

FA 2010 analysis Capital allowances buying

SPEED READ It has long been possible to effectively 'sell' unused capital allowances in a loss-making company. In summary, a company would disclaim capital allowances. Following its acquisition by a new group, the company would claim allowances to generate or augment a loss which could be surrendered by way of group relief. FA 2010 Sch 4 enacts legislation to close this perceived loophole. From 9 December 2009, where tax avoidance is intended, new rules introduce the concept of an 'excess of allowances' and create a 'new pool'. Amongst other restrictions, future losses arising from new pools cannot create a loss available for group relief.



Martin Wilson is Chairman of the Capital Allowance Partnership (cap-allow.com), specialists advising on all types of tax relief for capital expenditure. He is author of *Capital Allowances: Transactions and Planning*, and writes for numerous other publications, including *Tolley's Tax Planning and Finance Act Handbooks*. Email: martin.wilson@cap-allow.com, tel: 0121 355 1955.

Prior to December's Pre-Budget Report, HMRC attention had focused on what was perceived to be an unfair use of capital allowances where a company changed hands. Legislation has now been introduced to address this perceived tax avoidance. The legislation is in FA 2010 s 26 and Sch 4, which insert into CAA 2001 a new Chapter 16A (ss 212A–212S).

The new legislation targets the perceived avoidance, where a company is sold (or its ownership otherwise changes) at a time when the tax written-down value of its plant and machinery exceeds the balance sheet value of that same plant and machinery. Importantly, however, the legislation only targets those instances where the main purpose, or one of the main purposes, of the change in ownership was the obtaining of a tax advantage.

Basically, what HMRC found objectionable was where:

- a company made losses, such that it could not make use of the allowances to which it was entitled;
- it therefore disclaimed the allowances;
- the company was sold, so that it formed part of a new group; and
- the company (still loss-making) claimed allowances in order to create or augment a loss which was then available for surrender by way of group relief.

A variation of this was where, after the change of ownership, another trade was transferred in to the relevant company, so that losses on the 'old' trade could be set against profits on the 'new' trade, without any need for a group relief claim.

The new rules are extended to cover postponed allowances in respect of ships.

Was this avoidance?

On one level, one could argue that this was not 'avoidance' at all. The use of the capital allowances was merely the logical effect of the legislation. On the other hand, one might argue (as HMRC effectively has) that the acquisition of a company primarily for the value of a latent tax asset, rather than for its trading potential, scarcely reflected the intention or purpose of the capital allowances system.

Transactions of this type have been around for more than a decade, and for many observers, the surprise is not that HMRC has acted now, but that it has taken so long.

Importantly, HMRC has confirmed that the legislation will not affect normal commercial arrangements. Consequently, transactions which truly reflect pure trading considerations will be unaffected. HMRC has very helpfully given an indication of the factors they will consider in deciding whether a particular transaction has the characteristics of avoidance.

New Rules

Where the legislation has effect, it will be necessary to compare the tax written-down value of each 'plant pool' with the balance sheet value of the plant within that pool. The amount (if any) by which the tax written-down value of a pool exceeds the balance sheet value is transferred to a 'new pool', and future losses generated by allowances on that new pool may simply be carried forward against subsequent profits of the same trade, etc. They may not be surrendered by way of group relief, for example. Nor is it possible to transfer a trade (even a similar one) into the loss-making company in order to generate profits against which the 'new pool' allowances may be used.

HMRC interpretation of the legislation was provided in an excellent Technical Note of 9 December 2009, entitled 'Capital allowance buying: anti-avoidance'.

When do the new rules apply?

New CAA 2001 s212B sets out the four criteria required for the new restriction to apply, namely:

- a company carries on a trade;
- a *qualifying change* (broadly, a change of ownership) affects the company;
- the company has a *relevant excess of allowances*; and
- the qualifying change has an *unallowable purpose*.

Qualifying Change

A 'qualifying change' is defined by new CAA 2001 s 212C. The basic position is where a company is acquired by another company (its 'principal company'). In effect the company will be part of a group after the change, whether or not it was a member of a group before the change is irrelevant.

The definition is extended to include (as well as an outright sale) situations where the company is owned by a consortium or by companies in partnership, and the ownership shares are altered.

Subsequent sections define relevant terms. Key

among these is that a 'principal company' (and therefore the group, etc relationship) is defined in terms of 75% ownership (ie mirroring the group relief rules in TA 1988 s 402).

