Business tax reform: capital allowance changes

technical note

December 2007

HM TREASURY

HM Revenue & Customs

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1 INTRODUCTION

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 investment in environmentally beneficial plant and machinery. As a whole, this package is designed to ensure the tax system supports growth in the UK economy and better reflects modern commercial activity.

1.2 This document sets out the Government's intended way forward with regard to the capital allowances reforms announced in Budget 2007, reflecting the comments received in response to the consultation document *Business tax reform: capital allowance changes*. It also announces the withdrawal of Enterprise Zone Allowances from April 2011 following the earlier announcement of the phased withdrawal of Industrial Buildings Allowances. It contains draft legislation for the new Annual Investment Allowance, the new treatment of Integral features and the changes to the rates of writing down allowance for plant and machinery and long-life assets.

Objectives for reform

1.3 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

1.4 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;
- 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 features that are integral to a building, and their inclusion in the 10 per cent 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.

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

1.5 The Government is following a two-stage approach to seeking input from businesses and their advisors on the changes, other than to rates and the withdrawal of allowances, announced in Budget 2007. The first stage of this was exposing the key design features of the new elements of the tax system for comment.

1.6 In July 2007, the Government launched *Business tax reform: capital allowance changes*, inviting comment on three key new elements of the capital allowances regime:

1. the design of the AIA;

2. the definition of 'integral features' for the purposes of the new integral features allowance; and

3. the high-level features of the new payable ECAs.

This first stage of consultation closed on 19 October 2007.

1.7 The second stage to this approach is producing detailed legislation responding to the comments on these key features and showing how the new elements of the capital allowances system announced in the Budget will be implemented. The Government committed, in *Business tax reform: capital allowance changes*, to produce this draft legislation for a round of further, technical consultation by the end of the year. This document fulfils that commitment and marks the start of this technical stage of consultation.

1.8 The new payable credit for investment in environmentally beneficial plant and machinery is subject to a separate, technical consultation, *Payable enhanced capital allowances: technical note,* also published on 17 December 2007.

SUMMARY

Summary of responses

1.9 In *Business tax reform: capital allowance changes*, the Government sought the views of business on the high level proposals for the AIA, integral features and the new payable credit for investment in environmentally beneficial. It also set out how the transition to the new rates of writing down allowances for plant and machinery and long-life assets would operate. The draft legislation in this technical note has been prepared taking into account the responses the Government has received.

1.10 Chapter 2 summarises the 84 responses received in response to the high level proposals for the design of the AIA, the integral features classification and the transitional arrangements for the move to the new rates and allowances. The responses received on payable credits were summarised in *Payable enhanced capital allowances: technical note*.

The Annual Investment Allowance

1.11 As stated in *Business tax reform: capital allowance changes*, the Government's objective is that the AIA should be simple, transparent and be accompanied by light-touch and proportionate anti-avoidance provisions; the allowance is intended to be a simplification for the 95 per cent of businesses that invest up to £50,000 in any year as well as an incentive to increase investment. Chapter 4 contains the detailed proposals for the AIA, reflecting the comments the Government received from business.

1.12 Chapter 5 contains draft legislation and explanatory notes on the AIA and on the abolition of first year allowances for SMEs, which the AIA replaces.

Integral features

1.13 The Government's preference in July was for a simple, unambiguous list of assets that will be treated as integral features. The detailed proposals set out in Chapter 5 reflect the support of the majority of respondents for this approach.

1.14 Chapter 6 contains draft legislation and explanatory notes for the integral features.

Enterprise zone allowances

1.15 Whilst the Government is not consulting on the changes to rates and withdrawal of allowances, *Business tax reform: capital allowance changes* included detailed examples of how these new rates would be implemented. The Government also noted that there were some consequential issues arising from the phased withdrawal of Industrial Buildings Allowances (IBA) and Agricultural Buildings Allowances (ABA).

Chapter 7 reiterates the Government's intention to withdraw IBAs and ABAs and deals with the consequential issue of the special IBAs commonly known as Enterprise Zone Allowances (EZAs) by announcing that they will be withdrawn from April 2011, with IBAs. This chapter also confirms the transitional arrangements set out in July will be used.

Other capital allowances changes

1.16 Chapter 8 contains draft legislation and explanatory notes on the changes to the rates of plant and machinery allowances (PMA) and long life asset allowances (LLA). The Government will publish draft legislation and explanatory notes on the phased withdrawal of IBAs and ABAs, reflecting the announcement that EZAs will be withdrawn, in the New Year, and before the Finance Bill 2008.

2 SUMMARY OF CONSULTATION RESPONSES

2.1 *Business tax reform: capital allowances changes*, a consultation on the key elements of the package of changes announced in Budget 2007, was launched on 27 July 2007 and closed on 19 October. The consultation included high-level proposals for changes to the capital allowances regime, including the introduction of an annual investment allowance (AIA) and a new definition of 'integral features' to be assigned to the 10 per cent pool.

ANNUAL INVESTMENT ALLOWANCE

2.2 The Government sought views on the following key design features of the proposal:

- The general approach of offering simple and broad-based targeting for the AIA,
- Targeted anti-abuse safeguards to prevent artificial fragmentation and artificial use of unused allowances.
- The introduction of a specific 'hallmark', under the disclosure regulations.
- The relative merits of an alternative 'economic entity' approach.
- The extent to which the AIA rules will impose additional compliance burdens.
- Whether the anti-abuse rules are proportionate to the risk.

INTEGRAL FEATURES

2.3 The Government sought views on the following key design features of the proposal:

- The relative merits of a purposive definition of "integral features", that might list the features, but exclude features required to meet the particular purposes of the qualifying activity as opposed to a short list specifying the integral features to be assigned to the new 10 per cent pool
- Whether a short list approach would be preferable to one based on the definition of "background plant and machinery" in SI303/2007.
- Whether the proposed list of integral features could be improved by additions, omissions or refinement, bearing in mind the underlying policy objectives; and specifically
- Whether features that do not currently qualify for any allowance (such as general electrical systems or cold water systems) should be included in the list
- Whether the list should be expanded to include assets within structures as well as within buildings
- whether to include expenditure on specific environmentally beneficial features building within the new 10 per cent "integral features" classification

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

2.4 The Government is grateful for the responses it received from a variety of businesses and representative bodies; these are analysed in this chapter.

OVERVIEW OF RESPONSES

2.5 84 responses were received which offered comments on the proposals for the new AIA and the 'integral features' classification. This chapter sets out the key points raised by business with respect to the questions posed in the July consultation.

2.6 Respondents fell into the following broad categories:

Trade associations	23
Accountancy firms, consultants and tax advisers and their associations	36
Businesses	20
Other	5

Annual Investment Allowance

2.7 All respondents welcomed the proposal and agreed on the intentions of the incentive and identified in particular the benefit of the AIA to smaller businesses.

Simplification and broad based targeting

2.8 62 per cent of the respondents agreed that the AIA would provide simplification and a clear incentive to invest. Many recognised the need for anti -abuse safeguards to prevent artificial fragmentation and artificial use of unused allowances. A small number of respondents said that any safeguards against abuse should be fair and efficient; caution was, however, essential to prevent undue complexity adding to uncertainty. Amongst those respondents not in favour of the proposal suggested an increase to the allowance of £50,000 and noted that the proposal was of insignificant benefit to larger companies.

Hallmark

2.9 The responses received on the use of a specific 'hallmark' were largely unsure of its merit, questioning its use and suggesting a disclosure hallmark might lead to compliance issues for businesses. The minority of respondents in favour of the proposal suggested it would need to be closely targeted at abusive arrangements.

Economic Entity

2.10 A small number of respondents commented on the merits of an alternative 'economic entity' approach suggesting it brought few benefits and would lead to compliance burdens. Some respondents were in favour of exploring this approach further.

Compliance burdens

2.11 The responses received on the question of whether the proposed rules for the AIA would impose any additional compliance burdens and whether the accompanying anti-abuse rules would be proportionate to the risk were varied. The majority of respondents commented that the accompanying anti-avoidance rules will determine the level of compliance burden and therefore the rules should be kept to a minimum. Some respondents stated that AIA should reduce compliance burdens but businesses

will need to identify items that do not qualify for AIA. A small minority of the respondents stated that no additional compliance burdens were envisaged.

2.12 A suggestion was made that further simplification could be achieved by the introduction of a complementary transitional provision for the first year of the AIA. This provision would allow businesses with residual AIA entitlement, which was not used against new expenditure, to write off small main pools of expenditure which will no longer grow following the introduction of the AIA, as future expenditure will be written off by the AIA. This would remove the need for these businesses to track this expenditure as it is written off over a number of years.

General comments

2.13 A number of respondents also commented on the AIA more generally. One respondent suggested AIAs should be claimable in any open accounting period as current legislation stipulates. However, another response suggested that the current proposals give artificial importance to accounting periods and businesses may be able defer or accelerate expenditure according to maximise the benefits of AIA.

2.14 A number of respondents suggested AIA should be increased annually in line with inflation. One respondent noted that AIA should be available for expenditure on leased assets.

Integral features

2.15 The overwhelming majority of the responses welcomed the Government's proposal for a new capital allowance structure aimed at realigning capital allowances more closely with average rates of economic depreciation.

Approach to defining Integral features

2.16 91 per cent of respondents commented on the relative merits of the approach to defining "integral feature". 58 per cent were in favour of a short, unambiguous list of the integral features to be assigned to the new 10 per cent pool and stated it would provide simplicity and certainty. Advocates of this approach also noted, however, that it could adversely affect businesses that have integral assets with very short economic lives, such as specialist lighting and air conditioning, and went on to suggest it might be appropriate for the Government to establish a short life asset pool to redress the balance. The remaining 42 per cent of the responses favoured a purposive definition of "integral features", stating that a list approach will be too rigid and will need to be updated whereas the purposive approach offers flexibility and would allow trade specific functions. One respondent suggested that a better trade-off could be achieved if sufficient flexibility could be built into the list approach to accommodate innovation while preserving the benefits of certainty, consistency and transparency.

