The good, the bad and the ugly

ALUN OLIVER and **RUPERT GUPPY** highlight the new capital allowances rules for property transactions from 1 April 2014.

The most significant changes to capital allowances since July 1996 were introduced from 1 April 2014. Contrary to the views of some doom-mongers, the good news is that taxpayers will continue to benefit from claiming capital allowances where they incur capital expenditure on an existing property. CAA 2001 entitles a purchaser to claim tax relief in respect of the proportion of the expenditure that relates to eligible assets – known collectively as fixed "plant and machinery".

Capital allowances give tax relief for property owners, occupiers and investors. There are several types of allowances, applicable to different asset categories. The principal forms, found in all commercial properties are:

- plant and machinery; and
- integral features.

There are also capital allowances for:

- short-life assets;
- long-life assets; and
- energy-efficient and water-saving assets.

Since 2011, when industrial buildings allowances (IBAs) were abolished, there has been no tax relief available on the raw building or structural components of the property: the floors, walls, roof etc.

KEY POINTS

- Capital allowances will continue to be available on second-hand property.
- Optimising capital allowances improves cash flow.
- The fixed-value, pooling and disposal value requirements.
- Failure to comply with the new rules can mean that qualifying expenditure is nil.
- Property owners and advisers should review investment properties held without claiming capital allowances.

Plant and machinery is allocated to the "main pool" and attracts writing down allowances (WDA) at 18% a year on a reducing balance basis. The "special rate pool" is for integral features and thermal insulation added to existing buildings, which attract WDAs at 8% a year – also on reducing balance basis.

Capital allowances are not given automatically, other than for real estate investment trusts (REITs) where they are deemed to have been claimed. Consequently, the taxpayer must claim the annual WDAs within their tax computation to reduce their taxable profits and ultimately the tax due. The optimisation of the available capital allowances in a building is a key factor for successful property investors and also improves a business's cash flow.

All too often, capital allowances are left unclaimed for several years. The reasons for this include: lack of awareness (by clients and their advisers); that they are seen as of little value; perceived as risky or too complicated; and a common misconception that claiming reduces the capital gains tax base cost – potentially creating future issues – which is not the case, where properties are sold on for a profit.

Although the tax legislation – the first to benefit from HMRC's "tax law rewrite" simplification project – is far from simple, good and timely advice can yield significant tax savings or avoid costly mistakes.

New fixtures rules

The bad news on current capital allowances rules came with the new fixtures rules. The tax legislation relating to fixtures within buildings was amended by FA 2012, Sch 10. This is badly drafted legislation caused by protracted consultations and ultimately HMRC's desire to stop the increase of capital allowances as properties appreciate in value. Instead of an overt and simple cap on original costs, or fixing the costs at the first purchase after the rules came into effect, the legislative draftsmen came up with CAA 2001, s 187A and s 187B and created three new requirements:

- a "fixed-value requirement";
- a "pooling requirement"; and
- a "disposal value statement requirement".

The fixed-value requirement is that the part of the price apportioned to fixtures in the building must be fixed either by:

- the seller and buyer agreeing and entering into an election under CAA 2001, s 198 at the time of the purchase or within two years; or
- applying for a determination by the First-tier Tribunal within two years of the purchase.

The pooling requirement only affects transactions since 1 April 2014, and stipulates that the seller should have "pooled" expenditure on fixtures before a property is sold. The seller should either:

- make a claim for capital allowances; or
- notify HMRC of the amount of their qualifying expenditure and add it to their pool without making any claim.

In effect, this creates the HMRC's desired "cap" on the value of allowances in perpetuity by fixing the costs to the maximum of the pooled amount.

The disposal value requirement applies where a seller who has made a claim is disposing of the property at a price below market value, or the sale involves more than one interest in land being merged (eg freehold and leasehold). The disposal value requirement is that the seller must:

- make a written statement detailing the disposal value of the capital allowances eligible assets; and
- provide the purchaser with a copy of that statement within two years of the date of sale.

