Sudden impact

Alun Oliver considers the implications of the proposed changes to the capital allowances regime, introduced in the autumn Budget.

Chancellor of the Exchequer Philip Hammond – 'Fiscal Phil' to some – was clearly pleased with himself and his most recent Budget statement. While we await the detail of Finance (No 3) Bill and draft legislation, it was, on first glance, a 'giving' Budget, encouraging businesses to spend, and spend now.

The revisions to the UK capital allowances regime – or, as some would put it, 'fiscal incentives' – will have a sudden impact on UK taxpayers, with the first changes rolling out in January 2019. The chancellor's ambition is to encourage free trade and investment into the UK and its means of production. The world of capital allowances has changed with the introduction of a new category – not embedded capital allowances, a mythical asset category without reference in the lexicon of UK tax legislation – the structures and buildings allowances (SBAs).

In some way, SBAs reverse Gordon Brown's abolition of industrial building allowances (IBAs), albeit at the less generous rate of 2% a year for 50 years. For the first time in UK tax, almost all UK commercial property can benefit from tax relief on 100% of the project expenditure, excluding land.

Referencing the June 2018 report of the Office of Tax Simplification report on allowances (tinyurl.com/OTS-7335), the various Budget changes are largely simplifications, but others are perhaps less so. The only certainty of these unconsulted measures is that there will be winners and losers. The latter might be those investors who started a major new commercial development a few days before the chancellor's statement.

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Key points

- A new category of structures and buildings allowances reverses, to some extent, the abolition of industrial building allowances.
- Potentially, the allowances will be spread over 50 years leading to onerous record-keeping.
- Punitive anti-avoidance measures are promised if contracts are withdrawn, revoked or replaced by a later one.
- The complexity of lease transactions and potential for abuse has led to two new tests.
- The annual investment allowance limit will rise to £1m for two years from 1 January 2019.
- Generally, writing down allowances for the special rate pool will reduce from 8% to 6% from April 2019.
- Enhanced capital allowances will cease from April 2020.

The structures and buildings allowances

This new form of capital allowances will be given on eligible construction costs incurred on or after 29 October 2018 (the effective date) for new non-residential structures and buildings.

HMRC's Budget technical note (tinyurl.com/HMRC-99734) describes SBAs as 'a long-term commitment to improving the competitiveness of the UK as a destination for investment', and explains that businesses factor capital allowances into their investment decisions. The rules are not yet fully formed and still convey mixed messages about some aspects of government policy – not least, the continued pursuit of solutions to boost the UK's housing supply and the accelerating uptake over the past five years of the build-to-rent sector, while excluding these properties (on a commercial basis) from valuable tax relief.

Consultations are invited to HMRC by 31 January 2019 on the definition of a 'dwelling', lease criteria, the dis-use period and application of the rules to 'overseas buildings' if used for a qualifying activity and within the UK tax charge.

Commencement

An increasing trend is the use of statutory instruments. Although the government claims that these facilitate rapid introduction of legislation 'to provide taxpayers with certainty', they also invite quick amendments with considerably less consultation and scrutiny than traditional primary legislation.

The new relief is to apply to new construction expenditure on commercial structures and buildings if all the contracts for the physical construction works (including any preparatory works) are made in writing and entered into by the parties on or after 29 October 2018. The renovation and alteration of existing buildings will be included, as will purchases of a new structure or building from the developer – subject to the contracts underpinning such physical construction works having been entered into on or after Budget day. Much of the intended rules would appear to follow the former IBA regime. There are many changes and restrictions, which some tax advisers may consider neither useful nor simplifications.

Taxpayers undertaking their own construction activity – with an internal workforce – will need to keep documented evidence of the physical construction being on or after the effective date to ensure they too can claim SBAs.

Anti-avoidance

Taxpayers contemplating trying to 'fudge' the contract dates on recently started projects are cautioned that the government intends to include punitive anti-avoidance measures that will deny all SBAs if contracts are withdrawn, revoked or replaced by a contract dated later. One does wonder to what degree this can be effectively policed, particularly on smaller local and regional projects not subject to wider public awareness or profile.

