

A Flawed Election

When commercial property is acquired, capital allowances may be claimed on the part of the purchase price attributable to plant and machinery, whether fixtures or moveable chattels.

For many years, there was only one permissible way of ascertaining the amount to be allocated to plant, known as a 'just and reasonable apportionment'. This was confirmed by successive Capital Allowances Acts and is now CAA 2001, s 562. This method involves a specialist valuation of the various components of a purchase (land, building structure and plant) and relating the results to the actual price paid. Many readers will be familiar with the process. To do this properly requires not only tax knowledge but also surveying skills, and whilst professional fees will be incurred, they are generally a tiny fraction of the savings achieved.

The amounts claimable under a 'just apportionment' are generally much greater than the amounts that might be allocated (often fairly arbitrarily) to fixtures in the contract, and typically relate to substantial parts of a building's mechanical and electrical systems, including, for example, heating, electrical installations and sanitaryware.

However, in 1997 an alternative procedure was introduced (now CAA 2001, s 198), under which the purchaser and vendor could negotiate and elect jointly to set a figure to be treated by both parties as the disposal sale proceeds and purchase price for the fixtures (but not chattels). This figure would also be binding on HMRC and any subsequent purchaser of the property.

The aim of the election was purportedly to eliminate the 'burden and expense' concerned with valuing fixtures for capital allowances purposes. Equally important, no doubt, was the fact that, as the law required symmetry of treatment between the purchaser and vendor, the tax payable overall would in most cases be unaffected by the actual figure used. That is to say, any additional tax payable by the vendor (having to account for a higher disposal value) would be matched by additional future allowances

Martin Wilson of The Capital Allowances Partnership LLP highlights problems with and argues for the abolition of the 'fixtures election'

due to the purchaser, and *vice versa*. In summary, so long as someone paid the tax, HMRC didn't mind who it was.

PROBLEMS

Nevertheless, as with many tax innovations, there are many problems with fixtures elections.

The first is that, despite the 'spin' at the time, its introduction has in my view primarily benefited HMRC, which, where an election is made, no longer has to spend time and money considering whether the 'just apportionment' requirements of s 562 have been met.

The second problem is that the assumptions underlying the election were, with hindsight, somewhat naive. It was assumed that purchaser and vendor would negotiate and amicably agree upon an amount to be allocated to fixtures, which would be 'fair' to both parties. However, the only restriction applied by statute is that the elected amount must not exceed the original cost to the vendor. It was immediately evident that this was open to abuse. Consequently, it is not unusual to see fixtures in a multi-million-pound property deal being treated as sold for as little as £1. There are essentially two reasons why a purchaser would agree to give away something worth millions of pounds: (1) ignorance and (2) because it is the weaker party.

IGNORANCE AND WEAKNESS

Ignorance is easily understood, but what is meant by being the 'weaker party'? Essentially it is one of two things.

The first possibility is that the transaction is more important to one of the parties than to the other. For example, it may be that a property attracts numerous potential purchasers, in which case the vendor may announce that a condition of the sale is

that the purchaser will enter into a s 198 election for £1, effectively allowing all the allowances to stay with the vendor. If the purchaser doesn't agree, the property will simply be sold to another buyer. Whilst this is in essence part of the overall commercial decision, the cost is often misunderstood by purchasers and it cannot have been the intention of the legislators to facilitate such retention of allowances.

The second possibility is that deals are normally negotiated by property (not tax) personnel who lack understanding of the value of capital allowances, so purchasers will often 'gift' valuable allowances to vendors without realising the cost of what they have given up. Or one of the parties is simply better advised, generally because it is larger and more familiar with property transactions. Again, it seems unlikely to have been the legislators' intention to enable big businesses to take advantage of smaller competitors.

Ten years on from the introduction of the election, since when property may have already changed hands several times, it can also of course be difficult and impractical to establish the existence of irrevocable elections that may have been agreed many years previously.

