A sledgehammer approach

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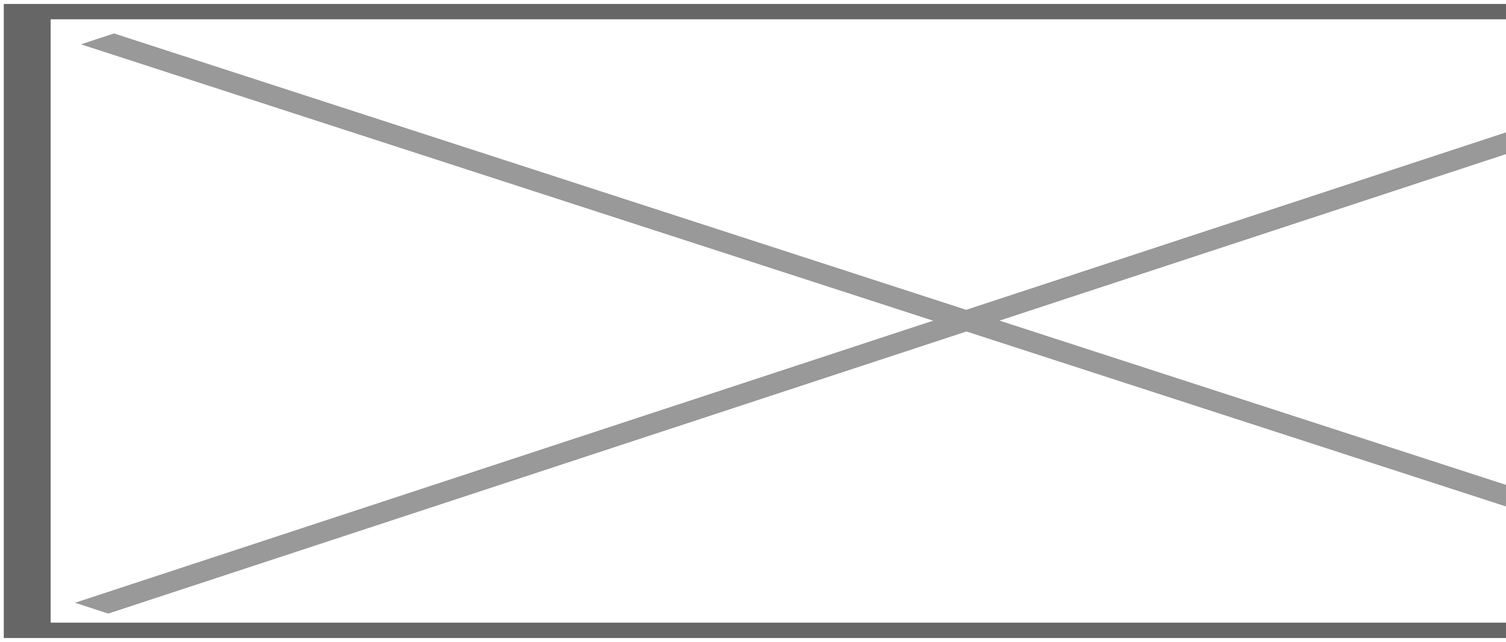

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Alun Oliver and *Rupert Guppy* set out the complex current capital allowances regime and issues affecting real estate transactions

Key Points

What is the issue?

There is a steady trend by clients to litigate against poor tax advice. The capital allowances rules remain complex and convoluted, especially CAA 2001 s 187A on second-hand property purchases, which changed in April 2014 and had a two-year window for action. Since April 2016 this window has had an impact on past transactions and potentially denies tax relief to purchasers and future owners.

What does it mean for me?

As an adviser to property investors or owners, failure to understand these complex capital allowances rules could create serious risk of a PII claim against tax relief lost by clients not benefiting from optimised capital allowances claims.

What can I take away?

This is a complex area of property tax and CPSEs now recommend early involvement to understand and protect the tax position.

Life has become more challenging since April 2014 and the introduction of the complex new fixtures rules (NFRs) governing the availability of capital allowances on the purchase of 'second-hand' buildings.

FA 2012 s 43 and Sch 10 introduced ss 187A and 187B into the Capital Allowances Act 2001 (CAA 2001) was the basis of these new convoluted requirements.

We are now starting to see increasingly antagonistic attitudes, with some vendors wanting financial compensation for co-operating with NFRs.

In addition, those who have lost out and subsequently found their capital allowances to be nil are now turning to litigation to recover the 'tax savings lost'.

The transaction due diligence and conveyancing puts solicitors, tax advisers and surveyors in 'pole position' to face PII claims if these matters have not been adequately addressed.

