Analysis

Capital allowances reform: assessing the options to encourage greater private sector investment

Speed read

Levels of capital investment committed by the UK private sector and the associated tax relief available lag behind its competitors, resulting in lower productivity and predicted growth. HMRC has published a consultation seeking views on changes to the capital allowances regime to encourage increased investment. Several options are under consideration and it is important that any changes made have a broad application, such that all taxpayers can benefit, including companies awash with losses. Taxpayers should model the impact of options and engage openly and honestly with HMRC so that feedback is acted upon, so changes can be made resulting in the desired outcome.

Suzanne Alcock
FTI Consulting
Suzanne Alcock is a managing director in tax depreciation services at FTI Consulting. She specialises in providing advice on tax relief for capital assets at all stages of the asset lifecycle across all sectors, with a particular focus on real estate, energy, infrastructure and sustainability. Email: suzanne.alcock@fticonsulting.com; tel: 020 7979 7458.

During the recent Spring Statement, the chancellor expressed his concerns that the level of capital investment by private businesses in the UK is low compared with the OECD. UK investment averages 10% of GDP compared with 14% across the OECD (*Spring Statement 2022*, para 4.22). The government believes that this, combined with other factors, may result in lower productivity and projected growth.

Despite the competitive headline rates of corporation tax, without the temporary first-year allowances (FYAs) of 130% super-deduction and 50% special rate allowance (SR allowance), the generosity of the UK's tax regime for capital investment lags behind our competitors (*Spring Statement 2022*, para 4.31).

One measure set out in the government's *Tax plan* is 'to cut and reform business taxes, to create a new culture of enterprise and the conditions for private sector-led growth' (*Spring Statement 2022*, para 4.5). The capital allowances regime has a long history of providing a mechanism to adopt incentives to encourage capital investment in specific areas, with the super-deduction and SR allowance for business being the incentive to compensate for the increase in the corporation tax rate to 25%. Altering the capital allowances regime appears to be at the heart of this government's strategy once again.

Potential reforms to the capital allowance regime

On 9 May 2022, the policy paper inviting views on capital allowances reform was launched. It sets out 'areas of interest' and options for changes to plant and machinery allowances ranging in simplicity, generosity, and impact on investment. The policy paper seeks views on a broad range of topics which should stimulate interesting discussions and insight from stakeholders. In the paper, the government has clearly stated that the changes are subject to the amount of funding available, and it asks for views on the best approach to address this aspect.

Areas of interest in which the government is seeking views include:

- how firms make investment decisions, the importance of capital allowances in those decisions and how they are considered (i.e. on a net present value basis (NPV), cashflow benefit or impact on effective tax rate);
- how the super-deduction has affected investment decisions; and
- what more the capital allowances regime can do to support business investment, whether it provides adequate support and how simple it is to understand and operate.

The options for changes detailed in the *Tax plan* are:

1. increasing the permanent level of the annual investment allowance (AIA), for example to £500,000;
2. increasing writing down allowances (WDAs) for main and special rate (SR) pool assets from their current levels of 18% and 6% to 20% and 8%;
3. introducing first-year allowances (FYAs) for main pool and SR assets; for example, 40% and 13% in the first year, with the remaining expenditure written down at standard WDAs;
4. introducing an additional FYA, to bring the overall amount that can be claimed to greater than 100% of the initial cost; for example, an additional capital allowance of 20% in the first year, on top of standard WDAs on 100% of the initial cost across the first and subsequent years; and
5. introducing full expensing allowing businesses to write off the costs of investment instantly.

None of these suggestions are new, but they have the potential to fully utilise the flexibility of the regime.

The focus for future changes

When any changes are made to a tax regime, the commentary is regularly provided from the position of the 'winners and losers'.

Businesses are often focused on their cashflow position and temporary FYAs have been welcomed by those able to immediately benefit from them, such as by making taxable profits or receiving a cash tax repayment from HMRC for taxes paid in an earlier period. However, there are many businesses that are not in this favourable position, and they need support. This particularly applies to those awash with losses, or newly established entities incurring material levels of investment on new assets, who are unable to immediately offset tax relief.

Leaving aside the temporary extension for the carry-back of losses (the Corporation Tax (Carry Back of Losses: Temporary Extension) Regulations, SI 2021/704), temporary FYAs may not have a positive impact in the short-term on the cashflow position of a loss-making company.

Examples of sectors that experience this fact pattern are real estate, energy and infrastructure. In line with the government's '10 point plan for a green industrial revolution' and the 'British energy security strategy', material levels of investment are sought for new assets which address the needs of the strategy. The corporate vehicle for developing assets of this nature is often a special purpose vehicle (SPV). The significant levels of capex incurred before a business commences trading can result in the SPV being tax loss-making during the early years of operation at the time the business most requires cash.

