



Office of Tax Simplification (OTS) Small business tax review March 2011 – capital allowances implications.

Following on from its final report on tax reliefs, on 10 March 2011 the OTS delivered its interim report on the review of small business taxation. Certain capital allowances measures were examined in the report and the impact of these is considered below.

Background

Alongside the main part of the OTS's work in looking at the UK tax system as a whole, it was also asked to report to the Chancellor in advance of Budget 2011 on areas of complexity and uncertainty for small businesses and to recommend priority areas for simplification.

Its focus was on the 95% of UK businesses that have less than 10 employees. The OTS concluded that major structural changes would be needed to the UK tax system if genuine and long lasting simplification is to be achieved and this would involve a lengthy process. It therefore suggested some changes be introduced relatively quickly to ease the burden of taxation on small business, one of which involved improvements to the existing capital allowances regime.

The OTS expects the Chancellor to respond to the report as part of Budget 2011 and to set the work programme and timetable for the final report.

The brief for the OTS was to be broadly 'revenue neutral' in its recommendations and in its terms of reference it was asked to:

- Set out areas of the tax system that cause the most day-to-day complexity and uncertainty for small business;
- Recommend priority areas for simplification; and
- Consider the impact of ideas for simplification on different business sectors, including large business.



Capital allowances issues in report

Improvements to the existing capital allowances regime was one of the priority areas that the OTS felt could be implemented on a shorter timescale than that needed for areas of structural reform.

The calculation of capital allowances was raised with the OTS as an area of complexity and that allowing depreciation to be deductible for tax purposes for small businesses would be a simpler method in giving tax relief for capital expenditure. However, the OTS considered that many small businesses to which this could apply do not routinely prepare financial statements showing depreciation in sufficient detail to make this viable as they rarely produce a detailed balance sheet. Also, the feedback the OTS received from its roadshow meetings was that capital allowances do not pose a significant problem and, rather obviously, businesses would not accept this change if it was to result in a greater tax liability.

In addition, it is considered that the Annual Investment Allowance (AIA) enables the majority of small businesses to benefit from 100% relief for the acquisition of capital assets. However, with the reduction of the AIA from £100,000 to £25,000 from April 2012, concerns were raised over the occasional purchases of single large assets which exceed £25,000 and so result in part of the AIA being wasted.

Whilst the OTS accepted that the regular nature of changes in capital allowances rates in recent years has caused some problems in their calculation, they do not see this as a significant issue, as the AIA and tax software has largely negated any potential issues, despite the suggestion to the contrary by some businesses.

One unfairness the OTS did comment on was the fact that, whilst capital allowances rates have changed for both incorporated and unincorporated businesses, companies have benefited through a reduction in corporation tax rates, but there has been no corresponding reduction for unincorporated businesses which are much larger in terms of numbers. Although this was essentially a policy rather than a simplification issue, the OTS felt bound to mention it in their report.



The OTS has therefore recommended that a move to tax relief for depreciation should not be pursued, but has suggested the following policy options in a move to improve the current position and help with certainty:

- Fix on a level of AIA and keep to it for a number of years;
- Consider allowing a small business to split a purchase that exceeds £25,000 over two years to enable the full amount of the AIA to be utilised; and
- Develop a process to allow a small business that acquires an interest in a building to identify quickly and agree the plant component of the building.

As well as these specific capital allowances issues, there were two other areas of the report where capital allowances feature. First, was the option of introducing a relief for disincorporation which would enable businesses to operate in the legal form which best suited their commercial needs without suffering a tax charge. The capital allowance point here would mean that capital allowances pools could be continued into the new legal form without generating a disposal event. Second, concerned the harmonisation of corporation tax rates with consideration being given to a single rate of corporation tax that would enable the associated companies rules to be abolished and the marginal relief legislation and close investment company legislation to become obsolete. This would mean either a reduction in the main rate, a rise in the small profits rate or a mix of the two. Whilst they would be costly options, the OTS see clear simplification benefits. One option considered is that an increase in the small profits rate could be balanced by an increase in the AIA (possibly restricted to smaller businesses), which would also help those unincorporated businesses which have not benefited from corporation tax reductions but have, at the same time, suffered from the reduction in the rates of capital allowances.

Conclusions

The issues raised in this Interim report will provide interesting debate around the issue of simplification of the tax system for smaller businesses which make up the majority of the landscape in the UK.

The report shows that capital allowances continue to be seen by business as an important tool in the tax system for providing tax relief for capital expenditure.



The suggestions to fix the level of the AIA for a number of years is sensible, even though the level is set to fall to only £25,000 from next April. This should still enable most small businesses to benefit from an immediate 100% relief and this, coupled with the suggestion to split the AIA over two years for major one-off purchases, is seen as positive in the overall context of simplification and certainty.

Whilst the suggestion to develop a process to enable capital allowances to be more quickly identifiable and agreed in property acquisitions would no doubt benefit small businesses, the inherent need to undertake due diligence to determine whether any restrictions to claims made by previous owners are in place may make it less workable in practice. The issue here would seem to be one of education to make businesses and their advisors aware of how to prepare the necessary claims and the use of statutory elections where appropriate and, that the use of specialist firms will speed up and provide added value to the process.

In general, the capital allowances recommendations in this Interim report would appear to be positive for small businesses and we eagerly await the findings of the Final report in due course.

If you would like to discuss any of the issues raised please contact:

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