Defining Integral Features Assets

2.17 67 per cent of respondents commented on whether a simple, short list approach would be preferred to the "background plant and machinery" definitions. 63 per cent of the respondents favoured a simple short list approach to the latter definition, however, several responses stated that there is the danger of an asset list becoming outdated. The remaining respondents were happy with the current provision and suggested there are number of cases to determine the definition for plant and machinery.

Asset List

2.18 Almost all respondents were in favour of the inclusion of electrical lighting and power systems and hot and water systems as it will reduce compliance burden and increase certainty. Only six percent of the responses opposed the proposed list of assets on the grounds that, for some businesses, such systems are specifically trade related and should qualify for the higher rate of writing-down allowance.

2.19 The vast majority of respondents endorsed the Government's proposal to exclude assets such as toilet and kitchen fittings from the scope of the new classification because of the difficulties of determining whether they are 'trade specific' or part of the building. However, a few respondents stated toilets and kitchens form part of any building hosting a work force and/or customers and therefore should be included in the list.

Structure

2.20 The responses received on the Government's proposal to extend the new "integral features" treatment to expenditure on relevant assets within structures as well as within buildings were varied. The majority of respondents agreed that integral features should be extended to specific features within structures as well as within buildings. A number of respondents added that allowing 10 per cent writing down allowance on integral features within structures might also encourage capital expenditure and investment in UK. Those that did not support the idea of extension instead suggested it would be simpler to keep structures outside the new integral features rules by using the existing definition of "Structures, Assets and Works" in section 22 CAA 2001. One respondent added that the extension would be particularly detrimental to businesses in the manufacturing and transport sectors, which are already at affected by the withdrawal of Industrial Buildings Allowance.

Environmentally Beneficial Integral Features

2.21 44 per cent of respondents commented on the inclusion of environmentally beneficial integral features. The majority of respondents welcomed the inclusion within the new "integral features" classification of expenditure on specific building features (such as brise soleil and active facades) that could have worthwhile environmental benefits. A number of respondents also added that the Government could take a more holistic approach and should be placing more emphasis on consulting more widely with industry to explore ways of using capital allowances, and the tax system generally, to pursue environmental objectives. Only one respondent disagreed with making parts of buildings eligible for plant and machinery allowances because of their environmental benefits stating it would make the tax system complicated.

2.22 A number of respondents noted it would be difficult to include every element which contributes to making a building environmentally efficient, and given the advances being made the list would regularly need to be revised. One respondent suggested introducing a system similar to that for safety at sports grounds where building regulations would be set in order that buildings achieve a basic level of environmental efficiency. Capital expenditure incurred over and above this in order to increase the environment of the building could attract relief.

Transitional Provisions

2.23 Respondents broadly welcomed the proposal that only expenditure incurred after the start date for the "integral features" classification should be subject to the new rules. However, some respondents suggested that it might be burdensome and time consuming for businesses to consider each construction project at the start date and that there might be problems with milestone payments. Furthermore it was suggested existing construction contracts should be grandfathered.

2.24 There was also agreement that the rules on integral features may cause difficulties where properties are sold and the vendor has been claiming allowances at 25 per cent (20 per cent from April 2008). Respondents welcomed the proposal that an election would be available for intra-group transfers. Clarification was requested on how this will be dealt with and whether it will be possible to make an election under section 198, CAA 2001. It was also suggested that section 198, CAA 2001, would merit review given the introduction of the classification of integral features.

2.25 Respondents also identified that the allocation of expenditure on second hand assets will become more complex given that, initially, vendors will be unlikely to have a detailed analysis of their expenditure split between integral features and standard rated costs.

2.26 One respondent would like the Government to reconsider the timescale and delay the proposal for one year which would allow legislation to be in place providing certainty for all and allowing sufficient time for tax compliance software to be updated for changes.

General comments

2.27 A number of respondents also commented on the Government's proposals regarding expenditure on second-hand integral features, stating this would add considerable cost and complexity. Another respondent added there should be a grandfathering provision for second hand integral features. There was also agreement from some respondents that the requirement to identify integral features on the sale of a property will place an additional compliance burden on businesses. One respondent suggested that pooling on a building by building basis might alleviate this difficulty. Another response stated that the proposed exclusion of integral features from the short life asset rules was regrettable.

OVERALL COMMENTS

2.28 Broadly, respondents welcomed the Government's proposals. There was general agreement that there are many positive and encouraging changes in the proposals, especially for small businesses looking to invest and grow.

3 The Annual Investment Allowance (AIA): detailed proposals

Policy background

3.1 As summarised in the introduction at Chapter 1, one of the main objectives of the Budget 2007 reforms is to refocus the tax system for small business, with the provision of more generous and better-targeted incentives for investment. The proposed, new annual investment allowance (AIA) provides this generous incentive.

3.2 The AIA will provide 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. It will replace the existing 40 or 50 per cent first-year allowances for investments in plant or machinery by small or medium-sized enterprises (SMEs). The AIA will enhance direct support for capital investment, by reducing the cost of capital and providing a valuable cash flow boost for both companies and the unincorporated.

Reducing complexity

3.3 To achieve its objective the AIA must be as simple and transparent as possible. It is intended as a simplification for the 95 per cent of businesses that invest up to £50,000 in any year.

Appropriate safeguards

3.4 However, the AIA is also a valuable incentive, and so 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.

Public consultation on the AIA proposal

3.5 As outlined in Chapter 2, the Government sought views on the following key design features of the AIA proposal in the July 2007 consultation document:

- Whether the general approach of offering simple and broad-based targeting for the AIA, with anti-abuse safeguards is appropriate.
- Whether a specific 'hallmark', under the disclosure regulations, would be appropriate.
- Whether an 'economic entity' approach that would give a single allowance where there is common ownership across businesses - whether carried on by individuals or companies - would be appropriate.
- Whether the proposed AIA rules would impose an additional compliance burden and whether the accompanying anti-abuse rules are proportionate to the risk.

Consultation responses

3.6 Chapter 2 contains a summary of all the consultation responses. With particular reference to the AIA, the Government is grateful for the responses received on the specific issues outlined above, which it has considered very carefully. The responses have informed the detailed design of the AIA, as now reflected in the draft legislation in Chapter 4. The Government welcomes business's views on the technical detail of the draft legislation.

DETAILED PROPOSALS

Qualifying expenditure

3.7 As with the present 40 or 50 per cent first-year allowances (FYAs) for SMEs, the AIA will not be available for expenditure on business cars, but expenditure on most other plant and machinery, including integral features and long life assets, will be eligible.

3.8 A number of exclusions[1] from qualifying expenditure under the present FYA system will also apply to the new AIA. P&M expenditure that is excluded from capital allowances more generally will also continue to be excluded[2].

Freedom to allocate the AIA between different types of expenditure

3.9 Businesses will be free to allocate their AIA to qualifying expenditure in any way they wish; there will be no rules to restrict their freedom of choice. They will therefore be able to set their allowance against expenditure qualifying for a lower rate of allowances (such as expenditure on 'long-life assets' or 'integral features') before using any balance against their general plant and machinery expenditure. In this way, the AIA may be seen as a sort of de minimis provision, allowing modest amounts of annual expenditure on the new category of 'integral features' or on 'long-life assets' to be completely covered by the new 100 per cent allowance. This may be of particular assistance to smaller businesses.

Expenditure over £50,000

3.10 All qualifying expenditure up to £50,000 in total will receive a 100 per cent first-year allowance. Any additional expenditure over this level will be dealt with in the normal capital allowances regime, entering either the 10 per cent or 20 per cent pool, where it will attract writing-down allowances at the appropriate rate.

Other ECAs, FYAs and initial allowances

3.11 The AIA does not replace the existing 100 per cent enhanced capital allowances (ECA) schemes for environmentally beneficial plant and machinery; these will continue to be available. Other plant and machinery allowances schemes offering 100 per cent first year allowances 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.

Who may qualify?

3.12 In line with the present FYAs, the new AIA will be available to individuals, partnerships of individuals and companies (including unincorporated associations). The person or persons must be carrying on a qualifying activity[3], such as a trade, profession or vocation, an employment or ordinary property business.

TARGETING THE AIA

3.13 As explained in the July consultation document, the Government considers that the rules, in sections 416 and 417 of the Income and Corporation Taxes Act 1988 and sections 575 and 575A of the Capital Allowances Act 2001, are too complicated for the purposes of the AIA, and so these rules will not apply. The Government has decided not to pursue the "economic entity", approach reflecting the comments received in responses to the consultation and in the interests of keeping the rules as simple as possible and keeping compliance burdens to a minimum.

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[1] See s.46 of CAA 2001: General exclusions 1, 7 and 8.

[2] See, for example, s.35 CAA 2001, excluding expenditure on P&M for use in a dwelling/house.

[3] The full list of qualifying activities is contained in s. 15 CAA 2001.

3.14 The Government instead intends to take a simple and broad-based approach to the targeting of the AIA, but at the same time, must ensure that this valuable new allowance is safeguarded from exploitation and avoidance.

Companies

3.15 As proposed in the July consultation document, companies that fall within the company law definition of a group are legally and economically inter-dependent and will therefore receive a single allowance per group.

"Related" and non-related companies

3.16 Where a person, or persons together, control a singleton company, but do not control any "related" company, each such singleton company will be entitled to its own AIA. For the purposes of the new AIA, whether one company is related to another in common control will be determined on the basis of a "similar activities" condition and/or a "shared premises" condition[4].

Individuals and partnerships

3.17 Similarly, where a person or persons control(s) an unincorporated business, but he/she/they do not also control another "related" business (that is, as for companies, a business engaged in the same qualifying activity or using the same premises) each separate and distinct business will be entitled to its own AIA.

Freedom of allocation for related businesses

3.18 In addition to the freedom business will have to allocate the AIA between different types of expenditure, as outlined in paragraph 3.9, the Government has taken further steps to reduce the regulatory impact of the AIA. Corporate groups, "related" companies, individuals and partnerships will be free to allocate their AIA between businesses as they see fit, for example in a group of 5 companies all of the AIA could be allocated to 1 company or could be split between more than one company as the group wishes.

