

Business tax reform: capital allowances changes

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HM TREASURY



HM Revenue
& Customs

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INTRODUCTION

FRAMEWORK FOR REFORM OF BUSINESS TAX

1.1 Budget 2007 announced a series of wide-ranging reforms to the structure of business taxation in the UK. Changes to the corporation tax (CT) rate structure and capital allowances regime have been accompanied by an increase in the level of the research & development (R&D) tax credit and the introduction of a new payable credit for environmentally beneficial investment. As a whole, this package is designed to ensure the tax system supports growth in the UK economy and better reflects modern commercial activity.

Objectives for reform

1.2 The Budget 2007 business tax reforms have three objectives:

- **Promote investment and growth** – by
 - reducing tax-driven distortions on commercial activity, ensuring that business decisions are based on commercial rather than tax considerations;
 - stimulating higher levels of foreign and domestic investment through a lower CT rate on a broader tax base; and
 - refocusing the tax system for small business with more generous and better-targeted incentives for investment.
- **Reduce administrative burdens and complexity** – by
 - removing anachronistic and onerous elements of the tax system, complementing the programme of improvements to the administration of the tax system following the Review of Links with Large Business.
- **Maintain the fairness of the tax system** – by
 - ensuring that business continues to contribute its fair share towards public services in the most efficient manner; and
 - ensuring that people engaged in similar economic activities pay broadly the same overall level of tax and national insurance contributions, regardless of the legal form they choose for their business.

The Budget 2007 reforms

1.3 Box 1.1 sets out the strands of the Budget 2007 business tax reforms.

Box 1.1 Summary of Budget 2007 business tax reforms

(Effective from April 2008 unless otherwise stated)

Reform of corporation tax rates

- reduction in the main rate of CT from 30 per cent to 28 per cent; and
- phased increase in the small companies' rate from 19 per cent to 20 per cent from April 2007, 21 per cent from April 2008 and 22 per cent from April 2009 to reduce the differential between incorporated and unincorporated businesses.

Reducing the distortive impact of capital allowances

- reduction in the main rate of capital allowances on the general pool of plant and machinery from 25 per cent to 20 per cent;
- increase in the rate of capital allowances on the pool of long-life assets, which applies to assets with a useful life of more than 25 years, from 6 per cent to 10 per cent;
- separate classification of fixtures that are integral to a building, and their inclusion in the 10% capital allowances pool; and
- phased withdrawal of the industrial buildings and agricultural buildings allowances with the effective rate of allowance falling to 3 per cent from April 2008, 2 per cent from April 2009, 1 per cent from April 2010 and full withdrawal taking effect from April 2011.

Improving environmental incentives

- introduction of new rules enabling companies to surrender losses derived from enhanced capital allowances (for expenditure on certain environmentally beneficial types of plant and machinery) in return for a cash payment.

Re-focusing of investment incentives for small businesses

- introduction of a new annual investment allowance (AIA), giving an annual 100 per cent allowance for the first £50,000 of investment in plant and machinery (other than cars) to all businesses regardless of size and regardless of legal form. One annual £50,000 allowance will be available to each individual business or company group.

Promoting innovation

- increases to the large company R&D tax credit (from 125 per cent to 130 per cent) and enhanced deduction element of the SME and mid-sized R&D tax credit (from 150 per cent to 175 per cent), subject to State aid clearance.

The Government's approach to consultation

1.4 Where significant changes to the business tax system are proposed, the Government's policy is to give businesses and practitioners the opportunity to help shape those changes. It is crucial to the Government's economic objectives that reforms to business tax meet the needs of both business and Government; this objective can

only be met through open and constructive dialogue with business and a shared understanding of the design of the proposed measures.

1.5 The Government is seeking feedback on the three new elements of the capital allowances regime:

- the annual investment allowance (AIA);
- the definition of ‘integral fixtures’ to be assigned to the 10 per cent pool; and
- payable enhanced capital allowances for environmentally beneficial investment.

1.6 This document is primarily concerned with the design of the two main structural changes to the capital allowances regime: the AIA and the new ‘integral fixtures’ definition.

1.7 The changes to rates of CT, rates of capital allowances and the withdrawal of the industrial and agricultural buildings allowances are not subject to specific consultation, but guidance on the transition to the new structure is included in Chapter 5. The Government welcomes evidence on the impact of these changes as part of the package as a whole. An Impact Assessment on the phased withdrawal of industrial and agricultural buildings allowances will be prepared and published before the relevant draft legislation is published in Finance Bill 2008.

1.8 The publication of this document marks the beginning of a two-stage approach to consultation on the annual investment allowance and the new definition of integral fixtures. The first stage is an outline of the reforms, with sufficient detail for business to scrutinise and offer their views. This stage of consultation will end on 19 October 2007. Towards the end of the year, the Government will produce draft legislation for a further round of technical consultation. Chapter 4 also contains a high-level description of the proposed design of payable enhanced capital allowances, on which the Government welcomes early feedback; the Government intends to consult further on the introduction of payable enhanced capital allowances (ECAs) in the autumn.

SUMMARY

Annual Investment Allowance

1.9 Since 1997, the Government has made small business investment a priority. Through successive reductions in the Small Companies’ Rate (SCR), it has tried to encourage greater investment with lower rates of tax for small companies. But, while low rates of tax can be successful in stimulating investment, it has become increasingly apparent that the positive impact of the SCR has been undermined by the opportunities that it offers the self-employed to reduce their personal tax and national insurance liability by incorporating and extracting labour income in the form of dividends.

1.10 The Budget 2007 reforms sought, in part, to address the issue of tax-motivated incorporation. The introduction of a new annual investment allowance (AIA) from April 2008 will refocus the tax system’s support directly on the *activity* of investment, providing a cashflow boost for both incorporated *and* unincorporated businesses. Chapter 2 outlines the broad design of the proposed AIA and its accompanying rules to defend against abuse.

1.11 The AIA will replace the existing system of first-year allowances for small and medium sized enterprises (SMEs) as the Government's primary tax incentive to support investment by SMEs. The proposed AIA will operate as a 100 per cent first-year allowance for capital investment in standard plant and machinery, capped at £50,000 per year for each individual business or group of companies. Expenditure above the £50,000 threshold will be dealt with in the standard capital allowances regime.

1.12 The AIA will not be available for expenditure on business cars, but expenditure on all other plant and machinery, including integral fixtures and long-life assets, will be eligible. The AIA does not replace existing 100 per cent first-year allowances for environmentally beneficial technologies; these will continue to be available. Expenditure that qualifies for these 100 per cent allowances will not qualify for AIA.

1.13 So that the AIA can act as an effective incentive for investment that is not open to abuse, rules are necessary to ensure that businesses cannot fragment to benefit from multiple annual allowances. Chapter 2 outlines the Government's proposals for managing the risk of abuse.

1.14 The AIA is intended as a simplification for the 95 per cent of UK businesses that invest up to £50,000 each year. As such, the anti-abuse rules are designed to be as simple as possible. The Government welcomes views on any additional compliance burdens imposed by these rules and whether they are appropriate.

Integral fixtures

1.15 For capital allowances purposes, the boundary between plant and machinery and commercial buildings is not defined in legislation and has been an area of considerable doubt and uncertainty in tax law. The boundary no longer reflects the commercial reality. Some assets that are commonly regarded as integral to a modern building currently attract standard plant and machinery capital allowances at a rate that does not reflect their actual, average rate of depreciation. This can be a distortive influence on commercial decision-making.

