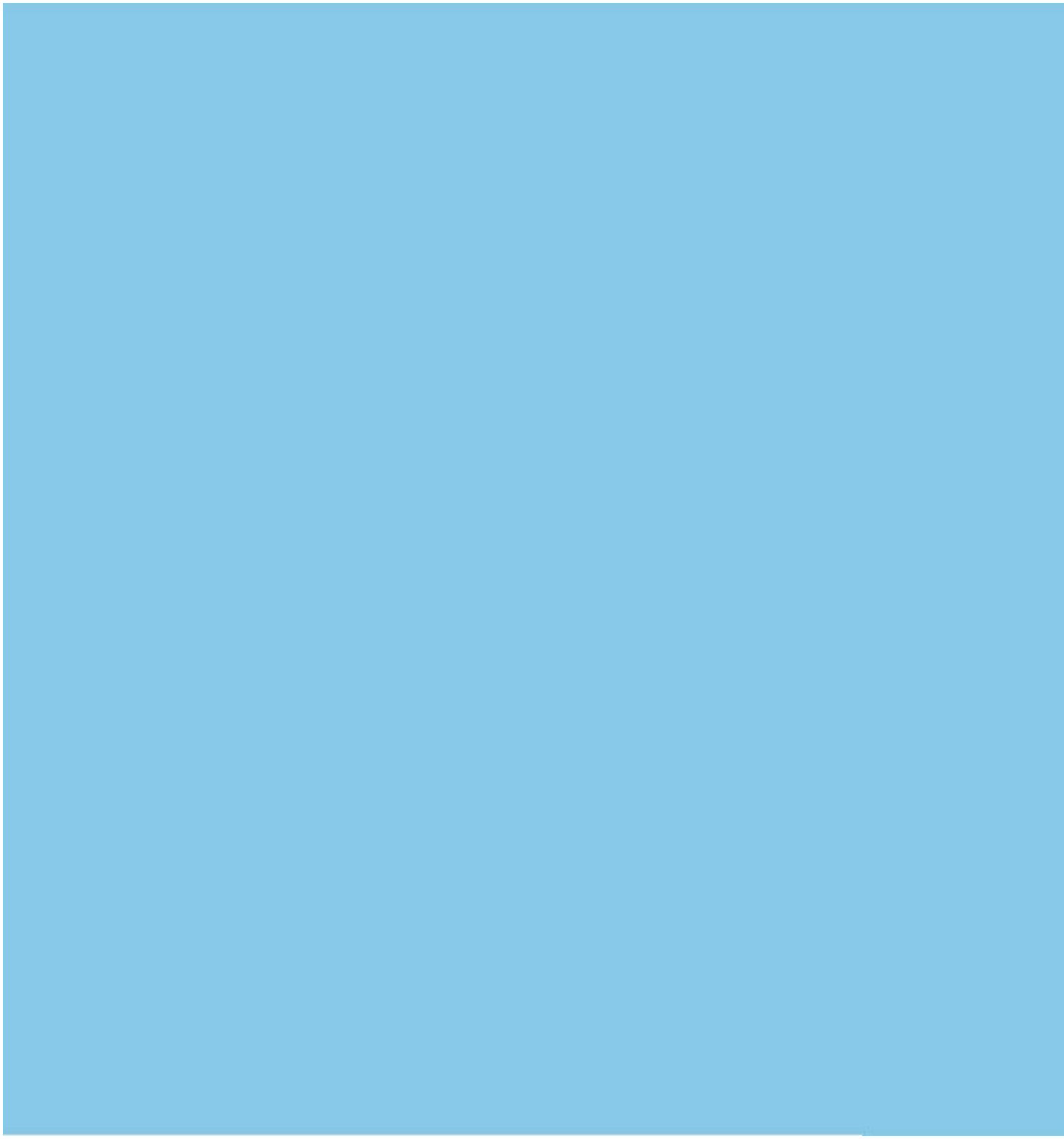
Navigating section 198/199 elections: common traps in property transactions

Property Tax OMB



20 November 2023

How to avoid common traps when providing guidance on capital allowances in property transactions.

Key Points

What is the issue?

This article delves into the nuances of section 198/199 elections, sheds light on the common pitfalls faced by taxpayers and tax advisors during commercial property transactions and underscores the substantial tax relief potential they bring.

What does it mean for me?