Light touch approach

3.19 By taking this 'light touch' approach to the targeting of the AIA, the Government aims to ensure that the allowance will be an effective incentive for the vast majority of businesses.

3.20 In designing "light touch" legislation in this area, one of the most difficult problems was how to define when a person was to be regarded as carrying on similar business activities, and to do so without introducing undue complexity. A major concern here was that a very simple rule might be ineffective. It would have been possible to have a very loose non-regulatory approach allowing "same business activity" to have its ordinary every day meaning, but it was considered that such an approach could lead to differences of view between inspectors and businesses creating unnecessary uncertainty. It was also less likely to achieve the balance intended. It would also have been possible to set out a special AIA definition in Regulations; however it was decided that such an approach would be too prescriptive and would not deliver the imperatives of simplicity and transparency.

3.21 The Government has decided therefore to use an existing and well established definition to decide whether business activities are similar. Accordingly when deciding whether or not a person is carrying on similar business activities the NACE classification system will be used. NACE means 'Nomenclature générale des activités Économiques dans les Communautés européennes' and is accepted as a convenient way of classifying activities into a common structure

3.22 It should be noted that the rules about "related" businesses and qualifying activities under common control will apply only to a very small minority of businesses.

[4] For a precise description of these conditions, please see the draft legislation in Chapter 4.

In the main, most people do not control such a multiplicity of related businesses, and so will not be affected by these rules.

Anti-abuse safeguards

3.23 The Government's 'light touch' approach clearly requires a robust underlying defence against artificial fragmentation to generate multiple allowances and the artificial use of unused allowances. The Government has sought to balance simplicity against the risk of abuse with this light touch and will keep it under review to ensure the safeguards in place are proving effective in maintaining this balance.

Anti-fragmentation

3.24 In addition to the "related" rules to prevent business fragmentation and restructuring, which would be difficult to target on the purely on the basis of anti-avoidance provision, 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.

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

3.26 The proposed new rules are included in the current draft of the legislation (see Chapter 4) in section 38B, General exclusion 4, and section 218A.

An AIA hallmark

3.27 The Government suggested in the July consultation that it was considering the introduction of a disclosure hallmark[5] to the existing disclosure regulations, as a further safeguard against abuse. The Government is considering whether a hallmark is necessary in light of the "related" rules and the anti-avoidance provisions set out above and would welcome the views on business on this issue.

Effect on administrative burden

3.28 The comments received in response to the earlier consultation generally agreed with the Government's view that the proposals for the implementation of the AIA would represent a simplification of the tax system for small businesses in particular. The figures set out in the consultation stage Impact Assessment in Annex B of this document support this view, showing significant savings arising from the introduction of the AIA.

OTHER ISSUES

Long chargeable periods

3.29 The draft legislation provides that, where a chargeable period is longer or shorter than a year, the allowance is proportionately increased or (as the case may be) reduced. For the overwhelming majority of businesses this rule is simple and straightforward to apply. However in some limited circumstances - particularly where the rules on "qualifying activities under common control" apply and only one annual investment allowance is available - it will be necessary to ensure that the allocation rules fairly provide for these long chargeable periods where they interact with other chargeable periods ending in the same or an earlier tax year. Legislation will be included in the Finance Bill to give clear rules on the allocation and maximum allowance available in such circumstances.

Further potential simplification

3.30 As noted in chapter 2, a number of respondents to the July consultation suggested that further administrative simplification could be delivered through the introduction of a transitional provision to complement the AIA. This provision would allow businesses to write off small pools of expenditure which will no longer grow following the introduction of the AIA, as future expenditure will be written off by the

[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.

AIA, removing the need for these businesses to track this expenditure as it is written off over a number of years. The Government is considering the costs and benefits of this proposal.

Varying the limit of the AIA

3.31 In response to consultation responses, the Government has decided to include a regulatory power to increase the limit of the AIA. 95 per cent of businesses will have their investment covered by the limit of the existing AIA, but the Government acknowledges that in order to maintain the simplification and investment benefits delivered by the AIA, this limit may need to be changed in future. This regulatory power will allow the Government to vary the limit of the AIA by negative resolution.

SME FYAs

3.32 As a result of the introduction of the AIA, the Government announced that 50% FYAs for SMEs would be extended for one year to 2008, at which point both 40% and 50% FYAs for SMEs would be abolished. The following chapter contains draft legislation for this change.

Invitation to comment

3.33 The Government would welcome the views on the draft legislation in the following chapter on the AIA and the abolition of SME FYAs.

4 AIA DRAFT LEGISLATION AND EXPLANATORY NOTES

4.1 This section contains draft Explanatory Notes based on the current draft of the Annual Investment Allowance legislation.

4.2 The legislation describing the annual Investment allowance and the way in which the Allowance will operate is drafted as if it was in Schedule 1 of the Finance Act 2008.

4.3 **Paragraph 1** provides that Capital Allowances Act 2001 (CAA) is to be amended.

4.4 **Paragraph 2** inserts a new chapter "Chapter 3A AIA Qualifying Expenditure" and two new sections (sections 38A and 38B) into Part 2 CAA 2001.

4.5 **New section 38A** explains what is and is not AIA qualifying expenditure and who can claim it.

- New subsection (1) explains that an annual investment allowance is not available unless the qualifying expenditure (Qualifying expenditure has the meaning given to it by section 11(4) as modified by section 11 (5)) is "AIA qualifying expenditure".
- New subsection (2) defines "AIA qualifying expenditure" and gives two conditions to be met for any expenditure to be "AIA Firstly the expenditure has to be incurred by a "qualifying person" and secondly the expenditure is not excluded by any of the general exclusions in new section 38B. However the amount of the AIA qualifying expenditure that qualifies for the annual investment allowance is subject to the entitlement rules in new section 51A.
- New subsection (3) defines "qualifying person" as an individual, or a partnership of which all the members are individuals, or a company. Mixed partnerships (including Limited Liability Partnerships where all the members are not individuals) and trusts are not within the definition of a "qualifying person" for the purposes of the "Annual Investment Allowance".

4.6 **New section 38B** lists the 5 general exclusions where expenditure is not to be regarded as AIA qualifying expenditure.

- General exclusion 1 mirrors general exclusion 1 in section 46(2) and provides that an annual investment allowance is not due in the chargeable period (chargeable period throughout this Schedule has the meaning given to it by section 6 CAA 2001) in which the qualifying activity is permanently discontinued.
- General exclusion 2 mirrors general exclusion 2 in section 46(2) and provides that expenditure on the provision of a car (as defined by section 81) is not AIA qualifying expenditure.
- General exclusion 3 provides that qualifying expenditure incurred for the purposes of a "ring fence trade" is not AIA qualifying expenditure. "Ring fence trade" has the meaning given to it by section 502(1) Income and Corporation Taxes Act 1988.
- General exclusion 4 mirrors general exclusion 7 in section 46(2)and is an anti-avoidance provision intended to stop a business that is not entitled to,

or has exhausted its entitlement to, AIA getting round the AIA restrictions by parking an asset in another business which has not used up its entitlement.

- General exclusion 5 mirrors general exclusion 8 in section 46(2) and prevents "deemed" expenditure where a person is treated as having incurred expenditure at a certain point in time under sections 13, 13A & 14 CAA 2001 being AIA qualifying expenditure.

4.7 **Paragraph 3** inserts 10 new sections into Chapter 5 of Part 2 CAA 2001. These sections set out the basic entitlement to the Annual Investment Allowance, give five sets of restrictions, and provide definitions for certain expressions used in the new sections.

4.8 **New section 51A** sets out the basic rules on entitlement to an Annual Investment Allowance.

4.9 **New subsection (1)** sets out that a person is entitled to an allowance provided two requirements are met. The first is that the expenditure has to be incurred in a chargeable period to which CAA 2001 applies and the second is that person incurring the expenditure must own the plant and machinery at some point during the chargeable period.

4.10 **New subsection (2)** gives the rule that an annual investment allowance can only be given for the chargeable period in which the expenditure is incurred and no other.

4.11 **New subsection (3)** gives the capping rules for the Annual investment allowance. It provides that :-

- if the AIA qualifying expenditure is less than or equal to the "maximum allowance" (defined in subsection (4)) the annual investment allowance is the AIA qualifying expenditure, and

- if the AIA qualifying expenditure is more than the maximum allowance the maximum allowance.

4.12 **New subsection (4)** sets the maximum allowance at £50,000.

4.13 **New subsection (5)** provides that the maximum allowance is proportionately increased or reduced where the chargeable period is more than or less than a year.

4.14 **New subsection (6)** provides the right for taxpayers to claim all or part only of the maximum allowance if they so wish.

4.15 **New subsection (7)** mirrors section 50 CAA 2001 and "turns off" the deemed date of incurring expenditure in section 12 only for the purposes of considering if any expenditure qualifies for AIA. It also serves to ensure that the correct maximum allowance is applied if there was any future increase of the maximum allowance.

4.16 **New subsections (8) & (9)** give a power for The Treasury to amend the amount of the maximum allowance in subsection (4) as it thinks fit and authorises the making of such other provisions as are necessary.

4.17 **New subsection (10)** states that section 51A is subject to:-

- the new provisions in sections 51B to 51J and section 218A which restrict an entitlement to an annual investment allowance, and

- The existing provisions (as amended by this Schedule) in sections 205, 210, 217, and 241 which also restrict an entitlement to an annual investment allowance. It also makes provision for it to be read with the special rules in section 236 relating to additional VAT liabilities.

4.18 **New section 51B** gives the first restriction on the application of section 51A and applies to companies only. Throughout the schedule "company" has the meaning given to it by section 832(1) ICTA 1988 unless otherwise explicitly provided for.

4.19 **New subsection (1)** provides that a company may only have a single annual investment allowance no matter how many qualifying activities it carries on. For example a company may carry on a trade as well as having a ordinary property business subsection (1) provides that the company only gets one AIA to be allocated between the two qualifying activities.