In the real estate sector, there is a requirement for improved energy efficiency on existing buildings which necessitates significant investment. The retrofitting of existing buildings is often needed to ensure the property does not become unlettable and a stranded asset, but this can be a very costly business. In conjunction with the energy sector, considerable investment is required, and it will be interesting to see if this is an area of focus for the new reliefs.

The availability of capital allowances may not, of course, be an immediate or a fundamental factor when deciding whether to proceed with a particular investment, and the approach will differ on a case-by-case basis. Businesses should model their tax profile to determine whether it is beneficial to claim FYAs, increasing the amount of losses available for relief (usually carried forward) subject to restrictions on their use, or to keep the capital allowances pools 'whole', allowing WDAs to be claimed in the future.

It is worth noting that due to the short period of time over which the super-deduction was implemented, some projects with long lead-in periods were unable to benefit from the additional and accelerated relief, where the expenditure is incurred on or after 1 April 2023. These projects often require significant investment in key areas where the government is seeking private investment, but they have been unable to benefit from the super-deduction and SR allowance.

Options for change

The chancellor has published an indicative cost to the exchequer of options available for changes to the capital allowances regime. The implications and value of each option to a taxpayer differ depending upon the specific facts, tax profile and plans of the business.

Undertaking a simple modelling exercise provides insight on the potential value of each option to a taxpayer. See our table (above right) for an example of this. Our model is based on a straight-forward fact pattern with the following assumptions:

- there is £10m capital expenditure incurred on plant and machinery, split 75% to main pool and 25% to SR pool;
- the company makes taxable profits and has a year end date of 31 March; and
- apart from the AIA, all other reliefs and capital allowances are ignored.

Prime facie, the taxpayer benefits under each option. But whereas option 1 gives a significant immediate cashflow benefit with the value rapidly falling away over time, options 4 and 5 provide substantial cashflow benefits in the short-term whilst retaining a material longer-term benefit. Based on our modelled assumptions, an increase of WDAs across the pools has the least overall impact. It is likely that a combination of options will result in a more attractive regime benefiting a broad range of taxpayers.

When a business models the impact of specific measures, consideration should be given to the impact on other financial and tax aspects. For example, the impact on deferred tax position or on the application of other taxes where relief arising from capital allowances is offset against other UK tax regimes, such as CGT.

The likely impacts and our analysis of each option are examined below.

Option 1

This option would increase the permanent level of AIA (CAA 2001 s 51A(5)), for example to £500,000. The estimated cost to the exchequer is £1bn per year.

The AIA is available to individuals, partnerships consisting solely of individuals, and companies (CAA 2001 s 38A(3)). Complex rules determine entitlement to claim for groups of companies. The allowance was introduced to remove the administrative burden of the regime from most taxpayers investing below the level of the AIA. The AIA has consistently been extended on a temporary basis since 2016 and is currently set at £1m until 31 March 2023. When investing significantly larger amounts, this relief is helpful but often not persuasive when committing to investment.

Example modelling exercise for each option

Option	Description	Increase in cash tax savings based on NPV in 1st year compared with base case	Increase in cash tax savings based on NPV over first ten years compared with base case
Base case	WDA rates remain unchanged, AIA claimed of £200k p.a. against SR pool additions, corporate tax rate 25%		
1	Increase the permanent level of AIA to £500,000 p.a.	£66,000 (17%)	£45,000 (4%)
2	Increase WDAs to 20% for main pool and 8% for SR pool	£46,000 (12%)	£104,000 (7%)
3	Introduce an FYA of 40% for main pool and 13% for SR pool, with standard WDAs available in subsequent years	£423,000 (107%)	£159,000 (11%)
4	Introduce an additional FYA of 20% in the first year, in addition to standard WDAs available in all years	£467,000 (119%)	£467,000 (31%)
5	Introduce full expensing	£1,940,000 (492%)	£841,000 (56%)

A permanent change in the level of AIA to £500,000 could result in a larger cash tax saving compared with returning to the current statutory level of £200,000; however, the value of relief rapidly erodes over time. Furthermore, reducing the AIA from its current level of £1m would bring more taxpayers within the remit of the full capital allowances regime, increasing their administrative burden.

This option would be beneficial to businesses in a tax paying position incurring capital expenditure below the AIA limit.

Option 2

Under this option, WDAs for main and special rate pool assets would be increased from their current levels of 18% and 6% to 20% and 8%. The estimated cost to exchequer is £2bn per year.

Changing the rate of WDA is frequently used to encourage private investment. Coupled with the increase in the corporation tax rate, increasing the rate of WDAs back to 2012 levels for the main pool and 2018 levels for the SR pool would be welcomed. However, the value of this option does not compare favourably with the levels of relief available when WDAs are combined with FYAs, such as in options 3 and 4.

