KEY NOTE

SIMPLIFICATION, OR BACK TO SQUARE ONE?

KEY POINTS

What is the issue?
The Office of Tax Simplification is inviting contributions on the future of Capital Allowances

Who does it affect?
This change will affect those who claim capital allowances in relation to the fixtures, fittings plant and machinery contained within the commercial property that they own or lease.

What does it mean for you?
A change in the rules will mean that capital allowances may be replaced by a system based on accounting depreciation

The Office of Tax Simplification is currently consulting with stakeholders about whether the UK should scrap the current capital allowances legislation and replace them with a tax depreciation regime similar to that used in the United States of America.

However as recent history shows us, the agenda of simplification can have the opposite effect. Dealing with the complexities that exist in the current rules may be a better approach that reinventing the wheel.

BACKGROUND

The Office of Tax Simplification (OTS) is consulting on whether tax relief for commercial property should be given in the form of accounting depreciation rather than using the existing rules set out in the Capital Allowances Act 2001. The reason for consulting on these changes on simplification centres around the following issues:

1. Uncertainty regarding the boundaries which separate an asset from being qualifying or non-qualifying for tax relief purposes.
2. The administrative burden involved in the claiming of Capital Allowances compared to the value of claiming no relief.
3. Whether the Capital Allowances rules are consistent with the commercial reality faced by businesses.

Overall, the OTS believe that “replacing Capital Allowances with a deduction for accounts depreciation would align the tax position with the accounts, removing the need for separate calculations”. The OTS report also advocated that “The use of accounting depreciation instead of capital allowances would be dependent upon resolving several significant issues arising from the change, including the potential for fiscal cost, avoidance opportunities and likely winners and losers.”

Whilst the ethos of simplifying the tax systems is one that would be broadly welcomed, historically such initiatives have often had the opposite effect, most recently the changes made by the 2012 Finance Act, which was meant to simplify matters, has led to a labyrinth of scenarios that added more complexity to the system.

There is a danger that such an attempt to simplify matters would again have a similar impact. Whilst some of the capital allowance rules are complex, they are on the whole relatively clearly defined and complexities that arise are often the result of a desire to achieve in practice, what was meant by the spirit of the legislation. The current system is also now widely understood by those that use it to invest in their business.

In addition, will Brexit have an impact on this piece of tax legislation or the whole tax legislation….Who knows?

THE UNCERTAINTIES

What can definitely be said is, this proposed change in approach has raised a few questions, all of which could add a level of complexity to the system and further cast new doubts as to where the boundaries lie?

1. Will “buildings” now receive tax relief?

Industrial buildings, agricultural buildings and certain hotels once qualified for tax relief in the shape of Industrial Buildings Allowances. However, with the Finance Act (FA) 2007, this practice ceased to exist. If we move to a tax depreciation system for land and buildings (and the plant and machinery contained within them), a further subset of questions arise.

a. What will be the impact on tax the client tax liability?

b. Will buildings that are lying unused receive a deduction?

c. How will we deal with the property that appreciates in value or is revalued? Will an annual revaluation increase your tax relief?

2. How will we deal with the complexity of extending rules on depreciation?

Qualifying items within commercial building currently receive tax relief at different rates. Some assets qualify for first year allowances of 100%, whilst other expenditure on plant and machinery receives relief at 18% and 8%. In addition, the changes in FA2007, mean that some assets no longer relieved at 18%. Instead, these assets were now considered to be part of the ‘special rate pool’ whilst others received no relief at all.

Moving to a tax depreciation regime again raises another set of sub questions:

a. Will assets currently in pools be tax depreciated at their current tax rate, or will the pools need rethought?

b. Will further disclosure be required in accounts to reflect this?

c. How will assets be treated as short and long-life assets be treated?

d. How will assets that were capitalised, but qualified as revenue deductions be treated?

e. What will the transition period look like?

3. How will we deal with the complexity of extending rules on depreciation?

The capital allowances system as we have touched upon before, provides different rates of tax relief for different classes of assets. If we are to move to a one shoe fits all approach, then it would be expected that some form of adjustment would be required to the tax computation. Again, this raises further questions.

a. What will the impact be on the calculations where assets have been included in the AIA deduction?

    i. Can we identify them?

    ii. Where are they included in general or special rate pools?

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b. What will be the impact where 150% land remediation relief has been claimed?

c. How do we deal with assets where Research and Development Allowances, Enterprise Zone Allowances or Business Premises Renovation Allowances have been claimed?

d. Will these higher rates be abolished or restricted because of the effect on profits by depreciating so quickly?

