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PIA response to HMRC consultation on capital allowances for fixtures

Introduction

The Property Industry Alliance ("PIA") brings together six leading property industry bodies which, while retaining their separate identities and roles, work together to tackle major industry issues in a more coordinated way. The PIA comprises the Association of Real Estate Funds, the British Council for Offices, the BCSC (British Council of Shopping Centres), the British Property Federation, the Investment Property Forum and the Royal Institution of Chartered Surveyors.

Capital allowances are important to many of our members – in relation to both new capital expenditure on buildings and acquisitions of existing buildings with fixtures in them; but their relevance differs depending on tax status, with REITs, non-taxpayers and ordinary property investors having quite different perspectives. We welcome this opportunity to comment on HMRC's proposals.

General comments

We are sympathetic to a number of the policy aims and concerns described in the consultation document. In a number of important respects, however, we think the proposals go further than necessary, and risk imposing inappropriate and disproportionate compliance burdens (particularly on smaller businesses). The proposals also risk compounding the effect of falling rates of writing down allowances and discouraging capital expenditure on new assets generally, at a time when the Government should instead be trying to stimulate investment and the jobs and growth it generates.

We have sought, below, to identify where HMRC's proposals risk failing in their intended aim "to make the rules fairer and clearer for businesses to understand and to operate, without giving rise to disproportionate administrative burdens". Where possible, we propose alternative ways in which HMRC could secure the policy purpose of "limiting allowances overall to the fixture's original cost" without depriving those investing in fixtures of the tax relief properly corresponding to their expenditure.

As a general observation, it strikes us that the problems which the proposals consulted on seek to address are for the most part not related to defective legislation, but rather to poor compliance and resource constraints affecting enforcement. The appropriate response to those problems would in our view be to clarify the existing legislation to improve taxpayer awareness and perhaps to shift burdens of

proof to encourage better compliance and make enforcement easier. Unfortunately, HMRC's proposals take a different approach.

(a) The proposals would apply to capital expenditure on the creation of new fixtures even though the policy case for change relates solely to transactions in second hand buildings/fixtures.

We would argue that the restriction of tax depreciation which has been fashionable in recent budgets is misconceived and counter-productive at a time of challenging economic conditions in which Government should be trying to encourage, rather than discourage, investment – indeed, the cumulative ramifications are ignored by the Taxes Impact Assessment in section 4. The UK is already at a serious competitive disadvantage when compared to other OECD and G20 countries in terms of the tax relief available for capital investment (whether affecting large scale investment in infrastructure or regeneration or smaller projects). It is quite extraordinary that proposals born of concerns about duplicate allowances claims when fixtures change hands should be applied also to new investment without even an attempt to justify that extension in policy terms. We propose excluding new capital expenditure from the proposals.

(b) **The proposals would impose compliance burdens which do not fit with the dynamics and practicalities of real estate transactions and would unjustifiably and inappropriately distort the bargaining positions of buyers and sellers.**

Capital allowances are rarely a significant consideration in the minds of commercial people executing transactions in real estate that includes fixtures. Getting a seller to provide all the necessary information and to sign a record of agreement as required by the proposals at the time the deal is signed is simply not realistic. Making the buyer's right to fixtures allowances contingent on a seller's willingness to do so (whether before or after the commercial transaction is signed) puts the seller in an unreasonably and inappropriately strong bargaining position. We propose a different approach.

(c) The proposals unjustifiably threaten to restrict the right to relief for expenditure actually and properly incurred in cases where no serious policy case for such restriction has (or, in our view, can) be made.

There is absolutely nothing wrong with a seller retaining some or all of the allowances after disposing of an asset. Most fixtures suffer a large loss in (re-sale) value as soon as they are installed – but the cost has been incurred, and is eligible for tax relief over time. Why should a taxpayer who has incurred expenditure and suffered a subsequent loss in value be denied the right to retain that tax relief after selling the asset? If HMRC are concerned about avoidance in this area, it should amend the anti-avoidance rules to stop transactions solely or mainly designed to generate a tax advantage – there is no justification for changing the rules for the vast majority of normal commercial transactions.

<u>Specific responses to the proposals</u>

(i) Main proposal: mandatory pooling

We are sympathetic to HMRC's concerns about the practical and evidential problems that can arise where claims are made long after the acquisition of second hand fixtures. Those problems do not arise in relation to new fixtures, however, so there is no justification for applying the new mandatory pooling

proposal to new fixtures as contemplated (without any policy case at all being made) by paragraph 3.8. Subjecting new fixtures to that proposal would also give rise to both practical and policy problems.

