

Capital Allowances

Capital allowances and the PBR

The last three years have seen extensive changes to the system of capital allowances, including changes to the rate of plant allowances, the phasing-out of industrial buildings allowances, and the introduction of integral features. Consequently it was anticipated that any changes to allowances in the Pre-Budget Report would be fairly narrow in scope, and so it has proved. Instead, most of the changes relate to anti-avoidance.

ANTI-AVOIDANCE

As is often the case with specific anti-avoidance legislation, the vast majority of taxpayers will be unaffected. HMRC pronouncements in Pre-Budget Report Note (PBRN) 12 are quite clear that the proposed rules will apply only where relevant transactions are tax-driven. The rules aim at restricting the use of losses generated by capital allowances, where a company has been sold, primarily for the value of those unused allowances. The new rules have effect from 21 July 2009 but from 9 December 2009 will apply also to ships. All examples in this article are based on those in PBRN 12.

Example 1 sets out the existing position.

Example 1

A Ltd spent £100,000 on machinery. It made a loss before capital allowances in each of its first six years of trading.

If A Ltd had claimed writing-down allowances in each of its first six years of trading it would have claimed approximately £81,000 in allowances and the tax-written-down value of the machinery would be about £19,000. The £81,000 allowances, which would be carried forward as part of the trade losses, would only be available to set against future trading profits.

If no capital allowances had been claimed, after six years the tax-written-down value of the plant or machinery would still be £100,000. Capital allowances on that £100,000 may be

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claimed in future years and, to the extent that they generate or augment losses, they may be surrendered as group relief or set against other profits of the company.

The perceived abuse

Where a company is sold by one tax group to another, the company continues to be able to claim capital allowances in the same way as when it was a member of the original group. Where such a claim augments or creates a tax loss, the loss can be used to reduce the taxable profits of the new owner's group.

HMRC has become aware of a number of transactions in which groups have acquired, or sought to acquire, companies with a large pool of unclaimed capital allowances, principally for the purpose of accessing those allowances.

Because the companies have not claimed the allowances, or only partially claimed them, the tax-written-down value of the plant and machinery is substantially in excess of its balance sheet value (an excess of allowances).

In these circumstances the price paid for the company by the acquiring group is likely to reflect the balance sheet value of the plant or machinery (which is likely to reflect its market value) rather than its tax-written-down value. However, the acquiring group is also likely to pay the selling group for the tax asset represented by the unclaimed allowances that will become available to the acquiring group. This is illustrated by Example 2.

Example 2

After six years of trading the parent of A Ltd begins to wind down the trade and A Ltd is put up for sale.

The market value of the machinery is £40,000 but an acquiring group would benefit from A Ltd claiming capital allowances on the full £100,000 cost of the plant or machinery.

A Ltd is sold to a member of Group B for £46,000. The price paid by B reflects the market value of the machinery and the capital allowances that will be available to Group B.

Shortly after the sale A Ltd ceases to trade. The machinery is sold for its market value of £40,000 and A Ltd becomes entitled to a balancing allowance of £60,000, which is surrendered as group relief, reducing B's tax liability by £16,800 (£60,000 at 28%). In effect B acquired a tax asset (the excess of allowances) for £6,000 and realised that asset for £16,800.

In this example it is clear, in HMRC's view, that B has acquired A Ltd only because of its unclaimed capital allowances. Commercially and pragmatically, one could argue that A was entitled to a tax relief, but being unable to use it, has benefitted from it via another route. As losses cannot generally be converted into a repayable tax credit, the legislation does rather discriminate against loss-making businesses, which is at best questionable in time of recession. Therefore not every taxpayer would agree that the transactions outlined in Example 2 should be tainted with the description 'avoidance'.

Example 3, again from PBRN 12, outlines a different set of circumstances, which do appear to be more artificial in character, and which many taxpayers would not be surprised to find the subject of anti-avoidance proposals.

Example 3

A loss-making group sets up a leasing company, C Ltd. C Ltd buys plant for £50 million and leases that plant or machinery out under a five-year finance lease. The rentals payable over the five years will total £60 million. C Ltd immediately sells the right to 90% of that income to a third party for £45 million. That income is taxable on C Ltd but the profits are sheltered by group relief from C Ltd's group.

C Ltd now has taxable income of £6 million (with a present value of £5 million) but can claim capital allowances on £50 million. Therefore, ignoring other costs, such as interest paid, over time C Ltd will generate trading losses of £44 million.

C Ltd is later sold to a member of profitable Group D for £13 million. C Ltd now claims capital allowances and generates trading losses that are surrendered to D.

The price paid by the member of D reflects the value of the future income (£5 million) and a further £8 million reflecting the value of the trading losses generated by the capital allowances.

