ICAEW
REPRESENTATION 54/22

POTENTIAL REFORMS TO UKS CAPITAL ALLOWANCES REGIME

Issued 29 June 2022

ICAEW welcomes the opportunity to comment on the potential reforms to UK's capital allowances regime set out in the policy paper published by HM Treasury on 9 May 2022, a copy of which is available from here.

For questions on this response please contact our Tax Faculty at taxfac@icaew.com quoting REP 54/22.

This response of 29 June 2022 has been prepared by the ICAEW Tax Faculty. Internationally recognised as a source of expertise, the ICAEW Tax Faculty is a leading authority on taxation and is the voice of tax for ICAEW. It is responsible for making all submissions to the tax authorities on behalf of ICAEW, drawing upon the knowledge and experience of ICAEW's membership. The Tax Faculty's work is directly supported by over 130 active members, many of them well-known names in the tax world, who work across the complete spectrum of tax, both in practice and in business. ICAEW Tax Faculty's Ten Tenets for a Better Tax System, by which we benchmark the tax system and changes to it, are summarised in Appendix 1.

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KEY POINTS

1. Thank you for this opportunity to respond to the proposals set out in the policy paper published on 9 May 2022. We understand that the government is seeking input in three main areas:
   - The relative impact of capital allowances on investment decisions made by businesses
   - Views on how the super-deduction has affected the investment decisions of businesses
   - The current role that capital allowances play in supporting business investment
2. It is also asking for comments on the options set out in the Spring Statement for reform to the capital allowances regime.
3. We have attempted to focus our response on the areas requested. However, where we think there are other related points to be made, we have also included these in the relevant section of this document.
4. This response has been informed by discussions we have had with members and volunteers with particular expertise in the capital allowances regime. These members are primarily tax advisers and surveyors and whose views have been shaped by the experiences their clients have had interacting with the capital allowances system.
5. The key points arising from those discussions are set out below and expanded on in the relevant sections of this consultation response.
   - Businesses are primarily looking for certainty. This can be at least partially achieved by avoiding changing rates and rules too often.
   - The consultation is focussed solely on plant and machinery allowances but some of the most significant expenditure in large scale infrastructure projects does not qualify for these allowances, especially that relating to planning and project management. The government may wish to re-examine the rules around tax deductions for such costs. As well as creating more certainty, this could also provide more tax incentives for large scale infrastructure projects.
   - The capital allowances system primarily rewards rather than incentivises capital investment because it provides a benefit after the expenditure has been incurred. Incentivisation might be achieved more effectively by providing upfront cash incentives rather than subsequent tax relief.
   - Most larger businesses plan capital projects at least two to five years in advance. Capital allowances can only be factored into those projects if there is certainty as to how those allowances will operate over a period of at least that length.
   - Businesses considering whether to invest in infrastructure or projects in the UK, as opposed to another territory, will consider a much wider range of factors than just tax incentives.
   - Many businesses would benefit just as much from simplification of the tax system as they would from being provided with additional tax incentives.
   - If the government wishes to incentivise capital investment, it would be most effective if incentives were focused on particular types of expenditure, industry sectors or geographical areas.

INVESTMENT DECISIONS

6. The government has sought evidence on how businesses make investment decisions and the relative impact of capital allowances in making those decisions.

Business decision making

7. The feedback we have received from our members is that different businesses have different processes for making investment decisions. Larger businesses in particular have a number of different departments involved in implementing their most significant projects. In many

cases, decisions will be based on the needs of the business at the time and it is often only subsequently that the financial impact of any relevant decisions is analysed.

8. Even if the business' tax or finance function is involved in discussions at the project planning stage, the capital allowances impact will often only be considered at a high level, using indicative numbers to model the position. Hence, exact rates and timing of allowances generally do not have much of an impact on whether or not a project goes ahead or the type of expenditure involved in it.

