Tax Representation

ICAEW TAX FACULTY

TAXREP 5/09

Capital allowances Finance Act 2008 changes: draft guidance and related matters

Representations submitted on 10 February 2009 by the Tax Faculty of the Institute of Chartered Accountants in England and Wales in response to guidance published on 29 December 2008

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CAPITAL ALLOWANCES FINANCE ACT 2008 CHANGES: DRAFT GUIDANCE AND RELATED MATTERS

INTRODUCTION

1. We welcome the opportunity to respond to the HMRC draft guidance on the capital allowances rules published on 29 December 2008 at *http://www.hmrc.gov.uk/briefs/company-tax/brief6608.htm*.

2. Details about the Institute of Chartered Accountants in England and Wales and the Tax Faculty are set out in Annex 1. Our Ten Tenets for a Better Tax System by which we benchmark proposals to change the tax system are summarised at Annex 2.

3. Paragraph references and the extracts below refer to the draft sections in the new capital allowances manual.

KEY POINT SUMMARY

4. The capital allowances changes will affect the majority of businesses in the UK. For many it will simply mean a change in rates, while for others the changes will be more radical.

5. We have indicated where we think that the proposed guidance could be made clearer, or where the tone implies culpability rather than an innocent mistake and hope that HMRC will reflect this in the final version.

6. We are concerned that HMRC has changed its view of the definition of a dwelling house without any change in the law and that this may have an adverse effect on businesses which own university halls of residence.

7. Applying the 50% test to repair costs to determine whether expenditure on integral features is a replacement is an area where it would be easy for taxpayers to inadvertently make mistakes and we are concerned that the guidance in this area may be unrealistic.

DETAILED COMMENTS

University halls of residence and similar facilities: Application of section 35 CAA 2001

8. We consider that this change of approach by HMRC is likely to have an impact on student accommodation Private Finance Initiative (PFI) projects,

and the calculation by universities of taxable profits arising from their non-student lettings.

9. We note that there has been no change in tax law, merely a change in HMRC's opinion. While it is helpful to be aware of HMRC's likely stance on this issue, we do not think that our members will feel bound by this and challenges are therefore likely. In particular, we consider that if a university hall of residence is of a more traditional specification, there would appear to be a good argument that the property should not be regarded as a dwelling house and thus be in line with the HMRC's original views.

10. Although not explicit in the published statement, we presume that the change in HMRC's view should not have any impact on previous claims made.

11. Where extensions are made to existing student accommodation buildings or existing bedrooms are refitted, the position is less clear.

Comments on the new CA manual

CA 10020

12. The double negative in the second paragraph is confusing. We suggest changing the second paragraph from:

    the main exceptions are:

    To:

    Common assets which do not qualify for capital allowances include:

CA 1101

13. Change the second bullet on the intent of CAs to:

    relief for the cost of a capital enhancement to an asset, even where the underlying asset does not belong to the taxpayer (i.e. certain improvements to leased property).

14. The opening line following is odd:

    But the reduction in value of the asset concerned or the way in which a cost is to be shared is normally impossible to predict when capital allowances begin to be given. Balancing allowances and balancing charges are the mechanism by which adjustments are made to achieve the broad intentions set out in the previous sentence.

and we would suggest instead:

It would be unmanageably complex to provide capital allowances on a basis exactly corresponding to the reduction in value of each asset. In place of complexity a relatively simple system is used whereby classes of asset obtain relief on either a reducing balance basis or a straight line basis (although the latter relief is now largely historic in nature). As a result it is also necessary to include 'corrections' when assets are disposed of to ensure that the correct total relief (initial cost less final value) is obtained; the mechanisms by which these corrections are made are known as balancing allowances and balancing charges.

CA 17000

15. An additional paragraph would be helpful:

The capital allowance regime is relatively flexible, and accordingly it is uncommon to have both balancing allowances and charges in the same allowance pool. For example a taxpayer may reduce a claim for an initial allowance on an addition in the period in order to prevent a balancing charge on a disposal of existing assets. This is envisaged by the legislation and does not represent unacceptable avoidance.

CA 15420.

16. We find the tone of this section to be overly aggressive.

17. The first line should be amended as we understand that *s 343ZA ICTA 1988* does NOT prevent the 'sale' of the unused capital allowances, but rather that it prevents the crystallisation of a balancing charge.

18. We suggest changing the first line to:

Section 343ZA ICTA 1988 is an anti-avoidance section that ensures that where a trade is transferred from one company to another, and one of the main reasons for the transfer is to obtain a balancing allowance on the transfer, the successor company stands in the shoes of the seller company from a capital allowance perspective preventing the obtaining of the tax advantage arising from the balancing charge.

