up to 25 years ago and a major blow to beleaguered British manufacturers and farmers. Even for those businesses not directly affected, the sudden, retrospective and draconian nature of this measure will, according to

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which overlaps those dates, the 'general pool' rate to be applied is calculated on the basis of time-apportionment, rather than by splitting the accounting period into 'pre' and 'post' segments and looking at when expenditure was actually incurred.

The reduction from 25% to 20% is said to reflect more accurately the true economic life of plant. This is debatable, or at least it should be. The Government has, however, presented the reduction as a *fait accompli* and the latest document fails even to refer to any responses received on that subject. Most experts agree that 20% was simply the figure needed to make up the shortfall in Gordon Brown's Budget caused by the reduction in the main corporation tax rate.

Integral features

The Government proposes that certain assets will qualify for relief, not at the

targeted assets would in fact be chattels. By now including them, the Government has effectively abandoned its pretended concern for a fairer system – the very nature of chattels is that they are not integral to a building and do not ordinarily share the lengthy economic lives of fixtures.

The Government has chosen to use a simple list rather than a 'purposive approach'. This may leave certain industries at a huge disadvantage. Some businesses, for example those in the hospitality and leisure sector, will need to replace such assets far more often than the life of around 30 years suggested by the 10% writing-down allowance. There is every chance that allowances will still be accruing on an asset not only long after the asset itself has been scrapped but also long after the original asset's replacement has been scrapped. This is a nonsensical situation, which could have

many commentators, reduce confidence that the UK tax system can be relied on.

The Government has also now announced the abolition of enterprise zone allowances, at the same time commenting merely that ‘the Government is not consulting on the changes to rates and withdrawal of allowances’. In other words, it wants taxpayers’ money, not their opinions.

The phasing-out of IBAs and ABAs will be achieved by reducing the rate by one quarter each year over four years from April 2008.

Example 3

Bobco Ltd incurred expenditure on the construction of a factory and has been claiming IBAs at 4% pa. This will be reduced to 3% from April 2008, 2% from April 2009, 1% from April 2010 and 0% from April 2011. It has another factory which it acquired second-hand with 10 years of its 25 year IBA life left to run, such that the current claim on that property is 10% pa. This will reduce to 7.5%, then 5%, 2.5% then nil.

Where an accounting period overlaps the date of the rate change, the rate of allowance for that year will be time-apportioned. Bobco Ltd makes up accounts to 30 September each year and will claim IBAs on its factory at the rates shown in Figure 1.

Allowances on the second factory would be phased from 10% to nil in the same manner.

Payable enhanced capital allowances (ECAs)

For a number of years a 100% capital allowance has been available for expenditure on designated plant and machinery technologies that are considered to be energy-efficient or environmentally beneficial (that is, water conserving). The rules have been notoriously complicated and will remain so. Even the Government appears confused: the latest consultation

document refers to *fourteen* ‘technologies’, of which *eleven* are ‘listed’, the other *four* being ‘non-listed’.

It is proposed that from April, where such allowances give rise to a loss, companies (and only companies) may claim a repayment. Around 83% of respondents were against this limitation to companies but the Government is unmoved, as it believes that, fair or not, extending the repayments to other businesses would be too costly.

The tax credit, for all companies, will be equal to 19% of the relevant loss and it is said it will be ‘linked’ to the small companies’ rate of corporation tax. The rules are planned to run from 1 April 2008, by which time the relevant tax rate will be 21%, so it is not clear what is meant by the ‘link’. There is an upper limit equal to the greater of (i) £250,000 and (ii) the company’s PAYE and NIC liabilities for the chargeable period. Tax credits will be recouped where, broadly, the relevant plant is sold within four years.

Example 4

Bobco Ltd, a small company, makes a loss of which £200,000 relates to

tax, almost a third of the loss will be effectively wasted. There is of course an advantage in having money immediately rather than at some future date, but even so, the tax credit seems to come at a very high price, and companies should be wary of claiming the repayments without a good deal of thought.

The consultation process

The Government has asked for further responses by 15 February. Its approach so far may be summed up as follows:

- do not consult on the major changes (rate reductions and IBA abolition);
- approve responses where they support present proposals (AIA and payable ECAs);
- accept the majority response where Government is ambivalent about which course of action to adopt (inclusion of electrical systems within integral features); and
- ignore responses where they object to present proposals (integral features ineligible for short life asset treatment, or the restriction of repayable ECAs to companies).

In short, the consultation to date has been a largely cosmetic exercise and one may question, therefore, whether

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Figure 1: XXX

Year ended 30 September	Rate of allowance	Calculation
2007	4%	Current rules apply
2008	3.5%	6/12 x 4% plus 6/12 x 3%
2009	2.5%	6/12 x 3% plus 6/12 x 2%
2010	1.5%	6/12 x 2% plus 6/12 x 1%
2011	0.5%	6/12 x 1%
2012	Nil	Allowances fully abolished

investment in energy-efficient plant. Its options are:

- carry the loss forward to offset against future profit, potentially saving tax at the proposed future rate of 22%, that is, a deferred £44,000; or
- surrender the loss for a tax credit at 19%, that is, £38,000 now.

In effect, claiming the tax credit ‘costs’ almost 14% of the loss. At the proposed 28% full rate of corporation

responding serves any useful purpose. I would suggest the answer is to focus on the one measure which could remove much of the patent unfairness of the proposals without prohibitive cost to the Treasury, namely to urge the Government to permit integral features to be the subject of a short life asset election. This is perfectly logical and Government cannot reasonably object, unless, of course, its concern for a fairer system, encouraging investment, is merely pretence.

Note

¹ ‘Business tax reform: capital allowances changes technical note, December 2007’ (hm-treasury.gov.uk).

For more information on the Capital Allowances Partnership LLP please go to their website: www.cap-allow.com