From the practical point of view, applying this proposal to new fixtures would be problematic in the context of major projects where expenditure is incurred over a period of several years and it can be very difficult (and expensive where external consultants must be involved) to allocate expenditure to particular fixtures and particular periods until the project is complete. Taxpayers involved in such projects generally put satisfactory arrangements in place with HMRC for ensuring that qualifying expenditure and fixtures claims are understood. It has not been suggested that such arrangements give rise to concerns such that a different approach is required. There are also considerable practical difficulties around determining the acquisition date for new fixtures, as compared to the relatively straightforward case of sale and purchase transactions. Expenditure often continues for a long time after practical completion for a project (for example, retention payments not being released for several years with some major projects); and it is not often clear when one project ends and another begins (for example, air conditioning may be installed in succession to each of seven floors in an old office building – are there seven separate projects, each with its own acquisition date, or just a single large project with a single acquisition date?).

From the policy point of view, while capital allowances do not drive real estate development projects, they are part of the financial picture that determines viability. Messages from Government in this regard have been unhelpful at least since the abolition of industrial buildings allowances was announced. It would be positively unhelpful to add new hurdles to the availability of tax depreciation, particularly in the current economic environment.

As regards second hand fixtures, we understand the thinking behind the proposal. However, one year from the date of acquisition is definitely too short a period from a practical perspective. We would favour a notification period of two years **following the end of the accounting period in which the acquisition occurred**. A shorter period risks operating, in effect, as a bar to tax depreciation, particularly for smaller businesses.

Agreeing just and reasonable apportionment values is likely to involve greater administrative and technical complexity where the parties are not entering into a section 198 election. A longer period than that for section 198 elections would therefore be reasonable – and two years from the accounting period end would be in line with most other tax elections. We would point out, too, that the example in paragraph 3.6 in fact demonstrates that a period longer than two years from the end of the accounting period in which the acquisition occurred (as we suggest), would fit with the normal time limits; it does not imply that the longest practical period is two years from the date of acquisition.

As regards historic fixtures, we think it is again helpful to distinguish between historic fixtures which were installed by the current owner, and historic fixtures which were not. We see no justifiable reason for any restriction on historic fixtures owned by the person who installed them at commencement of the new rules, because there can be no danger of mismatches and duplicate allowances until those fixtures change hands. On the other hand, we can see why it might make sense to impose a transitional pooling requirement for historic fixtures that had already changed hands at commencement. A period of three years from commencement would seem reasonable.

(ii) Second proposal: the record of agreement

Again, we are of course sympathetic to HMRC's desire to avoid duplicate allowances from being claimed by successive owners of a fixture. However, we believe that the record of agreement is the wrong way to try to address the problem because it fails to appreciate how commercial property transactions actually work.

HMRC suggest that "It is easier for both parties to reach a mutually acceptable agreement nearer to the time of sale". Unfortunately, "nearer to the time of sale" must mean either "at or before signing of the commercial transaction", or "after the commercial transaction has been signed". In general, capital allowances are often further down the list of priorities than the many other areas of due diligence which need to be addressed, and the relevant information to support an agreement may therefore not be available at that point. (Note that even where the parties have thought about fixtures allowances and want to make a section 198 election, a valid election cannot be completed at closing if the purchaser is a newly formed company or a non resident and has yet to be given a tax reference number, or if the election is to fix at tax written down value, and the seller hasn't completed its own fixtures claim(s), or is still within an enquiry period for its fixtures claim(s).) As a result, it is not likely to be realistic to expect records of agreement to be entered into until after the deal is signed. Once the deal is signed, the purchaser is likely to want to confirm the apportionment to fixtures with the seller. It is not always easy to get the seller's attention at this point some members have found that sellers are reluctant to share any further information after the deal is completed.

In commercial property transactions, there is no current need to determine the market value of fixtures within the property being sold, so for the buyer and seller to sign a record of agreement stating the market value of the fixtures will involve a great deal of extra work and cost to both parties – which may become even greater if (as usually happens) the two parties' valuers come up with different values. It needs to be appreciated that fixtures by their nature are difficult to value as they will frequently be hidden from view (for example electrical systems or air conditioning), and are often difficult or impossible to extract from a building once installed so have little or no re-sale value: lifts or escalators cannot be taken out of one property and installed at another, for example.

If the purchaser needs the seller's signature (not just co-operation) within a specified timeframe in order to get any allowances in relation to the fixtures acquired, that gives the seller an inordinately strong bargaining position, whether the issue is raised before or after the commercial property transaction is signed (unless the seller is legally obliged to co-operate). Making allowances contingent on a record of agreement also creates a tripwire by which the unwary (most likely to be smaller businesses) can lose allowances to which they are otherwise entitled, simply because of an administrative delay.