1.16 The Budget announced that 'integral fixtures' would be separately identified and included in a new 10 per cent asset pool. This is a better reflection of the actual, average rate of economic depreciation on these assets and will reduce the tax system's distortive impact on investment decisions. There may also be assets that are currently treated as being part of the building, but which, applying the new approach, will in future be included in the 10 per cent pool.

1.17 Chapter 3 discusses the Government's proposed definition of integral fixtures, based on a short list of integral fixture assets, and considers an alternative definition, based on a purposive test. The Government welcomes feedback from business on the relative merits of these approaches.

Enhanced capital allowances

1.18 Enhanced capital allowances (ECAs) are a key part of the Government's programme to manage climate change. They allow the full cost of an investment in designated energy saving and environmentally beneficial plant and machinery to be written-off against the taxable profits of the period in which the investment is made.

1.19 Budget 2007 announced an expansion of the existing arrangements with the introduction of a payable ECA from April 2008. Building on the established model used for the SME R&D tax credits, the new payable ECAs will allow loss-making companies to

surrender the element of their losses attributable to their qualifying expenditure in return for a cash payment from Government. The new payable credits will apply to companies only; unincorporated businesses will not be able to access the payable credit. The Government will announce the rate at which the new payable ECA can be claimed at a later date.

1.20 Chapter 4 sets out the Government's early proposals for payable ECAs. Given the clear and distinct environmental objectives of the new payable ECA and specific accompanying anti-avoidance safeguards, the Government intends to separate detailed consultation on the new payable ECA from the other strands to the business tax reforms. At this stage, the Government welcomes early feedback from business on the high-level proposals outlined in this document. A full consultation document on payable ECAs, including draft legislation, will be published in Autumn 2007.

Transitional arrangements and other technical aspects of the reforms

1.21 Chapter 5 sets out the transitional arrangements for the changes in the rates of standard and long-life plant and machinery capital allowances and the phased withdrawal of the industrial and agricultural buildings allowance. The chapter also clarifies a number of other issues relating to the Budget 2007 reforms.

1.22 The short-life assets regime, which has been in place since 1985 to allow businesses to elect for short-life assets to be treated in a single asset pool, will remain in place, but – as with “long-life assets”¹ – integral fixtures will be excluded from the regime.

¹ ‘Long-life’ assets are defined (with certain exceptions) as plant and machinery with an expected, useful economic life of at least 25 years.

2

THE ANNUAL INVESTMENT ALLOWANCE

BACKGROUND

2.1 The Budget 2007 reforms refocus the small business taxation system to enhance the Government's support for small business investment. The AIA will provide direct support for capital investment, providing a cashflow boost for corporates and the unincorporated.

2.2 The AIA will replace the existing first-year allowance for small and medium-sized enterprises (SMEs), giving all businesses, regardless of size, the opportunity to claim full relief for the first £50,000 of capital expenditure on plant or machinery.

HIGH-LEVEL OBJECTIVES

2.3 The AIA's central purpose is to encourage greater levels of investment by reducing the cost of capital. To achieve this objective the AIA must be simple and transparent; the allowance is intended as a simplification for the 95 per cent of businesses that invest up to £50,000 per year.

2.4 The AIA is a valuable incentive and requires appropriate rules to defend it against abuse. As an annual allowance, the AIA requires safeguards to address the risk of fragmentation and the artificial creation of multiple allowances.

2.5 This chapter outlines a simple approach to the targeting of the AIA, which will ensure that it acts as a clear incentive for business investment.

DETAILED PROPOSALS

Qualifying expenditure

2.6 As with the present first-year allowances (FYAs) for SMEs, the AIA will apply to expenditure on plant and machinery – covering the vast majority of capital assets, apart from buildings. The AIA will not be available for expenditure on business cars, but expenditure on most other plant and machinery, including integral fixtures and long-life assets, will be eligible.

2.7 The annual allowance is £50,000. All qualifying expenditure up to that level will receive a 100 per cent first-year allowance. Any additional expenditure over the £50,000 level will be dealt with in the normal capital allowances regime, entering either the 10 per cent or 20 per cent pool.

2.8 The AIA does not replace the existing 100 per cent enhanced capital allowances (ECA) schemes for 'Green Technology'; these will continue to be available. Other plant and machinery allowances schemes offering 100 per cent first year allowances² will also continue to be available. Similarly, expenditure that qualifies for 100 per cent capital allowances under separate capital allowances codes (for example, Business Premises Renovation Allowances, Flat Conversion Allowances or Research & Development Allowances) will be unaffected by the introduction of the AIA.

² Listed in s.39 of the Capital Allowances Act 2001

2.9 In line with the present FYAs, the AIA will be available to individuals, companies, partnerships of individuals, registered friendly societies and certain bodies corporate that are not companies, but are within the charge to corporation tax. The person or persons must be carrying on a qualifying activity, such as a trade, profession or vocation, an employment or ordinary property business².

2.10 A number of exclusions from qualifying expenditure under the present FYA system³ will also apply to the AIA. P&M expenditure that is excluded from capital allowances more generally will also continue to be excluded⁴.

Targeting the AIA

2.11 The Government has taken a simple and broad-based approach to the targeting of the AIA, underlining its objective to encourage greater levels of investment. The AIA will offer a £50,000 allowance to every business in the UK, regardless of legal form.

Companies **2.12** Singleton companies will each receive a single annual allowance. Companies that fall within the company law definition of a group are legally and economically inter-dependent and will therefore receive a single allowance. In the case of associated companies, each company will receive an annual allowance in its own right, unless the new anti-abuse provisions (described below) apply in any individual case.

Individuals and partnerships **2.13** Subject to the anti-abuse provisions, each business that is carried on by a sole trader or by individuals in partnership will receive a single annual allowance in its own right, even where the individual owns a number of businesses or is involved in a number of partnerships.

Anti-abuse safeguards

2.14 The Government plans to take a 'light touch' approach to the targeting of the AIA. This should guarantee that the allowance will be an effective incentive for the vast majority of businesses. However, this approach requires a robust underlying defence against artificial fragmentation to generate multiple allowances and the artificial use of unused allowances.

Anti-fragmentation **2.15** The Government proposes two targeted rules to defend against abuse of the AIA. One rule would ensure that businesses that have adopted a fragmented structure for the purposes of accessing additional tax relief should be considered as part of the same economic entity for the purposes of the AIA.

Unused allowances **2.16** The second rule would prevent businesses or individuals from benefiting from the artificial use of unused annual allowances.

Disclosure rules **2.17** The Government will also introduce an AIA hallmark⁵ to the existing disclosure regulations, as a further safeguard against potential abuse.

2.18 Recognising the difficulties of correctly identifying non-commercial fragmentation or use of allowances, the Government welcomes views on this general approach to preventing abuse of the AIA.

² See s.15 CAA 2001.

³ Covered by General exclusions 1, 7 and 8, in section 46 of CAA 2001

⁴ See, for example, s35 CAA 2001, excluding expenditure on P&M for use in a dwelling-house.

⁵ Under rules introduced in Finance Act 2005 and expanded in Finance Act 2006, promoters of certain avoidance schemes are required to disclose them to HMRC, and users of such schemes are required to disclose them in their tax returns.

Alternative approach

‘Economic entity’ 2.19 The Government has explored a number of alternative approaches to the targeting of the AIA. In particular, it has considered an approach that would give a single allowance where there is common ownership across a number of businesses, whether those businesses are carried on by individuals or by companies. Identifying the ‘economic entity’ in this way provides some protection against artificial fragmentation, but imposes a number of additional compliance burdens that may undermine the incentive effect.