4.20 **New subsection (2)** provides that how the single allowance is allocated is entirely a matter of choice for the company.

4.21 **New subsection (3)** provides that the section is subject to the further restrictions that apply to certain companies.

4.22 **New section 51C** gives the second restriction on the application of section 51A and applies to groups of companies. It provides that there is only one AIA to be shared by the whole group but the AIA can be allocated between the companies as they see fit subject to the companies having incurred "relevant AIA qualifying expenditure".

4.23 **New subsection (1)** explains that the section applies in relation to a company which in a financial year (1 April to 31 March) is the "parent undertaking" ("parent undertaking" is defined at subsection (6)) of one or more other companies as well applying to those other companies.

4.24 **New subsection (2)** limits the entitlement of the group to a single Annual Investment Allowance for any "relevant AIA qualifying expenditure" as defined in subsection (4).

4.25 **New subsection (3)** provides that a group of companies can allocate the annual investment allowance to "relevant AIA qualifying expenditure" incurred by any company in the group as it sees fit.

4.26 **New subsection (4)** defines "relevant AIA qualifying expenditure". It is the AIA qualifying expenditure incurred by any company whose chargeable period ends in the financial year mentioned in subsection (1).

4.27 **New subsection (5)** gives the rule for deciding whether or not a company "P" is a "parent undertaking" of another company during a financial year. The rule identifies all the companies that "P" controls at the end of each company's chargeable period in the financial year.

4.28 **New subsection (6)** for the purposes of section 51C "parent undertaking" has the meaning given to it by section 1162 of the Companies Act 2006.

4.29 **New subsection (7)** makes section 51C subject to section 52D.

4.30 **New section 51D** gives the third restriction on the application of section 51A. This section is intended to prevent behavioural changes by businesses seeking to avoid the intent of section 51E. The intent of section 51E, which only applies to companies under common control and not in a group, could be avoided if for each company "P"

potentially within the scope of section 51E a new company "C" was incorporated for which the company "P" became the parent undertaking. Section 51D applies where two or more groups of companies are controlled by the same "person" (defined later in section 51F) and the groups are "related" to one another (as defined in section 51G) in such circumstances only a single Annual Investment Allowance is available to be allocated between all members of the groups.

4.31 **New subsection (1)** sets out the conditions that have to be met before the section applies. The section only applies where in a financial year two or more groups of companies are "controlled by the same person" (as defined in section 51F) and the groups are "related to one another" (as defined in section 51G) in such circumstances the section applies to all the companies in the groups.

4.32 **New subsections (2), (3) & (4)** broadly mirror the provisions in section 51C.

4.33 **New subsection (2)** provides that only one annual investment allowance may be shared by all the companies in the related groups.

4.34 **New Subsection (3)** provides that the related groups of companies can allocate the annual investment allowance to "relevant AIA qualifying expenditure" incurred by any company in the groups as they see fit.

4.35 **New subsection (4)** defines "relevant AIA qualifying expenditure". It is the AIA qualifying expenditure incurred by any company whose chargeable period ends in the financial year mentioned in subsection (1).

4.36 **New subsection (5)** gives the same meaning to a group of companies as given by section 51C(1) but also makes clear that for the purposes of this section the members of the group include the parent undertaking. The meaning given to a group of companies in section 51D also applies for the purposes of sections 51F & 51G.

4.37 **New subsections (5) & (6)** mirror the provisions in section 51C giving the rules for determining when a company "P" is a "parent undertaking" of another company and the meaning of "parent undertaking".

4.38 **New section 51E** gives the fourth restriction on the application of section 51A. This section applies to companies which are controlled by the same person (as defined in section 51F), and related to one another (as defined in section 51G) but neither the second restriction in section 51C "groups of companies" nor the third restriction in section 51D "groups of companies under common control" applies. The section follows the model in sections 51C & 51D providing that the companies are only entitled to a single annual investment allowance between them leaving the allocation of the allowance as a matter to be decided by the companies (but in effect the person who controls the companies) and defining the relevant AIA qualifying expenditure as the AIA qualifying expenditure incurred by the companies in the respective chargeable periods ending in the financial year.

4.39 **New subsection (1)** sets out the conditions that have to be met before the section applies. The section only applies where in a financial year two or more companies are "controlled by the same person" (as defined in section 51F) and the companies are "related to one another" (as defined in section 51G) in such circumstances the section applies to all the related companies.

4.40 **New subsections (2), (3) & (4)** again broadly mirror the provisions in section 51C.

4.41 **New subsection (2)** confirms that only one annual investment allowance may be shared by all the related companies.

4.42 **New Subsection (3)** provides that the related companies can allocate the annual investment allowance to "relevant AIA qualifying expenditure" incurred by any related company as they see fit.

4.43 **New subsection (4)** defines "relevant AIA qualifying expenditure". It is the AIA qualifying expenditure incurred by any related company whose chargeable period ends in the financial year mentioned in subsection (1).

4.44 **New section 51F** gives the meaning of "control" as used in sections 51D and section 51E when used in the context of companies and groups of companies. Subsection (1) gives the rule for deciding when a company is controlled by a person for the purposes of sections 51D and 51E. Subsection (2) gives the rule for deciding when groups of companies are controlled by a person for the purposes of sections 51D and 51E. Subsection (3) provides for a very restricted definition of control in relation to a "body corporate and subsections (4) and (5) define control when considering any company which is not a body corporate.

4.45 **New subsection (1)** mirrors the rule in section 51C in looking at who controls a company in a financial year by reference to who controls the company at the end of the company's chargeable period ending in that financial year.

4.46 **New subsection (2)** gives a similar rule for groups of companies by looking at who controls the parent undertaking at the end of its chargeable period ending in the financial year in question.

4.47 **New subsection (3)** provides that section 574(2) defines control in relation to a company which is a body corporate. The provisions of section 575 and section 575A CAA 2001 are not relevant.

4.48 **New subsections (4) and (5)** define control in relation to any company that is not a body corporate.

4.49 **New section 51G** gives the meaning of "related" for companies and groups. When considering whether any company is related to any other company where the control test is met there are two separate tests to determine if companies are related and if one or both are satisfied then the companies are related. A similar rule applies for groups of companies under common control. The first test is called the "shared premises condition" and looks at companies under common control who share the same premises. The second test is called the "similar activities condition". The "similar activities condition" is, broadly, a turnover test looking at activities based on the first level of NACE ('Nomenclature générale des activités Économiques dans les Communautés européennes') common statistical classification of activities.

4.50 **New subsection (1)** sets out the rule that where companies are under common control a company is related to another company in a financial year if one or both of the two tests ("the shared premises condition" and "the similar activities condition") are met.

4.51 **New subsection (2)** gives a rule connecting related companies. However it is not possible for three companies to be connected solely under the similar activities condition where a company carries on a different first level NACE activity with more than 50% of its turnover being generated from that activity.

4.52 **New subsections (3) and (4)** give the rules for connecting groups of companies.

4.53 **New subsection (5)** gives the shared premises condition and applies where at the end of a chargeable period of a company it carries on a qualifying activity (or activities) from premises, and another company under common control at the end of that chargeable period also carries on a qualifying activity from the same premises. For example, C1 may have a chargeable period ending on the 30th April and have sole occupation of the premises, but if C2, with a chargeable period ending on 31 December, moves into those premises on 1 June in the same financial year, and C1and C2 still occupy the premises on 31 December, then the condition is satisfied. The section leaves "premises" to take its everyday meaning and is not further defined.

4.54 **New subsection (6)** gives the similar activities condition. The rule applies where two or more companies are under common control and more than 50% of the turnover of one company in the chargeable period ending in the financial year is derived from qualifying activities within a particular NACE classification and more than 50% of the turnover of another company (or companies) is derived from qualifying activities in the same NACE classification. There are 17 sections in the first level of the NACE common statistical classification of activities.

4.55 **New subsection (7)** gives the meaning of "NACE classification", "relevant chargeable period" and "turnover" turnover includes any amount that is or would fall to be treated as a receipt of an ordinary property business, furnished holiday letting business or overseas property business.

4.56 **New section 51H** gives the fifth restriction on the application of section 51A. This section applies to businesses, other than companies, and sets out the rules for determining how many annual investment allowances may be allocated. The section also mirrors sections 51B, 51C, 51D and 51E in that the annual investment allowance can be allocated as the person or persons think fit.

4.57 **New subsection** (1) sets out that the section applies in relation to two or more qualifying activities carried on in a tax year (6 April to 5 April) by a qualifying person (as defined in new section 38A in this context either an individual or a partnership consisting only of individuals) or where two or more activities are carried on by more than one qualifying person but those qualifying persons are "controlled" by another person "controlled is defined in section 51J. The section only applies where the qualifying activities are "related" to one another "related is defined at section 51K and uses the same concepts of the "shared premises condition" and the "similar activities condition".

4.58 **New subsection (2)** identifies which qualifying activities have to be considered for the purposes of section 51H. The section only applies to qualifying activities whose chargeable periods end in the particular tax year.

4.59 **New subsection (3)** gives the rule that where, and only where, the qualifying activities are "related" and carried on by one qualifying person there is only a single annual investment allowance available. For example an individual who has two qualifying activities where the chargeable periods for both end in the tax year and the activities fall under the same NACE classification is only entitled to one annual investment allowance.

4.60 **New subsection (4)** gives the rule that where, and only where, the qualifying activities are "related" and carried on by more than one qualifying person but those qualifying persons are "controlled by another person there is only a single annual

investment allowance available in respect of all "relevant AIA qualifying expenditure". For example three partnerships of individuals running estate agency businesses are all controlled by one individual who also runs an estate agency business in his own right there is only one annual investment allowance available to be shared between the three partnerships and the individual as the four qualifying activities all fall within the same NACE classification.

4.61 **New subsection (5)** mirrors the provisions in the sections relating to companies and provides that the annual investment allowance can be allocated by the person or persons as they think fit.

4.62 **New subsection (6)** identifies the "relevant AIA qualifying expenditure" in a similar manner to the identification rules for companies but works by reference to the chargeable periods ending in the tax year rather than the financial year.