19. Paragraphs 2 and 3 could then be reduced to:

This legislation is required to prevent the selling company artificially accelerating its capital allowance deduction. This may occur in cases such as where the buyer of the trade has little use for capital allowances within the trade, particularly where the value of the trade is minimal aside from the value of capital allowances attaching to the trade.

Here is an example of such a transfer where obtaining a tax advantage was one of the main reasons for the choosing the structure:

20. Add the following final paragraphs after the example:

The key point to consider when reviewing a transaction that may be within the scope of the legislation, is that the transaction must include some artificial contrivance to generate the tax deduction.

In normal commercial practice Nicks Nougat Niceties Ltd would be expected simply to sell its assets directly to Sue's Super Sweets Ltd for £250,000 without the imposition of the new company Nicks Nougat Ltd.

It should be noted that a complex restructuring may be without tax motivation. For example in the case of a direct sale followed by the cessation of the trading activities of Nicks Nougat Niceties Ltd, s343ZA ICTA 1988 would not apply and Nick's Nougat Niceties Ltd would obtain the balancing allowance. In this case an interim transfer as noted above would have no tax benefit and could represent an attempt to segregate commercial activities that was superseded by events.

CA 21010.

21. We suggest replacing from*: 'there is legislation that says that some items you would probably not think of as plant and machinery'* with:

The courts have been called upon to judge whether expenditure qualifies for capital allowances on a number of occasions resulting in the following items being ruled as plant:

22. Replace:

apart from that there is no guidance about the meaning of plant and machinery in the legislation

With:

The terms plant and machinery are not defined in the legislation and therefore take on their normal everyday meaning in the English language.

CA 21200.

23. We suggest that the 4th paragraph of text may require softening. Increasingly studies are showing that surroundings influence productivity – it is probably only a matter of time before artwork in offices is ruled as qualifying as it promotes efficient work for example. We suggest that HMRC

considers why such expense is now common place, including artwork in lobbies etc designed to suggest success, steady hands or innovation. Rather than fight costly court cases in the future HMRC could be pro-active and deal with the situation in advance.

24. Alternatively, the term ‘decorative features used as apparatus in the trade’ could be added to the integral features list.

25. The 5th paragraph is overly restrictive and suggests at best a grudging acceptance of a wider principle. We suggest adding:

    The cost of an asset includes necessary installation costs and peripheral expenditure which is directly required for the asset to be installed and used, for example:

26. Further to the last paragraph on television sets, a bullet ‘television sets’ should be added to the list at the start. There should be a link to the relevant sections on leased assets. It seems to us that this point has far wider application than just to televisions, and would apply to any asset appropriated from stock and leased out.

CA 22010.

Lift shafts

27. A lift shaft built when a building is erected is part of the structure of the building and only the mechanical element of the lift itself will qualify, s21, CAA 2001.

28. Where the needs of the particular trade require a new lift to be built in an existing building, the shaft qualifies as a necessary cost of installing the lift. Existing CA 21190 confirms this. It would be helpful for this to be cross referenced in the proposed amended CA22010.

29. Bullet 2, water should also be double starred as cold water systems are on the integral features lists. Hot water systems are on the list at 21200.

30. Bullet 6 should have a warning.

    Until FA08 fire safety systems such as fire doors qualified for CAs if required under the relevant sections of Health 7 safety legislation. The Budget speech referred to the removal of the administrative cost of obtaining the relevant certificates, but did not mention that the cost was removed as the assets no longer qualified. It is therefore highly likely that claims will be made in error for a number of years.

CA 22030.

31. The re-write could have tidied up some existing issues:
    1. Remove software and film rights – these are not structures. At best you may get software for an embedded piece of machinery in a building but neither really has any place in the list.

    2. UK law is based on binding precedent – if the courts have ruled that ‘X’ qualifies as plant, and ‘Y’ is very similar, then it is likely that ‘Y’ would also be plant (not certain, but likely). Accordingly, we consider that the list *does* operate by analogy - with the caveat being that each item should be considered on a case by case basis as the courts will decide based on the facts of each specific case.

32. We suggest removing the last two bullets which have no relevance to plant.

33. Amend paragraph 2 as follows:

34. The list does *not necessarily* operate by analogy*, as it is derived from case law and cases are decided on the facts of each specific case;* for example item 33 which refers…

35. Amend point 14 to make it clear – there are continual arguments on partitions. To improve clarity, add the following to the end:

    where the partitions perform an active function in the trade <u>*CAxxxx.*</u>

CA22320

36. Replace:
    This removes the previous special treatment for “trade specific” or “P&M specific” electrical and cold water systems. Now, all businesses’ expenditure on all such systems may be entitled to 10% WDAs as “integral features” expenditure on an equal footing.