2.20 The Government welcomes views from business on the relative merits of the alternative economic entity approach over the approach outlined above.

Allocation of the allowance

Annual period 2.21 One amount of allowance will be available each year, but the ‘annual period’ will vary according to the circumstances of each business. If a business’s chargeable period is more or less than a year the AIA will be proportionately increased or reduced.

2.22 Where a member of the group has a different accounting period from other group companies, the Government proposes that a time apportionment should be made by reference to a nominated period, so that the £50,000 can be allocated over a 12 month period. Changes in membership of the economic entity may also be managed through a time apportionment of the amounts available.

Effect on administrative burden

2.23 The move from the current system of first-year allowances for SMEs to the AIA is intended as a simplification for the vast majority of UK businesses. The proposed AIA has therefore been targeted in a clear and simple manner. The Government welcomes views on whether the proposed rules for the AIA would impose any additional compliance burdens and whether the accompanying anti-abuse rules are proportionate to the risk.

3

INTEGRAL FIXTURES

BACKGROUND

3.1 The Budget announced a series of changes to plant and machinery capital allowances, aimed at realigning the capital allowances system more closely with average rates of economic depreciation. The reforms will reduce the main rate of capital allowances for ‘general’ plant and machinery from 25 per cent to 20 per cent, and increase the rate of writing-down allowances for ‘long-life’⁶ assets from the current 6 per cent rate to a new 10 per cent rate.

3.2 Against the background of the two new pools for plant and machinery expenditure, the Budget announced that a new category of expenditure on certain ‘integral fixtures’ would be allocated to the new 10 per cent pool.

3.3 The new capital allowances structure reflects, more accurately, average rates of economic depreciation and reduces the distortive impact of capital allowances on commercial decisions. Together with changes to the corporation tax rate structure, these reforms will encourage more efficient allocation of resources in the UK economy.

Rationale for separate classification of integral fixtures

3.4 There is no statutory definition of ‘plant or machinery’ for capital allowances purposes. Instead, case law has drawn a distinction between equipment *with which* a business is carried on, and the premises or setting *in which* it is carried on. In broad terms the Courts have tended to accept that the former constitutes plant or machinery, whereas the latter does not.

3.5 Over the years this boundary has shifted, and more expenditure on assets that might be regarded as a standard part of a modern building (for example, air conditioning and lifts) has come to qualify for 25 per cent plant and machinery allowances. Their longer economic life means that the new 10 per cent pool offers a more appropriate rate of write-off for these assets.

3.6 This chapter seeks the views of business on the Government’s proposed approach for the separate classification of integral fixtures.

APPROACH TO DEFINING INTEGRAL FIXTURES

3.7 The Government’s objective is to identify correctly and reclassify the main fixtures that are standard fittings in a ‘normal’ modern building, and which should therefore be considered a part of the business premises or ‘setting’. This distinguishes integral fixtures from the ‘productive equipment’ acquired for use in the trade carried on by the building’s occupier – reflecting the distinction made in case law between “the place in which a business is carried on” and the plant and machinery “with which the business is carried on”⁷.

⁶ ‘Long-life’ assets are defined (with certain exceptions) as plant and machinery with an expected, useful economic life of at least 25 years.

⁷ Paraphrasing Fox, L J, in the leading case on the meaning of plant. *Wimpey International Ltd V Warland* (61 TC 51) Fox, L J at page 97B.

3.8 The Government has considered two alternative approaches: First, a purposive approach which would set out a high-level definition of integral fixtures, specifying certain fixtures, but which would exclude expenditure made to meet the particular requirements of the trade. Second, a simpler approach of listing the fixtures that will qualify for the allowance.

Purposive approach 3.9 The Government has identified a number of potential disadvantages with the purposive approach.

3.10 Although some assets that are normally part of a modern building may also have a high element of trade specificity, the subjective nature of the classification of integral fixtures under a purposive definition would create uncertainty. The range of differing opinions over assets that individual businesses might regard as ‘trade specific’ would add additional compliance burdens and might give rise to an inconsistent approach. The longer economic life of these assets means that, in most instances, a 10 per cent rate of writing-down allowance is still appropriate.

3.11 The Government does not therefore currently propose a purposive definition of integral fixtures. While this approach would provide flexibility, it would undermine the Government’s objective for a simple and transparent system.

The list approach 3.12 Instead, the Government proposes a simple list approach, to provide a better level of certainty. A clear list of qualifying assets carries the significant advantages of simplicity and consistency, and will deliver the Government’s objective of fewer distortions in the capital allowance system.

3.13 The Government welcomes views on the relative merits of:

- a purposive definition of “integral fixtures”, that might list the fixtures, but exclude fixtures required to meet the particular purposes of the qualifying activity; or
- a short, unambiguous list of the integral fixtures to be assigned to the new 10 per cent pool.

DEFINING INTEGRAL FIXTURE ASSETS

3.14 The business tax reform package is aimed at simplifying capital allowances and making them less distortionary, while delivering the wider objective of reducing administrative burdens on business. As a starting position, therefore, the list should be:

- as short a list of assets as makes sense - given the Government’s underlying policy objectives; and
- as simple and as clear a set of definitions as possible, ensuring that the list can deliver certainty for business.

‘Background plant or machinery’ 3.15 There is already a definition of “background plant and machinery for a building”, devised for the purposes of the recent reforms to the taxation of leasing and legislated in Finance Act 2006. This definition was designed to be as comprehensive as possible to ensure that the new leasing regime did not unnecessarily include “background plant and machinery” in a building.

A new short list 3.16 In contrast, the Government’s intention here is specifically to *exclude* integral fixtures from a more generous rate of allowance; the comprehensive definition of ‘background plant and machinery’ is not suited to this objective. The Government does

not currently propose, therefore, to make use of the existing background plant or machinery definition in this context.

3.17 The Government would welcome views on:

- whether a simple, short list approach would be preferable to the “background plant and machinery” definition; and
- whether it would be sufficient simply to list the assets to be included

Asset List

3.18 The Government proposes that the list of the fixtures normally integral to a modern building should include:

- lifts, escalators and moving walkways;
- central heating systems; and
- air conditioning systems;

3.19 It may also include:

- electrical lighting and power systems; and
- hot and cold water systems.

Toilet and kitchen facilities **3.20** This list does not include toilet and kitchen facilities. These may be standard in a business workplace, for use by the building’s regular business occupants, but they may also be an essential piece of productive equipment, for the purposes of the particular trade of the occupier (for example, kitchen equipment in a restaurant). The Government does not propose to classify toilet and kitchen facilities as integral fixtures; their inclusion may require a purposive test that would undermine the simplicity and certainty and consistency of the new rules.

Other building fixtures **3.21** Other building fixtures, for example, where milking equipment is affixed to a dairy shed, will not be within the new classification of integral fixtures.

Advantages of the new classification **3.22** The proposed classification will mean that some fixtures, which are currently classified as part of the building and do not generally attract any capital allowances, will in future attract 10 per cent capital allowances. Potential assets in this category are:

- general electrical lighting and power systems; and
- cold water systems.

3.23 Re-classifying these systems as plant and machinery will also entitle businesses that invest in these systems, where the expenditure includes items of equipment on the ‘Green Technology’ ECA list⁸, to a 100 per cent capital allowance on those items. Currently, expenditure of this type is not usually classified as plant and machinery and so cannot qualify for the enhanced allowances.

