Fistful of dollars

ALUN OLIVER and **RUPERT GUPPY** explain how advisers can optimise their clients' capital allowances claims on second-hand property transactions.

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Businesses incurring capital expenditure will typically depreciate the cost of the asset over its expected life and this deduction in the profit and loss account will reduce accounting profits. However, it is a well-established general principle that no tax deduction is allowable for expenses of a capital nature (ITTOIA 2005, s 33 and CTA 2009, s 53); instead, relief is granted for certain expenditure as capital allowances. Sometimes this will be available as an initial allowance, other times as writing down allowances spread over a year. The relevant legislation is in CAA 2001 and in this article all references are to that act, unless mentioned otherwise.

Capital allowances is a complex subject and they may be overlooked because difficulties arise in identifying qualifying expenditure. Generally, there is no prescribed list of qualifying assets, so practitioners must instead rely on a combination of legislation, precedent case law and published HMRC guidance. In addition, there are myriad rates at which relief is granted and this can cause further confusion.

Broadly, there are two principal categories of expenditure: plant and machinery and special rate expenditure. These are "pooled" and assets within the "main pool" currently attract relief at 18% a year on a reducing balance basis. This means that for every £100 of qualifying spend, the first year allowance is £18, the second year is £14.76 (£100 – £18 = £82 x 18%), and so on.

KEY POINTS

- Capital allowances are complicated by the lack of a definitive list of qualifying expenditure.
- The new fixtures rules are now a year old, but misconceptions remain.
- Best practice points to ensuring that expenditure is eligible for relief.
- For property refurbishment, construction or extension, consider whether expenditure could qualify for enhanced capital allowances.
- Accurate record-keeping and analysis of expenditure is very important.

The "special rate pool" covers expenditure on integral features, long-life assets and some other defined asset expenditures – such as insulation added to an existing building (s 28). Integral features are an exception to the general rule in that qualifying assets in this category are defined in statute (s 33A). Expenditure on long-life assets (those with an expected useful economic life of at least 25 years) is set out within s 90 to s 92. Special rate expenditure is currently relieved at 8% a year, again on a reducing balance basis.

This reducing balance system results in relief being spread over a period approximating the expected life of the asset. However, there are opportunities available to accelerate the relief, thereby boosting a business's cash flow. These opportunities, along with other key points, are detailed later in this article.

As mentioned, there is no statutory definition of plant and machinery. CAA 2001 contains a schedule of assets that do not qualify (s 21 to s 22, lists A and B) and those that may potentially qualify by exemption against the preceding List A or B (s 23, list C). Further, some well-known cases (*Wimpy International Ltd v Warland; Associated Restaurants Ltd v Warland* [1989] STC 273, *Cole Bros Ltd v Phillips* [1982] STC 307, *CIR v Scottish & Newcastle Breweries Ltd* [1982] STC 296 and more recently *JD Wetherspoon plc v HMRC (and cross-appeal)* [2012] STC 1450) have formulated a series of tests or precedents that can be applied to determine whether particular assets qualify for allowances.

Further, HMRC's *Capital Allowances Manual* also sets out their interpretation of the legislation. However, although this contains useful material, it should only be used as a reference tool because it is not impartial and there are alternative meritorious interpretations that conflict with HMRC's published position.

New fixtures rules

Significant change has taken place for capital allowances on second-hand property. April 2014 marked the full introduction

MR SMITH

Mr Smith purchased a building for £4.6m. No capital allowances claim had been made by the vendor, who had held the property for more than 25 years.

Despite the length of the initial ownership period, capital allowances in excess of £480,000 were available for the original cost, made up of £43,000 of plant and machinery and £440,000 of integral fixtures. Some of the latter were unrestricted because they were outside the scope of the vendor's pooling requirement. This was because the assets did not previously qualify as plant and machinery in the hands of the vendor. This resulted in tax savings of more than £90,000.

All of this saving was also available in the first year under the £500,000 annual investment allowance (discussed later in this article). This is a clear indication of the value of capital allowances that are still present in most purchase transactions.

of s 187A – the new fixtures rules. The first anniversary has recently passed and April 2016 will see the "first bite" of the two-year compliance deadline, so there is an opportunity to take stock and reflect on how the new rules are working in practice.