International investment decisions

9. If a multinational business is deciding whether to relocate to the UK or set up a UK operation, it is unlikely that the capital allowances system will be a deciding factor in this. Other factors such as the availability of grants, payroll taxes and a suitable workforce in the location of choice are likely to be much more important.
10. By contrast, if a large business is deciding where to locate its R&D activities, the availability of the Research & Development Expenditure Credit (RDEC) is likely to be more of a determining factor. This is largely because the credit is given 'above the tax line' in the business' accounts and hence the department responsible for making such investment decisions gets appropriate credit for those decisions.
11. The scheme gives approximately 11p back in tax credits to the business for every £1 it spends on eligible R&D expenditure. This means that the business can spend an extra 11% more on its R&D in the UK than if the credit didn't exist. The government may wish to consider introducing a tax credit system inspired by the RDEC to incentivise certain types of capital expenditure it would like to encourage.

The ever-changing capital allowances regime

12. Capital allowances rules and rates have changed frequently over the past 14 years. The annual investment allowance limit (AIA), for example, has changed six times over that period and is planned to change again next year when it returns to its permanent rate. Similarly, the rates of writing down allowances in both the main rate and the special rate pool have changed and various incentives providing 100% allowances have come and gone. A degree of stability in the system would allow businesses to take investment decisions with a greater degree of certainty.

Re-examine the tax rules around what constitutes plant and machinery

13. One of the major difficulties businesses face in implementing large scale infrastructure projects (especially those involving installation of environmentally friendly technologies, like offshore wind farms) is the uncertainty around what items of expenditure qualify for capital allowances.
14. A particular case in point is the recent case of Gunfleet Sands Ltd & Others v HMRC [2022] UKFTT 35 (TC). In this case it was found that a large proportion of the overall cost, including those related to feasibility studies and project management, did not qualify for P&M allowances. As the expenditure was considered to be capital in nature, it also didn't qualify for a revenue deduction. This case pre-dates the introduction of structures and buildings allowances (SBAs) but even if that regime had been in force at the time, this expenditure would not have qualified for SBAs either because it didn't form part of the cost of construction.
15. To incentivise these forms of expenditure, the government should look to examine the tax rules again and provide some form of capital allowances for expenditure on capital infrastructure projects that fails to attract a revenue deduction. This might constitute a whole new area of the capital allowances code (eg 'project management allowances') and a writing down allowances rate could be set at a rate that the government finds affordable.

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Focus on the accounting profit rather than tax cashflow

16. However, even with a stable tax system, the focus of many businesses is on the profit before tax figure rather than their after-tax profit position. Even if the overall tax charge is taken into account and the focus is shifted to the profit after tax figure, the current tax charge may not have a significant impact on decision making because deferred tax liabilities need to be recognised if writing down allowances are given more quickly than accounting depreciation. Hence, the overall impact of a change in capital allowances rates to the tax line would be nil.

Upfront allowances and grants

17. If the government wishes to incentivise capital investment through the tax regime, then it would be more effective to focus on incentives that provide an upfront cash benefit to businesses.
18. Small and medium sized businesses do not pay corporation tax until 9 months after the end of the accounting period, which could be quite some time until after the expenditure was incurred. Even those companies falling under the quarterly payments regime will largely need to wait for the tax cash benefit of allowances. Loss making companies may never see the benefit because they have no profit to deduct the allowances from.
19. It is worth stressing that, at least in theory, the premise behind the capital allowances regime is to provide relief for the depreciation of an asset between the date it is acquired and the date it is sold or scrapped by the business (acquisition price minus proceeds), rather than the expenditure itself. This is even true of the super deduction whereby the proceeds from the disposal of an asset falling under the regime need to be uplifted in certain circumstances to reflect the initial 30% additional deduction. A regime that was focussed more on providing an incentive for the gross expenditure incurred (ignoring disposal receipts) would be more impactful.
20. There are also issues around incurring expenditure subject to a contract. In those cases, the expenditure is not treated as incurred until both parties have performed their obligations under the contract. If a business pays a deposit for an item of plant and machinery, no allowances are available for this until the business pays the total amount due in full. Hence, if an asset is paid for over multiple transactions that span more than one accounting period, there can be a further delay in obtaining the associated allowances.
21. Examples of incentives the government may wish to consider are set out below:
    - Upfront grants and subsidies for particular types of expenditure the government is wishing to encourage. Given that grants are generally taxable, the government would get some of the cost back over time in increased tax receipts.
    - An ability for loss-making companies to surrender allowances for a repayable tax credit, similar to that provided under the SME R&D tax relief regime
    - In-year payable allowances for qualifying expenditure (assessed through a form of advance assurance procedure) which could then be adjusted for when the business' tax return is submitted.