INVALID ELECTIONS

Setting aside inherent flaws with the purpose of the legislation, there is another major problem. This is that many of the elections actually made appear to be so inadequate in detail that their very validity may be questioned.

Vendor didn't claim

It is explicitly stated that the s 198 legislation applies 'if the disposal value of a fixture is required to be brought into account'. This can only be the case if the vendor has claimed allowances on the

fixtures concerned. However, experience has presented many cases where a s 198 election purports to be valid but cannot be so. An extreme scenario is where the vendor is a developer, holding the property as trading stock, and therefore clearly not eligible to have claimed allowances. Very often this results from solicitors using a standard contract for all property transactions, regardless of the particular circumstances.

Missing information

Section 201 sets out certain information which a s 198 election *must* contain. This includes:

- (a) the amount fixed by the election;
- (b) the name of each party to the election;
- (c) information sufficient to identify the plant or machinery;
- (d) information sufficient to identify the relevant land;
- (e) particulars of the interest being acquired; and
- (f) the tax district references of each party to the election.

Some of these requirements present little by way of difficulty. Most claimants, for example, do remember to include their name and the amount of the election. However, other information is sometimes omitted, with the result that the election is at least arguably invalid. For example, an inspector would appear to be within his rights if he rejected an election which failed to give the tax reference numbers of each party. For a time inspectors were instructed to reject a claim where one of the parties was based overseas, on the ground that that person would not have a UK tax reference. That instruction has now been removed from the published HMRC Manuals, presumably because in most or possibly all cases, ownership of a UK property would by definition involve a UK tax presence, or a tax reference being issued in connection with the non-resident landlord scheme. I have also heard it suggested that it is not possible for a purchaser that is outside the charge to tax to enter into an election with a taxpaying vendor.

Identifying the fixtures

The requirement presenting the greatest practical difficulty appears to be the obligation for 'information sufficient to identify the plant or machinery'. In a great many cases the lack of detail could arguably invalidate the whole election. The following are the problems most commonly seen.

i Many elections refer simply to 'all the fixtures at the property', 'all fixed plant and machinery', or equivalent wording.



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There must be serious doubt whether this is sufficient to identify the plant or machinery which is purportedly subject to the election. Whilst HMRC has indicated (Capital Allowances Manual, para 26850) that it will accept an election covering all the fixtures in a property, that does not remove the statutory obligation to identify those fixtures, it merely removes the need to prepare a separate election for each fixture.

ii Some elections have attached a standard list of fixtures which may be typically found in a building (normally with no values against any of the descriptions) but which may or may not be present in the actual property which is the subject of the election. Again, this is surely insufficient to identify the plant or machinery which is purportedly subject to the election. At its worst, it can produce quite absurd results. I have seen an election for a nursing home listing such assets as beer distribution equipment. Whilst this might indicate an enlightened approach to nursing care, the more probable reason was simply that the fixtures list had been appropriated from a previous transaction involving a pub. More prosaically, I have seen many elections listing a lift when none was present in the building.

iii Some elections in effect combine (a) and (b) by referring to 'all the fixtures at the property, including but not limited to' the assets shown on an attached standard list. It is difficult to see how such terminology can be consistent with the legislation. As in (ii) above, it is arguable that if a taxpayer makes an election in respect of assets which do not exist, such action is fraudulent.

iv Some elections refer to an inventory of fixtures and fittings, which typically includes both fixtures and chattels. Section

198 can only relate to fixtures. Therefore, if an election purports to relate to both fixtures and chattels (with no separate amounts allocated), the entire election must be invalid. This is because the legislation states that the amount fixed by an election must be quantified at the time the election is made. Where the amount allocated to the fixtures (rather than the chattels) is not clear, the amount cannot be said to be fixed.

v When elections refer to 'all fixtures at a property', they typically do so without considering whether or not the fixtures concerned have been subject to a claim. More often than not, allowances will only have been claimed on some of the fixtures, in which case the election is partly invalid, to the extent that it relates to assets which have not been subject to a claim and for which no disposal value is therefore required to be brought into account.

vi The election sometimes claims to cover assets which appear to be ineligible (broadly, assets which are not accepted as plant). If an election purports to relate to both eligible assets and ineligible assets (with no separate amounts allocated), the entire election would again appear to be invalid, as the amount fixed by the election (for qualifying assets) has not been quantified at the time the election is made.

