Radical Review of Capital Allowances on Fixtures

Introduction

If there is one piece of tax legislation that has been the source of constant irritation to HM Revenue & Customs (HMRC), it must be the fixtures rules for capital allowances. The rules relating to plant and machinery fixtures were first introduced in 1985, and have become increasingly complex — largely the result of attempts by successive governments to limit the qualifying expenditure for capital allowances available to the purchaser of a building. Every revision, the resulting legislation became more complicated, but inevitably, HMRC has now decided that the rules are still not working as, they contend were, originally intended.

HMRC now considers the root of the problem being the absence of time limits as to when expenditure on qualifying fixtures need to be pooled. The result is that expenditure can be pooled many years after the fixtures were acquired. HMRC also considers there is a lack of adequate record keeping amongst businesses, to allow them to ascertain when a claim on a particular fixture has been made, and the value of that claim.

HMRC are increasingly concerned that this facility to make "late" claims, coupled with the uncertainty over whether a previous owner has claimed allowances on the fixtures, is leading to an increase in late fixtures claims, particularly from the owners of second-hand nursing homes, public houses and medium-sized hotels.

On 31 May 2011, the government published its consultation document on "capital allowances for fixtures" and has called for responses to the proposals contained in the document by 31 August 2011. The stated intentions are to prevent significant tax loss to the Exchequer and to simply the legislation.

As part of the consultation, HMRC convened a number of working groups of interested parties in order to discuss the details of the proposals and their potential impact. Davis Langdon, An AECOM Company was invited to represent on two groups.

Having examined the consultation document thoroughly, but more specifically with the benefit of attending the working groups, we believe the proposed changes have the potential to not only increase the complexity and uncertainty surrounding fixtures even further, but also in the future, they could deny allowances to many legitimate taxpayers.

The issues

The consultation document proposes measures for dealing with two issues that the government sees as resulting in a loss of taxation revenue if there is no change to the fixtures rules. These two issues are as follows:

A. Excessive capital allowances being obtained where the purchaser of a property delays pooling the expenditure on fixtures, resulting in an inability to establish whether or not a previous owner has claimed on the same fixtures that should then restrict the allowances available to that purchaser, in accordance with Section 185 of the Capital Allowances Act 2001 (CAA 2001).

B. The acceleration of capital allowances by a seller fixing a negligible or nil disposal value with an election in accordance with Section 198 or Section 199 of CAA 2001.

The proposals to deal with issue A

In order to prevent excessive capital allowances being obtained on fixtures, the consultation document contains the following proposals:

- Mandatory pooling within a period, yet to be agreed, but suggested as one or two years, of incurring any qualifying expenditure on fixtures.

- Mandatory record of agreed market value of the fixtures as a condition of the purchaser being able to claim capital allowances.

Probably the biggest surprise in the whole consultation, however, is that even though HMRC admit they are not sufficiently resourced to deal with the recent influx of late claims, the proposals as they stand provide a significant window of opportunity for these late claims to continue.

The devil is in the detail

While HMRC contend their proposals are aimed at preventing allowances from being given more than once on the original cost of a fixture, the proposals could extend far beyond this and end up denying businesses allowances on the cost of fixtures to which they are currently rightfully entitled to claim. This is certainly not apparent from reading the consultation document alone.

As always with any consultation, it is necessary to study the detail carefully and with this particular consultation "original cost" terminology, HMRC means the cost when the fixture is first brought within the capital allowances regime. So it is not until the fixture is acquired by a person undertaking a qualifying trade or activity and is within the scope for tax that the original cost of that fixture will be set.

Once that original cost has been established, that cost will be the maximum value on which any future owner of that fixture will be allowed to claim allowances on. This was not the original intention and will, if enacted mean allowances are restricted to the first potential claim value, as opposed to the current actual claim value.

The proposals for mandatory pooling would mean once the taxpayer had acquired a fixture, then they would have to notify HMRC within a set time limit, of the value of that fixture if intending to claim capital allowances on that item at any time in the future. Failure to notify HMRC would deny that taxpayer the ability to make a claim on those fixtures.

What isn't apparent from the consultation document, however, is failure to pool expenditure on a fixture will remove that fixture from the capital allowances regime forever, but it will also deny all future owners from claiming allowances too, at any time in the future.

It can be seen that if the proposed changes are introduced the effect will be potentially much more restrictive than the original legislation had first intended.

Also, whilst the consultation often refers to the problem being around fixtures in purchased properties, the proposals are to include all qualifying expenditure on fixtures within the mandatory pooling provisions. The proposals will, therefore, cover expenditure on construction and fit out projects as well as purchases.