In HMRC's view, it is clear that the main reason for Group D to acquire C Ltd is the value of the unclaimed allowances.

Proposals

The proposed legislation will prevent the tax-motivated purchase of a so-called excess of allowances. It will apply where a company carrying on a trade has an excess of allowances and is then sold (a qualifying change) in circumstances that constitute an unallowable purpose (essentially motivated by tax avoidance).

HMRC has indicated how the unallowable purpose test will be applied in practice. In summary, HMRC will focus on the following factors when considering whether a tax avoidance purpose is present:

- the amount paid for the acquired company relative to the book value of the net assets
- changes made to the business carried on by the acquired company prior to its acquisition, such that the acquired company in effect becomes little more than a shell for the excess of allowances
- the nature of the business carried on by the transferred company relative to the business carried on by the new group and
- the planned conduct of the transferred business following its transfer.

The unallowable purpose test means that the proposed legislation will not apply to normal commercial arrangements – for example, where a group acquires a company with a view to carrying on its trade as a going concern and the acquisition

of any excess of allowances is an incidental part of that acquisition (see Example 4).

Example 4

E Ltd started trading many years ago but has been making losses for the last six years. As a result no capital allowances have been claimed during that time. E Ltd's parent does not wish to invest in E Ltd's trade any longer, even though prospects for the trade are good. E Ltd is therefore put up for sale.

In this case, E Ltd owns plant and machinery with a tax-written-down value of £1 million but a market (and balance sheet) value of £400,000. The company owns other assets including premises and goodwill.

Group F purchases E Ltd for £1 million with the intention of investing a further £1 million in E Ltd's trade. At the time of purchase it is clear that E Ltd will make tax losses in the short term but is expected to become tax-profitable within three or four years. Group F is profitable and expects to claim group relief from E Ltd, which will include the capital allowances available on E Ltd's existing plant and machinery.

The excess of allowances (£600,000) will, over a period of years, reduce Group F's tax bill by £168,000, either by reducing E Ltd's taxable profits or by reducing profits elsewhere in the group.

On the facts in this example, it is clear (in the view of HMRC) that whilst Group F can benefit from E Ltd's capital allowances, Group F acquired E Ltd with a view to continuing and growing E Ltd's trade. The value of the excess of allowances is small in relation to the value of Group F's investment and any benefit from the excess of allowances is incidental.

Calculation of excess allowances

The calculation of the excess of allowances takes account of all plant and machinery (whether owned or not) in relation to which the company in question is entitled to claim capital allowances but not assets leased out by the company under a long funding lease, or assets owned by the company but which are the subject of a hire-purchase contract.

Effect

Where the legislation is triggered, losses generated by allowances derived from the 'excess of allowances' will not be available to reduce profits of an acquiring group. Instead they will be 'streamed' and only available to set against profits of the loss-making company arising from its activities as they were carried on at the time it was acquired.

The effect is that the excess allowances

will only be available to set against the company's profits on the basis of what it was actually doing at the time it was acquired but not against profits attributable to a trade or other business transferred to the company, even if the transferred trade is similar in nature to the trade already carried on.

FURNISHED HOLIDAY LETTINGS

PBRN 24 signalled that from April 2010 furnished holiday lettings will be regarded as a property business rather than a trade. This will entail a number of subtle changes in the tax treatment of such businesses, among which is one affecting capital allowances.

Capital allowances are not generally available for plant let for use in a dwelling house but furnished holiday lettings have previously been exempt from this rule, which applies only to property businesses and not, for example, to trades.

From 1 April 2010 for corporation tax and 6 April 2010 for income tax, capital allowances will not be available for new expenditure on plant in a furnished holiday let which is a dwelling house. This is not as straightforward as some may believe. PBRN 24 simply states, for example, that: 'Capital allowances will not be available for expenditure incurred on or after 6 April 2010 (or 1 April 2010 for companies) on plant and machinery for use within the let property,' as if every furnished holiday let was by definition a dwelling house.

A dwelling house for this purpose is not simply a house; it is a building used as someone's home. So unless new legislation specifically defines a furnished holiday let as a dwelling house, there may still be scope to argue that the dwelling house ban on allowances does not apply – PBRN 24 does say that furnished holiday lettings will be taxed under the 'normal' rules for property businesses, which implies that there will be no special rule deeming a holiday let to be a dwelling house.

Existing claims are unaffected – the change applies only for expenditure incurred on or after the relevant date.

Almost in passing, HMRC has confirmed that until the change takes effect, the current FHL rules will also apply to UK taxpayers with qualifying furnished holiday lettings elsewhere in the European Economic Area.

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