It was mentioned earlier that HMRC will accept an election covering all the fixtures in a property (but not in a portfolio – although I have even seen taxpayers getting that wrong). However, it is worth taking a closer look at what is actually said. Para 26850 states:

'The fixtures rules work on an asset-by-asset basis. In practice, you may accept a degree of amalgamation of assets where this will not distort the tax computation. Provided that there are no specific factors which could give rise to distortion, you may accept an election covering all the fixtures in a particular property but not for a portfolio of properties.'

This guidance appears to instruct inspectors to ignore the true meaning of the statute, which is to deal with each fixture on an asset-by-asset basis. Presumably a party to an election may therefore insist that a valid election may only be made on the true statutory basis – that is, asset by asset.

Furthermore, it is unclear what is meant by the term 'distortion'. Is it possible to argue that distortion of 'the tax computation' does take place where the amount allocated to fixtures by an election under s 198 is clearly insufficient, in that it bears no relation to the amount which has actually been paid for those fixtures, for example where an election for £1 covers assets clearly worth millions (particularly

because, given the election's irrevocable nature, it could affect a subsequent purchaser of the property that was not party to the original agreement)?

One may ask whether a party would be in breach of contract if it agreed to file an election but fails to do so. However, one should remember that contractual terms cannot override statute. In some cases a taxpayer may wish to 'cover himself' by submitting an election if required by the contract, whilst at the same time informing the inspector that he believes it is invalid.

AVOIDANCE

So-called 'avoidance cases' are dealt with by s 197, which operates to substitute tax written-down value for the (lower) elected amount but only where:

'the disposal event is part of, or occurs as a result of, a scheme or arrangement the main purpose or one of the main purposes of which is the obtaining by the taxpayer of a tax advantage under this Part [that is, plant allowances]'.

It is therefore not sufficient that the election had been made, or the amount fixed, to avoid tax; rather, the whole transaction must have had such a purpose in order for the anti-avoidance legislation

to take effect. Since the election was introduced, I have never once seen the anti-avoidance legislation successfully applied, which does rather call into question whether it is properly targeted.

FAIRNESS

If it cannot impose an elected value of £1, a vendor may often argue for tax written-down value on the grounds of 'fairness'. Such fairness is, however, an illusion where (as is generally the case) a property is sold at a profit. Consider the following example.

Example 1: tax written-down value

Albert buys a building for £1 million and claims allowances on fixtures of £250,000. After three years (when the fixtures are written down to £105,000) he sells the building to Bertram for £1.2 million. In the absence of a s 198 election the amount apportioned to fixtures could reasonably be expected to be around £300,000 but as Albert made a claim, the amount would be restricted to the original cost of £250,000. A s 198 election for £105,000 would allow Albert to keep allowances (intended, do not forget, to compensate for a fall in value) of £145,000 relating to assets on which he has in fact made a gain.

CONCLUSION

The election may have seemed like a good idea ten years ago, but experience has shown it is impractical and not working as expected. The anti-avoidance provision is so ineffective as to be little more than a curiosity for the exam room and has led to the election being primarily a tool for large enterprises to secure an unfair advantage over small businesses.

The attitude of governments, both past and present, has been to let the parties to a transaction come to an agreement, without intervention from HMRC (provided that the Treasury itself doesn't lose out). One might argue that this is analogous to the police letting burglars and householders 'come to an agreement' among themselves, provided, of course, that the police station is not being burgled!

Section 198 elections simply don't work as intended and the best course of action might well be immediate abolition.

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