Essentially, section 198/199 elections are conducted to ascertain the capital allowance disposal value for the previous owner and the acquisition value for the new owner.

What can I take away?

It is a well-known fact that section 198/199 elections do get rejected by HMRC. This is predominantly due to five factors which we will look at in detail in the article.

In the intricate realm of tax advice, one often overlooked facet is the section 198/199 election – a critical element in dealing with capital allowances within commercial property transactions. It is the kind of detail that can easily slip through the cracks, but the consequences of mishandling it can be substantial. Such oversights create knowledge gaps among involved parties. Advisors must acquaint themselves with these changes promptly; otherwise, their input may be deemed invalid.

This article delves into the nuances of section 198/199 elections, sheds light on the common pitfalls faced by taxpayers and tax advisors during commercial property transactions and underscores the substantial tax relief potential they bring.

The significance of valid section 198/199 elections

Many tax advisors underestimate the importance of valid section 198/199 elections when providing guidance on capital allowances in property transactions. When ownership shifts from one entity/individual to another, it is crucial for both parties to remember that a fixtures election can only encompass items for which the previous owner (vendor) has incurred qualifying expenditure (capital expenditure on plant and machinery provision).

Under the Capital Allowances Act (CAA) 2001, a section 198/199 election applies specifically when ‘the disposal value of a fixture is required to be considered’ for capital allowances purposes. Moreover, the vendor must have included the expenditure on plant and machinery provision in their tax computations, fulfilling the pooling requirement. Furthermore, for the new owner to make any capital allowances claim, they must jointly determine a transmission value for all embedded fixtures in the premises included in the vendor’s capital allowances calculations.

Essentially, section 198/199 elections are conducted to ascertain the capital allowance disposal value for the previous owner and the acquisition value for the new owner. In some cases, both parties may lose out on tax relief due to significant changes in the value of the fixtures specified in the election. The vendor can either retain the full value and claim allowances by setting a £2 value in the election or pass on the new value to the new

owner, still complying with the pooling requirement.

In summary, failing to meet the fixed value and mandatory pooling requirements (under CAA 2001 s 187A and Finance Act 2012 Sch 10 para 13) and providing inadequate evidence will prevent capital allowance claims, underscoring the importance of a robust section 198/199 election.

The costly ramifications of invalid elections

The gravity of this matter cannot be overstated. An invalid section 198/199 election can have dire financial consequences for taxpayers. Such oversights can lead to the loss of valuable tax relief opportunities and, in some cases, trigger the dreaded clawback of previously claimed allowances. The stakes are high, and there is little room for error.

If the joint agreement by both parties does not result in an amount included in the fixtures election, resorting to a tribunal becomes unavoidable. Additionally, the tribunal assesses the apportionable sum based on a request made by one of the concerned individuals within the two-year period. Going to tribunal can be exceedingly costly in terms of expert advice and yields an unpredictable outcome. Therefore, any issues or disagreements should be promptly resolved before finalising the property sale and purchase.

Nonetheless, HMRC has provided specific legislation for consultants and tax advisors who wish to take additional precautions before advising their clients.

The government was keen to make it clear that the proposal to make section 198/199 elections the norm should not be seen as detracting, in any way, from the right of either the seller or the purchaser to insist upon a just and reasonable apportionment of the sale value of a property to its fixtures.

Taxpayers or non-taxpayers: a longstanding debate

A debate that has persisted since April 2012 concerns whether section 198/199 elections are applicable only to taxpayers or non-taxpayers. This has undoubtedly caused confusion for HMRC.

Due to strong arguments suggesting that non-taxpayers, such as charities and pension funds, were ineligible to sign an election, HMRC definitively clarified that both parties are eligible for this specific election but under one condition. The non-taxpayer (charity) should only act as the purchaser (buyer) after the property changes hands. Up until this point, tax consultants speculated that section 198/199 elections were only for taxpayers, which was undoubtedly incorrect.

In conclusion, HMRC unequivocally clarified this matter, making it evident that both parties can sign an election, with necessary distinctions made based on whether the non-taxpayer is a seller or buyer.

The claim validity period: a two-year window or unlimited timeframe?

The standard timeframe for making the election is no later than two years after the purchaser's acquisition or recognition on the lease. However, if one of the parties has applied for a tribunal judgment to meet the 'fixed value requirement' in CAA 2001 ss 200-201, the timeline is extended, allowing the election to be finalised by any date. A copy of the election must be included in each person's tax return following the purchase date, which is often overlooked.