3.24 The Government welcomes views on these issues, and especially on:

- whether the suggested list of assets could be improved by additions, omissions or refinements, given the underlying policy objectives;

⁸ See www.eca.gov.uk

- whether fixtures that do not normally qualify for any allowances (such as general electrical systems or cold water systems) should be included as part of a new, simplified approach; and
- whether assets such as toilets and kitchens should be excluded from the scope of the new classification, given the difficulties of determining when such assets are “trade specific” as opposed to being part of a “normal building”.

STRUCTURES

3.25 Structures, as well as buildings, can contain integral fixtures that will be eligible for the new 10 per cent rate. Sometimes the structure itself can constitute an item of plant or machinery, such as a dry dock or grain silo⁹. In these cases, the integral fixtures provisions will not be relevant, but the ‘long life asset’ provisions may still apply.

3.26 The new treatment of integral fixtures will be extended to specified fixtures within structures, as well as within buildings. The Government recognises that some fixtures within a structure (for example, moving walkways or escalators at an airport) may have a more trade specific function than the equivalent fixture in a shop or office. However, a 10 per cent rate of writing-down allowance is a reasonable proxy for the average rate of economic depreciation of these assets and the Government proposes to include them in the integral fixtures classification.

3.27 The Government welcomes views on:

- whether the new “integral fixtures” classification should be extended to expenditure on the relevant assets within structures as well as within buildings.

EXPENDITURE ON SECOND-HAND INTEGRAL FIXTURES

3.28 The long-life asset (LLA) regime included ‘grandfathering’ rules when it was introduced by the Finance Act 1997. These rules provided that assets already within the capital allowances regime did not require to be re-classified under the LLA rules when they changed hands after the introduction of the new regime. At the time of introduction, the Government recognised that the provisions would only affect a relatively small number of assets, which were unlikely to change hands frequently.

3.29 Integral fixtures, however, are more common and asset transfers more frequent. Grandfathering of the previous capital allowance treatment is not, therefore, appropriate. The need to track numerous assets over a prolonged period would add an unacceptable degree of complexity to the new provisions. The Government therefore proposes that integral fixtures should be separately identified and classified when expenditure is made on second-hand assets.

INTRA-GROUP TRANSFERS

3.30 The Government recognises however, that it is common for property companies to transfer properties intra-group. In these circumstances, it would be unfair to require the company acquiring the property on or after 1 or 6 April 2008 to reallocate expenditure on integral fixtures to a 10 per cent pool. The Government proposes that

⁹ see List C at s.23 of CAA 2001

companies should be able to elect for integral fixtures to be transferred between group companies at their tax written-down value, remaining in the same plant and machinery category before and after the transfer.

ENVIRONMENTALLY BENEFICIAL INTEGRAL FIXTURES

3.31 The Government is committed to ensuring that the business tax reforms do not undermine the Government's wider objectives to address climate change and reduce greenhouse gas emissions.

3.32 The current 100 per cent enhanced capital allowances (ECAs) scheme for investment in certain energy-saving or environmentally-beneficial plant or machinery (the 'Green Technology' ECAs) will carry on alongside the two new plant and machinery pools and will be augmented by the new payable ECA credits for loss-making companies, outlined in Chapter 4.

3.33 Modern building design often incorporates technologies, such as brise soleil and active facades, that deliver energy-saving and other environmental benefits. These are currently regarded as part of the building and do not, therefore, attract capital allowances. The Government seeks the views of business on the specific inclusion of these technologies within the integral fixtures definition (for example, as 'air conditioning'), to allow them to qualify for the 10 per cent rate.

3.34 The Government welcomes views on:

- whether it would be desirable to include expenditure on specific building features (such as brise soleil and active facades), that could have worthwhile environmental benefits, within the new 10 per cent "integral fixtures" classification; and
- if so, which environmentally beneficial building features should be specifically included.

TRANSITIONAL PROVISIONS

3.35 Chapter 5 provides detailed information on the Government's proposed transitional arrangements for the changes to rates of writing-down allowance. Whereas the new 20 per cent rate can be applied to the existing 25 per cent pool from a specific date, there are real difficulties in applying the new integral fixtures categorisation to expenditure already incurred and included in P&M pools.

3.36 The Government proposes that the new categorisation of integral fixtures should only apply to expenditure incurred on or after 1 April 2008, in the case of businesses within the charge to corporation tax, and 6 April 2008, in the case of businesses within the charge to income tax.

3.37 These proposals will not override the normal rules in s.5 CAA 2001 for determining when expenditure is incurred by, for example, grandfathering expenditure pursuant to a construction contract entered into before April 2008.

3.38 Integral fixtures will not be eligible for inclusion within the 'short life' asset rules, on the same basis as the exclusion for 'long-life'¹⁰ assets.

¹⁰ 'Long-life' assets are defined (with certain exceptions) as assets with an expected, useful economic life of at least 25 years.

4

PAYABLE ENHANCED CAPITAL ALLOWANCES

BACKGROUND

4.1 Since 2001, the Government has provided an incentive for business investment in energy-saving and environmentally beneficial technologies through enhanced capital allowances (ECAs). ECAs give a 100 per cent first-year capital allowance for the purchase of qualifying plant and machinery.

4.2 The present arrangements deliver a cash flow boost and a shortened payback period by allowing businesses to write-off the capital cost of their investment against their taxable profits in the period in which they make the investment. This already provides some incentive for loss-making businesses by increasing their carry-forward trading losses, but there are circumstances where the benefit of these enhanced allowances may not be realised for some time. Budget 2007 announced an expansion of the ECA scheme to ensure that there is an even greater incentive for energy-saving or environmentally beneficial investment by start-up and other loss-making companies.

HIGH-LEVEL PROPOSALS

4.3 The proposed system would be broadly based on the successful model employed to deliver the small and medium-sized enterprise (SME) research and development (R&D) tax credit. This provides a payable cash credit for loss-making SMEs undertaking R&D.

4.4 As with the SME R&D tax credit, the arrangements for payable ECAs would allow companies to surrender the element of their trading losses attributable to ECAs in return for a cash payment from Government. The unrelieved trading loss would then be reduced by the amount surrendered.

4.5 To ensure that the scheme is as simple as possible, the system would be limited to companies – in the same way as the payable R&D tax credit. The compliance and Exchequer risks involved in extending the scheme to self-employed individuals would require additional rules and administrative burdens that would undermine the incentive effect of the scheme. The Government welcomes comments on this proposed restriction.

4.6 The proposed payable ECAs would use the same rules for measuring qualifying expenditure, ensuring that all assets that presently qualify for ECAs can also qualify for a payable credit. Cars with low CO₂ emissions, however, will not be eligible for a payable tax credit.

4.7 The Government is also presently engaged with the European Commission over a State aid application to extend the ECA scheme to the most carbon-efficient biofuels plant. The Government's intention is to extend payable credits to investments of this type, although this will be subject to the same State aid application procedure.

Compliance rules

4.8 A payment scheme in respect of unrelieved expenditure involves a higher level of risk to the Exchequer than one confined to reliefs given against tax liability. There is also an increased risk of fraud. The evidence from the SME R&D tax credit is that the system can be made to work successfully with the correct safeguards.

4.9 While it is intended that the model for payable ECAs should be based on R&D tax credits, there is a fundamental difference between the two schemes. Whereas R&D tax credits apply to revenue costs, ECAs relate to expenditure on physical capital assets. This further increases the risk to the Exchequer. The package of compliance rules that will accompany the introduction of payable ECAs will reflect this increased risk.