Purchase claims

Capital allowances are potentially available on all commercial property transactions. They generally equate to between 10% and 45% of the purchase price of a commercial property, depending on its design specification and its intended use. Hotels and hi-tech data centres or telecoms facilities typically yield capital allowances claims at the upper end of this range; while retail or industrial premises are normally towards the lower end, depending on the precise use – remembering that any tenant's fit-out expenditure is outside the scope of a landlord's claim.

However, tenants can claim capital allowances for their own costs – an important point that is not universally recognised, judging by the number of tenants and accountants we see ignoring these, wrongly presuming they are applicable only if they own the freehold interest.

Just and reasonable apportionment

Most purchase claims are assessed under CAA 2011 s 562 and use a 'just and reasonable apportionment' of the purchase price to allocate the qualifying expenditure against the relevant plant and machinery allowances (PMAs) or integral feature allowances categories (IFAs).

This methodology, which seeks to fairly apportion the price paid for a combination of assets into its constituent parts – land, building and plant and machinery – has been in place since the mid-1980s. It was re-affirmed last year by the First-tier Tribunal decision in *Bowerswood House Retirement Home Limited v HMRC* [2015] UKFTT 0094 TC.

The tax adviser for Bowerswood had sought to use differing valuation techniques for different aspects of the claim – skewing the values in the business's favour. Unsurprisingly the tribunal rejected this lop-sided method, stating: 'We consider that approach is flawed. It does not identify the value of all assets purchased on the same basis… In our view that does not amount to a just and reasonable apportionment.'

Commercial property standard enquiries

As part and parcel of commercial property transactions, solicitors usually exchange a set of commercial property standard enquiries (CPSEs) to seek out relevant facts about the property. Before the NFRs, many purchasers overlooked capital allowances or left any claims until long after the transaction – undertaking a retrospective or historic claim. CPSE capital allowances responses were rarely comprehensive or sufficient to understand the previous tax position – commonly left blank, or citing ‘No allowances’, or ‘Not applicable’.

Some commercial conveyancers will seek to exclude tax from their scope of services, occasionally referring the client to pursue further advice from their accountant. Under the NFRs all involved with a property purchase – be they surveyor, solicitor or accountant – should be mindful of *Clarke v Iliffes Booth Bennett* [2004] EWHC 1731 and *Mehjoo v Harben Barker* [2014] EWCA Civ358. These negligence cases in part addressed the reliance that clients place on their advisers and what services should be ‘standard’ and part of general advice and those that might be more specialist and so outside standard tax advice.

New fixtures rules

Since April 2014 the new fixtures rules have been fully in force (there being transition rules between April 2012 and April 2014). These inserted the ‘pooling requirement’ s 187A(4) and in turn the ‘fixed value requirement’ s 187A(6) in an attempt by HMRC to limit the cases of duplicate or invalid claims. Arguably, HMRC could have used case law – *West Somerset Railway plc v Chivers* [1995] STC (SCD 1) SP C1 – and trained its staff to understand the existing tax laws so they could refute the more spurious claims made without the proper due diligence and eligibility. However the proverbial sledgehammer was HMRC’s preferred choice, resulting in these complex requirements being inflicted on all taxpayers and their advisers.

The pooling requirement requires the vendor to have either:

- claimed capital allowances and thus enter a s 198 (CAA2001) election, or
- not having claimed (when they could have) must pool the relevant figure in their relevant tax computation.

Pooling requires the vendor to invest effort in addressing these points in their tax returns, possibly re-submitting them to satisfy the pooling requirement and so incurring additional costs and professional fees. Yet all the benefit will go to the purchaser, who will then be able to claim capital allowances up to the pooled amount and enjoy future tax savings after their purchase.

The fixed value requirement can be satisfied by:

- a s 198 election, or
- application to a tribunal to agree fixed value (where parties disagree), or
- preservation of fixed value. This is applicable if a non-claimant (charity or pension fund) might be an intermediate owner.

Failure of the parties to fulfil the pooling requirement and the fixed value requirement will lead to the ‘permanent loss’ of capital allowances for the buyer – and all future buyers – because the default position under s 187A is nil allowances.

Reality more complex than theory

The UK property market is considerably more complex than perceived by government legislators. The NFRs are clearly predicated upon the Treasury’s expectation that all property owners have claimed the capital allowances available; and therefore when selling the property the vendor just completes an s 198 election with the purchaser to agree the quantum of allowances to be transferred.

The expected election would normally be at ‘tax written down value’, whereby the vendor retains the allowances claimed to date of sale and surrenders the balance of allowances to the purchaser. However, there are numerous reasons why property investors may not have claimed any of the capital allowances, in particular those that perceived the value to be low, perhaps felt it too complex or the company was able to offset its profits due to interest deductions or had carried forward losses. Further, the Property Industry Alliance’s (PIA) *Property Data Report 2015* highlights that 15-25% of commercial property transactions involve non-taxpayers, such as charities or pension funds. Then you also have transactions by property developers, holding the property as ‘trading stock’.
In addition, since many buildings are bought and later re-sold, there is a need to identify the full sequence of ownership and the historic tax positions of all the relevant owners – markedly increasing the complexity.