The new legislation is complex and this, combined with the reality than many practitioners are not faced with the sale and purchase of property on a daily basis, means unfamiliarity with the new rules and how they operate. Set out below are a number of common misconceptions, followed by some real life examples of good (and bad) practice we have come across when dealing with second-hand property transactions:

(1) *A s 198 election is mandatory*. This is untrue. First, to enter into an election under s 198, the vendor must bring a disposal value into account (usually as a result of having made a claim). If no disposal value is required, no election is possible. In this respect, nothing has changed since the new fixtures rules were introduced. However, while a s 198 election was previously a voluntary mechanism to agree the allowances where a claim had been made, it is now the expected default position – but only where the vendor has a disposal value to bring into account.

(2) *Not worth the hassle*. The "pooling requirement" has led many to believe that there is no longer any value in pursuing capital allowances on second-hand property. If the vendor has not claimed capital allowances but was entitled to claim, a claim may still be possible for a purchaser; but this will be entirely reliant on co-operation from the vendor. In addition, the claim may be restricted to what the vendor could have claimed based on their historic purchase price. Although there are occasions when the benefit is uneconomic to warrant a full claim, many will yield valuable tax savings, as the example of ***Mr Smith*** clearly illustrates.

(3) *No longer available*. Some scaremongering has led to the mistaken belief that capital allowances were going to – or now have – disappeared from second-hand properties. This is untrue, but there is a risk that capital allowances could be lost if the issue is not promptly addressed when a second-hand property is acquired. The new fixtures rules include both a requirement for the vendor to pool the allowances (in absence of claiming) and a two-year window to comply with the legislation. The sting in the tail is that non-compliance means no allowances, now and in the future. Those who seek proper and timely advice should not suffer any loss, but advisers who fail to navigate the complex rules or do not highlight the opportunity or time sensitivity of these matters could find themselves having to scrutinise the wording of their professional indemnity insurance policy – if taxpayers seek compensation against poor or incomplete advice.

Improvise, adapt, overcome

Following the issues discussed in "The good, the bad and the ugly" (*Taxation*, 10 April 2014, page 14), the title of this article provides further homage to Clint Eastwood in our recommended approach to the new fixtures rules. The rules are here to stay, so those acting for clients buying and/or selling property should invest time to understand the requirements, adapt their templates for each specific situation, and overcome the hurdles created by HMRC to optimise the tax savings available.

Some examples of good practice have emerged in the past year and are illustrated below to help practitioners protect their clients' entitlement to relief under the new regime, as well as avoiding being accused of negligent advice.

Buying property

In many respects nothing has changed on "best practice" – address capital allowances early in any transaction, otherwise they may be lost. Ideally, the correct figures should be pooled by the vendor before exchange or completion. Where this is not possible (we all get those last-minute calls with transactions imminent...) the minimum is that contract clauses should be included in the sale and purchase agreement stating the buyer and seller agree to co-operate (typically at the buyer's expense) to ensure compliance with s 187A – as soon as possible after exchange/completion, and within two years of the completion date.

Depending on the sums involved, the parties, and the relationship between them, it may be appropriate to add contract wording to include a warranty or indemnity from the vendor, or even a retention. Part of the sale price could be held in an escrow account with the solicitors until the capital allowances pooling requirements have been properly evidenced and satisfactorily resolved in accordance with the contractual obligations and CAA 2001.

During the transaction process, it is vital that all information required to validate a claim is compiled. These should include fully completed commercial property standard enquiry (CPSE) forms, copies of any relevant elections and, perhaps, the claim reports underpinning the elections. As soon as a client considers buying (or selling) a property, specialist advice might be sought so that the adviser can assess the capital allowances potential of the property, and properly review any proposed election to apportion the sale price under s 198 as may be applicable. This could be by reference to the original cost, the tax written down value or £2 (£1 for each of the plant and machinery and special rate pools).

Often, past claims may not be complete or thoroughly represent *all* of the assets in a property. If so, the heads of terms and ultimately the contract should represent the reality rather than stubbornly use standard but incorrect wording. By way of example, we have seen a vendor's solicitors insist on the s 198 election attributing £1 to plant and machinery and £1 to integral features even though the vendor acquired the building in 2005. This was three years before the creation of integral features allowances which they could not possibly have claimed. The election should have referenced plant and machinery only. This eliminated the purchaser's ability to make a subsequent claim for integral features because they would have been in breach of contract for progressing a claim for more than the £1 elected amount.