Relevant excess of allowances

New CAA 2001 s 212J defines a 'relevant excess of allowances' as the amount by which the relevant tax written-down value exceeds the balance sheet value (of the relevant plant). However, one must exclude from the calculation any 'excluded plant and machinery', which is plant that is owned by the company but which is:

- let under a long funding lease (CAA 2001 s 34A); or
- hired out under an HP agreement (CAA 2001 s 67).

In each case, allowances would not in any case be available to the lessor or hirer. Relevant tax written-down value is defined by new CAA 2001 s 212K as the total of any unrelieved expenditure in single asset pools, class pools or the main pool. Any expenditure which could have been added to a pool (but has not been) is deemed to have been added to the pool for the purpose of calculating relevant tax written-down value. It is not possible, therefore, to distort the calculation by failing to allocate expenditure to a pool (with the intention of so allocating it after the change in ownership).

Unallowable purpose

The rules apply only if the change in ownership, etc is effected for an *unallowable purpose*. An unallowable purpose is one where the main purpose, or one of the main purposes, of the 'change arrangements' (transactions or other arrangements connected with the change) is to obtain a *relevant tax advantage*.

A relevant tax advantage is defined as becoming entitled to a reduction in profits (or increase in losses) for corporation tax purposes, in consequence of a claim for capital allowances on the plant and machinery relevant to the 'excess of allowances' calculation.

HMRC confirmed in the Technical Note that the rules will not be triggered simply by the existence of an 'excess of allowances' – the unallowable purpose test has to be in point. So how will taxpayers know whether they risk being caught by the new rules? Helpfully, the Note confirms that inspectors will consider the following factors:

- the amount paid, compared to the balance sheet value;
- changes made prior to the change (eg attempts to isolate the 'excess of allowances' from other trading activities);
- whether the trade of the company sold is compatible with that of the acquirer (for example, a financial institution acquiring a shipping company would be more likely to attract attention than a business acquiring another in the same industry);
- the planned conduct of the business (whether the acquirer intends to run the acquired business in the long term, or a sell-off seems imminent).

Although it is not explicitly stated, actual events will be strong evidence of what was planned – if the transferred business is in fact sold off within, say, six months, it may be difficult for the acquirer to argue that a sale was not intended throughout. Even then, each case will depend on the circumstances – an unexpected offer from a competitor would not indicate the 'planned conduct of the business'.

The Technical Note confirms that normal due diligence enquiring into the capital allowances status and history of a potential acquisition does not imply that obtaining the capital allowances is a 'main purpose'. This, of course, is not reflected in the legislation, and it may well be that a taxpayer ends up arguing the point with his inspector in a few years' time. Advisers would be well-advised to save a copy of the HMRC Technical Note!

Mechanics: the 'New Pool'

New CAA 2001 s 212P provides that the comparison of tax written-down value and balance sheet value must be done on a pool-by-pool basis, but the overall results may be netted off. For example, if one pool has excess capital allowances of £300,000 and another has an excess balance sheet value of £50,000, the net relevant excess of allowances is £250,000.

Following the 'qualifying change', the unrelieved qualifying expenditure in each relevant pool is reduced by the amount of the excess of allowances relevant to that pool. The amount of that excess of allowances is transferred to a 'new pool' of the same type (ie single asset, class or main pool). It will therefore be possible for an affected company to have two 'main pools'.

Allowances arising in the 'new pool' can be used only in calculating the profits of the existing trade – any trade transferred into the affected company will be regarded as a separate trade entirely. It should be noted that if the company merely expanded its trade, without acquiring an existing trade (previously carried on by another party), this rule would not seem to apply.

Any loss attributable to allowances in the 'new pool' cannot be surrendered by way of group relief, nor can it be offset against other profits of the relevant company, unless the activity generating those profits was carried on by the relevant company before the qualifying change.

Conclusion

The fundamental concept underlying capital allowances is that they provide tax relief for a business incurring capital expenditure in the pursuit of profit. It is unfortunate if a business cannot use those allowances because it is loss-making, but to give tax relief in such cases (via some form of rebate) would in effect be governmental underwriting of unprofitable businesses. A group acquiring a loss-making business can scarcely be said to be following the profit motive, and it never was the intention of the legislation to allow a loss-making business to benefit from otherwise unusable capital allowances by 'selling' them as a separate financial asset. ■

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