Integral features

For transactions that involve a property acquired by the vendor pre-April 2008 (before Integral Features CAA 2001 s 33A), although the PMAs may be subject to the NFRs restrictions, the purchaser may have an unrestricted claim on IFAs that had not previously been eligible as PMAs – general power, some lighting and cold water installations.
We regularly see owners dismissing the possibility of tax relief without properly exploring the scope for any IFAs. Equally, when a previous s 198 election (or CAA 1990 s 59B) exists from a pre-April 2008 purchase – possibly at only £1 in respect to PMAs – there may be further scope for an IFAs claim.

We would highlight that typically such ‘IFA only’ claims are in the range of 3-15% of the purchase cost, subject to the design, specification and use of the property. Even at these modest levels, IFAs can still generate enough tax savings to make a claim worthwhile and should always be explored carefully before being disregarded.

Two years on

As stated, the NFRs came fully into force in April 2014 and s 187A(11) requires that these steps must be met within two years of the relevant purchase date. Accordingly, since April 2016 (1 April or 6 April for corporation or income tax respectively) there will be more properties whose two-year period lapses, triggering permanent loss of allowances if the parties have not agreed the position. Section 187A(7) permits a referral of the valuation to the First-tier Tribunal for determination if the parties can’t agree, but this is likely to be an expensive option – and still must be done within the two years.

Section 198 election

Although elections have been with us since 1996, the s 198 election is another complex area and fraught with the potential for error. We regularly see ‘default’ contract wording in sale and purchase agreements that requires the parties to enter into a s 198 election – in all cases – even when not relevant or possible. Too often the elections are badly drafted and not in accordance with CAA 2001 s 201, which specifies the details the election must include:

- the amount fixed by the election
- names of parties making the election
- information sufficient to identify the plant and machinery (or IFAs, being a subset of PMAs)
- information sufficient to identify the relevant land
- particulars of the land interest freehold (s 198) or lease granted (s 199)

- tax references and relevant HMRC contact details for each party

Care should be taken in preparing the contract wording and any requisite elections to be made. We would advocate seeking to obtain copies of the prior claims that underpin the proposed numbers so that the claim can be validated and any scope for additional claims on items not previously claimed might be considered.

Construction claims

The second key area for capital allowances is claims derived from new construction expenditure. These could be new buildings, extensions to existing ones, refurbishment projects or fitting-out costs.

There are different, but simpler, rules applicable to claiming capital allowances on such projects. As well as PMAs and IFAs, there are also 100% allowances that can be obtained for energy- or water-efficient assets incorporated into any projects under the enhanced capital allowances (ECAs) rules. There are also long life assets (LLAs) set out by CA 2001, s 91 and, within the special rate pool at 8% per annum, writing down allowances. LLAs are concerned with assets whose economic life is 25 years or more – typically those within the utilities, infrastructure and petro-chemical sectors rather than more traditional commercial properties. Short life assets – mostly found in the retail sector – are those with an economic life of eight years or fewer and can be written off over the expected life on a straight-line basis.

Within a construction project, the expenditure qualifying for allowances is not limited to the individual asset cost, and can be enhanced by a proportion of the project preliminaries, the contractor's overheads and profit and the construction-related professional fees – e.g., architects, quantity surveyors or engineers. Those not familiar with construction projects can often overlook these 'add-on' costs from a capital allowances claim, potentially under claiming the available tax relief by 15-45%, particularly on design-and-build or GMP (guaranteed maximum price) projects.

For many years HMRC challenged the level of preliminaries and professional fees, seeking to reduce capital allowances claims. But the long-running case of *J D Wetherspoon plc v HMRC* [2012] UKUT 42 (TCC) decided that an apportionment of these project costs provided generally a reasonable and pragmatic solution.

Annual Investment Allowances (AIAs)

Applicable in either instance – capital allowances claims on second-hand property acquisition or new build expenditures – AIAs are available at 100% to all taxpayers on the first £200,000 of qualifying expenditure (since 1 January 2016).

AIAs accelerate the cash flow impact of the capital allowances and are usually beneficial for SMEs. For larger 'institutional' investors, AIAs are unlikely to form a key part of their tax strategy. Lastly, AIAs are time-sensitive and must be claimed within the normal two-year tax window of the expenditure being incurred. Outside this timeframe, the normal WDAs will be the default position.

Conclusion

As a result of this complex legislation, it is vital that capital allowances are addressed early on in any given project. Advisers who think ahead, treat each transaction separately can reduce risk and ensure their clients will benefit.