4.63 **New section 51I** is a similar provision to section 51F but in this section gives the meaning of control when considering persons other than companies.

4.64 **New subsection (1)** gives the rule that broadly mirrors the rule for companies given by sections 51C and 51F(1) in looking at who controls a qualifying activity (rather than a company) in a tax year (rather than financial year) by reference to who controls the activity at the end of the chargeable period ending in that tax year.

4.65 **New subsection (2)** states that, for the avoidance of any doubt, a qualifying activity carried on by an individual is controlled by the individual who carries on the qualifying activity.

4.66 **New subsections (3), (4) and (5)** give the rules for partnerships and confirm that only section 574(3) applies to determine control in reference to partnerships. The subsections also confirm that where partners who between them control one partnership also control another partnership the qualifying activities are to be treated as controlled by the same person. However the partnerships still need to met either, or both of, the shared premises condition and the similar activities condition.

4.67 **New section 51J** is very similar to section 51G and gives the meaning of "related" for persons other than companies. Section 51K works by reference to the qualifying activity being carried on in the tax year where the chargeable period ends in the tax year. As with section 51G there are two tests the "shared premises condition" and the "similar activities condition". However when considering the "similar activities condition" there is no need for the reference to "turnover" as the "similar activities condition" for persons other than companies looks at each separate activity.

4.68 **New subsection (1)** sets out the rule that a qualifying activity is related to another qualifying activity in a tax year if one or both of the two tests ("the shared premises condition" and "the similar activities condition") are met in that tax year.

4.69 **New subsection (2)** gives a rule connecting related activities however as with the rule in section 51G the rule only has application in connecting qualifying activities that are caught under the "shared premises condition" with qualifying activities that are caught under the "similar activities condition"

4.70 **New subsection (3)** gives the shared premises condition and applies where, in the same tax year, at the end of a chargeable period (the "relevant chargeable period") the qualifying activity is carried on from premises and another qualifying activity at the end of that chargeable period is also carried on from the same premises. For example

A1 may have a chargeable period ending on the 30th April and have sole occupation of the premises but if A2 with a chargeable period ending on 31 December moves into the premises on 1 June in the same tax year and A1and A2 still occupy the premises on 31 December then the condition is satisfied. As with section 51G the section leaves “premises” to take its everyday meaning and is not further defined.

4.71 **New subsection (4)** gives the similar activities condition. The rule applies where a person controls two or more qualifying activities in a tax year. If the qualifying activities fall within a particular NACE classification then the qualifying activities are related.

4.72 **New subsection (5)** gives “NACE classification” the same meaning as in section 51G(see paragraph 5.55) and defines “relevant chargeable period” where used in subsections (3) and (4) above.

4.73 **Paragraph 4** inserts new section 52A into Chapter 5 part 2 CAA 2001.

4.74 **New section 52A** makes it explicit that a person may not claim a first year allowance and an annual investment allowance in respect of the same expenditure. For example if a person acquired an item of plant or machinery appearing on the energy technology list which could qualify for 100% allowances under section 45A the person has to choose whether or not to claim the allowance under section 45A or 51A it cannot claim under both in respect of the same expenditure.

4.75 **Paragraph 5** deals with the balance of an amount of AIA qualifying expenditure in excess of the maximum allowance and gives the rules on allocating the balance of expenditure to a pool (even if the balance is nil) where a disposal event occurs.

4.76 **Subparagraph (1)** provides that section 58 is to be amended

4.77 **Subparagraph (2)** inserts three new subsections in section 58 after subsection 4.

4.78 **New subsection 4A** ensures that where a person incurs AIA qualifying expenditure and an annual investment allowance is made then the balance can be allocated to a pool for any chargeable period (subsection 3 still provides that the expenditure cannot be allocated to a pool for a chargeable period before that in which the expenditure was incurred). The rule is not mandatory in requiring the balance to be allocated in the first available chargeable period rather it follows the approach described in Change 8 of Annex 1 of the Capital Allowances Bill explanatory notes: annexes.

4.79 **New subsections 4B and 4C** are (like subsections 6 and 7 for first year allowances) a necessary corollary to section 64 CAA 2001 which provides that a person does not have to bring a disposal value into account if they have allocated no expenditure to the pool. Without the rule in subsections 4B and 4C a person might for example buy plant or machinery for £50,000 sell it for £49,000 and be left with the £50,000 annual investment allowance when the next cost is only £1,000. The subsection provide that where an annual investment allowance has been claimed and a disposal event occurs in respect of the plant or machinery and none of the balance left after deducting the AIA has been allocated to a pool then the balance must be allocated to a pool even if the balance is nil.

4.80 **Paragraph 6** ensures that the special rules on transactions between connected parties in section 64(2) to (4) also apply to annual investment allowances.

4.81 **Paragraphs 7 and 8** ensures that the special rules on assets provided or used only partly for the purposes of a qualifying activity and partial depreciation subsidies also apply to expenditure qualifying for an annual investment allowance.

4.82 **Paragraph 9** amends section 217 so that it also applies to prevent an annual investment allowance being available where a person acquires an asset from a connected person. Connected person retains the meaning given to it by section 575 and section 575A CAA 2001.

4.83 **Paragraph 10** introduces a new section 218A into Chapter 17 Part 2 CAA 2001 after section 218. The new section is aimed at arrangements entered into to access an annual investment allowance where a person would not otherwise be entitled to the allowance.

4.84 **New section 218A** denies a person an annual investment allowance where there is an arrangement entered into wholly or mainly to enable a person to obtain an annual investment allowance which the person would not otherwise be entitled to.

4.85 **Subsection** (1) explains that the section applies when arrangements are entered into (wholly or mainly) for a disqualifying purpose.

4.86 **Subsection** (2) explains what is meant by a disqualifying purpose.

4.87 **Subsection** (3) provides that where subsection (2) applies the annual investment allowance is not to be made.

4.88 **Subsection** (4) provides that any annual investment allowance made which is prohibited is to be withdraw.

4.89 **Paragraphs 11, 12 and 13** make a number of changes to the special rules in Chapter 18 of Part 2 CAA 2001 in respect of additional VAT liabilities and rebates. The changes ensure that if the original expenditure qualified for an annual investment allowance then the additional VAT liability may also qualify. The changes also apply to the anti-avoidance provisions in section 241.

4.90 **Paragraphs 14** make a minor amendment to section 263 to ensure that as with writing down and first-year allowances any annual investment allowance is also made to the present partners of a partnership.

4.91 **Paragraph 15** makes a minor amendment to section 265 to ensure that as with first-year allowances no entitlement to an annual investment allowances arises where (provided all the other conditions are met)a person succeeds to a qualifying activity carried on by another person.

4.92 **Paragraphs 16 to 22** all make minor amendments of other enactments namely ICTA 1988, Finance Act 2000 and Income Tax Act 2007 ensuring that where appropriate reference is correctly made to the annual investment allowance.

4.93 **Paragraph 23** gives the commencement provisions for the Schedule.

4.94 **Subparagraph** (1) says when the amendments made by the Schedule have effect.

4.95 **Subparagraph** (2) gives the transitional rule for calculating the maximum allowance under section 51A where a chargeable period begins before the “relevant date” and ends after that date. The rule states that the maximum allowance is to be

calculated as if the chargeable period started on the "relevant date" and ended at the end of the chargeable period.

4.96 **Subparagraph** (3) gives the relevant dates for both corporation tax purposes (1 April 2008) and income tax purposes (6 April 2008).

There follows the legislation on Annual investment allowance:

1 Annual investment allowance

Schedule 1 makes provision about an annual investment allowance in respect of certain qualifying expenditure on plant and machinery.

SCHEDULES

SCHEDULE 1

Section 1

ANNUAL INVESTMENT ALLOWANCE

PART 1

AMENDMENTS OF CAA 2001

1 CAA 2001 is amended as follows.

2 In Part 2, after Chapter 3 insert—

"CHAPTER 3A

AIA QUALIFYING EXPENDITURE

38A AIA qualifying expenditure

(1) An annual investment allowance is not available unless the qualifying expenditure is AIA qualifying expenditure.

(2) Expenditure is AIA qualifying expenditure if—
  (a) it is incurred by a qualifying person, and
  (b) it is not excluded by any of the general exclusions in section 38B.

(3) "Qualifying person" means—
  (a) an individual,
  (b) a partnership of which all the members are individuals, or
  (c) a company.

38B General exclusions applying to section 38A

Expenditure within any of the following general exclusions is not AIA qualifying expenditure.

General exclusion 1
The expenditure is incurred in the chargeable period in which the qualifying activity is permanently discontinued.

General exclusion 2
The expenditure is incurred on the provision of a car (as defined by section 81).

General exclusion 3

The expenditure is incurred wholly for the purposes of a ring fence trade in respect of which tax is chargeable under section 501A of ICTA (supplementary charge in respect of ring fence trades).

General exclusion 4

The circumstances of the incurring of the expenditure are that—

(a) the provision of the plant or machinery on which the expenditure is incurred is connected with a change in the nature or conduct of the trade or business carried on by a person other than the person incurring the expenditure, and

(b) the obtaining of an annual investment allowance is the main benefit, or one of the main benefits, which could reasonably be expected to arise from the making of the change.

General exclusion 5

Any of the following sections applies—

section 13 (use for qualifying activity of plant or machinery provided for other purposes);

section 13A (use for other purposes of plant or machinery provided for long funding leasing);

section 14 (use for qualifying activity of plant or machinery which is a gift).

This is subject to section 161 (pre-trading expenditure on mineral exploration and access)."

3 In Chapter 5 of Part 2 (allowances and charges), at the beginning insert—

"Annual investment allowance

51A Entitlement to annual investment allowance

(1) A person is entitled to an allowance (an "annual investment allowance") in respect of AIA qualifying expenditure if—

(a) the expenditure is incurred in a chargeable period to which this Act applies, and

(b) the person owns the plant and machinery at some time during that chargeable period.

(2) Any annual investment allowance is made for the chargeable period in which the AIA qualifying expenditure is incurred.