4.10 At present, the Government is considering a range of safeguards. These may include a cap on any cash payments. One option would be to set the cap at the level of the company's PAYE and national insurance contributions payments – as happens with the payable SME R&D tax credit. There may be a need for other safeguards against abuse. The Government welcomes the early views of business on this issue, and in particular, on the mechanism for setting any cap.

GOVERNMENT'S STRATEGY FOR CONSULTATION

4.11 The Government welcomes comments from business on the high-level proposals for payable ECAs outlined in this chapter. However, given the clear and distinct environmental objectives of the new payable ECA and specific accompanying anti-avoidance safeguards, the Government intends to separate detailed consultation on the new payable ECA from the other strands to the business tax reforms.

4.12 The Government will publish detailed proposals for the new payable ECA scheme – including draft legislation – later in the year.

5

TRANSITIONAL ARRANGEMENTS AND OTHER TECHNICAL ASPECTS

5.1 This chapter expands on the announcements made in Budget 2007. It sets out in more detail the technical arrangements for the transition to the new business tax structure and offers examples of how these rules will be applied in practice.

MAIN RATE OF PLANT & MACHINERY ALLOWANCES

5.2 The main rate of plant and machinery allowances will fall from 25 per cent to 20 per cent, with effect from 1 April 2008 for companies, and from 6 April 2008 for unincorporated businesses. This rate change will apply to both expenditure in the main plant and machinery (P&M) pool and expenditure allocated to single asset pools. This includes expenditure on short life assets, ships and certain cars¹¹.

5.3 In constructing the transitional arrangements, the Government has balanced the need to minimise additional compliance burdens over the transitional period with the need to ensure a fair and orderly transition to the new rate structure.

Fixed date 5.4 The new plant and machinery allowances rate will apply from a *fixed date*: 1 April 2008 for companies and 6 April 2008 for unincorporated businesses. The Government considered an alternative approach based on applying the new rate to *chargeable periods* beginning on or after 1 or 6 April 2008, but considers that the fixed date approach strikes the appropriate balance between fairness and administrative burdens.

Hybrid rate 5.5 The fixed date approach will be implemented by applying a hybrid rate, which will be calculated and applied to all relevant expenditure for the entire transitional period. This involves, firstly, calculating the proportion of a chargeable period falling before the date of change and the corresponding proportion falling after the date of change.

5.6 For example, if a company's chargeable period began on 1 January and ended on 31 December, one-quarter¹² of that period would fall before the date of the change (on 1 April 2008), and three-quarters would fall after that date. The calculation of the hybrid rate would therefore be as follows:

$$\begin{aligned} & \frac{1}{4} \times 25\% = 6.25\% \\ & \text{Plus } \frac{3}{4} \times 20\% = 15.00\% \\ & \text{Hybrid rate for transitional period} = 21.25\% \end{aligned}$$

5.7 Box 5.1 sets out two examples of the treatment where the hybrid rate is applied to periods of account covering more than the transitional period.

¹¹ See s.54(3) Capital Allowances Act (CAA) 2001.

¹² Time apportionments are normally made on the basis of the number of days. We have, however, used simple fractions, based on the number of months in a year, where this seemed to make the principle involved easier to follow.

Box 5.1 Application of the hybrid rate**Example 1**

A sole trader has a 16-month chargeable period that starts on 1 September 2007 and ends on 31 December 2008. Her chargeable period spans more than a year (it amounts to 1.33 years). In this situation, s.56(3) CAA 2001 provides that the rate of writing-down allowance (WDA) should be increased proportionately. Thus, had the 25% rate still applied, the trader's effective rate of WDA would have been increased to $1.33 \times 25\% = 33.33\%$.

On this basis, her hybrid rate would be similarly increased as follows:

- 1 September 2007 to 5 April 2008 - 218 days at WDA rate of 25%. The rate for this part period is: $218 / 366 \times 25\% = 14.89\%$
- 6 April 2008 to 31 December 2008 - 270 days at WDA rate of 20%, the rate for this part period is: $270 / 365 \times 20\% = 14.79\%$
- Therefore hybrid rate to be applied to her chargeable period of 1.33 years is $(14.89 + 14.79) = 29.68\%$

Example 2

A sole trader newly starting up in business has an initial period of account of 28 months that starts on 1 September 2006 and ends on 31 December 2008. His period of account therefore spans a period of 2.33 years. In this situation s.6(6) CAA 2001 applies, so that the first and second chargeable periods are periods of 12 months and the third chargeable period is a part period of 4 months or 0.33 of a year.

In this example, the hybrid rate applies only to the second chargeable period, as follows:

- First period: 1 September 2006 to 31 August 2007, WDA 25%, as currently.
- Second period: 1 September 2007 to 31 August 2008

For this period, his hybrid rate would be calculated as follows:

- 1 September 2007 to 5 April 2008. 213 days at WDA rate of 25%, the rate for this part period is $213/366 \times 25\% = 14.89\%$
- 6 April 2008 to 31 August 2008. 148 days at WDA rate of 20%, the rate for this part period is $148/365 \times 20\% = 8.11\%$
- Therefore hybrid rate for the second period = $(14.89 + 8.11) = 23\%$

In the third period: 1 September 2008 to 31 December 2008 (0.33 of a year), the rate of writing down allowance will now be the new rate of 20 per cent and $0.33 \times 20\% = 6.6\%$.

Single asset pools

5.8 The existing arrangements for short-life assets, which have been in place since 1985 to allow businesses to elect for short-life assets to be treated in a single asset pool, will remain in place. Expenditure on integral fixtures and long-life assets will not be eligible for the short-life treatment.

5.9 A short life asset pool where the company has a calendar year chargeable period would be subject to the hybrid rate of 21.25% as in paragraph 5.6.

5.10 The rules for single asset pools for “cars above the cost threshold” of £12,000 (sometimes called “expensive cars”) are currently subject to an ongoing consultation¹³. However, on the basis of the current rules, annual WDAs are capped at £3,000 under s.75 CAA 2001.

5.11 Box 5.2 outlines two examples of the hybrid rate calculation for an “expensive car” in a single asset pool.

Box 5.2 Hybrid rate calculation for ‘expensive cars’

Example 3

A company has a chargeable period that starts on 1 January 2008 and ends on 31 December 2008 and owns an ‘expensive car’ in a single asset pool, which has been written down to a value of £20,000 by 1 January 2008.

The single asset pool in this example would be subject to the hybrid rate of 21.25% (as in paragraph 5.6 above). 21.25% of £20,000 = £4,250, which exceeds the cap of £3,000 so allowances for this period would be restricted to £3,000.

Example 4

Using the facts in the previous example, but assuming that the written-down value as at 1 January 2008 had become £14,000, the hybrid rate would, once again, be 21.25%. 21.25% of £14,000 = £2,975. This is less than the cap of £3,000, so allowances for this period would be £2,975.

Ready reckoner

5.12 The calculation of the hybrid rate is intended to be straightforward, but to further simplify the calculation, HMRC will provide a ready reckoner to assist businesses in calculating the hybrid rate for any chargeable period affected by the transitional provisions.

P&M EXPENDITURE IN THE NEW 10 PER CENT POOL

5.13 Expenditure to be allocated to the 10 per cent pool falls into two broad categories:

1. **Pre-existing long-life asset expenditure**, in the current 6 per cent pool, where the application of a hybrid rate will be consistent with the method for the change in the rate for the main P&M pool; and
2. **Expenditure incurred on or after 1 or 6 April 2008** on long-life assets and on the new ‘integral fixture’ class of plant and machinery. For these assets, the Government’s intention is that relevant expenditure should receive the full 10 per cent rate for the chargeable period in which the expenditure is incurred, even if that period is a transitional period.