    With:
    Electrical and cold water systems specific to particular P&M or trades no longer qualify for capital allowances as part of the general pool. However most companies will benefit as all expenditure relating to a qualifying trade on such systems will be entitled to 10% WDAs as expenditure within the definition of integral features.

CA 22330.

37. We believe that the expense of mains electrics/cold water qualifies on everything from the mains source to the specific plant. It therefore follows that where the cost includes trunking across land to link the building to the mains, the cost outside the building also qualifies.

38. The first paragraph of both the electrical and cold water paragraphs (paras 1 and 3) should therefore be modified from:

    from the point of entry to the building or structure, or generation within the building or structure, and distributing it through…

    to

    from the mains supply or generation within the building or structure, and distributing it through…

39. Since the work outside the building can include the creation of electrical substations, transformers, uninterruptible power supply systems, external overload circuit breakers, etc, the external expense can be considerable. Since the expense is required for the machinery in the building (for example if it is required to upgrade a storage warehouse to a manufacturing industrial unit) presumably the intent is to allow a claim for the integral features rate of allowance on both the external electrical works and on the internal electrical works?

A lift, an escalator, or moving walkway.

40. It would be worth highlighting some general principles in relation to how much of a lift shaft might qualify for capital allowances. For example, three sides of the lift shaft (Two if it is in a corner, all four if it is central with no sides being structural walls), the tracking for the lift and counterweight, etc.

41. These costs are likely to be a significant part of the total cost and clarity would reduce error. Where case law has prevented claims then such a restriction should be spelt out and the case named – otherwise taxpayers following general principles may make excessive claims.

CA 22340.

42. Para 2 – bold text. Remove ‘the whole’ – it is superfluous. One cannot replace the whole without replacing more than 50%. The page should also refer to the longstanding provisions regarding the replacement of an entirety of an asset.

43. This is an area where it would be easy for taxpayers to inadvertently make mistakes and it may be worth highlighting this to over zealous inspectors, particularly in the following situations.

Common mistakes anticipated

44. Depending on the year end of the business, the point at which 50% of the cost is incurred may be after a year end. In this case the legislation still applies to the expenditure in the earlier period. This may be the source of errors by taxpayers in preparing returns for either or both of the earlier and later periods.

45. Similarly the legislation applies regardless of the intent of incurring the expenditure, such as where repairs are poorly carried out or do not resolve an underlying problem. It is easy to incur unexpected additional repair costs which cause costs to spiral over 50% even on ‘minor repairs’.

46. Circumstances where problems may occur are:

1. The taxpayer does not intend to replace or substantially replace the asset – the intention is irrelevant, the legislation applies to the expenditure incurred, not the intent of the expenditure. This is unlikely to be appreciated by taxpayers, and even advisers, who will, under normal accounting procedures, look to whether expenditure creates or enhances an asset when attempting to identify capital expenditure. This legislation, as with all specific legislation regarding the tax treatment of business income and expenditure, directly overrides accounting principles. Accordingly, the accounting concept of capital expenditure is irrelevant, as is the accounting concept of materiality.

2. The expenditure is inflated due to over-charging or poor workmanship requiring remedial repairs. Again the legislation applies to expenditure on the asset, irrespective of whether or not the expenditure was productive. Note however that where expenditure on earlier repairs is reduced (for example by insurance proceeds, or refunds) only the net expenditure incurred is considered when applying the 50% test. The timing of insurance proceeds, credit notes, refunds, etc should follow a just and reasonable basis. If the amounts directly relate to an invoice then they should reduce the expense of that invoice even if received several months after the original invoice.

3. Expenditure in the following period causes expenditure in the current period to be treated as capital rather than revenue. Where the taxpayer has not exceeded the 50% repair expenditure test within 12 months at the time they submit their return, they will submit a correct return

at that time. However, if they incur further expenditure within the 12 month window which takes the total over 50%, the earlier return will later be rendered incorrect regardless of their skill or intent. An amended return will be required.

47. In general when reviewing the tax treatment of repairs, you should consider the availability of the Annual Investment Allowance, 100% allowances on energy saving equipment, the use of loss claims, and so on. To require an amended return where there is no increase in tax liability imposes an unnecessary administrative burden.

CA 22350.