In order to pool any expenditure it is envisaged that the taxpayer will either:

1. install the fixture themselves and so know the cost of that fixture
2. as a result of acquiring an existing property also acquire a fixture that has previously not been within the capital allowances regime and so need to ascertain the cost of that fixture based on a Section 562 "just and reasonable apportionment", or
3. acquire a fixture that has previously been within the capital allowances regime and so the cost of that fixture has already been set by a prior owner.

With regards to (3) above it is envisaged that the buyer and seller of that fixture will jointly agree the fixture's value and notify HMRC of that value in a "record of agreement" within a set timescale. It is proposed this record of agreement would be a similar format to the current Section 198 alternative apportionment election notice, identifying and stating separate values for any fixtures that have already fallen within the capital allowances regime and on which a claim has been made, as well as those fixtures that have fallen within the capital allowances regime, but on which no claim has been made. The latter will effectively be the fixtures that going forward will be barred from having a claim ever being made upon.

The practical issues

Whilst the mandatory pooling proposals may sound relatively straightforward, and as HMRC contend may also assist taxpayers by serving to remind them to act timeously and thus helping ensure they do not lose out, we can see a number of issues.

Firstly, requiring a purchaser to pool allowances within a fixed time period will mean they will now need to commission a capital allowances review at a time when they may not have tax capacity to use the allowances and so may not benefit from the exercise.

The need to undertake this early review will also be necessary if the allowances are to be preserved for the benefit of future owners, even where the current owner has insufficient tax capacity to benefit directly from the allowances themselves.

A further problem is on large or complex construction projects that may span over many years and possibly beyond the timescales set by the mandatory pooling provisions.

The next potential issue we foresee is the accurate record keeping of when qualifying expenditure needs to be pooled and more specifically any expenditure that has not yet fallen within the capital allowances regime and so is still available to a future owner. Failure to keep accurate records that can withstand the scrutiny of HMRC could result in significant allowances being lost.

With regards to the proposed "record of agreement" we can see this being relatively straightforward where the seller has made a claim for allowances on a fixture. Indeed, in our experience this process already occurs using the Section 198 alternative apportionment election provisions.

The practical problem, however, will be more around the proposal to identify and record fixtures on which no claim has yet been made. This affects the further splitting out of items on which a claim could have been made, but wasn't and so are now claim barred going forward, from those items that haven't yet entered the capital allowances regime.

What it could mean, therefore, is that the buyer and seller may need to enter a Section 198 election on assets where the seller has made a claim and then a separate, but similar record of agreement that also sets out any fixtures on which no prior claim has been made.

Next, bearing in mind HMRC have admitted they are not sufficiently resourced to check the current influx of late claims, questions arise how HMRC propose to police and check these new "record of agreements," which will apply to virtually every property, regardless of whether a claim is being made, increasing the need for more resources.

Finally, it is unclear at present if when a property is sold between two parties, neither of who are able to claim allowances, whether those two parties also need to enter a "record of agreement." Whilst this has certainly been suggested verbally, we see no practical benefit to this, or relevance it would have to any legitimate future claim.

What can be certain is that there will be significantly more due diligence required as we enter a new "prove it or lose it" regime. This will be coupled with a requirement of much better record keeping of expenditure and capital allowances claims on fixtures and the reliance on past owners to make this available when properties are bought and sold.

The proposals to deal with issue B

In order to prevent the perceived acceleration of capital allowances, the consultation document contains the following proposals:

- The minimum disposal value of fixtures covered by a Section 198 election (or Section 199 in the case of leasehold property) to be tax written-down value.

- The anti-avoidance provision at CAA 2001, Section 197, which requires the minimum disposal value under Sections 198 or 199 to be tax written-down value in avoidance cases, to be amended in order that it is more effective.

The consultation acknowledges that if the minimum disposal value that can be fixed under a Section 198 election (or Section 199 in the case of leasehold property) is tax written-down value, then there may well be no need to amend the anti-avoidance provision at Section 197.

Dealing with avoidance

Firstly, we do not believe it is desirable to fix the minimum disposal value for an election in cases where there is no avoidance motive. As stated in the consultation document, there will usually be "a natural tension" as to the apportioned value of the fixtures when both the buyer and seller are taxpayers. Additionally, there may be instances where the market value of a fixture using a just and reasonable apportionment is actually below the tax written-down value of the fixture and so it would seem strange if that was the case that the two parties were unable to elect for tax certainty.

In cases where the capital allowances are of little or no perceived value to the purchaser, (such as when the purchaser is a property trader or pension fund), we contend that it is illogical to deny the seller the opportunity of retaining the balance of the pooled expenditure. The agreement between the parties would have been reached on an arms length basis and should factor in the value of the capital allowances to both parties. Furthermore, the necessity of electing at tax written-down value would potentially inflict a high compliance cost on the seller because of the additional record keeping that would be necessary.