Those involved in large regeneration schemes undertaken under frameworks or call-off arrangements may need to take careful note of the eventual legislation to see whether they can benefit from these SBAs or be denied under an existing contract. This is a reversal of the 'golden contracts' concept that extended old-style enterprise zones by providing for buildings to be constructed within ten years of the contract.

Further, the government intends to introduce rules to prevent leases being used to give more than one party separate interests in the same structure or building. As with VAT, the timing of the works may also become more important. Demolition and site clearance undertaken separately from the creation of a new asset may not be eligible for SBAs if the work is seen as a discrete contract. However, this may be useful in some situations to allow SBAs on the subsequent build phase if a separate contract is completed after the effective date.

Key elements

SBAs will be given as a straight-line relief at 2% for 50 years for eligible capital expenditure on new commercial structures and buildings, including costs for new conversions or renovations. Claims can be made only after the new structure or building is brought into use for a qualifying activity.

All the costs associated with the physical creation of the asset – including spend on demolition or land alterations necessary for construction – and direct costs required to bring the asset into existence will qualify. In common with all other capital allowances, expenditure on the acquisition of, or rights over, land (including SDLT and legal fees) is not eligible, nor is the costs of obtaining planning permission. However, the claimant must have an interest in land on which the structure or building is constructed.

The sale of the asset will not trigger a balancing allowance – instead, the purchaser simply takes over the remaining allowances written down over the residual part of the original 50-year period. Thus, there is no requirement to recalculate for a new period, other than apportionment for part periods.

Purchases of property new and unused from a developer will require a 'just and reasonable apportionment' to segregate the value of land from the acquisition costs that would otherwise be eligible for SBAs and, presumably, other eligible capital allowances relevant to the asset – highlighting the need for some assessment or segregation analysis.

> “There are many changes and restrictions, which some tax advisers may consider neither useful nor simplifications.”

Interaction with other capital allowances

Expenditure eligible for the long-standing plant and machinery allowances (PMAs) and integral feature allowances (IFAs) will continue to qualify for these reliefs and are thus ineligible for SBAs. This is in contrast to the earlier IBA rules, under which taxpayers had the choice to claim the different reliefs as they saw fit. Further, SBA expenditure will not qualify for the 100% annual investment allowances (AIAs). Hence, for taxpayers to benefit from all the available capital allowances reliefs and truly optimise their tax savings, they will need to undertake some form of detailed analysis of the project expenditure into the various forms of allowances relevant – PMAs, IFAs, AIAs, long-life assets (LLAs), SBAs and, until their abolition, enhanced capital allowances (ECAs).

However, an example sale and purchase from HMRC's technical note makes no reference to PMAs or IFAs and assesses SBAs as available on the purchase as costs less land value. I presume that this illustrative position ignores these other allowances for simplicity's sake only and does not represent a more radical denial of them on secondhand transactions.

Further, SBAs are not available against costs that are deductible in calculating profits chargeable to tax, such as land remediation relief or repair and maintenance expenditure.

Structures are explicitly stated as including 'walls, bridges, tunnels' and highways are referenced in the draft Finance (No 3) Bill but there is no mention of railways, trams, piers, dams or similar utility and infrastructure assets. It must be hoped that the legislation will not seek to limit structures or buildings from these sectors by some anachronistic schedule of qualifying assets and uses.

Dwellings

HMRC's technical note advises that 'expenditure on residential property and other buildings that function as dwellings' will not qualify for SBAs. It further defines 'dwellings' as buildings primarily intended as or used for long-term residence, including university or school accommodation, military accommodation and prisons.

Given the desire to increase the UK housing stock and encourage greater participation by commercial landlords in the private rented sector (PRS), these restrictions seem outdated to current needs and housing trends. It is to be hoped that the consultation will help to find a path that balances the legitimate concerns of HMRC on widening the availability of relief on residential dwellings with those clearly engaged in commercial provision of homes for rent because why should this sector be any different from a care home or hotel?

