friend

Briefing note

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CAPITAL ALLOWANCES AND PROPERTY – THE NEW RULES

Introduction

Since April 2012 new rules have been in place for taxpayers who are claiming capital allowances on fixtures in property. There was a transitional period which ended in April 2014. Buyers and sellers of property need to be aware of the new rules in order to identify issues at an early stage so as to avoid delays and maximise the tax position for a buyer going forward.

This Briefing Note sets out the main provisions but as always specific advice should be sought when contemplating individual transactions.

Background

A company cannot claim a deduction for the depreciation of its fixed assets. Instead, it can claim capital allowances for capital expenditure on certain items (including fixtures in properties). A company may claim capital allowances at a rate of 8 per cent on a prescribed list of integral features (e.g. lifts, escalators, electrical systems) and at a rate of 18 per cent on other plant and machinery. These allowances are calculated on a reducing balance basis.

Expenditure on integral features must be pooled in a special rate pool and any expenditure on other plant and machinery must be pooled in a general rate pool. Allowances are claimed on the balance of the tax written down value in the pool each year.

When a seller disposes of a property which contains fixtures upon which it has claimed capital allowances it must bring a disposal value into account. This involves the seller deducting an amount from the tax written down value of the special rate pool equal to the purchase price attributable to the fixtures. A balancing charge will arise if the disposal value is higher than the seller's written down value of this pool. In such situations buyers and sellers often enter into an election in accordance with section 198 of the Capital Allowances Act 2001 (s.198 election). Such an election is evidence of the parties' agreement on the amount of the purchase price to be allocated to integral features and to other plant and machinery. In the absence of a s.198 election, the buyer may choose to apportion a just and reasonable amount of the sale consideration to the fixtures. This is restricted to the disposal value which the seller brings into account when computing its capital allowances. The buyer will often not know what the seller's disposal value is. This may result in the buyer attributing a higher value to the fixtures than the amount attributed to them by the seller. As a result capital allowances may be claimed by both the buyer and the seller on the same capital expenditure.

The new provisions do not apply where there has been no previous owner of the fixtures who was entitled to claim capital allowances. Thus, as with a property bought from the original developer of the building, the new rules will not be applicable. The sale by the developer would have been a trading transaction such that the capital allowance rules would not apply. Similarly, if the building with fixtures is sold by an exempt person such as a charity or a pension fund, the provisions will not apply. However, the new rules will apply if there has been a "past owner" who was entitled to claim capital allowances (regardless of whether they did or not), even if it was not that person who sold the building to the current owner. Where there has been more than one such owner who was entitled to claim the allowances the most recent one is the one to turn to for the purposes of this legislation.

If a buyer wishes to claim capital allowances on fixtures in a property the following points need to be addressed:

- **The pooling requirement** - the past owner must have allocated its expenditure on the fixtures to a capital allowance pool prior to its sale of the property or must have claimed a first year allowance in respect of its expenditure; and

- **The fixed value requirement** - a s.198 election must have been signed within two years of the buyer's acquisition of the interest in the property or, if this has not been done either the buyer or seller can, within two years of the buyer's acquisition of the property, ask the First Tier Tax Tribunal to determine the proportion of the purchase price to be allocated to fixtures.

In limited circumstances (e.g. where the seller has permanently discontinued its business) the Fixed Value Requirement will not need to be satisfied. Instead, the seller will be required to make a written statement specifying the disposal value of the fixtures within two years of ceasing to own them.

As an aside, taxpayers are entitled to a 100 per cent first year allowance on capital expenditure they incur converting or renovating certain business premises located in designated disadvantaged areas which have been vacant for at least a year in order to bring them back into use. This allowance is known as the Business Premises Renovation Allowance. Where the 100 per cent initial allowance is not claimed, a writing down allowance of 25 per cent of the residue of the expenditure on a straight line basis can be claimed. If the taxpayer disposes of the property within seven years of it being brought back into use they will suffer either a balancing charge or a balancing allowance.

Legal issues

Many sellers and buyers will be aware of the Commercial Property Standard Enquiries ("CPSE") following contact with their lawyers. In the past many questions in the CPSE were answered with 'N/A'. This will no longer be appropriate. Now it will be necessary to document in the CPSE the expenditure already pooled. If this has not been done, detailed explanations will have to be provided. Any reader of the CPSE will see that Section 32.3 requires information to be provided on whether the seller will pool on the instructions of the buyer and if so when, and if not, why not.

The latest version of the CPSE was released in February 2014 in response to the new legislation. Parties to property transactions will now need to pay much closer attention to the questions.

Taxpayers unable to claim capital allowances

The legislation operates so that if a person purchases a property from a person who cannot claim capital allowances, e.g. a pension fund, charity or company trading in property, the pooling and fixed value requirements must still be met if a previous owner of the property was entitled to claim capital allowances.

As the seller has been unable to claim capital allowances, it will not be able to either pool its expenditure or enter into a s.198 election. The legislation provides that these tests will be met if the relevant conditions had previously been satisfied by an earlier owner. The previous owner that was entitled to claim capital allowances must have met the pooling requirement and it and the person to whom it sold the building, usually the person now selling the building, must have entered into a s.198 election in order to meet the fixed value requirement. Failure to achieve this will mean that any subsequent buyers will be unable to claim capital allowances.

Implications

If buyers wish to claim capital allowances the pooling and fixed value requirements may cause complications and delays in the purchase process.

If a seller has not claimed allowances to which they were entitled, because of lack of knowledge of the rules or they chose not to do so, this will create issues. The buyer will have to negotiate with the seller to force it to pool its expenditure. A seller may also be unwilling to sign a s.198 election such that an approach to the Tax Tribunal might be inevitable.

These issues will undoubtedly lead to delays but may also lead to discussions on pricing. This legislation is likely to result in more onerous questions being asked by the lawyers and additional due diligence work for buyers. This will be especially so if sellers are unaware of the new rules or the seller has been unable to claim capital allowances.

Conclusion

The rules create a number of material issues for those involved with the disposal and acquisition of commercial property.

Sellers and buyers will need to make sure that they are familiar with the rules and brace themselves for the additional work and cost which may now be relevant for even simple transactions.

Complications will undoubtedly arise when ignorance of the rules is encountered or there is an owner, or series of owners, who have been unable to claim capital allowances.

How can we help?

- We can work with existing owners to ensure that they meet the pooling requirement;
- We can advise sellers on both the pooling and fixed value requirements;
- We can assist buyers so as to ensure that the future capital allowance claims are maximised;

- We can advise both sellers and buyers on all the other tax and financial issues associated with sales of commercial property; corporation tax on capital gains, VAT, SDLT etc.; and
- If you are contemplating any form of property transaction you will need to take appropriate professional advice at the earliest opportunity.

If you have any questions in connection with this Briefing Note please contact Simon Littlejohns, Tax Partner, on 0121 633 2007 or your usual contact at Friend.

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