4. Will the introduction of a Tax depreciation system lead to new Anti-Avoidance rules?

With any change in legislation, new loopholes appear. It is often the case that the general Anti Avoidance provisions do not close all of these. It is therefore important to ask:

a. Could a revaluation of assets come within the Anti-Avoidance rules?

b. Could a new wave of tax cases and legislation follow leading to years of uncertainty?

The most obvious example we have of how this system may work in practice can be seen across that Atlantic. A tax depreciation for property and the Alternative Depreciation System currently being used by the Internal Revenue Service in the USA.

Both systems use some broad methodologies of changing the number of years that a property or business asset is depreciated to calculate the tax deduction.

However, technical guidance publicised by the IRS currently highlight problems with the system which on the face of it would be contrary to what the office of taxation is trying to achieve. In particular:

1. "The use of cost segregation studies will likely continue to increase"

2. "There are no standards regarding the preparation of these areas"

3. "These studies vary in terms of methodology"

The IRS go further in commenting that "The lack of consistency in cost segregation studies and the absence of bright-line tests for distinguishing property contribute to the difficulties of this issue. The purpose of this ATG [Audit Techniques Guide] is to provide the foundation to a better understanding of cost segregation studies and to provide the examination steps that will facilitate the audit process and minimise burden on taxpayers, practitioners and Service examiners alike." The result in terms of tax simplification is therefore that we are back to square one and an increase in the workload for HMRC in checking claims.

5. **Property Companies – How will relief be given?**

As many companies investing in property do not depreciate their investment assets, their tax relief position will be significantly affected by the removal of the Capital Allowances regime.

a. Will they be compensated for the loss of this tax relief?

6. **What will be the impact on tax revenues?**

Currently, for many reasons, Capital Allowances claims are not made on many properties. If a more standardised approach is likely, will this cause an increase intake up of the relief to be given via depreciation. The current capital allowances regime limits a claim to the first owner to incur expenditure, so the cost to the Government will increase, especially as property values increase.

In addition, the costs of transition, the changing of the laws and the lack of consistency in how depreciation calculations are prepared will surely make this valuable advice costlier which again goes against the original recommendations of the review. As the UK already has the largest tax legislation system, and as it constantly plays with the Capital Allowances regime (the AIA value for example) to recoup Corporation Tax deductions, maybe a period of consolidation is what is required.

DON'T REINVENT THE WHEEL

So rather than reinvent the wheel, it is our view that the OTS should focus on dealing with some of the existing complexities.

1. In relation to fixtures on second hand property, it may be worthwhile having a new rebasing date so that timely and costly research back to 24 July 1996 is no longer required. This is a huge barrier to claiming as in a lot of occasions, businesses are no longer trading, meaning that the requirement of S 185 CAA2001 is difficult to meet.

2. We would welcome the introduction of some form of tax relief for buildings to promote economic growth. Our town centres are struggling, our manufacturing base is depleted, therefore some form of targeted relief would be welcomed. Although, the rules would need to be relatively simple and straightforward.

3. Finally, we would welcome the scope of Land Remediation relief being widened to sole traders and partnerships. This coupled with an increase in the rate may encourage more house building.

SUMMARY

In conclusion, we feel that a total change in the tax deprecation regime will lead to greater uncertainty, more administrative burdens and higher compliance cost. All areas which the OTS is trying to improve.

We are raising awareness of this consultation as, we feel, yet again the property industry will suffer by the Government changing the Capital Allowances regime. We are currently compiling our response for the OTS, and we are keen to hear any feedback you may have on the effects of this proposed change.

USEFUL LINKS

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/646263/CAs_and_depreciation_-_scoping_document.pdf

https://webcache.googleusercontent.com/search?q=cache:xSY8CxtsIroJ:https://www.irs.gov/businesses/cost-segregation-audit-techniques-guide-chapter-1-introduction+&cd=3&hl=en&ct=clnk&gl=uk

ABOUT US

At Ċavetta Consulting our directors have considerable experience advising businesses, property investors, landlords and occupiers on all capital allowances implications that impact their business.

Our fee structure is tailored to take account of the tax status of the individual or business and is designed to add value to your business.

We offer free advice to businesses at the pre-planning stage of their business to make them aware of the benefits the tax system allows and a no obligation review of completed or potential schemes in order to determine whether a viable claim for property.

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