These legislative changes (CAA 2001, s 187A and s 187B) initially came into force in April 2012 as "transition measures" and became fully operational from 1 April or 6 April 2014, for corporation and income tax respectively. Buried in the detail is that failure to satisfy the new pooling requirement, or the fixed value or disposal value requirements where applicable, triggers s 187A(3). This results in the new owner's (and all future owners') qualifying expenditure being deemed as nil.

Truly complex

The ugly part of the regime is that the rules are now truly complicated. And the complexity that these new fixtures rules will create on real-life property transactions will, we predict, quickly become incomprehensible, denying capital allowances to the lax, careless or ill-advised property purchaser.

The ***New Fixtures Rules*** table illustrates a few possible scenarios, but the picture could rapidly become more complex, when previous owners who may or may not have claimed allowances before invoking the 1996 capital allowances restrictions are factored in.

Furthermore, record-keeping is poor among many businesses, the main pool becoming a "bucket depository" rather than an accurate record on a property-by-property basis. There will now be a need for more transparent records to be maintained and additional notes or records to illustrate all the different expenditures during the period of ownership. One can only imagine the plethora of tax data that will now be required for future sales of any major, multi-storey, multi-tenanted office, business park or shopping centre. The newly drafted CPSE has clause 32.9 requesting details of expenditure for each asset, but only time will tell whether any parties to new transactions will see this as appropriate, fair or reasonable. We suspect not.

Will landlords have captured their historic purchase/development costs, contributions to tenants, subsequent refurbishments, or fit-outs? In our experience, not if the current standard of transaction due diligence is a reliable barometer of market practice.

The resulting "dog's dinner" will have three potential outcomes.

NEW FIXTURES RULES

CAA 2001, s 187A and FA 2012, Sch10. Changed colour signifies change of ownership.

		1/6 April 2012	1/6 April 2014
1	Investor owner – claim made	Purchased by investor "Fixed value requirement" applies s 198 possible (recommended) or First-tier Tribunal referral	
2	Investor owner – no claim made	Purchase by investor = s 562 apportionment purchase claim – s 198 not applicable	
3	Charity/pension/ developer owner – unable to claim	Purchased by investor = s 562 apportionment purchase claim – obtain statement from prior owner(s)	
4	Investor owner – no claim made	Investor purchases – no claim made, not pooled	Future owners – allowances nil
5	Investor owner – no claim made	Investor purchases – no claim made but allowances 'pooled'	Future owners – claim avaibable on s 562 as pooled
6	Investor owner – claim made	Charity/pension/developer purchases – no claim made but s 198 possible or fixed/disposal value agreed	Future owners – claim available on s 562 – pooled or historic s 198 cap?
7	Investor owner – no claim made	Investor purchases – no claim made, pooled	Charity/pension – no pooling requirement but data for future owners

1/6 April 2012 — 1/6 April 2014 →

- An urgent future need for HMRC and/or the government to radically overhaul these oppressive rules to create a simpler solution.
- Wave upon wave of litigation as disappointed taxpayers seek retribution from their advisers (solicitors, accountants or surveyors) whom they hold responsible for their loss of capital allowances tax relief on their purchases. Advisers should be especially wary of this in light of the findings in *Clarke v Iliffes Booth Bennett* [2004] EWHC 1731. This required the solicitor to "understand important aspects of the transaction" and advise clients appropriately. Potentially subject to further litigation, *Mehjoo v Harben Barker* [2014] EWCA Civ 358 may also be relevant.
- A system which becomes so complex that, over time, it simply becomes uneconomical for taxpayers to bother claiming capital allowances on all but the newest or most expensive of properties.

1996 RULES – CAPITAL ALLOWANCES

Changed colour signifies change of ownership – before or after 24 July 2006.

