



Office of Tax Simplification (OTS) Review of tax reliefs Final report March 2011 – capital allowances implications.

The Final report by the OTS as part of its review of all the tax reliefs, allowances and exemptions contained within the UK's tax system was delivered on 3 March 2011. Of the 155 reliefs looked at in the Final report, 13 related to capital allowances and the impact of these is considered below.

Background

The OTS was launched in July 2010 to provide the Government with independent advice on simplifying the UK tax system and one of the two initial reviews announced was a review of all tax reliefs. The first step in this review saw the publication on 8 November 2010 by the OTS of a complete list of tax reliefs, which amounted to 1,042 in total, and the criteria that would be used for future reports. The second step saw the release of the interim report on 13 December 2010, which was designed to test whether the methodology and criteria adopted would produce sensible results and identify those reliefs which should be repealed or simplified to support the Government's overall objective of a simpler tax system for the UK.

The Final report presented on 3 March 2011, looks in detail at 155 of the 1,042 reliefs originally identified and the recommendation is that 54 remain unchanged, 37 be looked at in more detail, and 47 be abolished as they are either time expired, have no ongoing policy rationale, have negligible value, or the benefit is outweighed by administrative burden. The final 17 are recommended for simplification. The report will go to the Chancellor of the Exchequer where it is expected that a formal response is to be included in Budget 2011 with any amendments being included in Finance Bill 2012 at the earliest.



The criteria used by the OTS in its review as set out in the Final report is:

- Whether the policy rationale for the reliefs is still valid and whether it remains the optimal method to achieve the policy objective, given other potential Government interventions;
- Evaluation of whether there is currently a policy rationale for the relief;
- The likely impact of changing or repealing the relief or exemption;
- Evidence of taxpayer take-up and awareness of the reliefs;
- Evidence of complexity, compliance costs and administrative burdens in claiming the reliefs; and
- Evidence of the impact the reliefs have on taxpayer behaviour.

Capital allowances in the Final report

Of the 155 reliefs considered in the final report, 13 related to capital allowances, with the recommendation that 7 be retained, 3 be simplified and 3 be abolished as shown in the table below:

Retain	Abolish	Simplify
Short life assets	Business premises renovation allowance	Annual investment allowance (AIA)
100% first year allowance for cars with low CO2 emissions	Flat conversion allowances	Enhanced capital allowances for energy and water efficient technologies
Mineral extraction allowances	Capital allowances – safety at sports grounds	Research and development allowances
Dredging allowances		
Ships		
First year allowances in ring fenced oil trades		
Capital allowances – mining and oil industries		



Capital allowances to retain

- **Short life assets (SLA)** – Whilst the AIA ensures most businesses need not consider SLAs, they are still important for many businesses and evidence was found of the popularity of the relief as it enables a business to obtain tax relief more in line with commercial depreciation of assets with a short life.
- **100% first year allowance for cars with low CO2 emissions** – It was considered that the validity and achievement of the policy rationale together with the simple operation meant this allowance should be retained, although a lowering of the qualifying criteria was suggested to encourage further use and development.
- **Mineral extraction allowances** – The greater administrative burden than for normal capital allowances was outweighed by the effectiveness of the relief for relevant companies.
- **Dredging allowances** – Retained to recognise that dredging activities are necessary to the UK's water and maritime transport infrastructure.
- **Ships** – Although the tonnage tax regime has impacted the relief, its flexibility is seen as important for the shipping industry and it is not a complex relief.
- **First year allowances in ring fenced oil trades** – It is a simple system with a valid policy rationale that only provides a timing difference to the claiming of the relief.
- **Capital allowances for mining and oil industries** – Retained to continue not to disadvantage those businesses in these industries that have to incur large up-front costs prior to being treated as commencing a trade.

Capital allowances to abolish

- **Business premises renovation allowance** – Finally introduced in 2007 it was designed to enable physical and social regeneration in deprived areas and was considered a better form of incentive than grants to deliver its goal. Whilst it was accepted that the policy rationale remained valid, whether it was achieving the desired aim was questioned and HM Revenue & Customs (HMRC) had estimated its fiscal value at £20million, a relatively modest level. Therefore it was decided that the relief should be abolished once its five year period comes to an end in April 2012.