5.14 Box 5.3 outlines an example of the application of the hybrid rate for P&M expenditure in the new 10 per cent pool.

¹³ This consultation began at Budget 2006: “Modernising tax relief for business expenditure on cars: A consultation document” which was followed by a “consultation update” at Budget 2007 – both documents are available at hm-treasury.gov.uk

Box 5.3 Hybrid rate calculation for expenditure to be included in the 10 per cent pool**Example 5**

A company has a chargeable period beginning on 1st January 2008 and ending on 31st December 2008.

(i) Pre-existing expenditure

At 1 January 2008, it has unrelieved expenditure of £1 million in the 6 per cent long-life asset pool. A hybrid rate therefore needs to be calculated on a time apportioned basis as follows:

- 1/1/08 to 31/3/08 = 3 months at WDA rate of 6%. So the rate for this part period is $\frac{1}{4} \times 6\% = 1.5\%$
- 1/4/08 to 31/12/08 = 9 months at WDA rate of 10%. So the rate for this part period is $\frac{3}{4} \times 10\% = 7.5\%$
- Hybrid rate on existing pool for the chargeable period = 9.0%

Therefore WDAs on £1 million at 9 per cent = £90,000 and balance of unrelieved expenditure to be carried forward into new 10 per cent pool = £910,000.

(ii) New "10% expenditure" incurred after April 2008

On 1 May 2008, the company incurs new expenditure of £400,000 on additional long-life assets and on 31 August 2008 it incurs £100,000 on assets falling within the new classification of "integral fixtures". This total expenditure of £500,000 will receive the full 10 per cent rate in the company's 2008 chargeable period. So this expenditure will give rise to allowances of $10\% \times £500,000 = £50,000$, leaving £450,000 to be carried forward in the 10% pool.

Thus, from 1 January 2009 (after the transitional period), the total in the new 10% pool will be $£910,000 + £450,000 = £1,360,000$. Thereafter, the total in this pool, at the end of each chargeable period, will carry on being written down at 10 per cent per annum on a reducing-balance basis.

THE ANNUAL INVESTMENT ALLOWANCE & FIRST-YEAR ALLOWANCES

5.15 The annual investment allowance (AIA) will apply to qualifying expenditure incurred on or after 1 April 2008 in the case of businesses within the charge to corporation tax, and on or after 6 April 2008, for businesses within the charge to income tax. The existing capital allowances rules for determining when expenditure is incurred¹⁴ will apply to determine whether expenditure is incurred before or after the 1 or 6 April start date.

5.16 For those businesses whose chargeable periods span the 1 or 6 April 2008 start date, the AIA will be proportionately reduced or increased on a time-apportioned basis. Thus, for a company with a chargeable period starting on 1 January 2008 and ending on 31 December 2008, the AIA available (from 1 April to 31 December, i.e. for 9 months) will be $\frac{3}{4}$ of £50,000 = £37,500. In other words, the AIA will simply be reduced on a time-apportioned basis.

¹⁴ See Section 5 CAA 2001.

5.17 Box 5.4 sets out two examples of time apportionment for the AIA.**Box 5.4 Time-apportionment of the annual investment allowance****Example 6**

A small company has a year-end of 31 December 2008. It spends £30,000 on a new lorry on 1 February 2008 and £45,000 on a new lathe on 30 November 2008.

The £30,000 qualifies for a 50% first-year allowance (FYA) of £15,000 and the balance of the expenditure (£15,000) will go into the general pool in the next chargeable period.

As the company's chargeable period spans 1st April 2008, its AIA is reduced proportionately to $\frac{3}{4}$ of £50,000 = £37,500. So, £37,500 is written off against the expenditure on the lathe. The balance of the expenditure over the AIA (i.e. £45,000 - £37,500 = £7,500) is added to the general pool and will qualify for a hybrid 21.25% writing-down allowance (see paragraph 5.6). $21.25\% \times £7,500 = £1,594$.

The total allowances due will therefore be:

- 50% FYA: £15,000
- AIA: £37,500
- WDA: £1,594
- Total: £54,094

This compares with 50% FYAs $\times (\£30,000 + \£45,000 = \£75,000) = \£37,500$ under pre-1 April 2008 rules.

Example 7

A sole trade (small enterprise) starts up in business on 1 March 2008 and incurs expenditure of £20,000 on a baler in March 2008 and £65,000 on a tractor in November 2008. The first accounts are drawn up to 31 July 2009.

The £20,000 qualifies for a 50% FYA of £10,000 and the balance of the expenditure (£10,000) will go into the general pool in the next chargeable period.

As the period of account spans 6th April 2008 and is also longer than 12 months, the AIA is calculated on a time-apportioned basis. The number of days from 1 April 2008 to 31 July 2009 is 487 so the AIA calculation is $\frac{487}{365} \times \£50,000 = \£66,712$. So, the total expenditure of £65,000 on the tractor will qualify for 100% AIA relief.

Therefore, the total allowances due will be:

- 50% FYA: £10,000
- AIA: £65,000
- Total: £75,000

Compared to 50% FYAs $\times (\£20,000 + \£65,000 = \£85,000) = \£42,500$ under pre-1 April 2008 rules.

INDUSTRIAL AND AGRICULTURAL BUILDING ALLOWANCES

5.18 Budget 2007 announced the phased withdrawal of the industrial and agricultural buildings allowances. The allowances will be withdrawn completely from 1 April 2011 for companies and from 6 April 2011 for unincorporated businesses.

5.19 At present, the basic rule¹⁵ for these allowances is that qualifying expenditure¹⁶ is written down at a rate of 4 per cent a year. That rate is proportionately increased or reduced if the chargeable period is more or less than a year. However, that basic rule does not apply if the allowances are recalculated after a sale or acquisition of the relevant interest¹⁷.

5.20 The Budget announced that the rate of the writing-down allowances (WDA) would effectively fall in successive 1 percentage point steps: to 3 per cent from April 2008; 2 per cent from April 2009; and 1 per cent from April 2010; with full abolition from April 2011.

5.21 In effect, the phasing-out of industrial and agricultural buildings allowances is achieved by a reduction in the value of the allowance of 25 per cent in 2008-09; 50 per cent in 2009-10; and 75 per cent in 2010-11. Expressing the transitional provisions in this manner also caters for the phasing-out in the case of recalculated allowances on a sale or acquisition.

5.22 Thus, the value of the writing down allowances (either 4 per cent of the original expenditure, or the recalculated annual allowance after a sale or acquisition) will be progressively reduced as follows:

- in 2008-09 or financial year 2008 a business will be entitled to 75 per cent of the WDA;
- in 2009-10 or financial year 2009 a business will be entitled to 50 per cent of the WDA; and
- in 2010-11 or financial year 2010 a business will be entitled to 25 per cent of WDA.

5.23 Where a business's chargeable period is the same as the income tax year (in the case of an unincorporated business) or the same as the financial year (in the case of a company), the reductions above will apply to the whole of the chargeable period. Where a business has a chargeable period that spans the date when the rate reduces, time apportionment rules will apply.

5.24 Box 5.5 sets out an example of the phased withdrawal of the industrial buildings allowance. The example is also relevant for the agricultural buildings allowance.

¹⁵ In s.310 for industrial buildings allowances (IBAs) and s.373 for agricultural buildings allowances (ABAs).

¹⁶ Except in the case of qualifying enterprise zone expenditure where the rate is 25 per cent.