24 July 1996

1	Investor purchases – no claim made		Purchased by investor = unrestricted claim s 562	
2	Pension fund purchases – no claim – non-taxpayer		Purchase by investor = unrestricted claim s 562	
3	Investor purchases – claim made		Purchased by investor = restricted claim to vendor disposal value – s 185 or s 198 election	
4	Investor purchases – claim made	Pension purchases – no claim	Purchased by investor = unrestricted claim s 562	
5	Investor purchases – claim made	Pension purchases – no claim	Purchased by investor = unrestricted claim s 562	
6	Investor purchases – claim made		Pension purchases – no chain	Purchased by investor = restricted claim to investor disposal value – s 185 or s 198

24 July 1996 →

How did we get here?

Before April 2012, three common scenarios arose when a second-hand property was sold. First, it was possible for the seller and buyer to deal with capital allowances by making a joint election under CAA 2001, s 198. Typically this is referred to as a "section 198 election". However, this presumes that the vendor has claimed the capital allowances. Some vendors (and/or their conveyancing solicitors) mistakenly request s 198 to be entered into by the parties when they come to dispose of a property. But it is only possible for a valid s 198 election to be made if the seller has actually claimed capital allowances during their ownership. Any such election fixes the portion of the sale/purchase price corresponding to the fixtures in the property qualifying for capital allowances.

Second, the property could be sold with the vendor's commercial property standard enquiries (CPSEs) confirming that no capital allowances claims had been made. In this case, the purchaser should make an unrestricted claim based on a just and reasonable apportionment of the purchase price as set out in CAA 2001, s 562 between land, non-qualifying elements and assets eligible for capital allowances. Such a claim would typically be undertaken by specialist capital allowances surveyors using long-established valuation techniques.

Finally, the sale contract could be silent on capital allowances, making no mention of prior claims. This required purchasers to backtrack the historic ownership to confirm the existence of any claims made since 24 July 1996, before being able to make a valid claim themselves.

Section 198 elections

This is clearly HMRC's preferred (and expected) method of complying with the new requirements. However, it is worth noting that where the parties opt to enter a s 198 election, it must be in the correct form as set out by CAA 2001, s 201 and contain sufficient detail to recognise all the relevant plant and machinery fixtures. If this is not done it might not be considered to be a valid election. We see far too many elections that fail to set out all the assets that they relate to, or elections that are not properly completed in the correct timeframe.

The vendor could suffer a tax clawback if the transaction is found to have an invalid election, although suitable contract wording or warranties may help to protect the vendor if pursuing a different amount of capital allowances might put the purchaser in breach of contract. Once made, a valid election is irrevocable and binding upon the parties, as well as HMRC, so long as no tax abuse is involved.

One of the opportunities around s 198 elections is that, for properties held since before the introduction of integral features (April 2008), purchasers may still be able to claim capital allowances over and above the election figure in respect of assets that did not previously qualify.

Elections under s 198 replaced elections under CAA 1990, s 59B which came into effect from 24 July 1996. Before this, many taxpayers relied on allocations to fixed plant and machinery within the purchase contract. However, HMRC found these largely unsatisfactory, hence the election mechanism was introduced in FA 1997, Sch 16.

At the same time as introducing a formalised election, the Labour government of the time introduced restrictions to prevent claims being constantly re-generated (then in an upwardly moving property market). Accordingly, and if applicable, where a second-hand property is purchased, there is still an obligation to track the tax history of fixtures and fittings back to 24 July 1996 to ensure that a valid claim can be made after satisfying the new requirements. See ***1996 Rules – Capital Allowances***.

Although the amount of the election is open to negotiation, it is typically in the seller's interest to apportion a nominal amount, say £2, to fixtures, being £1 to those in the main pool and £1 to the fixtures in the special rate pool. So long as they are not ceasing to trade, this would accelerate the retained pool of allowances into a balancing allowance; however, it would be seen as abusive by HMRC.

The buyer, on the other hand is likely to want to negotiate a figure as close to the tax written down value or even the full quantum of qualifying expenditure as possible. As a result, the election figure is often influenced by the parties' respective tax positions and commercial objectives.