48. The illustrations used imply that the owner of a business has an intimate working knowledge of the 50% test. It seems unreasonable to suggest that a jewellery designer and shop keeper would know this. Indeed most business owners would be in the same position. Further, they would be unlikely to take professional tax advice before repairing the central heating.

49. We suggest a change of emphasis to make the unplanned breach of the rule less aligned to a planned avoidance strategy.

50. Change

Jonathan has, in fact, incurred expenditure on replacing either 70% or 65% of his CH system (depending on the valuation base) so it is likely that he would be aware that the replacement rules would be likely to apply. In many cases too, it is quite likely that a business would decide to 'go the whole hog' and replace the whole system, rather than 70-75% of it, but this example illustrates how the rules might apply.

When this happens – that is when the integral features rules apply because of the fact that expenditure in aggregate over a 12-month period exceeds 50% of the replacement cost – then CAA01/S33B(5) lets any assessments or adjustments of assessments be made as are necessary to ensure the tax treatment is correct.

To:

The application of the integral features rules when expenditure in aggregate over a 12-month period exceeds 50% of the replacement cost are analogous to the concept of replacement of an entirety (CAxxxxx) and similarly act as an anti-avoidance mechanism to prevent a taxpayer fragmenting capital expenditure over a period to obtain a tax advantage.

CA 22370.

51. Replace ‘bourn’ with ‘borne’ (para 3, last sentence).

CA 23083.

52. There is a possible mis-interpretation arising from the example which should be clarified – a taxpayer cannot (as far as we are aware) claim an AIA on pre-trading expenditure incurred in one period and also trading expenditure incurred in the commencement period, even if they would have gained the AIA in two periods had they been trading in the first.

53. Add **example 3.**
Harry Ltd incurs pre-trading capital expenditure of £50,000 in the year ended 31 December 2009, commences to trade on 1 January 2010 and incurs £50,000 of expenditure in the year ended 31 December 2010. All expenditure qualifies for the normal P&M pool and the trade itself is qualifying.

54. In terms of s12, CAA 2001, the expenditure in the year ended 31 December 2009 is deemed to have been incurred on 1 January 2010. Accordingly Harry Ltd is entitled to an AIA of £50,000 and capital allowances of 20% (£10,000). Note that Harry Ltd does not obtain two AIAs of £50,000, even though it would have received an AIA in the year ended December 2009 on the expenditure in January 2009 had it been trading at the time.

CA 23084.

55. Last line on page 1. The AIA replaces the WDA – it does not ‘convert’ it. If commentary is required we suggest:

    It is to be expected that businesses will allocate the AIA against the assets that would otherwise receive the lowest rate of capital allowances (generally the 10% special rate pool).

56. General exclusion 4. Presumably the example means that Dan buys the lathe ‘for his new qualifying activity of leasing the lathe to Smithson’ as he will not directly operate the lathe under the scheme.

57. Similarly the comment on tax saving should be amended to say:
the benefit gained by accelerating allowances, or through differing tax rates payable by Dan and Smithson Plc…

CA 23087

58. Example 1 should state that Fred’s business is unincorporated.

59. S205, CAA 2001 is badly drafted in that it fails to distinguish the difference in nature between the AIA, being an allowance for total amounts spent in a

year on business assets, and the first year allowance which attaches to specific assets.

60. It seems to us that the drafting allows for a variety of interpretations and that therefore the taxpayer can adopt whichever suits his circumstances. In this example, Fred has incurred expenditure of 90% of £75,000 = £67,500. He has spent more than £50,000 so he will be allowed a full £50,000 AIA plus WDA of 20% on the remaining £17,500.

CA 23090

61. Using just the first letter of the NACE classification means that the related rule remains very broad. We hope that this will be curtailed going forward when the associated companies rules are revised as it covers far more than merely the potential mischief of fragmented businesses it seeks to prevent – sections D, G, H and J are each very wide.

62. It would be good to define premises (or link to same) on the page since it is not necessarily obvious for some sites. For example, are two floors of the same building the same premises? What about two flats in a block? Two industrial units in the same industrial park? Does it matter if they are 'terraced' in the same overall block?

63. Ideally example 2 would contrast Tracy's situation for similar locations that are, and are not, legally part of the same premises.

64. A note explaining the process for transferring the AIA around a group would be helpful. For example, we presume that some consent to surrender is required.

CA23135

65. We note that if the expenditure covers several years a considerable period may elapse before the exact figures can be determined. A better method would be to make reasonable claims based on the expected split in the first periods and then revise. Indeed, as long as the estimations are reasonable, why require a change at all?

CA 23176.