¹⁷ See s.311 for IBAs and s.376 for ABAs.

Box 5.5 Phased withdrawal of industrial buildings allowance**Example 8**

A company is entitled to industrial buildings allowances (IBAs). It has a chargeable period that starts on 1 January 2008 and ends on 31 December 2008. Its annual entitlement to IBAs will be made as normal (either under s.310 or s.311) and that amount will then be time-apportioned. In this example the annual amount is calculated at £46,000. So the time apportionment calculation would be as follows:

- 1 January 2008 to 31 March 2008: $\frac{1}{4}$ of £46,000 \times 100% = £11,500
- 1 April 2008 to 31 December 2008: $\frac{3}{4}$ of £46,000 \times 75% = £25,875
- Year ended 31 December 2008, total IBAs deductible in computing profits £37,375

In the year ended 31 December 2009, assuming no new expenditure is incurred, the time apportionment will be:

- 1 January 2009 to 31 March 2009: $\frac{1}{4}$ of £46,000 \times 75% = £8,625
- 1 April 2009 to 31 December 2009: $\frac{3}{4}$ of £46,000 \times 50% = £17,250

Year ended 31 December 2009, total IBAs deductible in computing profits £25,875

CONSEQUENTIAL ISSUES

5.25 The Government recognises that several provisions in CAA 2001 – other than those in Parts 3 and 4 – will be affected by the abolition provisions (for example, the provision relating to thermal insulation of industrial buildings in s.28 of Part 2). There are also a number of provisions where consequential amendments will be required, following the abolition of Parts 3 and 4. These consequential issues will be considered and any necessary adjustments to the CAA 2001 will be made. At this stage, the Government welcomes the views of business on the detailed consequential requirements of reform to CAA 2001.

6

QUESTIONS FOR CONSIDERATION

6.1 This consultation document sets out proposals for three new elements of the capital allowances system. Specific requests for comments are made under each strand of the reforms below.

6.2 In addition, the Government welcomes evidence from business on the impact of the business tax changes announced in Budget 2007 as a whole.

ANNUAL INVESTMENT ALLOWANCE

6.3 Comments are requested on the following issues:

- Recognising the difficulties of correctly identifying non-commercial fragmentation or use of allowances, the Government welcomes views on the general approach of offering simple and broad-based targeting for the AIA, accompanied by targeted anti-abuse safeguards to prevent artificial fragmentation and artificial use of unused allowances. The Government also welcomes views on the use of a specific ‘hallmark’, under the disclosure regulations.
- The Government welcomes views from business on the relative merits of an alternative ‘economic entity’ approach over the approach outlined above.
- The Government welcomes views on whether the proposed rules for the AIA would impose any additional compliance burdens and whether the accompanying anti-abuse rules are proportionate to the risk.

INTEGRAL FIXTURES

6.4 Comments are requested on the following issues:

- The Government welcomes views on the relative merits of:
 - a purposive definition of “integral fixtures”, that might list the fixtures, but exclude fixtures required to meet the particular purposes of the qualifying activity; or
 - a short, unambiguous list of the integral fixtures to be assigned to the new 10 per cent pool.
- The Government welcomes views on:
 - whether a simple, short list approach would be preferable to the “background plant and machinery” definition; and
 - whether it would be sufficient simply to list the assets to be included.
- The Government welcomes views on the proposed ‘asset list’ of integral fixtures, and especially on:
 - whether the suggested list of assets could be improved by additions, omissions or refinements, given the underlying policy objectives; and

whether fixtures that do not currently qualify for any allowances (such as general electrical systems or cold water systems) should be included as part of a new, simplified approach.

- The Government welcomes views on whether the new “integral fixtures” classification should be extended to expenditure on the relevant assets within structures as well as within buildings.
- The Government welcomes views on:

whether it would be desirable to include expenditure on specific building features (such as brise soleil and active facades), that could have worthwhile environmental benefits, within the new 10 per cent “integral fixtures” classification; and

if so, which environmentally beneficial building features should be specifically included.

PAYABLE ENHANCED CAPITAL ALLOWANCES

6.5 Comments are requested on the following issues:

- The Government welcomes comments from business on the high-level proposals for payable enhanced capital allowances (ECAs) outlined in Chapter 4.
- The Government welcomes comments on the proposed restriction of payable ECAs to companies only.
- The Government welcomes the early views of business on how a cap on any cash payments could be applied.

A

HOW TO RESPOND

A.1 The Government welcomes comments on the proposals in this discussion paper. Any comments should be sent to:

Business tax reform consultation
Corporate Taxation Team
HM Treasury
1 Horse Guards Road
London SW1A 2HQ

Email: businesstaxreforms@hm-treasury.x.gsi.gov.uk
Telephone (Treasury switchboard): 020 7270 5000

A.2 Comments should be received by 19 October 2007.

DISCLOSURE OF RESPONSES

A.3 Information provided in response to this discussion paper, including personal information, may be published or disclosed in accordance with the access to information regimes (these are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004).

A.4 If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals, amongst other things, with obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances.

A.5 An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on the Department.

A.6 If you have any queries concerning confidentiality or the FOI then queries should be directed in the first instance to the above address.

A.7 This document is available at www.hm-treasury.gov.uk/consultations.

B

CONSULTATION STAGE IMPACT ASSESSMENT

B.1 This consultation stage impact assessment gives an early exploration of the potential impacts of the proposals in this consultation document. A full impact assessment will be published in advance of the publication of Finance Bill 2008.

What is the problem under consideration? Why is Government intervention necessary?

B.2 The pressures of globalisation and changing patterns of domestic business activity have created new pressures for reform of the business tax system. This consultation document outlines a series of reforms to the corporation tax rate structure and to capital allowances, and seeks feedback on the design of three new elements of the capital allowances system.

Policy objectives and intended effects

B.3 Overall, the package of proposals is intended to:

- **Promote investment and growth** – by
 - reducing tax-driven distortions on commercial activity, ensuring that business decisions are based on commercial rather than tax considerations;
 - stimulating higher levels of foreign and domestic investment through a lower CT rate on a broader tax base; and
 - refocusing the tax system for small business with more generous and better-targeted incentives for investment.
- **Reduce administrative burdens and complexity** – by
 - removing anachronistic and onerous elements of the tax system, complementing the programme of improvements to the administration of the tax system following the Varney Review of Links with Large Business.
- **Maintain the fairness of the tax system** – by
 - ensuring that business continues to contribute its fair share towards public services in the most efficient manner; and
 - ensuring that people engaged in similar economic activities pay broadly the same overall level of tax and national insurance contributions, regardless of the legal form they choose for their business.

Alternative policy options and justification for preferred option

B.4 Maintaining the status quo has a number of unwanted effects:

- It preserves a number of tax-driven distortions on commercial activity, relating principally to the mismatch between the present rates of writing-down allowance and true economic depreciation. This encourages the inefficient allocation of resources in the UK economy and constrains economic growth;

- The UK's competitive position relative to other countries will decline as other countries seek to reduce headline corporate tax rates; and
- The practice of tax-motivated incorporation, whereby the self-employed can reduce their overall tax and national insurance liability by adopting the corporate legal form and extracting labour income in the form of dividends, will continue unchecked.

Annual investment allowance

B.5 The reforms outlined in this document include the introduction of the annual investment allowance (AIA). This preserves the Government's ongoing objective of supporting small business investment. An alternative option of 100% first-year allowances for small businesses – building on the existing first-year allowances for small and medium sized enterprises – was considered. However, the Government's assessment was that 100% first-year allowances for small businesses would constitute selective assistance and would not meet the requirements of the European Commission's State aid framework. This option was not taken forward further.

