



# Capital Allowances

## General application of CA's to commercial real-estate & FA2012 Changes

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### INTRODUCTION

Capital allowances afford businesses tax relief for expenditure on plant and machinery (P&M), fixtures & fittings and integral features that are used within the business. This can include items such as trade related machinery, vehicles and fixtures.

Wide sweeping reforms have been introduced to enforce the correct protocols when a building changes hands. Anyone who owns or is involved in commercial property needs to be aware of the implications of these changes.

### CAPITAL ALLOWANCES IN COMMERCIAL REAL ESTATE

Allowances on systems endemic to a building are often overlooked as their value forms part of a purchase consideration. This means that most property owners are only claiming the tip of the iceberg, while the majority of the value remains hidden from them.

What can be claimed will vary from building to building and between different industries. A claim would typically include systems like the heating, security, general power, fire alarms and even the carpets! The purchase price paid for a property is deemed to have contained an amount for the plant & machinery and integral features present in the building at that time.

To accurately value and claim these items requires a fusion of tax and surveying expertise. These claims can often equate to a substantial percentage of the value of a freehold.



## ANNUAL INVESTMENT ALLOWANCE (AIA):

The AIA allows businesses (including property rental businesses) to claim a 100% deduction against taxable profits on a proportion of their expenditure in a year.

Before Christmas (2012) this was set at £25k. In his autumn statement the Chancellor increased the AIA to £250k, effective from 1st Jan 2013, for two years.

The AIA can be allocated as the tax payer wishes. For larger projects it is normally best utilised against expenditure that qualifies for the lower 8% WDA. This offers a fantastic opportunity for tax relief to be accelerated on new expenditure.

Accurately assessing qualifying items and processing an effective claim will in many cases form the basis of a substantial write-off against the profits of your clients' businesses, resulting in a lower tax charge or in some cases a cash rebate for previous years. Due to the complexities of valuing and claiming in a compliant manner, the majority of businesses are thought to be under claiming their rightful capital allowances.

Calculating a fair and reasonable apportionment of the original purchase consideration [s562 CAA 2001] can sometimes deliver claims for as much as 35% of the value of a freehold i.e. £350K of tax relief for a building bought for £1m.

Combining a fusion of tax and surveying expertise STax is able to quantify and process historic claims on the funds already expended, in a fully compliant manner accepted by HMRC and advocated by the Office of Valuation.

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## ELIGIBILITY FOR CAPITAL ALLOWANCES

To claim capital allowances the items in question need to be employed in the of the business. This covers both trades and investment businesses e.g. property letting (as long as they are run on a commercial basis).

Do bear in mind that capital allowances are used to reduce taxable profits. They are generally only ever as much benefit as the business in question is profitable. For individuals sideways loss relief is available for rental losses created by capital allowances (restriction apply see [PIM4220]).

## FA 2012 CHANGES

When a commercial building changes hands the parties should enter into a joint election to fix the transfer value of these allowances at the point of sale. For freehold transactions these are referred to as section 198 elections (s198) after the relevant part of the Capital Allowances Act (CAA[2001]) that empowers them (see section 7 for further details).

These elections are often not put in place or are implemented badly. Because of this the Treasury felt there was a risk that businesses were double claiming allowances and brought in new legislation to effectively enforce the use of these elections.

FA2012 contained additions to CAA[2001] in the form of s187A & s187B. Broadly speaking these mean that unless the transference of allowance is handled correctly, both parties (purchaser and vendor) lose and the Treasury has a net gain (in the form of allowances being permanently taken out of the system).



From April 2012 if the transfer value is not fixed on items that the vendor has claimed, then all of the capital allowances on these items are set to £0 for the purchaser and a market value disposal charge can be levied against the vendor. This is binding on future owners as well, so will almost certainly devalue the underlying asset overnight.

This legislation comprised two main components: The fixed value requirement and mandatory pooling, these I have detailed below.

#### 5.1 Fixed value requirement (effective from April 2012):

From April 2012 if a transfer value is not fixed (by s198 election or decision at tribunal) on items that the vendor has claimed, then qualifying expenditure for the purchaser will be set to NIL on these items. This is binding on future owners as well, so will almost certainly devalue the underlying asset overnight.

Furthermore, HMRC are within their rights to impose a disposal value under s196 CAA 2001 (market value at disposal in most cases) against the vendor's pool. This could result in a balancing charge to the P&L. This will effectively claw back previously given allowances leading to a potential tax charge on the vendor and of course a permanent mismatch in the treasury's favour (treasury estimates they will net £35m a year by 2016/17, you can draw your own conclusions as to where the real figure will end up).

#### 5.2 Mandatory pooling (effective from April 2012 but with 2 year delay i.e. April 2014):

After April 2014 pooling of allowances prior to sale becomes mandatory. This works in conjunction with the transfer value requirement detailed above. This means that anything not quantified, claimed and then transferred in a 100% correct manner will be lost forever.

This could result in a significant proportion of commercial buildings falling outside of capital allowances and a substantial reduction in the latent claim out there.

