Where next?

Large Corporate OMB

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Paul Vohmann examines the recent OTS review of the capital allowances regime, and considers how it can be improved

Key Points

What is the issue?

The Office of Tax Simplification considered and rejected the complete replacement of capital allowances. Taxpayers and advisers need to understand this valuable tax relief.

What does it mean for me?

Capital allowances are not going away; rather we can expect further refinement of the system to simplify it and encourage taxpayers to claim the relief.

What can I take away?

Taxpayers and advisors need to understand the extent of the capital allowances regime, and that claims for tax relief are not being overlooked.

First introduced in 1946 to encourage investment in post war Britain, capital allowances (CAs) have long provided businesses with tax relief on capital investment in fixed assets. Although inevitably changes have been made to the system during the intervening decades, the original system is one that would still be familiar to us today.

Although CAs broadly reflect the accounting depreciation of equipment used by the business, the commercial reality is the depreciation of some assets, although reflected in the financial statements, does not benefit from tax relief. Using CAs as a fiscal tool to incentivise investment favours certain business sectors and certain asset types.

Review of capital allowances

It has become clear that half a century of continually tweaking CAs and evolving case law have made the tax relief complicated and often hard to navigate.

During the Office of Tax Simplification’s (OTS) July 2017 review of the corporation tax computation, there was significant and repeated feedback from respondents that CAs were indeed a confusing and underutilised area of tax relief. Respondents were incurring fees either in appointing specialist advisers to identify the tax relief, or at risk of erroneously claiming the relief.

Identifying CAs for those whose capital investments centred on commercial property is even more complicated, as the tax law diverges from property law.

It was therefore of no surprise that the OTS would put CAs at the forefront of tax reliefs to be simplified, and in December 2017 it was announced that the OTS would begin what turned into a six-month review and consultation of the CAs system and the impact of replacing it with allowable depreciation.

The brief

The brief of the OTS was *[to consider] whether the use of accounts depreciation to provide relief for capital expenditure instead of capital allowances (CAs) would simplify the preparation of tax returns for incorporated and unincorporated businesses.*

The final report would consider what an alternative system may look like, would it actually be simpler than CAs, and would the effort required to change tax relief regimes be worth it.

Capital allowances are here to stay

The OTS concluded that the system of claiming CAs should remain, and depreciation should not be an allowable tax deduction. Although there had been an earnest attempt to assess the benefits of depreciation as a form of tax relief, even a tax system designed from scratch, allowing tax relief on depreciation stated in the accounts would create new difficulties that would dilute the concept of using original depreciation.

If for example accelerated CAs such as Enhanced Capital Allowances (ECAs) and Research & Development Allowances (RDAs) were to be maintained, they would require their own depreciation rates. How would assets that are not depreciated receive tax relief, such as investment properties?

That is not to say that a depreciation based system would be without benefits, and going forward there may be opportunities to apply some principles of depreciation to capital expenditure to help simplify the CAs system.

Another influential reason in retaining CAs is the question of just how far-reaching a revised system would be. HMRC's data showed that a change in tax relief systems would not affect the majority of businesses who already benefited from the £200,000 Annual Investment Allowance (AIA). So perhaps simplification for the majority could be achieved through a refinement of the existing capital allowances system.

It should also be noted that the impact to the Exchequer of a revised system that allowed tax relief for depreciation would be substantial. HMRC forecast that it would lead to a fall in tax revenues of up to £7bn a year in comparison to the current system.

Improving CAs

The OTS recognised that much work can be done to simplify, clarify and improve the current system. It is clear that CAs are not a simple tax relief.

Paul Morton, OTS Tax Director commented: 'However, what has come through is a strong desire to see improvements to the existing system, in particular to look at extending the scope of assets which qualify for inclusion within the present £200,000 Annual Investment Allowance, which is such a key feature of the system for most businesses.'

Simplification was key to the review of CAs, and it is clear that recommendations will be made to simplify the system for the majority of tax payers (in particular SMEs).

The Annual Investment Allowance

Less than 0.5% of businesses consistently spend above the AIA limit. Using the AIA therefore applies to the vast majority of businesses, allowing them to easily and quickly claim a tax relief.

Certainly, it is clear that the use of the AIA is a measure favoured by the Government. However, it does nothing to address the complications in identifying the eligibility of assets for CAs in the first place. Using the AIA is unlikely to be the only simplification of the system we will see in the future.

Accounts based CAs

Such a system would use the account's segregation of assets, taking these groups to CAs pools (where the assets are listed as eligible for tax relief) and leaving other assets unrelieved, such as land.

Such an approach would allow the Government the option to use standard depreciation rates as a basis for a rate of tax relief, or to align the CAs writing down rate with the actual life of an asset type.

Some may argue that such a codified record of qualifying assets would certainly clear up much of the ambiguity around whether assets qualify for tax relief; others will argue that how to classify an asset will always be open to interpretation, and as such relies on the decades of case law that underpins the basis for CAs.

Property purchases

CAs are commonly available for the plant and machinery element of commercial property acquisitions. However, identifying this tax relief is complex and usually requires specialist advice. Typically the vendor and purchaser agree the tax value at which assets pass between them by way of a s198 election. This agreed value can be within a wide range and is rarely clear at the start of negotiations.

In some (increasingly less frequent) instances a valuation exercise must be undertaken to identify the tax value of the assets acquired.

In either case the rules are complex and nearly always require specialist advice. The OTS identified property purchases as a particularly difficult area to address by way of depreciation. It would come as no surprise if the OTS were to further review the process of identifying CAs on property acquisitions.

Accelerated reliefs

A number of accelerated reliefs are favoured by the Government, including Enhanced Capital Allowances for investment of energy efficient assets, and Research & Development Allowances for assets used in qualifying Research & Development.

The importance of these reliefs as an incentive to investment were stressed by the OTS, and it would be expected that any alternative or simplified system would need to retain these incentives to invest.

What should business being doing?

We can see that it was no surprise the OTS chose not to move to a system of depreciation-based tax relief. The adjustments and exemptions would have created a system as complicated as CAs.

CAs are there for all businesses to claim, and businesses should challenge themselves and their tax advisers to ensure their claims for CAs are being maximised.

The good news is that the AIA appears to be here to stay, it being the primary method to provide tax relief on capital expenditure for most businesses. All businesses should look to allocate their AIA to their least lucrative CAs pool (typically the Special Rate Pool), allowing this to be relieved in the first year.

Loss-making businesses should not overlook the availability of tax credits where expenditure is on ECAs and RDAs. Targeting these enhanced reliefs should be in a business's scope prior to procuring assets to ensure expenditure is compliant.

Finally, when commercial property is acquired, CAs should be raised with the lawyers at an early stage; without an election, purchasers are at risk of obtaining no tax relief on assets acquired.