Focus on the who, what and where

22. One of the limitations of the capital allowances system in encouraging investment is its lack of targeting. Some specific incentives remain (such as enhanced allowances for expenditure on electric vehicles) but many of the initiatives that had been in place over recent years have now been repealed.
23. By providing specific allowances for specific types of expenditure, the government could nudge businesses into investment behaviour that helps to meet its strategic policy objectives, such as its net zero targets and the levelling up agenda. Targeted allowances would also be more cost-effective than a blanket increase in writing down allowances, for example, which would cost billions of pounds and may not actually incentivise investment.
24. We believe it is useful to think about this in terms of who, what and where.

Who?

25. Are there any particular industries that the government is looking to support in making capital investment? Now that the UK has left the EU, there may be more scope for providing incentives that might previously have been prohibited under state aid rules. The government could use existing standard industrial classification (SIC) codes to distinguish which types of business are entitled to which types of allowances.
26. Is the government looking to incentivise large multinationals, small businesses or somewhere in between? Each size sector will be influenced by different policies which makes it difficult to apply a one-size-fits-all approach which might cost a lot of money for little return. Focussing on one particular sector and designing policies that would encourage that particular sector could be a more cost-effective approach.

What?

27. Does the government wish to encourage expenditure on particular types of assets? For example, to what extent is the government interested in using the capital allowances regime to encourage progression to net zero by 2050? Since the repeal of the Enhanced Capital Allowances (ECA) regime, there is no longer a comprehensive mechanism for encouraging investment in energy-efficient plant and machinery, which seems to be at odds with the government's carbon reduction targets.
28. The ECA regime had its flaws. For example, it was notoriously difficult to use the list of equipment to determine whether particular items qualified for the relief. However, it should be possible to learn from this experience to design something that is easier for HMRC, businesses and advisers to use.
29. The government may also wish to incentivise the acquisition of refurbished assets, given that the repair of existing assets rather than the manufacture of new ones is likely to be more environmentally friendly. The exclusion of second-hand assets from the super deduction was curious at a time when the government might wish to encourage cost-effective investment.
30. Similarly, the government may wish to use the capital allowances regime to encourage development of advanced technologies as a way of driving up productivity, particularly in the manufacturing sector. It could take inspiration from the Italian government's advanced manufacturing incentives plan (Piano Transizione 4.0) which allocates Euros 13.4bn in tax credits for investment in advanced manufacturing technologies.
31. Other areas where the government may wish to provide more targeted relief include:
    a) Use of brown field sites
    b) Special incentives for ailing high street retailers
    c) Support to the private rented sector

Where?

32. The government may wish to support its levelling up agenda by providing more generous allowances to businesses operating in particular geographical areas, similar to the enterprise zone system of the 1980s. The government has already shown that it is willing to take a similar approach with the introduction of freeports and the availability of 100% first year allowances in tax zones. If the Government wishes to encourage investment in the North and the Midlands, for example, capital allowances remain another tool which is available.
33. More power could also be given to local authorities and government bodies to issue grants on a regional basis. Such bodies may be in a better position to assess the impact on the local economy of investment-based incentives than central government.

IMPACT OF THE SUPER DEDUCTION

34. From the discussions we have had with members, we have gathered very little evidence of the super deduction having a meaningful impact on business investment decisions. One of

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the reasons for this is that the super deduction has only been in place for a little over a year and was always only intended to be in place for two years. As set out above, larger businesses tend to make investment plans at least two to five years in advance and hence any major expenditure that has benefitted from the 130% deduction is likely to have been planned a number of years ago.