## **RELEVANCE TO ACCOUNTANTS/TAX ADVISERS**

### 6.1 Benefits/Risk to client

Capital allowances represent significant opportunities and risks to your clients. In even the smallest of buildings we could be talking about hundreds of thousands of pounds of tax relief. The implications for the businesses who own these properties are self-evident and if realised could assist them to grow and thrive during this age of austerity.

If your clients are buying or selling and they ignore capital allowances they are running substantial dangers. These include:

- Potentially missing out on significant amounts of unused tax relief on the property they are buying or selling.
- By failing to comply with the new legislation the full market value of previously given allowances could be clawed back by HMRC. This can result in a tax charge being issued to the vendor whilst the buyer loses all ability to claim capital allowances.
- Not putting in place a robust and thorough s198 election will leave vendors open

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to a myriad of manoeuvres by a tax savvy purchaser, which could cost them dearly.

- Tax savvy vendors often seek to impose nominal transfer values and therefore retain the tax benefit of your clients' expenditure!

Capital allowances have an easily quantifiable benefit in the hands of a tax paying purchaser. For example imagine a £10m property with £3m of transferable allowances. For a purchaser paying corporation tax at the main rate, these allowances have a total value over time of  $23\% \times £3m = £690k$  in saved tax for the new owner. By addressing this question before marketing the following benefits can be realised by taxpayers who are looking to sell a property:

- A higher sale price should be achievable
- Putting these details into the marketing material should attract more interest and potentially facilitate a quicker sale

For example, an office worth £1m with £250k of transferable allowances is clearly more attractive than an identical office with no transferable allowances.

#### 6.2 Risks to your practice:

With the new legislation having a potentially deep bite, it is paramount that taxpayers are advised correctly. If they are not, they stand to potentially lose substantial amounts and in many cases will be looking for someone to blame when their situation comes to light. But who owes the duty of care here?

As we saw in *Clarke v Iliffes Booth Bennett* [2004] a solicitor has a duty of care to understand and advise on every facet of a contract they are instructed on, regardless of what their care letter states. We would envisage that if put to test this would extend to capital allowances in a commercial conveyance.

However they will often look to shift the duty of care on to the taxpayer's accountants telling the taxpayer to speak to their accountant, this might be you. If you are providing general accounting services it is unlikely that your engagement letter covers the transference of capital allowances in a property deal. However if you do give some advice to your client, you now owe a duty of care even if you are not being paid for your input.

If you are to give advice it would be prudent to put in place a separate engagement letter and be 100% sure of what you are advising your client to do. Especially now in light of the recent *Mehjoo v Harben Barker* [2013] ruling. If in any doubt we would recommend referring to a specialist, like STax (other specialists are available) rather than risking tabling partial advice.

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## **s198 ELECTIONS**

Section 198 elections (S199 for leasehold) are joint elections that set the transfer value of capital allowances when a commercial building changes hands.

In the past making a valid robust election was crucial for vendors. Without a correctly structured election covering only the items it should or can, vendors are left in dangerous waters. Tax savvy purchasers could challenge or potentially ignore invalid elections altogether and seek to impose a transfer value that is advantageous to them.

But what makes a robust s198 election? In short a good s198 is detailed and exact.

s201 CAA[2001] states the elements that must be present.

- 1.) Parties' details: Names, tax ref
- 2.) Particulars of interest being acquired (including date of transaction)
- 3.) Information to identify the property: address and title no.
- 4.) Amounts to be transferred
- 5.) Information sufficient to identify the P&M

Generally the first four points do not cause too many issues however there is an interesting variety of ideas on what satisfies point 5. HMRC's guidance states the following "the rules work on an asset by asset basis, inspectors may accept a degree of amalgamation where it will not distort the tax computations" [HMRC CA manual para 26850].

So s198 elections should list as much detail as possible, only contain items claimed on and only amalgamate at an elementary level. You will not get penalised for having more detail than is required! Submitting a detailed election should cause no problem or great amount of extra work where a thorough analysis was conducted to substantiate the original claim.

Sweeping statements like "all plant and machinery in the building" or generic lists which cover everything that could possibly exist in a commercial building, are not sufficient and could lead to substantial problems further down the road.

Historically it has only been buyers or sellers who could gain or lose by deploying the correct strategies in this area. With the changes in the FA2012 there may be a new interested third party, HMRC.

If the fixed value requirement in the new legislation is not met within two years of a transaction then not only do buyers have a starting position of NIL but a market value disposal value can be imposed on the vendor. The difference becomes a permanent tax gain to the treasury. So whilst HMRC may have let invalid elections slide in the past there could be a new strong motivator for an inspector who takes a "proactive interpretation" of the new legislation to start rejecting these invalid documents.

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**Further information:**

Every taxpayer's situation is unique and what applies to one may not apply to another.

We would strongly advise that circumstances are looked at by us here at STax, before any decisions are made based on the availability of allowances.

**Please feel free to contact us on the details below to discuss these points further.**

Yours sincerely,

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