A bodge job

Simplification, added taxpayer burden or years of litigation on missed allowances? ALUN OLIVER and JAMES DANIELS review HMRC's latest consultation paper on capital allowances reform.

On 31 May 2011, HMRC published a consultation paper proposing important changes to the capital allowances regime on fixtures in buildings (www.lexisurl.com/FLXpR). Although HMRC admit their inability to cope with the current flow of capital allowances claims and to properly apply the existing rules and case precedents, they have proposed drastic new changes that will affect all businesses spending money on property. The consultation period closed on 31 August 2011 and the changes could be implemented as soon as next April within the Finance Act 2012.

There are four main proposals:

- imposing a time limit on when expenditure on plant and machinery, including fixtures, is required to be pooled (claimed) after acquisition;
- restricting the minimum transfer value a purchaser and vendor can adopt for a CAA 2001, s 198 election to the tax written down value (TWDV) of the asset;
- requiring the purchaser and vendor to decide a single agreed value verifying the amount of the sale price attributable to the fixtures, which both parties should record and formally notify to HMRC within one or possibly two years; and
- tightening the anti-avoidance rules within CAA 2001, s 197, to prevent the increase of capital allowances claims on fixtures by artificial arrangements.

KEY POINTS

- Mandatory pooling of capital allowances within a short period.
- Record of agreement of sale price relating to fixtures.
- Is this the end of £1 elections under CAA 2001, s 198?
- Claim all historic expenditure – or lose it.
- The increased administrative burden.
- Will HMRC impose cost over value?

Various justifications have been set out for the above proposals as follows.

- HMRC's intention to reduce the volume of late capital allowances claims on historic expenditure, where taxpayers revisit historic expenditure records to squeeze more value out of their assets.
- HMRC's belief that capital allowances are being claimed more than once by different owners on the same fixtures, due to the complicated nature of tracing the tax history of the acquired fixtures.
- HMRC's perception that the capital allowances tax history of previous owners and disposal value aspects of law are being ignored.

It seems that HMRC are admitting that they do not have sufficient resources or proper record systems in place to track the tax history of previous owners or properties. Additionally, they seem unaware of the case law governing historic claims and interpret their failure to apply the current rules as tax avoidance by property-owning taxpayers. In reality, these taxpayers are only seeking to claim their legitimate capital allowances as and when they wish and to suit their individual business needs and tax position.

Historic purchases and prior claims

As a cursory introduction, capital allowances enable UK taxpayers to obtain tax relief for expenditure on certain fixed assets used within their businesses, thereby reducing their taxable profits. The current position allows expenditure on fixtures in a building to be claimed at any time for any open tax return, as long as the fixture is still owned by the taxpayer. Consequently, many taxpayers continue to make new and valid capital allowances claims on expenditure incurred many years ago, some dating as far back as the 1980s.

These rules have proven valuable to those taxpayers who have purchased commercial property, but who have not fully assessed or optimised the capital allowances available on the fixtures in the property until after the purchase. In the retail and leisure sectors, where businesses regularly undertake rolling fit-out programmes, it is usual to pool the expenditure on fixtures, sometimes without specific reference to the property in which it was installed.

Furthermore, it can be problematic to trace the tax treatment of the previous owners with respect to what, if any, allowances were claimed by them or the vendor, and what proportion of the purchaser's costs may have already benefited from tax relief. The situation is exacerbated if the claim is being undertaken some years after the purchase, where records may have been archived or even destroyed. While we understand and share HMRC's concerns on capturing adequate data on previous claims, we do not believe the proposals will vastly improve the situation.

The Granleys v HMRC

These issues have been considered recently by the First-tier Tribunal in the case *Mr & Mrs Tapsell & Mr Lester (as partnership The Granleys) v HMRC* [2011] UKFTT 376. The capital allowances claim in this case was refused because the claimant had not obtained sufficient information about the vendors' tax history, and so could not prove that the vendor had not previously claimed allowances on those fixtures.

The tribunal dismissed the claimants' argument that the onus is on HMRC to show that the conditions in CAA 2001, s 185 have been satisfied, thus restricting the amount of any claim in respect of fixtures. The tribunal held that the burden of proof lies with the claimant to demonstrate that there were no previous capital allowances claims or, if so, the prior disposal value. Given the inadequate evidence available, the claimants failed to discharge this burden of proof. The tribunal, helpfully, confirmed that even if the burden is not discharged, there should be consideration of what the answer is on the balance of probabilities and where the evidence points to the fact that a claim has been made (as previously held in *West Somerset Railway plc v Chivers (Inspector of Taxes)* [1995] SSCD 1). This judgment serves as an important reminder to all professional advisers, irrespective of the proposed changes, to establish carefully the correct position in regard to fixtures and to ensure capital allowances form an integral part of the due diligence when advising property owners on their purchase transactions.