What of furnished holiday lettings? The current schedule of 'qualifying activities' has been pared down from those set out in CAA 2001, s 15. This is confirmed by Finance (No 3) Bill, cl 29(4)(b), which confirms that prescribed holiday accommodation will be denied SBAs – while remaining eligible for other capital allowances. True simplification would not seek to 'carve out' different qualifying activities, forcing more segregation of allowances, but would use the existing categories consistently.

Live/work premises are to be excluded and mixed-use properties will also require a 'just and reasonable apportionment' although shared and dual use will be treated as non-qualifying – again in contrast to the treatment for PMAs, IFAs and AIAs within common areas. Finally, if the potentially eligible proportion of a mixed-use property has 10% or less of the costs that could qualify for SBAs, then none would be permitted. Care needs to be taken with such calculations to ensure they reference costs and not simply floor areas, in the manner that some assessed IBAs in the past.

> "If a property or asset has a non-qualifying change of use, the associated 2% relief is lost."

Non-qualifying activity

If a property or asset has a non-qualifying change of use – say it becomes a dwelling or is acquired by a non-taxpayer such as a pension fund – the associated 2% relief is lost and not carried forward or recalculated for each year.

Non-taxpayers or Crown and local authorities that develop assets after the effective date will not benefit from SBAs, but must retain some evidential records as to, for example, the start date of the notional 50-year period. This will be needed if subsequent purchasers are to benefit from SBAs on the remaining period. Given our experience in operating the 'new fixtures rules' on secondhand purchases, this record-keeping could be problematic – in effect, denying claims to buyers if there are insufficient records.

It will be possible to continue to benefit from SBAs if the asset is damaged by fire or otherwise becomes incapable of qualifying use. This temporary dis-use, if less than two years, will not deny SBAs to the owner until the building or structure is brought back into use. The new construction expenditure (net of any insurance proceeds and the like) will qualify for SBAs in its own right with a new 50-year period. If there is extensive damage to the asset, it will be possible for this temporary period to be extended up to five years.

Confusingly, HMRC's technical note suggests that 'shadow SBAs' will continue to be available against the original expenditure, even if a taxpayer decides against redevelopment – allowing tax relief against no continuing asset or qualifying activity? The draft legislation on this will need to be considered carefully because, in reality, land rarely sits idle for long and thus a disposal of the derelict site for redevelopment by others would no doubt trigger a new 50-year period, potentially doubling up the 'shadow SBAs'.

Leasing and capital gains tax

Tax simplifications are rarely that, and somewhere along the line there are aspects of prevailing practice and procedure that rub against the proposed new measures. Here, a simplified, straight-line, 50-year capital allowances regime without balancing adjustments introduces new capital gains tax issues and complex measures for leasing. It attempts to deny relief in abusive avoidance situations, while recognising that transactions can be complicated, but not necessarily intended to be abusive.

Capital allowances rarely interact with capital gains tax other than disposals in a loss situation. However, the new SBA rules propose that the taxpayer's base cost will be reduced by the total value of these allowances claimed up to the point of sale. Given only an annual 2% benefit of SBAs there will, no doubt, be some investors that may prefer not to reduce their base costs and so not bother with SBAs at all.

The example of ***Company A*** illustrates how the allowance will apply in a purchase and later sale.

Company A

Company A acquires a new office from a property developer at a cost of £75m. Of this, £20m is considered the land value, leaving a net construction cost of £55m. The property was brought into use in the accounting period ended 31 December 2020.

The annual SBA (ignoring PMAs and IFAs) will be:

£55m x 2% = £1.1m for 50 years

On 31 December 2039, the property is sold to Company B for £140m of which land is treated as £50m. Company B claims SBAs at £1.1m a year for the remaining 30 years. Company A's capital gains computation will be:

	£m	£m
Sale proceeds		140
Base cost	75	
Less SBAs claimed (£1.1m x 20 years)	22	
Allowable		53
Net gain		87

These calculations will become considerably more complex after PMAs, AIAs and IFAs are taken into account. Typically, these capital allowances do not require an adjustment to base cost, although SBAs will.