Industrial and agricultural buildings allowances

B.6 The withdrawal of the industrial and agricultural buildings allowances was considered against an alternative option to introduce a blanket allowance for all commercial buildings. This option was the subject of earlier consultation on 'CT reform'¹⁸. A commercial buildings allowance, with a reducing balance calculation to permit pooling, has the attraction of simplicity. However, even at a very low rate of writing-down allowance, the Exchequer costs are extremely high and it does not address the wider issue that many commercial buildings appreciate in value. The Government's assessment is that these resources are more efficiently allocated to a cut in the main rate of corporation tax and the introduction of a new incentive for investment, the AIA.

B.7 The new payable enhanced capital allowances and the integral fixtures definition build on existing approaches already used in the tax system and no alternative mechanisms were considered to deliver their policy objectives.

When will the policy be reviewed to establish the actual costs and benefits, and the achievements of the desired effects?

B.8 The business tax reforms are designed to elicit a number of pro-growth effects – notably through increases in investment through a lower headline rate of CT and the new AIA, but also through increases in innovation through a more generous research and development (R&D) tax credit. The impact of these various effects is important, but difficult to accurately measure.

B.9 The Government will monitor the impact of the Budget business tax reforms generally, but there are a number of restrictions on accurate evaluation. In general, the effect of tax measures on business behaviour can take a number of years to manifest itself. For example, the Government has a comprehensive evaluation strategy in place to evaluate the impact of R&D tax credits. An independent feasibility study, published last year¹⁹, established that econometric analysis of the effect of R&D tax credits on levels of business R&D would require a minimum of 10 years' data.

¹⁸ CT reform consultation was run by Inland Revenue between 2002 and 2005.

¹⁹ <http://www.hmrc.gov.uk/research/non-technical-summary.pdf>

B.10 Similar constraints apply to evaluation of this package of measures. Furthermore, the effects of specific tax measures on investment can be difficult to isolate from other tax and non-tax factors affecting investment. The introduction of the new regime will commence from April 2008 and will be dependent on the outcome of this consultation and any proposals issued for further consultation. The Government expects to undertake a Compliance Cost Review (CCR) between one to two years following the implementation of any reform.

MINISTERIAL SIGN OFF

6.13 I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsible Minister

Jane Kennedy

Financial Secretary to the Treasury

19 July 2007

Summary of the policy change

Annual costs 6.14 The annual costs of the package as a whole are set out in the Budget statement, published earlier in the year. The transition to the new structure will carry additional compliance costs, but these have been minimised in the construction of the new regime. Overall, this package is intended to reduce overall administrative burdens.

Annual benefits 6.15 Overall, the package is intended to make a positive impact on trend rates of growth – predominantly through increases in investment, but also through higher levels of R&D. The increases in investment will come through a lower main rate of corporation tax for larger companies and the introduction of the annual investment allowance, which applies to both corporates and the unincorporated. A reduction in the distortive impact of capital allowances will also encourage more efficient investment and will have a similarly positive impact.

Sensitivities and risks 6.16 The package is a significant change in the UK's system for giving relief for capital expenditure and could elicit a range of behavioural responses. Overall, these behavioural responses are expected to be positive, but there may be a number of individual taxpayers for whom this package will have a negative impact. These will also be highly dependent on the detailed design of the proposals. One of the aims of this discussion is to understand better the likely behavioural response to the proposals in order to ensure that they are developed in a way that minimises risks and uncertainties for Government and taxpayers.

Administrative burdens 6.17 Overall, the package will reduce the administrative burden imposed by the tax system. The withdrawal of industrial and agricultural buildings allowances removes a source of significant compliance costs. The annual investment allowance also provides 100% write-off for most plant and machinery investment. For the 95% of businesses that invest up to £50,000 in qualifying plant and machinery per annum, this will also represent a reduction in the costs of compliance.

6.18 The transition to the new structure will carry additional compliance costs, but these are transitory and have been minimised in the design of the new regime. Overall, the package is intended to place the tax system on a more rational footing, which better

accords with underlying commercial activity. A full assessment of the impact on administrative burdens will be included in the full impact assessment, to be published in advance of the publication of the 2008 Finance Bill.

What is the geographic coverage of the policy?	The proposals will be implemented in the UK.
On what date will the policy be implemented?	The date of implementation of the proposals is April 2008.
Which organisation(s) will enforce the policy?	HMRC
Does enforcement comply with the Hampton principles?	Yes
Will implementation go beyond minimum EU requirements?	No
What is the value of the proposed offsetting measure per year?	None
What is the value of changes in greenhouse gas emissions?	None
Will the proposal have a significant impact on competition?	No

EVIDENCE AND RATIONALE FOR REFORM

B.17 The proposals in this document are informed by evidence from a number of sources. These include aggregated taxpayer data, published data on levels of business investment and information shared with Government by business stakeholders in the course of previous consultation on reform of the corporation tax regime. The proposals reflect the Government’s initial understanding of the likely benefits and costs of the proposals. On this basis, the Government believes they represent a fair package, which will deliver a less distortive tax system that is more supportive of growth and investment.

B.18 The package announced in the Budget makes a number of changes to the business tax base, largely through changes to capital allowances, and makes associated changes to the corporation tax rate structure. The main rate of corporation tax will fall from 30 per cent to 28 per cent from April 2008 and the small companies’ rate will increase from 19 per cent in 2006/07 to 22 per cent in 2009/10.

B.19 For small businesses, the package of changes refocuses support for investment – moving away from an *indirect* investment incentive through a lower small companies’ rate, to a *direct* incentive for investment with the introduction of a 100 per cent first year allowance for most plant and machinery expenditure up to £50,000 per year. Overall, this change lowers the cost of capital and will encourage greater levels of investment.

B.20 The wider changes to capital allowances, including the changes to the standard and long-life rates of plant & machinery allowance and the withdrawal of the industrial and agricultural buildings allowances, are intended to realign the capital allowances system more closely with average rates of economic depreciation. These changes will encourage more efficient allocation of resources in the UK economy.

Competition assessment

B.21 Application of the competition filter test shows that the new rules are not likely to have a material effect on competition.

Specific impacts tests – Checklist

B.22 The assessment above covers the Competition assessment and the Small Firms Impact Test. The Government has considered the other potential impacts and confirms that they are not relevant to the policy proposals set out in this consultation document.

C

CABINET OFFICE CODE OF PRACTICE ON WRITTEN CONSULTATIONS

C.1 This consultation is being conducted in accordance with the code, which sets down the following criteria:

- Consult widely throughout the process, allowing a minimum of 12 weeks for written consultation at least once during the development of the policy.
- Be clear about what your proposals are, who may be affected, what questions are being asked and the timescale for responses.
- Ensure that your consultation is clear, concise and widely accessible.
- Give feedback regarding the responses received and how the consultation process influenced the policy.
- Monitor your Department's effectiveness at consultation, including through the use of a designated consultation co-ordinator.
- Ensure your consultation follows better regulation best practice, including carrying out an Impact Assessment if appropriate.

C.2 You can see the full Cabinet Office Code of Practice on consultation on the internet, at the following address:

www.cabinet-office.gov.uk/regulation/Consultation/Code.htm

Complaints

C.3 If you have any comments or complaints about the consultation process, please contact:

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London SW1A 2BQ

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Details of how to respond to the consultation itself can be found at paragraph A.1 of this consultation document.

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