(3) The amount of the annual investment allowance is—

(a) if the AIA qualifying expenditure is less than or equal to the maximum allowance, the amount of that expenditure, and

(b) if the AIA qualifying expenditure is more than the maximum allowance, the maximum allowance.

(4) The maximum allowance is £50,000.

(5) But if the chargeable period is more or less than a year, the maximum allowance is proportionately increased or reduced.

(6) A person who is entitled to an annual investment allowance may claim the whole allowance or part only of the allowance.

(7) In determining when AIA qualifying expenditure is incurred, any effect of section 12 on the time at which it is to be treated as incurred is to be disregarded.

(8) The Treasury may by order substitute for the amount for the time being specified in subsection (4) such other amount as it thinks fit.

(9) An order under subsection (8) may make such incidental, supplemental, consequential and transitional provision as the Treasury thinks fit.

(10) This section is subject to—

(a) sections 51B to 51J (restrictions on entitlement to annual investment allowance),

(b) section 205 (reduction of allowance if plant or machinery provided partly for purposes other than those of qualifying activity),

(c) section 210 (reduction of allowance if it appears that a partial depreciation subsidy is or will be payable), and

(d) sections 217, 218A and 241 (anti-avoidance: no allowance in certain cases),

and needs to be read with section 236 (additional VAT liabilities).

51B First restriction: companies

(1) A company is entitled to a single annual investment allowance in respect of all the qualifying activities carried on by the company in a chargeable period.

(2) The company may allocate the annual investment allowance to the AIA qualifying expenditure incurred by the company in that chargeable period as it thinks fit.

(3) This section is subject to sections 51C, 51D and 51E.

51C Second restriction: groups of companies

(1) This section applies in relation to—

(a) a company which, in a financial year, is a parent undertaking in relation to one or more other companies, and

(b) those other companies.

(2) The companies are entitled to a single annual investment allowance between them in respect of the relevant AIA qualifying expenditure.

(3) The companies may allocate the annual investment allowance to the relevant AIA qualifying expenditure as they think fit.

(4) The relevant AIA qualifying expenditure is the AIA qualifying expenditure incurred by the companies in chargeable periods ending in the financial year mentioned in subsection (1).

(5) A company ("P") is a parent undertaking of another company ("C") in a financial year if P is a parent undertaking of C at the end of C's chargeable period ending in that financial year.

(6) In this section "parent undertaking" has the same meaning as in section 1162 of the Companies Act 2006 (c. 46).

(7) This section is subject to section 51D.

51D Third restriction: groups of companies under common control

(1) Where in a financial year two or more groups of companies are—
(a) controlled by the same person (see section 51F), and
(b) related to one another (see section 51G),
this section applies in relation to the companies which are members of those groups.

(2) The companies are entitled to a single annual investment allowance between them in respect of the relevant AIA qualifying expenditure.

(3) The companies may allocate the annual investment allowance to the relevant AIA qualifying expenditure as they think fit.

(4) The relevant AIA qualifying expenditure is the AIA qualifying expenditure incurred by the companies in chargeable periods ending in the financial year mentioned in subsection (1).

(5) In this section and in sections 51F and 51G, a group of companies means—
(a) a company which, in the financial year mentioned in subsection (1), is a parent undertaking in relation to one or more other companies, and
(b) those other companies,
(and the members of the group are the company which is the parent undertaking and those other companies).

(6) A company ("P") is a parent undertaking of another company ("C") in a financial year if P is a parent undertaking of C at the end of C's chargeable period ending in that financial year.

(7) In this section "parent undertaking" has the same meaning as in section 1162 of the Companies Act 2006 (c. 46).

51E Fourth restriction: other companies under common control

(1) This section applies in relation to two or more companies which in a financial year are—
(a) controlled by the same person (see section 51F), and
(b) related to one another (see section 51G),
and in relation to which to neither section 51C nor section 51D applies.

(2) The companies are entitled to a single annual investment allowance between them in respect of the relevant AIA qualifying expenditure.

(3) The companies may allocate the annual investment allowance to the relevant AIA qualifying expenditure as they think fit.

(4) The relevant AIA qualifying expenditure is the AIA qualifying expenditure incurred by the companies in chargeable periods ending in the financial year mentioned in subsection (1).

51F Companies and groups: meaning of “control”

(1) A company is controlled by a person in a financial year if it is controlled by that person at the end of its chargeable period ending in that financial year.

(2) A group of companies is controlled by a person in a financial year if the company which is the parent undertaking is controlled by that person at the end of its chargeable period ending in that financial year.

(3) Section 574(2) defines control in relation to a company which is a body corporate.

(4) In relation to a company (“C”) which is not a body corporate, control means the power of a person (“P”) to secure—

(a) by means of the holding of shares or the possession of voting power in relation to C or another body, or

(b) as a result of any powers conferred by the constitution of C or another body,

that the affairs of C are conducted in accordance with P’s wishes.

(5) In subsection (4), “shares” has the meaning given by section 1161(2) of the Companies Act 2006 (c. 46).

51G Companies and groups: meaning of “related”

(1) A company (“C1”) is related to another company (“C2”) in a financial year if one or both of—

(a) the shared premises condition, and

(b) the similar activities condition,

are met in relation to the companies in that financial year.

(2) Where C1 is related to C2 in a financial year, C1 is also related to any other company to which C2 is related in that financial year.

(3) A group of companies (“G1”) is related to another group of companies (“G2”) in a financial year if in that financial year a company which is a member of G1 is related to a company which is a member of G2.

(4) Where G1 is related to G2 in a financial year, G1 is also related to any other group of companies to which G2 is related in that financial year.

(5) The shared premises condition is met in relation to two companies in a financial year if, at the end of the relevant chargeable period of one or both of the companies, the companies carry on qualifying activities from the same premises.

(6) The similar activities condition is met in relation to two companies in a financial year if—

(a) more than 50% of the turnover of one company for the relevant chargeable period is derived from qualifying activities within a particular NACE classification, and

(b) more than 50% of the turnover of the other company for the relevant chargeable period is derived from qualifying activities within that NACE classification.

(7) In this section—

"NACE classification" means the first level of the common statistical classification of economic activities in the European Union established by Regulation (EC) No 1893/2006 of the European Parliament and the Council of 20 December 2006 (as that Regulation has effect from time to time),

"relevant chargeable period", in relation to a company and a financial year, means the chargeable period of the company ending in that financial year, and

"turnover", in relation to a company, means the amount derived from the provision of goods and services within the company's ordinary activities (including any amount which is, or falls to be treated as, a receipt of an ordinary property business, furnished holiday lettings business or overseas property business), after deduction of trade discounts, value added tax and any other taxes based on the amounts so derived.

51H Fifth restriction: qualifying activities under common control

(1) This section applies in relation to two or more qualifying activities which, in a tax year—

(a) are carried on by a qualifying person other than a company,

(b) are controlled by the same person (see section 51I), and

(c) are related to one another (see section 51J).

(2) A qualifying activity is carried on by a qualifying person in a tax year if it is carried on by the person at the end of the chargeable period for the activity ending in the tax year.

(3) Where all the qualifying activities are carried on by one qualifying person, that person is entitled to a single annual investment allowance in respect of the relevant AIA qualifying expenditure.

(4) Where the qualifying activities are carried on by more than one qualifying person, those persons are entitled to a single annual investment allowance between them in respect of the relevant AIA qualifying expenditure.

(5) The person or persons carrying on the qualifying activities may allocate the annual investment allowance to the relevant AIA qualifying expenditure as the person or persons think fit.

(6) The relevant AIA qualifying expenditure is the AIA qualifying expenditure incurred for the purposes of the qualifying activities in the chargeable periods for those activities ending in the tax year mentioned in subsection (1).

51I Qualifying activities: meaning of control

(1) A qualifying activity is controlled by a person in a tax year if it is controlled by the person at the end of the chargeable period for that activity which ends in that tax year.

(2) A qualifying activity carried on by an individual is controlled by the individual who carries it on.

(3) A qualifying activity carried on by a partnership is controlled by the person (if any) who controls the partnership.

(4) Section 574(3) defines “control” in relation to a partnership.

(5) Where partners who between them control one partnership also between them control another partnership, the qualifying activities carried on by the partnerships are to be treated as controlled by the same person.

51J Qualifying activity: meaning of “related”

(1) A qualifying activity (“A1”) is related to another qualifying activity (“A2”) in a tax year if one or both of—
   (a) the shared premises condition, and
   (b) the similar activities condition,
are met in relation to the activities in the tax year.

(2) Where A1 is related to A2 in a tax year, A1 is also related to any other qualifying activity to which A2 is related in that tax year.

(3) The shared premises condition is met in relation to two qualifying activities in a tax year if, at the end of the relevant chargeable period for one or both of the activities, the activities are carried on from the same premises.

(4) The similar activities condition is met in relation to two qualifying activities in a tax year if, at the end of the relevant chargeable period for one or both of the activities, the activities are within the same NACE classification.

(5) In this section—
“NACE classification” has the same meaning as in section 51G, and
“relevant chargeable period”, in relation to a qualifying activity and a tax year, means the chargeable period for that activity ending in that tax year.”

4 After section 52 insert—

“Prevention of double relief

52A Prevention of double relief

A person may not claim an annual investment allowance and a first-year allowance in respect of the same expenditure.”

5 In section 58 (allocation of qualifying expenditure to pools), after subsection (4) insert—

“(4A) If an annual investment allowance is made in respect of an amount of AIA qualifying expenditure, the amount that may be allocated to a pool for any chargeable period is limited to the balance left after deducting the annual investment allowance.

(4B) If—
   (a) an annual investment allowance is made in respect of an amount of AIA qualifying expenditure,

(b) a disposal event occurs in respect of the plant or machinery in any chargeable period, and

(c) none of the balance left after deducting the annual investment allowance has been allocated to a pool for an earlier chargeable period,

the balance (or some of it) must be allocated to a pool for the chargeable period in which the disposal event occurs.

(4C) Subsection (4B) applies even if the balance is nil (because of the annual investment allowance).”