In simple terms, normal assessment of each taxpayer's respective positions will prevail. Thus, a lease on full market rent with no premium would leave the SBAs with the lessor's property investment business. However, a very long lease (say 999 years) at a token 'peppercorn' rent and with a significant capital premium will be treated as akin to a sale and the lessee will become entitled to the SBAs.

Between these two 'end markers', the complexity of lease transactions and potential for abuse has led the government to set out two tests. First, if the premium paid is 75% or more of the capital amount and the value of the retained interest, the lessee will have the SBAs as a deemed sale. If the capital sum is less than 75%, the lessor will retain the SBAs.

Second, if the lease term is no more than 35 years, the SBAs are to stay with the lessor.

Annual investment allowances

Aptly nicknamed the 'yo-yo allowance', the cap on AIAs has varied considerably since its introduction in April 2008. From 1 January 2019, the new cap will be set at the first £1m of qualifying expenditure. This is a temporary increase for two years and is intended to revert to £200,000 after 31 December 2020. As before, those with different accounting periods will have to calculate the relative proportions of the current and increased cap that may apply. In part, this measure will help to offset the April 2020 withdrawal of the 100% ECAs for energy-and water-saving measures.

Businesses planning new capital assets in the next few years may wish to consider the project timing to optimise the tax savings generated from capital allowances, whether as SBAs, AIAs, PMAs, IFAs or otherwise.

Special rate pool

The chancellor also announced that the writing-down allowances (WDAs) rate for the special rate pool – covering IFAs, LLAs and thermal insulation works under CAA 2001, s 28 – would fall from 8% a year on a reducing balance basis to 6% from April 2019. These changes will not apply to 'ringfenced trades', which will remain at 10%.

Although this reduction will hit many taxpayers claiming IFAs, it is considered the AIA increase (and potential SBAs on wider project costs) will offset the impact of this for most.

Enhanced capital allowances

One of the more surprising changes was the announcement to end ECAs from April 2020. These provide 100% FYAs against assets on the energy or water technology lists or that otherwise meet the qualifying criteria.

These allowances work in tandem with the minimum energy efficiency standards (known as the MEES regulations – see tinyurl.com/yat5ay4w) as part of the 'carrot and stick' approach of government to persuade landlords to improve the energy efficiency of the UK's property stock. Although the ECA system was by no means perfect, linking or adjusting the rate of WDA – by reference to either the property's energy performance certificate or BREEAM® rating (the Building Research Establishment's energy assessment methodology) – whereby the rate of WDAs could have been set at 100%, 75% or 50% depending upon the rating of the property – would have maintained a clear link to ensuring buildings became more energy- and water-efficient at a time when some landlords really need to raise their game. However, in light of SBAs and the £1m AIA limit, this withdrawal will affect only a relatively modest group of taxpayers on the largest capital projects.

> "Businesses planning new capital assets may wish to consider the project timing to optimise the tax savings generated from capital allowances"

Planning point

SBAs are not available against costs that are deductible in calculating profits chargeable to tax, such as land remediation relief or repair and maintenance expenditure.

Conclusion

In the main, these changes will benefit taxpayers, particularly over the next two years for which the boosted AIAs will result in most projects of up to about £5m or so of capital expenditure benefiting from all their allowances in the year. This contrasts favourably with the current 'drip feed' of capital allowances over 15 to 25 years.

The new SBAs will also boost the tax relief to all new commercial development, but the capital gains tax changes and the evidential requirements to maintain accurate records for up to 50 years on the construction costs and start date may prove too restrictive for many taxpayers to take seriously.

These points need to be forcefully made to HM Treasury and HMRC during the consultation period to see whether a better balance could be struck. This might then better achieve the government's ambition of continued investment in UK, without becoming too onerous in record-keeping or expensive to the exchequer. However, taxpayers will not take up an ineffective incentive, thereby inhibiting the desired investment while jeopardising growth and economic prosperity.

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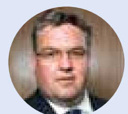

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