35. If the government wishes to incentivise investment through a particular allowance, it should provide reassurance that the allowance will be available for at least five to seven years so that businesses can factor this into its strategic financial modelling.
36. Another limitation of the super-deduction is that it only applies to companies. We understand the reasons for this but consider that if a similarly generous allowance is introduced in the future, it should be made available to both incorporated and unincorporated businesses.

CURRENT IMPACT OF THE CAPITAL ALLOWANCES SYSTEM

37. Not all entities that purchase plant and machinery are subject to the capital allowances rules. For example, a large number of commercial properties are owned by real estate investment trusts (REITs) which are not subject to the corporation tax regime. Therefore, a focus on capital allowances already excludes a proportion of decision makers that might otherwise be impacted by other incentives (eg grants) to encourage investment.
38. The most significant infrastructure projects in the UK are also generally carried out by organisations that are regulated by the government (eg energy, water and oil companies). If the intention is to incentivise organisations in these sectors, the government has other ways of encouraging investment than the tax system that it may wish to consider.

Lack of certainty

39. Above all else, businesses appreciate certainty in making investment decisions. Constant changes to the capital allowances rules creates uncertainty in the financial impact of investment decisions. The vast majority of comments received from our members related to the frequency of change. We recommend making as few changes to the capital allowances system as possible, and that any changes should be announced a few years in advance.
40. There has been a perception by successive governments that a change in rates or allowances will affect business investment decisions. While this is partly true, the changes are most likely to impact the timing of the related expenditure, rather than the quantum of that expenditure. For example, if an increase in writing down allowances is announced then businesses will be encouraged to defer planned expenditure until the increased allowances come into force. That expenditure would have happened anyway, but it has now become more expensive for the government to reward it. This is the reason why businesses will always welcome increased rates but those increases are unlikely to have a significant impact on their overall investment plans.

Anti-avoidance rules

41. One of the biggest challenges in introducing a genuine incentive to invest in capital is that it brings into question whether the expenditure has been incurred wholly and exclusively for the purposes of the business (given that, by definition, at least one of the reasons for incurring the expenditure would have been to obtain the associated tax allowance).
42. One of the challenges that the business premises renovation allowance and similarly generous regimes faced in the past was that they needed to be disclosed under the Disclosure of Tax Avoidance Scheme (DOTAS) rules where external investors were enticed in by the relatively risk-free nature of the investment due to the availability of the allowance. This tended to discourage some would-be participants from investing because they didn’t want to disclose a DOTAS number on their tax returns even though, in many cases, HMRC would have no intention of enquiring into these schemes.

43. If the government wanted to encourage investment in larger infrastructure projects which would require outside investment or financing, it might wish to introduce an advance assurance facility for such projects to ensure that no DOTAS disclosure is required.

Pooling issues

44. One particular aspect of the plant and machinery allowances regime that reduces the incentive to invest is the reducing balance nature of its writing down allowances.
45. For example, the special rate pool rate of 6% means that less than 50% relief has been given after 10 years' and just under 70% relief has been given after 20 years' worth of allowances. This is unlikely to reflect the useful economic life of the vast majority of the assets falling within the pool.
46. For example, items acquired in a re-fit of a retail unit will typically be replaced every six or seven years. The government should consider moving to a straight-line basis for both pools in order to better reflect the useful economic life of the associated assets.
47. Another alternative that might incentivise expenditure on special rate assets is to allow businesses to elect such assets to be short-life assets. Special rate pool assets are currently excluded from the short-life asset regime (item 4 of the table at s84 CAA 2001). We struggle to see the policy rationale for excluding special rate pool assets. Surely whether or not an asset is used for a short period in the business is determined by when it is scrapped or disposed of, not what pool it falls into?
48. There may also be a good argument for moving away from a pooling system altogether. Now that digital record keeping has become the norm and HMRC is pushing for all businesses to eventually take part in Making Tax Digital, it seems reasonable to conclude that tracking individual assets is considerably easier than it was when the capital allowances pooling system was introduced. Keeping assets separate would ensure that 100% relief is given by the time an asset is disposed of or scrapped.
49. Uncertainties also arise when determining whether certain assets fall within the main plant and machinery pool or the special rate pool. Creating individual asset pools would not remove this distinction but a more radical reform would be to give the same rate of relief for all items of plant and machinery, irrespective of their nature and expected useful economic life.
50. The additional administration burden caused by tracking assets individually would be felt most by smaller businesses but if the AIA is set at an amount that means that all the expenditure of such businesses would be covered by the AIA, then this burden would be removed, although unincorporated businesses would still need to track those assets with an element of private use.