Time limit on mandatory pooling

The government is intending to overhaul these rules by requiring businesses to pool their expenditure on fixtures within a short period of time following purchase in order to qualify for capital allowances. The consultation is seeking views on the proposed time limit, initially suggesting one year or possibly two years after purchase. Under this proposal, purchasers would need to notify HMRC of pooling through the existing corporation tax and income tax self-assessment processes.

This new mandatory pooling obligation will apply to the following types of fixture:

- second-hand fixtures – where the previous owner/s have already claimed capital allowances;
- second-hand fixtures – where the previous owner/s did not claim capital allowances;
- new fixtures – purchased by the current owner, including plant and machinery, integral features or long-life assets; and
- historic second-hand fixtures – where expenditure was incurred prior to any changes in law.

If these rules are introduced, the purchaser will need to inform HMRC of their expenditure on fixtures within the required time limit or risk losing the ability to claim capital allowances forever. This would mean future owners no longer having the right to claim either.

Don't think this only applies to second-hand property, as 'new fixtures purchased by the owner' includes new-build construction, fitting-out or refurbishment works. The key concern here is that major construction projects can span several years and a one or two-year timeframe for claiming may deny taxpayers the correct tax relief, as figures may not be properly ascertainable if all of the project costs have not been finalised within the mandatory pooling timeframe – increasing the scope for rushed and potentially incorrect assessments by those not familiar with the capital allowances legislation.

CAA 2001, s 198 election

This is the mechanism whereby purchasers and vendors of existing property assets that include fixtures can agree a fixed apportionment of the expenditure within the full purchase price to be attributed to these assets. The current position allows the elected value to be any figure from £1 up to the value of the eligible assets as previously claimed by the vendor, or the price paid by the purchaser, whichever is the lower.

An election is used to safeguard the allowances in the hands of the vendor when the asset has been transferred to the purchaser. The £1 election is particularly useful for vendors where it may be problematic to ascertain the TWDV of specific assets in specific properties, or when the purchaser may not benefit from tax relief because they are non-taxpayers, such as a pension fund or a developer seeking to redevelop a site that doesn't incur capital. Some purchasers also fail to adequately value the benefit of capital allowances and the certainty of a s 198 election, or give them away too easily, sometimes without even realising they have done so.

When a s 198 election is suggested, it should be assessed to determine whether the suggested level of allowances is 'fair and reasonable' and explore any other tax implications for the parties involved. However, we have often found that vendors (and particularly their solicitors) simply follow the previous transaction or a 'house policy', often without any true understanding of the specific consequences for individual transactions. This is leading the government to believe the system is not working as intended or is possibly being abused. It therefore advocates that the unrelieved expenditure should be transferred at the same time with the asset, irrespective of the parties' wishes, when it is only in avoidance cases that this restriction would be merited.

Minimum price proposal

The consultation document proposes that the minimum amount that may be fixed as the price incurred on the provision of the fixture should be the TWDV of the fixture in the hands of the vendor. This will prevent attempts by the property vendor to claim and hold back the allowances not previously claimed and consequently, if enacted as proposed, purchasers will be able to benefit from an increased quantum of allowances, assuming they are tax-paying.

The change in the minimum amount for a s 198 election is likely to prove unpopular with purchasers and vendors (as well as their advisers) as it will deny the parties the ability to allocate the allowances to the party to whom they are most valuable, which could affect the pricing of deals in future. This may also result in arduous and expensive reviews of the composition of pooled expenditure, leading to an added administrative burden for both parties, as well as additional transaction costs and significant risks of future litigation to parties that fail to properly consider the capital allowances position at the right time.

> ***"Businesses will also need to review how their properties are marketed."***

Many businesses will also need to review how their properties are marketed in relation to their tax attributes. These proposals extend the punitive capital allowances position for real estate investment trusts (REITs), whereby REITs lose their allowances if not claimed within their respective tax computation. They also remove tax planning opportunities where the parties have different effective tax rates or where one party may be tax exempt. Additionally, they will force a claim to be made by loss-making businesses that have no immediate need for the allowances, other than to carry forward losses, incurring additional compliance costs.

Record of agreement

In order for the fixtures rules to work satisfactorily, both the purchaser and vendor must understand how much of the sale price is attributed to fixtures at the time of sale. Consequently, a new obligation will be imposed on the vendor and purchaser to agree the part of the sale price attributable to the fixtures and to submit a joint record of their mutual agreement to HMRC with their respective tax returns. It has been suggested that the timescale for this record of agreement should be similar to the mandatory pooling requirement, i.e. within one or possibly two years.