- **Flat conversion allowances** – Since their introduction back in 2001 as part of a raft of regeneration measures, their use has been lower than expected and given that they only represent a timing difference, they are not considered as having an influence on whether projects are actually undertaken where applicable. The detailed nature and number of conditions needed to be met to fall within the scheme make it complex and provide a higher burden than the benefit it provides. On that basis the recommendation is that the relief is abolished.
- **Safety at sports grounds** – Since it was introduced in 1975, the use of the relief has been widespread across all sports especially with the significant development in stadia and facilities in the last twenty or so years following the Hillsborough disaster in 1989. The OTS's assessment of the relief does not appear to be well informed and seems to display a lack of understanding of how the legislation regarding the issue of safety certificates by Local Authorities. A key element in the OTS's reasoning for recommending abolition of the relief is that it does not apply to new stadia. How they came to this decision is not given and certainly a read of the capital allowances legislation does not appear to support this contention, and it is also known that there is opinion from Tax Counsel which backs this view. It is however, the view of HMRC that the relief cannot be applied to new stadia. The decision to include it under those reliefs recommended to be abolished is not a surprise given HMRC's view and could enable HMRC to reach an agreement on some outstanding cases knowing that there would be no precedent set going forward. The impact of its abolition would be felt throughout sport as there are a number of projects, especially at the lower levels, which are planned where this could make a considerable difference.

Capital allowances to simplify

- **Annual investment allowance (AIA)** – The AIA was introduced in 2008 and replaced the system of first year allowances. Originally set at £50,000 per annum (increased to £100,000 from April 2010 and to be reduced to £25,000 from April 2012) it has been of significant benefit to small businesses and even with its reduction to £25,000, HMRC still estimate it will cover all the qualifying expenditure of 95% of UK businesses. Although the AIA does

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appear to add complexity and increase compliance and administrative burden costs where groups of companies are involved, it is widely used, although it was reported to the OTS that the changing of the limits has made the calculations more complex, especially for businesses whose year end is not aligned to the fiscal year. Although the relief is recommended to be retained it has been placed on the simplification list with the recommendation that the limit remain unchanged for a number of years to give taxpayers certainty and simplification. The OTS intends to make further comments on the AIA in their Small Business Report.

- **Enhanced capital allowances (ECA) for energy and water efficient technologies** – The ability to claim 100% first year allowances on ECA qualifying assets, or from 2008 take a payable tax credit for loss making situations is seen as one element in enabling the Government to allow businesses to ensure the UK meets its commitment to reduce carbon levels up to 2050. However, as the OTS Interim report stated and backed up by further evidence as part of the Final report, the feeling is that the ECA system has had minimal impact on investment decisions, the listing of assets in the scheme is too bureaucratic, expensive and time consuming and its usefulness is primarily reserved for larger businesses. Therefore the recommendation is that the relief is simplified and the OTS has put forward the following suggestions for what the new system could look like:
 - A system that looks at energy efficiency of a whole project not just individual components;
 - A 'kite mark' system to make identification of "green" assets easier;
 - Use of the A-G rating already in use for appliances to determine qualification;
 - An improvement of the search tool on the website to make it more user friendly and help in asset identification; and
 - Self certification by manufacturers.

Also, they have looked at alternative methods to achieve the same policy objectives in a simpler way, such as:

- Incentives in the form of grants for the purchase of "green equipment";



- Adaptation of schemes such as the Feed in Tariffs, Renewable Heat Incentive or the Green Deal, to assist the installation of energy-saving and water efficient technologies;
- Additional allowances for the manufacturers of "green" equipment; or
- A generally wider basis for the relief

The recommendation to simplify the scheme continues to provide an interesting debate around the usefulness of ECAs. However, with the commitment given to the reduction in carbon emission levels, some form of tax incentive must remain and the continuation of the debate over what that incentive should be is eagerly awaited.

- **Research and development allowances** – Research and development allowances (RDA) are given for expenditure on assets used for carrying out research and development (R&D) and they represent a 100% allowance. The definition of R&D is similar to that used for the R&D tax relief and represents a valuable benefit for businesses as it covers all fixed assets, apart from a few specific exclusions e.g. land. The policy rationale for this relief remains valid as encouraging innovation continues to be one of the keys aims for the tax system, plus the calculation is not complex and the administrative burden is not great. However, the relief is still recommended for simplification, though as it would appear that the issues relate to the actual definition of R&D for tax purposes which, is already subject to a separate consultation process. The OTS has not offered any thoughts on what this may entail.

Conclusions

The issue of the Final report has continued to be as informative and insightful as the Interim report was and continues the commitment to the principles of the "Tax policy making: a new approach" identified by the Government being predictability, stability, simplicity, scrutiny and transparency.

Tucked away in the report was a comment as to whether capital allowances should be replaced with tax-deductible depreciation. Whilst this question has been posed many times in the past, the feeling has always been that the capital allowances system provides the most effective way of giving tax relief for capital expenditure. The OTS

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intend to comment further on this point in their Small business report and recognise that a major study would be needed before any real conclusions could be reached, but it is interesting that the question has been raised again, especially in the light of the manifesto position the Conservatives took prior to the 2010 general election where it was thought that this was something they were actively considering.

In general though, the recommendations which affect capital allowances are helpful and should assist in giving businesses that stable platform from which to make their future decisions.

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