Selling property

If the buyer or any subsequent owners wish to claim capital allowances on property acquired since April 2014, in the absence of a claim or s 198 election, they will be reliant on co-operation from the vendor, in particular the vendor agreeing to pool the qualifying expenditure within two years of sale.

Given the level of co-operation required, those considering the imminent sale of property may benefit from making a retrospective claim before disposal. This may enable them to retain some of the benefit of capital allowances going forward and then use the default s 198 election process on the sale of the property. We have seen several sellers become sensitive to putting figures into their tax computations purely for the benefit of the buyer.

Bad practices

We have seen many instances in which contract clauses have been entered into sale and purchase agreements that purport to address the new capital allowances rules, but have instead been "recycled" from previous contracts or transactions with materially different facts.

In some cases this has resulted in onerous burdens being needlessly placed on clients, or it has put them at a risk of increased tax charges. These could, and should, have been avoided with proper consideration and better bespoke advice and contract wording addressing the specific situation rather than simply relying on a practice's precedent templates.

Risk of negligence

Many readers will be familiar with the case of *Mehjoo v Harben Barker (a firm) & Anor* [2014] EWCA Civ 358, in which the defendant accountancy practice was ultimately successful in the Court of Appeal. However, this judgment also drew a useful distinction between "mainstream tax advice" (upon which an accountant or tax adviser owes a duty to advise on) and tax planning (which may not be within the adviser's duty). Routine tax advice was defined in paragraph 38 of the judgment as "taking advantage of any available tax reliefs under the relevant fiscal charge which may be available to him to reduce his tax liabilities", whereas sophisticated tax planning "often involves a reformulation of the transaction in order to bring about particular tax consequences".

From a capital allowances standpoint, the challenge presented is that it is clearly part of routine tax advice – income and corporation tax self-assessment returns devote entire sections to claiming this relief, yet it is also very complex to arrive at the correct figures. There is also the conveyancing case of *Clarke v Iliffes Booth Bennet* [2004] EWHC 1731 (Ch) when it was held that solicitors had a duty of care to their client to understand the contract sufficiently to give proper advice.

Herein lies the problem: most advisers will be aware that certain assets qualify for capital allowances, but many will be unsure how to capture or determine the correct value of the relief. It can be described, perhaps in the words of former US Secretary of Defense Donald Rumsfeld, as a "known unknown". This complexity is exacerbated in the context of second-hand property because identifying and valuing the assets eligible for tax relief is even more challenging.

Historically, it had been possible to retrospectively claim capital allowances on a second-hand property acquisition – in some cases many years after it was acquired. The due diligence requirement extended only as far as verifying whether the current or previous owners had made claims. As a result, failure to address capital allowances when expenditure was incurred usually had little or no tax effect; at worst it may have resulted in a timing difference due to loss of first year or annual investment allowances. Unfortunately, this is no longer the case – if the new fixtures rules are not complied with, the default claim is nil.

However, despite the complexity, capital allowances remains an area where practitioners can make a real difference to their client's tax liabilities. Here are five simple tips that can help unlock tax savings in existing buildings and optimise the impact of capital allowances on current and future new build projects.

Forward thinking

A business claiming the writing down allowance each year will obtain the relief for most of their expenditure within 20 years of incurring it. However, there are incentives available that can accelerate the relief, including enabling all of the expenditure to be relieved in the first year – if care is taken with project planning.

Annual investment allowances (AIAs) have been available since April 2008 and many readers will be familiar with them. These allow businesses to claim a 100% allowance on their qualifying expenditure, up to a prescribed limit. This provides a significant cash flow benefit when compared with the usual rates of relief afforded by the 18% and 8% annual writing down allowances.

In recent years, the annual limit for AIAs has been subject to almost constant variance – it has been as low as £25,000 and as high as £500,000, which is the current threshold until 31 December 2015. In his summer budget statement, the chancellor announced that, from 1 January 2016, the AIA will be set at £200,000 for the duration of this parliament.

