

## Pre-Contract Negotiations for Capital Allowances

### Introduction

The value of capital allowances to either party to a property transaction will depend on various factors, but the bottom line is that capital allowances save tax and therefore, have value. This is even true where either party is unable to utilise the allowances (as a non-taxpayer or property trader) because a future owner may well place a value on the potential tax savings. The issue of capital allowances is invariably one of the matters that should be agreed between buyer and seller, or landlord and tenant as part of the pre-contract negotiations. Sometimes what either party thought had been agreed is not clearly reflected within the terms of the contract.

This article touches on some of the practical implications of badly worded contract clauses dealing with capital allowances and the relevance of the pre-contract documentation that may exist in some common situations that we have encountered.

### Apportionment clauses within contracts for sale

If a seller has claimed capital allowances in respect of machinery or plant fixtures, it is highly likely that the seller will want to retain as much of the capital allowances as possible after the sale of the property. The seller can achieve this objective by entering into an election with the buyer in accordance with the Capital Allowances Act 2001 (CAA 2001), Section 198, effectively fixing the disposal level of the fixtures at the elected figure. Very often the elected figure is £1 and in such cases the seller retains all the capital allowances, even the capital allowances that have yet to be utilised.

Notwithstanding the above, we have come across numerous situations where it is agreed at pre-contract stage that the seller will retain all the capital allowances, but the contract clause dealing with this matter simply states that a figure of £1 is apportioned to the fixtures. The contract does not mention the requirement of a Section 198 election. This can be extremely costly for the seller because, in the absence of an election, HM Revenue and Customs (HMRC) can insist that the disposal value of the fixtures is based on a “just apportionment” of the sale price. Such an apportionment can lead to the full claw-back of capital allowances from the seller and the loss of significant tax savings. To look at it another way, the seller gets less than agreed for the property.

Even where there is pre-contract documentation that stipulates that the seller is to retain all the capital allowances, it may not be possible for the seller to successfully apply to the court for rectification of the contract on the basis that a mistake has been made. Whilst rectification is not prevented by Section 2 of the Law of Property (Miscellaneous Provisions) Act 1989, which requires that all the contract terms are incorporated into one document, the seller would nevertheless need to produce

convincing evidence that the contract does not reflect the intentions of the parties. This could prove difficult because an apportionment of £1 to fixtures within the contract does not invariably give rise to an irrefutable argument that the parties must have intended the making of a Section 198 election.

### Contribution clauses within agreements to lease

When a landlord makes a capital contribution to a tenant's fitting out works, the landlord may be entitled to claim capital allowances in respect of the machinery or plant covered by the contribution in accordance with CAA 2001, Section 538. This is often another common situation where the contract provisions are often inadequate to secure the result desired by one of the parties, in this case, the landlord.

The heads of terms may make it quite clear that the landlord is to benefit from the available capital allowances in respect of the machinery or plant covered by the contribution. We have seen many agreements to lease that failed miserably to set out clear provisions in order to secure the capital allowances for the landlord. Sometimes the contract provisions relating to the contribution do not even mention capital allowances, leaving the tenant with the obvious argument that the contribution was just a general incentive payment agreed as part of the lease terms. In such a case, the tenant is not required to set the contribution against the fitting out works, with the result that the tenant's entitlement to capital allowances is undiminished by the landlord's contribution.

It is unlikely that the court would allow the inclusion of an additional term from the pre-contract negotiations covering capital allowances, especially if the agreement to lease contained an “entire contract clause” stating that all agreed terms are incorporated in the contract document. In the recent case of *Chartbrook Limited -v- Persimmon Homes Limited* (2009), the House of Lords confirmed that the traditional English law position will continue to prevail for the foreseeable future. Pre-contract negotiations will generally be inadmissible in disputes relating to the interpretation of contract clauses.

### Replies to CPSEs

For most commercial property transactions the buyer's solicitor is likely to use one of the forms that incorporate the commercial property standard enquiries (CPSEs) formulated by the legal profession in conjunction with the property industry. These standard forms usually include questions on capital allowances that are aimed at collecting sufficient information for the buyer to assess the likely level of capital allowances that will be attached to the property as part of the transaction.

In most contracts there will be a clause acknowledging that the representations and warranties made in the replies have been made to induce the buyer to enter into the contract. The replies do not constitute terms of the contract, so the requirement to incorporate all terms in accordance with Section 2 of the Law of Property (Miscellaneous Provisions) Act 1989 is not breached. Representations and warranties concerning capital allowances that prove to be a misrepresentation of the facts can result in damages being awarded to the buyer. It is, therefore, surprising, even allowing for the pressure to complete a property transaction, why the buyer does not always insist on receiving comprehensive replies to the queries on capital allowances.

A common situation that we experience concerns the accuracy of the replies. Sometimes the seller will state that he has no knowledge of any capital allowances claim having been made by any previous owner, despite the fact that the seller entered into a Section 198 election at £1 with the party from whom the property was purchased. This constitutes a negligent misrepresentation and the purchaser could sue for damages. Statements made by the seller's property agent as to the level of capital allowances available to the seller would not normally constitute a representation or warranty to which the seller could be held liable in damages, provided the estimate did not get reproduced within the replies.

We have only touched on the problems that can arise in respect to capital allowances when the contract documentation does not properly stipulate the agreed terms. This brief review attempts to highlight that it may not be possible to examine evidence of the negotiations in seeking to establish the parties' intentions. Expert advice on capital allowances should be sought at an early stage in the drafting of the relevant clauses to prevent the unanticipated loss of valuable tax relief to either party. In addition, clearly drafted capital allowances clauses will avoid disputes.

### Summary

Finally, we would suggest that replies to pre-contract enquiries on capital allowances are treated with at least equal importance as other pre-contract enquiries. By this we mean that sellers should ensure that the replies given are accurate and do not contradict the contract provisions and buyers should insist on receiving comprehensive replies that are then properly evaluated. It would, therefore, be sensible for both parties to seek the advice of a capital allowances specialist to ensure that they get these things right.

For further advice concerning any of the issues raised, please contact one of our key individuals detailed below, or alternatively call our helpline on 0800 526262. Information on other property tax related topics can also be found on our website at <http://bankingtaxfinance.davislangdon.com>.

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