Unfortunately, the issue arises because the two-year window is sometimes missed in exceptional cases. Vendors must recognise plant and machinery no more than two years after relinquishing ownership, a fact not always known to them, resulting in losses for anything unclaimed within this window. Mistakes and breaches have prompted vendors to become more aware of the necessary actions to prevent their elections from being withdrawn or invalidated.

Assets and associated value allocations: amalgamation or asset-by-asset basis?

The rules for assets apply on an asset-by-asset basis. In some cases, parties may need to combine assets if it does not impact tax calculations. However, with the introduction of 'embedded fixtures' for compatible expenditure incurred on or after 1 April 2008 (companies) or 6 April 2008 (individuals), it is essential to distinguish between:

a) embedded fixtures qualifying for writing down allowances in the special rate pool at 6%; and

b) embedded fixtures qualifying for writing down allowances in the main pool at 18%.

Corresponding to the Finance Act 2008 modifications, for the time being it is less feasible for the parties to be able to recognise an election including all the embedded fixtures in a specific property without expecting some allocation of value between the two categories being demonstrated above. In fact, it has never been recognised as acceptable to acknowledge an election enclosing all the fixtures for more than three properties simultaneously.

The buyer's stronger position: the impact on the signed election

The vendor desires the property to be sold, and capital allowances can be part of the transaction. The purchaser, on the other hand, may have the power to enforce a significant value in the capital allowance election.

The vendor must weigh whether losing allowances is worthwhile to proceed with the deal. In fact, if the vendor has carried forward losses, they might voluntarily offer a significantly higher value in the election as a way of attempting to bargain a higher sale transaction to accurately display the fact that the buyer will acquire an invaluable tax relief. In this case, additional consideration should be taken before signing the election. Therefore, both parties should reconsider their negotiating position and any losses made so far in case the new owner wants to jointly experience an incomparably higher tax relief.

If the vendor has carried forward losses, they may willingly offer a higher value in the election to negotiate a higher sale price, highlighting the buyer's valuable tax relief. In such cases, both parties should reevaluate their negotiation position and any incurred losses, especially if the new owner seeks significantly higher tax relief jointly.

The perils of common errors

It is a well-known fact that section 198/199 elections do get rejected by HMRC. This is predominantly due to five factors which we will look at in more detail below. These details are easily mistaken and will catch out almost everyone – therefore we hope that the list below will save you both time and money.

1. Incomplete party information

Frequently these crucial details are absent from the elections. HMRC expects comprehensive information about both the seller and the buyer, including their Unique Taxpayer Reference (UTR) numbers. Neglecting to provide this data can render the entire election invalid.

2. Property identity crisis

Another leading cause for election rejections is the misidentification of the property itself. Mistakes in addresses, title numbers or the type of interest (leasehold or freehold) can cause confusion at HMRC. Indeed, section 198 primarily deals with freehold properties, while section 199 focuses on leaseholds. Although these may seem like standard legal distinctions, not understanding the difference between them can result in tribulations which will cost taxpayers thousands of pounds in lost tax relief.

3. Missing plant and machinery details

The devil, as they say, is in the detail. Unfortunately, many elections fall short in providing sufficient information to identify the plant or machinery within the property. Moreover, they often fail to specify the amount fixed by the election, making it impossible for HMRC to process them. In fact, failing to differentiate between main rate pool and special rate pool might cause perplexity to the purchaser.

4. Wrong information given in relation to the value of the market

Elections are rendered invalid if the transaction of the premises does not exceed the current market's value. Anything less than that can easily give HMRC the opportunity to decline the elections.

5. Negligence and carelessness relating to the qualifying activity being in place

Attention should be given in case the invariable discontinuance of the qualifying activity corresponds to the demolition or displacement of the fixture being in place. In this case, HMRC will surely reject the election, as there is no proof to confirm the fixtures' verification. Therefore, attention should be taken to those fixtures being in place if the qualifying activity is no longer in use.

To avoid these pitfalls, aspiring tax advisors and experienced professionals alike must remember that s 201 mandates the inclusion of all these critical details in a valid section 198/199 election. Diligence in gathering and presenting this information can make the difference between a successful claim and a missed opportunity.