Think green

In addition to AIAs, 100% first-year allowances are also available for expenditure on some energy-efficient or water conservation assets. These are known as enhanced capital allowances (ECAs). As with AIAs, installing assets that are eligible for ECAs can deliver accelerated (but uncapped) tax savings when compared with assets that are eligible to "normal" capital allowances. Many types of asset qualify for ECAs, including LED lighting, air-conditioning, sanitary ware and pipework insulation. The Department of Energy and Climate Change is responsible for administering the scheme and maintains the "the energy technology list" (ETL) while the environment department, DEFRA, oversees the "water technology list" (WTL). In many cases there is only a subtle difference and negligible cost differentials, between ECA and non-ECA assets, while the tax impact can be much more beneficial. Any business that is building, extending or refurbishing commercial property should properly consider every opportunity to design and install ECA-eligible assets. There are thousands of energy or water-efficient assets specified by architects and engineers, but not all will attract this 100% tax relief.

In addition, loss-making companies may be able to surrender losses attributable to expenditure on ECAs in exchange for a payable tax credit. This means that part of the refurbishment could pay for itself.

AIAs and ECAs are time-sensitive and must be claimed in the year incurred (or within the normal two-year "tax window"), otherwise they expire. If that happens, the allowances default to the relevant 18% or 8% rates of writing down allowances as PMAs or IFAs respectively.

Think transaction

Every property transaction could give rise to capital allowances and associated tax savings. This includes buying second-hand property, demolishing a building, refurbishments, extensions and even the disposal of an existing asset. In many cases, the scale of savings or even the availability of capital allowances may not be fully appreciated by the client/owner or their advisers.

As mentioned, the rules concerning the acquisition of second-hand property changed significantly in April 2014 and have made claiming capital allowances even more complex. However, there are still opportunities to unearth valuable tax savings – contrary to some doom-mongers. There are still potential claims on older acquisitions that pre-date the new fixtures rules and new builds offer scope for accelerated relief, as well as "add-on" expenditure that can qualify for allowances under specific CAA 2001 clauses. For example:

- Section 25: "Building alterations connected with installation of plant and machinery." As an example, the costs of installing a lift shaft, which ordinarily would not be eligible, would qualify for capital allowances if a lift is being added to an existing building as part of a refurbishment.
- Section 26: "Demolition costs." Here, the cost of stripping out old and redundant plant and machinery can also be claimed against the relevant pool.
- Section 28: "Thermal insulation of buildings." Some thought that this section had been abolished when industrial buildings allowances were removed. However, it was modified to allow thermal insulation – such as double glazing and thermal lagging – that is added to existing buildings to qualify within the special rate pool.

Deeper thinking

HMRC are increasingly taking a robust approach to reviewing and scrutinising capital allowances claims. It is therefore more important than ever that claims are carefully prepared and supported by detailed information that has been thoroughly analysed.

A recent example of this concerned the refurbishment of a city centre shopping precinct where the taxpayer included a claim of £150,000 for repairs, out of a total project spend of about £6m. HMRC challenged the repairs and maintenance deduction and requested substantive back-up, which the client and their surveyor were unable to provide – despite the relatively modest sum claimed. Once HMRC refused the initial claim in respect of repairs and maintenance, the client sought specialist support to review the project information and agree the tax relief available. When submitting the initial claim for repairs, capital allowances had been entirely overlooked. A full and detailed review, including proper apportionment of project preliminaries and construction-related professional fees, allowed the client to submit and agree a revised claim. This was for more than £820,000 of repairs and maintenance expenditure and capital allowances (after negotiations with HMRC and the Valuation Office Agency) of about £1.7m.

Think housekeeping

Notwithstanding the importance of actively considering capital allowances at the time any capital project is undertaken, a historical review can often turn up unexpected benefits. Even properties that have been held for many years can have valuable tax savings hidden away. These savings can make a big difference to a business's current and future tax liabilities – and unlocking this value can be a simple way of preserving a business's cash and keeping its directors and shareholders happy.

Even corporate transactions should be revisited because, if the business acquired has substantial property interests, there may be "latent" capital allowances claims on those if the former owners had not fully optimised their capital allowances.

Conclusion

The common themes that connect all of these points above are value and awareness. Our experience is that most businesses could benefit from a review of their capital allowances position so that they do not waste that fistful of dollars.

Alun K Oliver is managing director of E3 Consulting and has specialised in capital allowances advice for nearly 25 years. **Rupert J Guppy** is a dual qualified senior property tax surveyor with E3 Consulting and has nine years' experience in capital allowances.
The authors can be contacted by email at Alun.Oliver@e3consulting.co.uk or Rupert.Guppy@e3consulting.co.uk.