CAPITAL ALLOWANCES FOR FIXTURES

Tax Steven Dowers and Mark Harryman explain a recent revision to UK tax law and the hurdles buyers of property must now satisfy to claim tax relief on the value of fixtures

Since 1 April 2012 (for corporation tax) and 6 April 2012 (for income tax), UK tax law has been revised to change the basis on which relief is given by way of capital allowances. There is a transitional period during which both the old and the new rules may apply to purchases of property. The changes have introduced a number of hurdles which buyers of property must now satisfy before they are able to claim tax relief on the value of qualifying fixtures within the property. These must be borne in mind when completing any new property purchase as, unless the new requirements can be met, there is a danger that potentially valuable tax relief may be permanently lost.

Basis of allowances

Where property is acquired for investment or operational use, the accounting treatment will typically be different from the tax treatment. The book value will show the property at cost as revised for annual revaluation and will take into account depreciation of the asset over time. These accounting adjustments are not relevant to the tax position: gains and losses on revaluation are not taxed until disposal of the property, while depreciation is not tax-deductible. Instead of depreciation, tax relief is given by way of allowances against capital expenditure on property on the element that represents qualifying fixtures.

Qualifying fixtures

In practice, there are two categories of qualifying fixtures:

- Integral features: These are items integral to a modern building which have a longer average economic life than other plant and machinery. They comprise a designated list of items including lifts, escalators, air conditioning, lighting systems and electrical systems.
- Plant and machinery: Machinery is often identifiable, but "plant" is a more difficult concept and there is a large volume of case law examining whether or not certain items should be classified as plant. Cases tend to focus on whether the expenditure is on something that performs a function (which would be plant) or is merely part of the setting.

Relief for qualifying expenditure is given on a pooled basis for each of the two categories, ie, various items of expenditure are pooled together rather than being treated individually. Generally, plant and machinery attracts tax relief at an annual rate of 18% on the pool and integral features at 8% (each on a reducing balance basis where the relief given reduces the value of the pool). Amounts received on the disposal of fixtures are treated as reducing the balance on the relevant pool. If these amounts exceed the balance on a pool, the excess is taxable.

The old rules

Where a property owner incurs expenditure directly on the initial installation of qualifying fixtures, the owner may claim capital allowances on that expenditure. The owner's entitlement will not be removed as a result of the new rules.

However, because fixtures are legally part of a building, any qualifying fixtures are also sold along with the building when a property is sold. An entitlement to claim capital allowances also transfers with ownership of the fixtures, with the buyer able to claim on the remaining value of the fixtures transferred. Under the old rules, the value at which fixtures were deemed to be transferred between seller and buyer on the sale of a property was calculated by making a "just and reasonable apportionment" of the sale price. Where fixtures had already been subject to a capital allowances claim by the seller, this apportionment was restricted to the original cost of the fixtures.

The requirement for a just and reasonable apportionment often put the seller at a disadvantage because it was calculated by reference to the sale price of the property rather than original cost of the fixtures. In practice, this often led to a higher disposal value than the remaining value of the fixtures in the capital allowances pool, which could lead to HMRC effectively clawing back some of the tax relief previously claimed by the seller. There was no time limit by which the buyer needed to establish a just and reasonable apportionment of the purchase price. Hence the buyer was in a position to claim capital allowances at any time up until the date they ultimately disposed of the property.

An alternative to this apportionment was for the seller and buyer to agree what part of the sale price should be apportioned to fixtures and to enter into a joint election (a section 198 election) attributing specified values to each category of fixtures. These values were open to negotiation between the parties at any amount up to a maximum of the original cost of the fixtures. Buyers would argue that the just and reasonable apportionment value should be used. However, sellers often suggested a value of £1 be apportioned as this would entitle them to tax relief on the remainder of the value in the pool without passing any of the benefit on to the buyer.

The new regime

In most cases following the recent changes, the old rules will cease to apply. Now before a buyer can claim allowances on inherited fixtures, it will be necessary for fixed values to be put on each of the two categories of fixtures. This needs to be done within a statutory time limit of two years from the date of purchase of the property.

The fixed values can generally be established in one of two ways:

- by a section 198 election between the seller and buyer, as was possible under the old rules; or, in the absence of such an election
- as determined by a tribunal on the application of either party.

However, where the seller is not entitled to claim capital allowances but a previous owner was, the fixed value requirement must be met by way of a written statement from the seller to this effect and a written statement from the previous owner of their disposal value (which becomes the fixed value).

The burden of proof that the fixed value requirement has been met rests with the buyer who will be denied the opportunity to claim capital allowances on fixtures they have acquired if the disposal value has not been fixed within the two-year deadline.

The new rules also introduce a mandatory pooling requirement that does not apply until 1 April 2014 (for corporation tax) and 6 April 2014 (for income tax). This will require anyone who is entitled to claim capital allowances on expenditure incurred on fixtures, and who then disposes of those fixtures, to have the relevant expenditure recorded in the appropriate capital allowances pool of the tax return for an accounting period beginning on or before the date of sale. Once the requirement comes into effect, any buyer will be unable to claim capital allowances on fixtures they have acquired if this stipulation is not met. As with the fixed value requirement, the burden of proof will fall on the buyer.

Although the new rules have already taken effect, there are cases where the old rules will continue to apply. For the new rules to apply to a buyer, there needs to have been a prior owner who was entitled to claim capital allowances in respect of the fixtures. This will not always be the case: property developers who construct buildings as part of their trade have no entitlement to claim capital allowances on the fixtures they install in the property and which are part of their stock in trade. Accordingly, buyers will usually be entitled to claim capital allowances based on a just and reasonable apportionment of the purchase price paid for such properties.

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WHY THIS MATTERS

Due to their complexity and to low levels of awareness, capital allowances are often overlooked in property sales but potential claims can be of significant financial value to a buyer and should not be ignored.

The new requirement for the seller and buyer to agree a fixed value for qualifying fixtures before a claim can be made, and the time limit of two years from the date of sale to accomplish this, will mean that a buyer cannot deal with capital allowances as an afterthought once the property has been acquired.

It will need the seller's co-operation to agree a fixed value if it wants to avoid applying to the tribunal to determine that value and the costs involved in such an application. The only way for the buyer to ensure that it receives that co-operation is to deal with capital allowances as part of the sale process: unless the contract deals with it specifically there will be no motivation for the seller to assist once completion takes place.

The following practices are likely to be adopted as a result of the new rules:

- As buyers will want to ascertain the capital allowances position before completion to ensure they are able to make a claim, the importance of proper due diligence will be brought to the fore. Sellers should be liaising with their advisors to gather the relevant information as early as possible to prevent the transaction being held up once it is underway. There could be an added benefit to early clarification of the position, as marketing the property with information on available capital allowances could have a positive impact on the price a buyer is willing to pay.
- All buyers should now be looking to agree the fixed value of the qualifying fixtures at the contract stage, with the contract requiring the parties to enter into a section 198 election to record it. Even if the buyer is not interested in claiming the capital allowances itself, failure to obtain a section 198 election (or apply to the tribunal within two years of completion) will prevent the buyer from passing on the allowances to a future buyer down the line. This may have potential consequences for the achievable resale price. As before, determining what the fixed value should be will be a matter of negotiation between the parties.