We believe that a much better approach would be to amend section 185 to make it clearer that the evidential burden is on the claimant to demonstrate that he is not claiming allowances in excess of the past owner's disposal value and that there is therefore no duplication of allowances. Rather than HMRC having to "disprove an assertion" that capital allowances have not previously been claimed, they could simply require the claimant to substantiate his assertion with reasonably acceptable evidence. As we understand it, this would be in line with the judgements in the cases of *Tapsell, Tapsell & Lester (t/a The Granleys) vs HMRC* and *West Somerset Railway plc vs Chivers*, but the legislation could be clarified to put it beyond doubt. Purchasers could even be required to make a formal declaration that they have the evidence to support a claim being made in accordance with section 185, so as to focus minds on the

importance of the issue. Where a purchaser was unable to provide appropriate evidence, the claim would fail.

This approach would give the purchaser the flexibility to supplement due diligence during the negotiation phase of a commercial property transaction with further due diligence after it, without however allowing the seller to hold the purchaser to ransom with a record of agreement.

(iii) Other possible improvements (sections 198 and 197 CAA 2001)

Para 3.17 suggests that there are problems around:

- "the retention of allowances by the party who no longer holds the underlying asset", and
- "the artificial acceleration of capital allowances on fixtures".

It may be that HMRC wish to target particular avoidance which abuses the normal rules to derive a tax advantage; but we think it is important to be clear that there is nothing objectionable in such retention or acceleration when they occur in the normal course of commercial property transactions. (Indeed, it would be objectionable if a taxpayer who had incurred expenditure on a fixture was denied the right to allowances reflecting the market value of the fixture simply because the low rate of writing-down allowances means that the tax written-down value is higher than that market value at the point of sale.)

If the buyer of a fixture is willing to agree (by way of section 198 election) for the seller to retain the right to claim allowances on it, why shouldn't the seller, who incurred qualifying expenditure on the fixture himself which has not been fully written down at the time of the sale, be allowed to continue to claim them, or (assuming there is no tax avoidance motive) to obtain a balancing allowance, as the case may be? The tax status and attributes of different investors will often mean that one is indifferent to allowances while the other is not. It is not fair for HMRC to treat that commercial reality as an opportunity to deny a seller who has incurred qualifying expenditure the allowances attributable to it.

We would therefore strongly oppose the introduction of a tax written down value floor to the apportionment permitted under sections 198 and 199.

As regards section 197, HMRC have not articulated why they consider that it needs to be made "clearer", and paragraphs 3.17 and 3.19 are arguably inconsistent in describing what is proposed. Paragraph 3.17 suggests the section should bite "in all circumstances where capital allowances on the fixture are accelerated by a balancing allowance, *as a result of a scheme or arrangement where the main purpose, or one of the main purposes is the obtaining by the taxpayer of a tax advantage*" (emphasis added to highlight the condition in section 197(1)(d)). Paragraph 3.19 on the other hand talks about "improving the anti-avoidance provision to make it more effective in preventing the acceleration of allowances *in all cases*" (emphasis added to highlight the absence of any reference to the condition in section 197(1)(d)).

It is difficult for us to comment on the proposal in relation to section 197, or indeed to offer "suggestions for alternative proposals that would be more effective in delivering the underlying policy purposes", because we do not understand what those underlying policy purposes are. We can confirm however that we would support an appropriately targeted anti-avoidance measure which stops identified abuses, provided it does not complicate matters for the ordinary commercial transactions which dominate the market.

Conclusion

As mentioned above, we are sympathetic to HMRC's desire to reduce non-compliance and prevent loss to the Exchequer resulting from duplicate allowances claims (whether arising from ignorance, oversight or deliberate exploitation of the current problems of proof). However, we do not think the proposals set out in the consultation paper represent a good way of achieving that objective without creating unnecessary and disproportionate problems for ordinary businesses trying, in economic conditions that seem likely to remain challenging for some time, to transact and to invest for growth in the wider economy.

In summary, we propose that:

- Where fixtures are bought and sold after commencement, the buyer must pool them within a period of two years after the end of the accounting period in which the acquisition occurred;
- For fixtures which were already second-hand at commencement, there is a transitional period of three years from commencement for the owner of those fixtures to pool them;
- For new fixtures – whether owned by the person who installed them at commencement, or installed after commencement – no time limit for pooling should be introduced;
- No record of agreement would be required on a sale of fixtures, but instead legislation and improved guidance would make it clear that the burden of proof under section 185 falls on the taxpayer to prove that his claim was not excessive/duplicative; and
- There should be no further restriction to the value agreed in a section 198 election, but targeted changes could be made, if required, to section 197 to stop identified tax advantage-driven abuses without impacting on normal commercial transactions.

We have tried to make our comments as constructive as possible and would be delighted to work with HMRC to develop better targeted solutions than those set out in the consultation paper.

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On behalf of:

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