66. Outline: The first two bullets should end in '*or*'

CA 23183

67. Example 2. This should be re-written as 'details are as in example 1, except that it has a second subsidiary…

68. Currently the point (that the group relief loss deemed offset is the maximum offset possible) might be lost.

CA 23187.

69. We suggest adding a line at the bottom:

    If a tax computation is prepared and accompanies the submitted return, the claim should be included within the computation.

70. There should also be a link to whatever source states when a ‘relevant certificate’ will be required.

CA23188

71. Bullet two, we suggest adding a line:

    Provisional payment would be expected where the enquiry was not expected to invalidate the claim (for example where the company has excessive losses, the enquiry is advanced and approaching closure with any amendments known, the enquiry is protective and made to allow consequential amendments only) or where withholding payment would cause hardship.

CA 23189

72. We presume that the comment that the assessment is made under schedule D case VI is simply because HMRC feels it needs to make a new assessment? Surely the proper way to correct the position is to require the taxpayer to amend the original return, or for HMRC to do so – the original receipt was non-taxable and so too is any reduction of it. The assessment seems to imply that it is income.

73. Is the interest CTSA interest (i.e. deductible) or is it something else?

CA23190.

74. Para 1 assumes malice where none is likely. The sale of the plant would immediately crystallise a balancing charge. At best one gets a timing advantage of accelerated allowances on the existing pool.

75. We suggest rewording this paragraph to:
    Where a company claims a first-year tax credit, and subsequently sells the plant within the clawback period (see below), there is a claw-back of the tax credit. CA23189 explains the assessment procedure in such a situation.

CA23191

76. Suggest rewording the last paragraph of the first example to:
    Where a tax credit is clawed back, the loss position of the company is restored to the position that would have existed if the claim had not originally been made. So, although the tax credits…

CA26850

77. Two points regarding the assets and related value apportionments:

    1. Fixtures that do not qualify for any plant and machinery allowances will not be mentioned in most cases – they will simply be lumped in with the building.

    2. Presumably the seller removes the expenditure from the relevant pools? So for 'integral features' which were acquired before 1 April and sold after 1 April the vendor simply ignores the allocation?

CA34600

78. The relevant event paragraph is written in a very confused manner. As it is obsolete for transactions after 1 April the poor wording is not a major issue. A more useful description could be *'sells all or part of a building on which industrial building allowances have been claimed where the building is less than 25 years old (50 yrs if the qualifying expenditure was incurred before 6 November 1962)'*

79. Page 2.The first para is somewhat odd. We suggest:
    The legislation on balancing events only applies to industrial buildings which are under 25 years old (50 yrs if the qualifying expenditure was incurred before 6 November 1962).

80. The second para should be higher up – or have a subheading – it is not part of the 'No relevant event' text.

81. Page 3. 'EZ' is used without being defined – the reference to Enterprise Zone at the bottom of the relevant event text on page 1 should be followed by the abbreviation.

Anti Avoidance.

82. Add a paragraph.
    When considering one of the main purposes of the sale you should consider the taxes incurred as a result of the sale (i.e. SDLT) and compare them to the tax saving (i.e. the additional IBAs available of up to 4% of the original cost of the building).

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ANNEX 1

WHO WE ARE

1. The Institute of Chartered Accountants in England & Wales is a professional body representing some 128,000 members. The Institute operates under a Royal Charter with an obligation to act in the public interest. It is regulated by the Department of Trade and Industry through the Accountancy Foundation. Its primary objectives are to educate and train Chartered Accountants, to maintain high standards for professional conduct among members, to provide services to its members and students, and to advance the theory and practice of accountancy (which includes taxation).

2. The Tax Faculty is the centre for excellence and an authoritative voice for the Institute on taxation matters. It is responsible for tax representations on behalf of the Institute as a whole and it also provides services to more than 11,000 Faculty members who pay an additional subscription.

3. Further information is available on the ICAEW Tax Faculty website at www.icaew.com/taxfac or telephone 020 7920 8646.

ANNEX 2

THE TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. **Statutory:** tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.

2. **Certain:** in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.

3. **Simple:** the tax rules should aim to be simple, understandable and clear in their objectives.

4. **Easy to collect and to calculate:** a person's tax liability should be easy to calculate and straightforward and cheap to collect.

5. **Properly targeted:** when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.

6. **Constant:** Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.

7. **Subject to proper consultation:** other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.

8. **Regularly reviewed:** the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.

9. **Fair and reasonable:** the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.

10. **Competitive:** tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in C 1999 as TAXGUIDE 4/99, see* http://www.icaew.co.uk/index.cfm?route=128518*.