REVIEW OF THE GOVERNMENT'S OPTIONS FOR REFORM

Increase annual investment allowance

51. Any increase in the permanent level of the AIA would increase the number of businesses for which full expensing is available for expenditure on plant and machinery (excluding some items). We believe that the simplification benefits of this option would be just as great as the incentivisation it would provide and so we support an increase from the permanent level of AIA of £200,000.
52. We assume that the government could do research to determine what proportion of businesses would experience full expensing relief at each potential level of the AIA and set a level that hits the target proportion of businesses it wishes to achieve. Our main feedback on this option is that if the AIA level is changed, to create more certainty and stability it should then be kept the same for at least six or seven years.

Increase writing down allowances

53. Comments from members suggest that a significant increase in writing down allowances would be needed to provide any meaningful incentive for businesses to invest more. An increase of 2% would simply be factored into financial calculations. We believe that a greater incentive would be achieved by moving to a straight-line basis, as set out above. For these reasons, we believe that this option on its own would have little impact.

First-year allowances

54. The earlier that the financial benefit of an allowance is received, the more of an incentive it provides to incur the related expenditure. Cash flow is vital to most businesses. While a partial first year allowance (FYA) would have some impact, a 100% allowance would provide a greater incentive. As mentioned above, the government could target such FYAs at specific types of expenditure, businesses and locations to help it to achieve its other policy aims around net zero, levelling up and supporting manufacturing exports.
55. Providing a first-year allowance for all expenditure in the two plant and machinery sets of rules would be a return to the position before 2008 and would also create more complexity in business' capital allowances calculations. Therefore, we do not favour this option.

Additional FYA

56. Providing relief for an amount in excess of the actual amount of expenditure could provide some incentive but, as mentioned above, it is the often the timing of allowances that is more important than the amount. Hence, in many cases, a 100% up-front allowance is likely to be more of an incentive than a 120% allowance spread over a number of years. This option would also create additional complexity in business' capital allowances calculations.
57. For these reasons, we do not favour this option.

Full expensing

58. We assume that 'full expensing' means an unlimited AIA, but with the expenditure that is currently excluded from the AIA (eg cars) being included as well. We also assume that only plant and machinery expenditure would be included and that spend on structures and buildings would attract the structures and buildings allowance instead.
59. This option would give the greatest simplification to the business tax system out of all those suggested. Although it would still be necessary to use case law to distinguish between plant and machinery and buildings, if an item is considered to be plant, it would not be necessary to determine whether the expenditure on it is capital or revenue. This would bring considerable benefits for businesses, advisers and HMRC.
60. We have not received any specific feedback on whether full expensing relief would provide a greater incentive for businesses to invest. We understand that reform of this type would be expensive and that HM Treasury would like to ensure that the economic benefits of introducing it would outweigh the costs.
61. One downside that we can envisage to this policy is that it would remove a lever the government currently has to provide 100% relief for specific types of expenditure it would like to encourage (unless relief is given in excess of 100% for these types of expenditure). As we set out above, we believe that targeted first year allowances for specific types of expenditure could be an effective tool in influencing business' investment behaviour.
62. Hence, while we support this measure as a means of achieving much needed simplification, we do not endorse it as a means of encouraging investment.
63. We recommend that the government considers the following two aspects of its economic strategy and then makes decisions designed to meet its objectives.
    i. Clarify which types of expenditure, business and locations it wishes to support and then introduce grants, tax credits and first year allowances designed to provide that support.
    ii. Decide up to what size of business the government would like to provide an AIA that covers all of its expenditure on plant and machinery and then set the AIA at a permanent level that matches this.

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APPENDIX 1

ICAEW 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 October 1999 as TAXGUIDE 4/99 (see https://goo.gl/x6UjJ5).

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