Increasing the rates to 25% and 10% respectively would have a larger impact for businesses and would have a negligible impact on the administrative burden on businesses.

This option would be beneficial to all businesses and individuals in tax paying positions or that can utilise losses in current or historic chargeable periods. The administrative burden should be minimal as taxpayers are used to applying these types of changes.

Option 3

This option would introduce an FYA for main and special rate pool assets where firms can deduct, for example, 40% and 13% in the first year, with the remaining expenditure written down at standard WDAs. The estimated cost to the exchequer is £3bn per year.

An FYA would likely be welcomed by businesses and individuals in tax paying positions. It could result in the receipt of significantly more relief immediately in the first year compared with option 2, with the amounts available over the first ten years increasing by 50% overall compared with the WDAs option. It may add a small layer of complexity to the regime.

This option would be beneficial to businesses in tax paying positions, those able to utilise losses in current or historic chargeable periods and those expecting to be in a position to utilise the losses carried forward over a short term (subject to the loss restriction rules).

Option 4: additional FYA

This option introduces an additional FYA to bring the overall amount that can be claimed to greater than 100% of the initial cost. This option allows an additional capital allowance of 20% in the first year, on top of standard WDAs on 100% of the initial cost across the first and subsequent years. This would spread relief over time, while giving relief on over 100% of the initial capital cost. The estimated cost to the exchequer is £4bn per year.

This option differs from the current super-deduction and SR allowance, as the full relief is not required to be taken in the year expenditure is incurred, only the part relating to the additional FYA (i.e. 20%). This could be helpful to businesses in a loss-making position which do not wish to restrict the future use and availability of capital allowances by being required to claim in full in year one. This could have a positive impact on cashflow over a longer term, the NPV of an investment and ultimately the IRR of a business.

For tax paying businesses, it provides some certainty over the amount of relief available going forward for planning purposes. It may add a layer of complexity to the capital allowances regime through changing the rules again.

This option would be beneficial to businesses in a tax paying position, although it may not be as attractive to some as the current super-deduction. An additional 20% allowance on the special rate pool would be helpful to those businesses acquiring special rate assets such as integral features or those falling within the long-life asset regime, depending upon the rules introduced.

Option 5: full expensing

This would allow businesses to write off the costs of qualifying investments in one go. No other country in the G7 has implemented this on a permanent basis. The estimated cost to the exchequer is £11bn per year.

Full expensing of costs for tangible fixed assets are used as part of the cash basis regime for small businesses. The approach could remove some of the risks identified with using accounting depreciation as a basis by the Office for Tax Simplification in their report *Accounting depreciation or capital allowances?* (June 2018), however, it could be difficult to completely remove all the risks and complexities. It is unclear whether the intention is for all capital assets to attract relief in this way, albeit this seems unlikely due to the costs involved which would mean that a detailed capital allowances exercise may still need to be undertaken.

The approach would not suit all businesses as the flexibility for taxpayers to manage their capital allowances claims for use at a more advantageous time would be removed. Furthermore, two systems for relief would be required to be retained and managed to increase the administrative burden on businesses.

This option would be beneficial to businesses that depreciate their assets. It is unclear how this approach would work for investors who do not depreciate their assets (i.e. real estate). Consideration should be given to the impact of full expensing on the wider business plans, deferred tax positions and capital gains tax base rate calculations.

Other options that could be considered

Many options and combinations could be applied, resulting in differing impacts for taxpayers. Some further options could include:

- repayable tax credits similar to R&D tax credits available on the surrender of losses;
- the ability to surrender losses in return for a cash tax credit, which may be influential in attracting investment by delivering cash to a business (as the impact of a cash injection into a business model at the time of its development may be a key influencer and/or make the difference of a project being commercially viable);
- introducing an above the line tax incentive that impacts EBITDA calculations; and
- specific reliefs focused on targeted sectors to support areas of the government's focus.

Conclusion

Some key considerations for building a capital allowances regime that meets the needs of business and government are:

- the options should be available to all businesses, regardless of which operating model is used;
- the capital incentives should give loss-making businesses the opportunity to receive an immediate benefit; and
- the changes should be long-term in order to address additional administrative burdens involved and give businesses a degree of certainty that is needed for planning and investment decisions.

Given the confusion that arose on the introduction of the FA 2021 changes to FYAs, it is also hoped that there will be a further consultation ahead of the implementation of any further changes in order to reduce any ambiguity arising over the drafting of the new legislation.

It is positive news that the government is engaging with shareholders to understand the factors impacting investment decisions and to help ensure that changes to the regime result in higher levels of investment. But to build a regime that is truly fit for purpose for the 21st century, it is vital that the changes are wide reaching, are long-term and simplify the process to support the demands of businesses in these uncertain times. ■

The policy paper is available via bit.ly/3wE3T2U. Views are invited by 1 July 2022.

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