6 In section 64(4)(a) (meaning of “qualifying expenditure” in section 64(3)), after “if” insert “an annual investment allowance or”.

7 (1) Section 205 (reduction of first-year allowances) is amended as follows.

(2) In subsection (1), after “any” insert “annual investment allowance or”.

(3) In subsection (3), after “deducting” insert “an annual investment allowance or”.

(4) In the heading, after “of” insert “annual investment allowance and”.

8 (1) Section 210 (reduction of first-year allowances) is amended as follows.

(2) In subsection (1), after “amount of any” insert “annual investment allowance or”.

(3) In subsection (2), after “deducting” insert “an annual investment allowance or”.

(4) In the heading, after “of” insert “annual investment allowance and”.

9 (1) Section 217 (restrictions on allowances) is amended as follows.

(2) In subsection (1), for “a first-year allowance is not” substitute “no annual investment allowance or first-year allowance is”.

(3) In subsection (2), after “Any” insert “annual investment allowance or”.

(4) In the heading, after “No” insert “annual investment allowance or”.

10 After section 218 insert—

“218A Further restriction on annual investment allowance

(1) This section applies where an arrangement is entered into wholly or mainly for a disqualifying purpose.

(2) Arrangements are entered into for a disqualifying purpose if their main purpose, or one of their main purposes, is to enable a person to obtain an annual investment allowance to which the person would not otherwise be entitled.

(3) The annual investment allowance mentioned in subsection (2) is not to be made.

(4) Any annual investment allowance which is prohibited by subsection (3), but which has already been made, is to be withdrawn.”

11 (1) Section 236 (additional VAT liability generates first-year allowance) is amended as follows.

(2) After subsection (3) insert—

“(3A) Subsection (3B) applies if—

(a) the original expenditure was AIA qualifying expenditure, and

(b) the additional VAT liability is incurred at a time when the plant or machinery is provided for the purposes of the qualifying activity.

(3B) The additional VAT liability is to be regarded for the purposes of this Part as AIA qualifying expenditure on the same plant or machinery as the original expenditure.

(3C) Section 51A(6) applies to AIA qualifying expenditure constituted by the additional VAT liability as it applies to other AIA qualifying expenditure.”

(3) In the heading, after “allowance” insert “or annual investment allowance”.

12 In section 237(1) (exceptions to section 236), after “liability is not” insert “AIA qualifying expenditure or”.

13 (1) Section 241 (no first-year allowance in respect of additional VAT liability) is amended as follows.

(2) In subsection (1)(b), before “a first-year” insert “an annual investment allowance or”.

(3) In subsection (2), for “A first-year allowance is not” substitute “No annual investment allowance or first-year allowance is”.

(4) In subsection (3), after “Any” insert “annual investment allowance or”.

(5) In the heading, after “No” insert “annual investment allowance or”.

14 In section 263(3) (qualifying activities carried on in partnership), after “Any” insert “annual investment allowance,”.

15 In section 265(4) (successions: general), after “to” insert “an annual investment allowance or”.

PART 2

AMENDMENTS OF OTHER ENACTMENTS

ICTA

16 ICTA is amended as follows.

17 In section 395(1)(c) (leasing contracts and company reconstructions), after “for which” insert “an annual investment allowance or”.

18 In paragraph 1(6)(b)(i) of Schedule 18 (group relief), before “a first-year” insert “an annual investment allowance or”.

FA 2000

19 (1) Schedule 22 to FA 2000 (tonnage tax) is amended as follows.

(2) In paragraph 87(1)(a), for "a first-year allowance shall not" substitute "no annual investment allowance or first-year allowance is to be".

(3) In paragraph 94(2), after "any" insert "annual investment allowance or".

ITA 2007

20 ITA 2007 is amended as follows.

21 In section 76 (first-year allowances)—

(a) after "from" insert "an annual investment allowance or", and

(b) in the heading, after "allowances" insert "and annual investment allowances".

22 In section 78 (arrangements to reduce tax liabilities)—

(a) in subsection (1)(a), after "the" insert "annual investment allowance or", and

(b) in the heading, after "allowances" insert "and annual investment allowances".

PART 3

COMMENCEMENT

23 (1) The amendments made by this Schedule have effect—

(a) for corporation tax purposes, in relation to expenditure incurred on or after 1 April 2008, and

(b) for income tax purposes, in relation to expenditure incurred on or after 6 April 2008.

(2) In relation to a chargeable period which—

(a) begins before the relevant date, and

(b) ends on or after the relevant date,

the maximum allowance under section 51A CAA 2001 is to be calculated as if the period beginning with the relevant date and ending with the end of the chargeable period were the chargeable period.

(3) The relevant date is—

(a) for corporation tax purposes, 1 April 2008, and

(b) for income tax purposes, 6 April 2008.

FIRST-YEAR ALLOWANCES FOR SMALL OR MEDIUM –SIZED ENTERPRISE

4.97 This section contains draft Explanatory Notes based on the current draft of the legislation discontinuing first–year allowances for small or medium –sized enterprises.

4.98 The legislation describing the discontinuance is drafted as if it was clause 1 in the Finance Bill 2008.

4.99 **New subsection (1)** provides that the Capital Allowances Act 2001 (CAA) is to be amended in accordance with subsections (2) and (3).

4.100 **New subsection (2)** omits section 44 from the Act.

4.101 **New subsection (3)** makes 4 consequential amendments to CAA 2001 arising from the omitting of section 44.

4.102 **Subsection (a)and (b)** removes the references to section 44 in sections 39 and 46(1)

4.103 **Subsection (c)** omits sections 47 to 49 which contained definitions of small and medium-sized enterprises and gave a rule to decide whether or not a company was a member of a large or medium-sized group.

4.104 **Subsection (d)** makes two further consequential amendments to section 52(3).

4.105 **New subsection (4)** omits three provisions that changed the rate of first-year allowances for small enterprises in Finance Act 2004, Finance Act 2006, and Finance Act 2007.

4.106 **New subsection (5)** provides that the repeals made by subsections (2) and (3) have effect in relation to expenditure incurred on or after " the relevant date"

4.107 **New subsections (6) and (7)** are savings to ensure that the provisions of Chapter 18 Part 2 CAA 2001 continue to apply in respect of additional VAT liabilities incurred on or after the relevant date where an entitlement to a first year allowance under section 44.

4.108 **New subsection (8)** gives the relevant date for corporation tax purposes (1 April 2008) and income tax purposes (6 April 2008).

There follows the legislation on First-year allowance for small and medium-sized enterprises discontinued:

1 First-year allowance for small and medium-sized enterprises discontinued

(1) CAA 2001 is amended in accordance with subsections (2) and (3).

(2) Omit section 44 (expenditure incurred by small or medium-sized enterprises).

(3) In consequence of the amendment made by subsection (2)—
   (a) in the list in section 39 (provisions under which first-year allowances available), omit the entry relating to section 44,
   (b) in the list in section 46(1) (provisions subject to general exclusions), omit the entry relating to section 44,
   (c) omit sections 47 to 49 (definition of small and medium-sized enterprises), and
   (d) in section 52(3) (first-year allowances) omit—
      (i) in the table, the entry relating to expenditure qualifying under section 44, and
      (ii) from "In the case" to the end.

(4) Omit the following provisions (which relate to provisions repealed by subsection (3))—
   (a) section 142 of FA 2004 (increase in first-year allowance under section 44 for 2004),
   (b) section 30 of FA 2006 (increase in first-year allowance under section 44 for 2006), and
   (c) section 37 of FA 2007 (increase in first-year allowance under section 44 for 2007).

(5) The repeals made by subsections (2) and (3) have effect in relation to expenditure incurred on or after the relevant date.

(6) But subsection (7) applies in relation to an additional VAT liability incurred on or after the relevant date which under section 235 of CAA 2001 is treated as qualifying expenditure.

(7) If the original expenditure (within the meaning of that section) was first-year qualifying expenditure by virtue of section 44 of CAA 2001, Chapter 18 of Part 2 of that Act (additional VAT liabilities and rebates) applies to the additional VAT liability as if the provisions repealed by this section were not so repealed.

(8) The relevant date is—
   (a) for corporation tax purposes, 1 April 2008, and
   (b) for income tax purposes, 6 April 2008.

5 Integral features: detailed proposals

Policy background

The plant and machinery boundary

5.1 The July consultation document noted that the boundary, for capital allowances purposes, between plant and machinery and commercial buildings is not defined and that, over the years, this boundary has been an area of considerable doubt and uncertainty in tax law.

5.2 The consultation document went on to highlight the Government's view that the current boundary no longer reflects commercial reality: over time, assets that are commonly regarded as integral to a modern building (such as central heating and lifts) have come to attract standard plant and machinery capital allowances at a rate that does not generally reflect their average rate of economic depreciation. This effect can have a distortive influence on commercial decision making.

The wider context

5.3 As summarised at Chapter 1, the wider Budget 2007 reform package has three main objectives: (i) to promote investment (ii) to reduce administrative burdens and complexity and (iii) to maintain the fairness of the tax system.

5.4 The wider reform package seeks to promote investment through a lower corporation tax (CT) rate on a broader tax base and by other reforms, such as reducing the distortive impact of capital allowances. It therefore included the announcement of a 2 per cent cut in the main rate of CT and the introduction of a simplified capital allowances structure with two main plant and machinery pools: one with the rate of writing-down allowances set at 20 per cent and the other with the rate set at 10 per cent.

5.5 Against this background, the Government announced its proposal that it would introduce a separate classification of features that are integral to a building, so that expenditure on these assets may be included in the new 10 per cent pool. In order to reflect more closely their economic depreciation, the Government also included in this pool long-life assets, increasing the rate of allowance they receive 6 per cent to 10 per cent. Together with the CT rate changes, the capital allowances reforms are designed to simplify the system and encourage a more efficient allocation of resources in the UK economy.