But is this simply another reworking of the current s 198 election procedures? It is certainly similar in that the proposal would involve the purchaser and vendor conducting a detailed fixtures survey or review at the time of purchase. However, the two methods differ in that this new proposal will require the apportionment to be on a market value basis and will become compulsory as a prerequisite for capital allowances on second-hand fixtures in *all* transactions – significantly increasing the parties' tax compliance burden. It is not yet clear how charities or pension funds may be required to comply with this record-keeping obligation despite gaining no meaningful benefit from it.

This record of agreement not only creates a greater administrative burden on the taxpayer, but also increases complexity at the due diligence stage prior to exchange of contracts. This will result in greater transaction fees and potentially slow average transaction times unless the vendor has proactively taken appropriate capital allowances advice early on. Additionally, the rules would limit the level of flexibility that purchasers and vendors currently possess to negotiate at arm's length for a higher or lower value for assets qualifying for capital allowances.

Tightening the anti-avoidance rule

The anti-avoidance rule in CAA 2001, s 197 applies where the actual disposal value of any plant and machinery is less than its TWDV and a disposal event occurs as a result of an arrangement where the main purpose is for the taxpayer to obtain a tax advantage. Section 197 enables HMRC to substitute the disposal value for a 'notional tax-written down value'. The government believes s 197 may not always be effective in preventing tax avoidance – or is this again a case of HMRC not applying the existing legislation and case law effectively?

The consultation paper proposes to make it clearer that these provisions will be activated in all instances where an artificial tax arrangement is used to result in capital allowances on the fixtures being accelerated by a balancing allowances and the taxpayer obtaining an unfair tax advantage.

However, HMRC admit that if the s 198 proposals are accepted, future elections will not be validly made at a value lower than the vendor's TWDV, and the proposed changes to the s 197 anti-avoidance rules may not be required.

Conclusions

If these proposals are accepted, purchasers and vendors will need to mutually agree on the transfer value of the fixtures, at the point of sale of a property, so the purchaser will be able to claim capital allowances on the cost of the fixtures. These added administrative requirements will be incorporated in sale and purchase transactions to guarantee that both parties enter into the record of agreement.

The difficulty arises when the vendor and purchaser cannot agree on the market value apportionment. In practice, it may be less problematic for the parties to enter into a s 198 election at a minimum of the TWDV, although this in itself may cause difficulties in knowing the make-up of the asset pool. In particular, this could be a barrier to transactions for retailer or pub groups where the size of property portfolios and the time they have been held increases the difficulty in accurately recording the allowances against specific properties.

A time limit on claiming the allowances will undoubtedly require the taxpayer to pool the qualifying expenditure as it is incurred, as opposed to delaying the fixtures claim to a time of their choosing. In effect, HMRC are introducing mandatory claims – unless the risk of the loss of the tax relief on that property forever is accepted. The time limit would also mean that loss-making businesses, which often perceive little benefit from immediate claims, should take steps now to ascertain their claims for qualifying expenditure, thus retaining the right to their allowances and deferring future tax payments.

In addition, it is unclear whether the proposed changes will deny the taxpayer's ability to revisit previous capital allowances claims and earlier periods of expenditure where allowances may have been overlooked or completely ignored. Furthermore, buried within the tax impact assessment the stated intention is to 'prevent duplicate claims by late claimants on *more than the original cost of a fixture'* – this might signal HMRC's desire to restrict purchase claims to historic original asset cost, not the current apportionment value determined from the purchase price to the claimant. A careful review of the draft legislation, in due course, will be necessary to ensure that further erosion of capital allowances is not allowed to undermine economic growth through discouragement of industry to invest in their respective businesses – not what the Chancellor, George Osborne MP, is currently aiming for.

By imposing this time limit upon taxpayers, some suggest it will actually incentivise taxpayers to proactively identify their entitlement to the tax relief and optimise their allowances by analysing the expenditure while the information is readily available, rather than trawling through the project records retrospectively. If capital allowances are considered at the property transaction stage or, better still, beforehand, then there is more opportunity for the taxpayers to identify correctly the qualifying expenditure and optimise fully their capital allowances claims – saving more money.

Next steps

Too many taxpayers fail to consider capital allowances opportunities associated with purchases or disposals of commercial property, often perceiving that their professional advisers, whether accountants, solicitors or surveyors, have 'dealt with them'. The reality is that allowances are rarely comprehensively reviewed or considered proactively. Whatever the cause, failing to do this will result in under-claiming or the completely losing the available tax savings.

The proposed changes make it imperative for property owners, occupiers and investors to review their historic capital allowances claims now to secure capital allowances benefits and take necessary precautionary steps to preserve any future claims. If the proposed changes are enacted into the Finance Act 2012, allowances not claimed on historic expenditure could be lost completely (hopefully after transition arrangements lapse), making it essential to act now to prevent losing this valuable tax relief.

Time spent now considering any tax planning opportunities before the changes are confirmed and enacted could yield valuable tax savings.

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