At present, the seller does not usually need to establish the tax written-down value of the individual items within a capital allowances pool when a property is sold. In fact a property company that has a large portfolio of properties, any of which could have been refurbished during the period of ownership, would likely find it nearly impossible to track the tax written-down value of the fixtures going in out of the pool. Indeed, that is one reason why a seller would invariably elect a negligible or nil disposal value for the fixtures.

A further point worth adding is that because allowances are given at prescribed rates set down by successive governments, these rates don't always reflect true economic depreciation. Certain assets may, therefore, depreciate in value at a rate that is much faster then the annual writing down allowance given. In these cases it would seem illogical to restrict the allowances a seller is able to realise to less than their true economic loss.

We believe that the anti-avoidance provision at Section 197 should already be considered sufficient to tackle accelerated allowances forming part of an avoidance scheme. In accordance with Section 197, the minimum disposal value of fixtures in avoidance cases is tax written-down value where "the main purpose or one of the main purposes" is obtaining a tax advantage. This wording is in-line with the proposed amendments to the anti-avoidance rules for plant and machinery contained in Chapter 17 of CAA 2001, as set out in a separate consultation document that was also published on 31 May 2011. In Chapter 17 the existing anti-avoidance applies where "the sole or main purpose" is obtaining a tax advantage. We do not believe, therefore, that the government needs to make any amendments to Section 197 as it is already drafted in-line with the tighter anti-avoidance test proposed for plant and machinery generally.

Alternative proposals for tackling the issues raised in the consultation document

As far as the issue of excessive capital allowances is concerned (as set out above as issue A) we propose the following:

1. No mandatory pooling of qualifying expenditure for fixtures. Instead, we recommend that the legislation at Section 185 is tightened so that there is an explicit requirement on the part of the taxpayer to prove beyond any doubt that the capital allowances being claimed do not exceed any disposal value brought into account by a previous owner. This would be a "prove it or lose it" rule. Such a rule would provide HMRC the required statutory power to reject any claim for fixtures in cases where there is any doubt about the existence of a prior claim or previous disposal value. This is how we understood the current legislation to already apply but, as HMRC seem to have a problem in cases where there is doubt about the tax history of the fixtures, we suggest that the doubt is removed by amending Section 185(d) to cover cases where the past owner may have been required to bring a disposal value into account.

   Not only would the above amendment tackle the situation which arises when a taxpayer delays pooling qualifying expenditure, it would also apply in cases where there are gaps in the tax history of the fixtures caused by previous owners not having made a capital allowances claim.

We believe our proposals will tackle the current perceived problem and achieve the original intention of the fixtures rules, whilst at the same time not denying businesses entitlement to continue claiming allowances on any fixtures where no prior claim has been made at all.

2. No requirement for a notice of agreed market value of fixtures. Instead, we propose that the Section 198 and Section 199 election provisions are amended so that instead of an election, it becomes a mandatory notice of the agreed disposal value between buyer and seller.

   It is in effect, therefore, a mandatory election and the seller is given no choice as to whether or not a Section 198 election is executed.

   Likewise, the buyer is not able to claim capital allowances in respect of the fixtures purchased from a seller that is required to bring a disposal value into account without producing the notice of agreed disposal value. This would preserve the long-standing right of the purchaser to decide when to claim the available capital allowances, as well as ensuring that the seller will have every incentive to agree a disposal value at the point of sale.

   Where the owner is outside of the scope of tax, then there will be an increased administrative burden on them to ensure they have obtained and make available the Section 198 from the last claimant. We feel, however, this is best practice and a small price to pay if it creates a system that safeguards the Exchequer and sets out without question the allowances for future owners to claim.

   It is possible that the seller might inadvertently omit to agree the disposal value with the purchaser when the purchaser is not interested in claiming capital allowances, or is simply unaware of the consequences of not obtaining such a notice. This could then result in a gap in the tax history of the fixtures to be overcome by a subsequent owner of the property.

   However, this problem can be overcome quite easily if the taxpayer is required to tick a box in the tax return when any fixtures have been sold within the chargeable period on which the seller has claimed capital allowances. If the taxpayer ticks the box, then HMRC is alerted to the necessity of a notice of agreed disposal value. If the taxpayer does not tick the box, then HMRC has two choices:

   A. raise an enquiry into the issue, or
   B. accept that the taxpayer does not need to tick the box.

   In the case of option A, HMRC will either establish that a notice of agreed disposal value was necessary and therefore, the alternative disposal value equivalent to the seller's cost would be imposed. Alternatively, HMRC will establish that no notice was necessary and therefore, there will be a record that no disposal value for fixtures was relevant in respect to that particular previous owner of the property.