The full force of these changes will have an impact on all property sales from April 2014. It will no longer be acceptable to keep the sale contract silent on capital allowances. Historically, this may have kept the options open but would now most likely deny all allowances, not only for the next purchaser but also for all future purchasers of the property.

While, technically, these requirements can be agreed up to two years from a transaction, experience from the market place on s 198 elections leads us to conclude that vendors will be reluctant to be helpful after the sale has completed – unless there is a clear contractual obligation to co-operate.

Due diligence

Purchasers (especially those that actively engage capital allowances advisers) will no longer accept the old generic responses to CPSEs of "not applicable", "none available", "info to follow" etc.

Arguably, the points below have previously been part of the optimum capital allowances due diligence for purchasers but should now become the base level of project data to support the availability of capital allowances for the purchaser and future owners.

- Details of the seller's capital allowances claims history on every asset within the property.
- Details of the capital allowances history of any prior owners.
- Details of any capital contributions made to tenants, or received by freeholders.
- Extracts from the seller's tax returns or, more likely, written confirmation of the pooled amount, relevant to the property.

From April 2014, sellers will need to pool their fixtures expenditure (even where they have not, nor do not wish to claim allowances themselves) unless they are prepared to risk the price of their property being chipped down in recognition that no allowances will be available.

Ideally, sellers should budget for obtaining capital allowances advice well in advance of disposing of the property. To avoid unnecessary costs, confusion, delays or jeopardising the whole transaction, prudent sellers should collate all the relevant capital allowances information and have their capital allowances adviser liaise with their solicitor to ensure the position is included within the draft heads of terms for the sale of their property. The capital allowances position should be reflected within the agent's marketing particulars and become a selling point for the property. After-tax yields can be increased by incorporating capital allowances benefits so capital allowances particulars should not be perceived as being of little value or simply a nuisance. CPSEs clause 32.10 now requests details of the vendor's capital allowances adviser – illustrating the importance of dealing with these points correctly.

Points to ponder

Where the buyer is tax-exempt or cannot claim capital allowances themselves, they would be foolish not to consider the future capital allowances position because details would become necessary for a future sale. If they do not do this, any subsequent purchaser of the property may find that the available allowances are nil, which in turn might affect their chances of selling on the property or the price they obtain for it.

In situations where a seller has not claimed and is happy for the capital allowances to pass to the buyer, the seller will be required not only to pool the expenditure but also make a corresponding notional disposal from the pool to reflect the allowances that pass to the buyer on completion.

The requirement for a seller to value the plant and machinery/integral features within the property, regardless of whether they have any interest in claiming capital allowances, raises the possibility of values that are inaccurate or fail to reflect the full extent of the assets within the property. One concern is the lack of any legislative mechanism for challenging the pooled amount, particularly if an arbitrary amount has been used.

It is also possible – where the capital allowances are more important to the purchaser than the seller – that the purchaser may be the one to meet the fee costs in preparing a "just apportionment" claim figure for the seller to include in their capital allowances pool.

Most taxpayers or their accountants have, for too long, been complacent about claiming the capital allowances to which they are entitled. These changes should encourage all property owners to instigate a review of any investment properties held without claiming capital allowances and, in particular, the positions on properties likely to be sold over the next few months/years.

It can be acceptable for vendors not to claim, but only where this is a conscious decision. They should be aware that this could lead to a reduction in sale price or a more limited demand for the property when it comes up for sale.

Final warning

The failure of tax advisers, lawyers or surveyors to highlight the importance of these "requirements" and their impact on capital allowances or to address these matters early enough at the appropriate time will, in our view, lead to significant increases in litigation for negligent advice.

Those taxpayers (and senor accounting officers) who take the time to get organised, putting in place systems to retain the relevant records of their properties, will continue to enjoy capital allowances tax savings. They will also ensure that the capital allowances are either retained by them, through using the s 198 election mechanism, or are passed on safely to a new purchaser by having been pooled and so not "wiped out" to nil by s 187A(3).

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