   In the case of option B, HMRC is required to accept the default position that no disposal value was relevant for fixtures in respect to that particular previous owner of the property.

   Whilst this may not appear a perfect solution, it is our experience that sellers who have made a claim and their advisers are sufficiently aware of the implications of not electing on disposal of an asset. Indeed, it was this ability to claim and retain the allowances that led to the last increase in taxpayers making claims on fixtures. It is unlikely, therefore, that will fail to agree a value with the purchaser.

As far as the issue of accelerated capital allowances is concerned (as previously set out in issue B) we propose the following:

1. There is no need to amend the wording of Section 197.
2. There is a minimum disposal value for fixtures under Section 198 and Section 199 equal to tax written-down value only where the ownership of fixtures is transferred between connected parties.

The proposal in 2) above will prevent negligible or nil disposal values being agreed in circumstances where there is no "natural tension" between the parties. In addition, the proposal will also avoid a potential gap within the tax history of the fixtures when the property is eventually sold to a third party.

Summary and conclusions

The consultation proposals are potentially far-reaching and much wider in scope than was first thought. Not only would it result in further complexity to the fixtures rules, but it would add extra administrative responsibility on taxpayers and non taxpayers alike, with the potential to remove large chunks of qualifying expenditure from the capital allowances regime, completely. Ultimately there would only be one winner — the Exchequer.

In the short-term we envisage the proposals, now they have been announced, will result in even greater numbers of late claims prior to any deadline, claims which HMRC have readily admitted they don't have capacity to check or police.

The mandatory pooling provisions will remove the long-standing right of a taxpayer to choose when capital allowances are pooled and could result in extra upfront costs being incurred to ascertain their qualifying expenditure, even where there is insufficient tax capacity initially to benefit from those allowances.

The proposals for a notice of agreed market value of fixtures is misconceived for a number of reasons and we believe that such a separate notice is unnecessary. We have suggested that a seller is always required to fix the disposal value of fixtures by an amended version of an election in accordance with Section 198 or Section 199. Failure to enter such an election would result in a just and reasonable apportionment disposal value being imposed on the seller.

By effectively imposing a penalty on the seller if the disposal value is not fixed, there is more possibility that historical evidence will be available to both future owners of the property and HMRC, rather than placing the onus on taxpaying purchasers.

We would also propose that HMRC scrutinises more rigorously that the information required under Section 201 is actually provided in any agreed alternative apportionment election, particularly information sufficient to identify the fixtures to which the election relates and their respective values. This would certainly make it easier to establish in the future which fixtures have had a prior claim made upon them.

As regards to the issue of preventing acceleration of capital allowances in avoidance cases, we suggest that the anti-avoidance provision at Section 197, fixing a minimum disposal value for fixtures at tax written-down value in avoidance cases, should be robust enough to deal with this issue.

The mere ability to elect at any value that is lower than market value could be seen by many as avoidance, especially if no real loss in value has been realised by the seller. On the basis that HMRC were happy to introduce the alternative apportionment election rules back in 1997 and still see they have a place, then we see no reason for fixing a minimum disposal value generally.

However, we have suggested that a possible loop hole in the legislation, that permits negligible or nil disposal values for fixtures between connected parties, should be closed by imposing a minimum disposal value equivalent to tax written-down value.

Finally, it is important to realise that the provisions in this consultation document are as significant as those that were proposed for capital allowances on fixtures in 1996, particularly if the intention is to potentially remove large amounts of expenditure that aren't pooled in time from the capital allowances regime altogether. Had taxpayers not responded in numbers and with resistance to the proposals set out in that earlier consultation document, the cost to the taxpayer would have been significantly higher than that which resulted from the amendments enacted by the Finance Act 1997. We will certainly, therefore, be forwarding our response to the issues raised in the consultation document and we strongly recommend that all interested parties respond to HMRC before 31 August 2011.

A full copy of the consultation document can be found at http://www.hmrc.gov.uk/consultations/index.htm.

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.

London

Paul Farey
+44 (0)20 7061 7139
paul.farey@
davislangdon.com

Scotland

Michael Murray
+44 (0)131 550 9473
michael.murray@
davislangdon.com

North

Christine Weaver
+44 (0)161 819 7600
christine.weaver@
davislangdon.com

Midlands

Tim Beresford
+44 (0)121 710 1333
tim.beresford@
davislangdon.com

South

David Rees
+44 (0)23 8068 2801
david.rees@
davislangdon.com

Program, Cost, Consultancy
http://bankingtaxfinance.davislangdon.com
www.davislangdon.com
www.aecom.com

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