Public consultation on the integral features proposal

5.6 As outlined at Chapter 2, in the July consultation document, the Government sought views on the following key design features of the integral features proposal:

- The relative merits of a **purposive definition** of "integral features" in comparison with a **short list** approach.
- Whether a short list approach would be preferable to the
- "**background plant and machinery**" definition;
- Whether it would be sufficient simply to list the assets to be included and whether the suggested **list of assets** could be improved.
- Whether features such as **general electrical systems or cold water systems** should be included.

- Whether features such as **general electrical systems or cold water systems** should be included.
- Whether the new approach should apply to "integral features" within **structures** as well as in buildings.
- Whether to include **environmentally beneficial features** in the new classification and, if so, which environmental building features should be included.

5.7 The Government is very grateful for the responses received in relation top the integral features classification, which it has considered carefully and which it continues to study. The responses have informed the detailed design of this proposal, as now reflected in the draft legislation at Chapter 6. The Government welcomes business's further views on the technical detail of the draft legislation.

KEY DESIGN FEATURES

"Purposive" or short list approach

5.8 The July consultation invited views on the relative merits of :

- A purposive approach that might list the features, but exclude features required to meet the particular purposes of the qualifying activity or
- A short, unambiguous list of the integral features to be assigned to the new 10 per cent pool.

5.9 In the July consultation document, the Government explained why it was not attracted to the so-called "purposive approach": although the Government recognises that some assets that are normally part of a modern building can have a high element of trade specificity, the subjective nature of the classification of integral features 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 as a result of the need to decide in each case whether assets were "trade specific" or not, and might give rise to an inconsistent approach. In any event, the longer economic life of these assets means that, in most instances, a 10 per cent rate of writing-down allowance is still appropriate.

5.10 The majority of respondents to the consultation shared the Government's preference for the greater simplicity and certainty that the list approach would provide. Although a large number of respondents (for example, representatives from the hotel, retail and transport sectors) favoured a purposive test, the majority recognised that such an approach would be significantly more complex to administer and would have the potential to increase, rather than decrease, grey areas and uncertainty. The majority view was that certainty should be the paramount aim.

5.11 Given the underlying policy objectives outlined at paragraphs 5.1 to 5.5, and the fact that the assets in question do tend to have a longer economic life than the generality of business plant and machinery, the Government remains of the view that a list approach is the preferable approach. The legislation at Chapter 6 has therefore been drafted on this basis.

Short list or "background plant or machinery" definition

5.12 As indicated in the July consultation document, the Government wants to keep the list of integral building features as short as is practicable and therefore does not want to adopt the definition of "background plant or machinery for a building", devised for the purposes of the reform of leasing taxation in Finance Act 2006. The leasing reform definition was designed with the opposite objective: that is, to be as comprehensive and inclusive as possible, so as not to unnecessarily include background features in a building within the new leasing regime.

5.13 The majority of respondents who commented on this aspect of the proposal, agreed with the Government's stance. So the draft legislation does not adopt the leasing reform definition.

Intra –group transfers

5.14 The July consultation proposed that companies should be able to elect for integral features to be transferred between group companies at their tax written-down value, remaining in the same plant and machinery classification before and after the transfer. Of those respondents who commented on this proposal all were in favour. The draft legislation exposed in this technical note does not contain provisions relating to this election, but the Government will bring forward a provision in the Finance Bill that will enable integral features to be transferred intra group, retaining the same plant and machinery classification before and after the transfer.

THE ASSET LIST

"Integral fixtures allowance"

5.15 On reflection, the Government has decided that the term "integral features", rather than "integral fixtures", is more appropriate for this measure because the assets in question may not always be "fixtures".

Features integral to structures

5.16 Structures, as well as buildings, can contain integral features that will be eligible for the new 10 per cent rate of allowance. The Government sought views on whether the integral features allowance should cover expenditure on the relevant assets within a building. The Government's view that, although some features within structures may have a more trade specific function than the equivalent feature in a building, a 10 per cent rate of allowance was a reasonable proxy for the economic depreciation of these assets. The majority of respondents agreed that it was reasonable to include features integral to structures in the scope of the new allowance and the draft legislation includes clauses to this effect.

Toilet and kitchen facilities

5.17 In the July consultation, the Government aired its view that it would be unnecessary to include toilet and kitchen facilities in the proposed list. Although such items are generally standard in a modern workplace, their inclusion would also catch, for example, kitchen facilities in a hotel or restaurant. All those who commented on this aspect of the proposal in the consultation were not in favour of including such items in the "integral features" list. The Government has therefore decided that such assets, which are not amongst the main integral building assets in terms of cost, should not be included in the proposed short list, and the draft legislation has been prepared on this basis.

Electrical and cold water systems

5.18 The July consultation asked whether business would be in favour of including expenditure on electrical and cold water systems, which are currently classified as part of the building and do not generally attract any capital allowances, within the new category of "integral features", which will in future qualify for allowances at 10 per cent a year. The overwhelming majority of respondents were in favour of this proposal. The Government is therefore pleased to announce its intention to include these building systems in the new "integral features" list.

Benefit for enhanced capital allowances

5.19 Because expenditure on electrical and cold water systems is not usually classified as "plant and machinery", many businesses have not been able to claim 100 per cent enhanced capital allowances (ECAs) when their expenditure on these systems has included specific items on the 'Green Technology' ECA list[6]. Re-classifying these systems as "plant and machinery" will enable businesses to claim ECAs on such specific items, and will further encourage businesses to invest in the most environmentally beneficial energy-efficient and water-efficient technologies. The Government was pleased to note that businesses commented to welcome this aspect of the proposal.

Environmentally beneficial features

5.20 The Government sought views on whether environmentally beneficial and energy-saving features incorporated in modern buildings, which are currently regarded as part of the building and so do not attract capital allowances, should be allowed to qualify for the integral features. The Government suggested that this could include brise soleil and active facades.

5.21 The response to this was overwhelmingly positive and respondents suggested a number of other technologies that could fall within this category. The Government is considering these suggestions. For the purposes of the draft legislation, the Government has included the two technologies suggested in the July consultation, external solar shading (brise soleil) and active facades.

Adding technologies to the list

5.22 In order to reflect technological and market developments, the draft legislation includes a regulatory power for the Government to amend the list of features integral to a building or structure, as was suggested in consultation responses. This power will be used to amend the list with regard to features which would not otherwise receive any allowances, rather than for features which could receive plant and machinery allowances.

Thermal insulation

5.23 In 1975, a provision was introduced as part of a package of measures to support energy saving which allows plant and machinery capital allowances for the addition of thermal insulation to an existing industrial building. The provision was restricted to industrial buildings, used for the purposes of a "qualifying trade" - rather than applying to all commercial buildings used for any "qualifying activity" (which would have included professions and vocations, as well as trades).

5.24 As a result of the phased withdrawal of the industrial buildings allowance by April 2011, the definitions on which this provision relies will be repealed. In order to continue to provide relief for the addition of thermal insulation to existing buildings the Government will extend the provision to all buildings used for any "qualifying activity", other than residential property businesses7, deeming this expenditure to be plant and machinery, for which a 10 per cent rate of allowance will be given. This reflects the Government's proposal to allow environmentally beneficial features incorporated in modern buildings to qualify for the integral features allowance.

The list

5.25 Following consideration of the responses to the consultation, the Government has decided that the list of the "integral features", normally integral to a modern building, that will in future qualify for the new 10 per cent rate of writing-down allowances, is as detailed below:

- electrical systems (including lighting systems),
- cold water systems,

[6] See www.eca.gov.uk

[7] Residential landlords receive

- space or water heating systems, powered systems of ventilation, air cooling or air purification, and any floor or ceiling comprised in such systems,
- lifts, escalators and moving walkways,
- external solar shading
- active facades

OTHER ISSUES

Section 198 elections

5.26 A number of respondents suggested that the Government should consider how section 198 elections will interact with the new integral features allowance. The Government will consider this issue and make any announcement on reform at the Budget.

Guidance

5.27 In response to requests received as part of the July consultation process, the Government acknowledges the need of business for early sight of guidance on how HMRC will interpret the legislation governing the integral features allowance. In order to give businesses and tax practitioners early sight of this guidance, HMRC will aim to publish draft guidance on the integral features allowance with the 2008 Finance Bill.

Invitation to comment

5.28 The Government would be grateful for comments on the draft legislation for the new integral features allowance, which is set out in full in chapter 6.

6 INTEGRAL FEATURES DRAFT LEGISLATION AND EXPLANATORY NOTES

6.1 This section contains draft Explanatory Notes based on the current draft of the legislation introducing the new integral features assets, extending thermal insulation to all property used for business purposes other than residential property and making provisions for the special rate pool.

6.2 The legislation has been drafted if it was clause 1 and schedule 1 in the Finance Bill 2008.

6.3 The clause introduces the schedule and explains what the schedule makes provision for.

Schedule 1

Integral features and the special rate pool

6.4 **Paragraph 1** provides that the Capital Allowances Act 2001 (CAA) is to be amended.

6.5 **Paragraph 2** amends section 23 CAA 200 which is about expenditure unaffected by sections 21 and 22.Sections 21 and 22 make provisions excluding expenditure on the provision of buildings and structures and certain other assets from being expenditure on plant or machinery. It removes "industrial" from the description of section 28 inserts the reference to the new section 28A and makes changes to three entries in List C (removing completely one of those entries).

6.6 **Paragraph 2(1)** introduces the changes.

6.7 **Paragraph 2(2)** omits the word industrial from the phrase thermal insulation of industrial buildings in preparation to the changes make later to section 28. It also inserts a new entry into subsection (2) of section 23.

6.8 **Paragraph 2(3)** omits part of item 2, the whole of item 3 and the whole of item 6, however it substitutes "Hoists" for the previous text in item 6. All the changed items now appear in the new section 28A.

6.9 **Paragraph 3** amends section 28. The amendments extend the scope of the section to all expenditure incurred on adding thermal insulation to an existing building used for the purposes of a qualifying activity other than dwelling houses.

6.10 **Paragraph 3 (1)** introduces the changes.

6.11 **Paragraph 3(2)** amends subsection 1 so that it now applies to all qualifying activities other than ordinary property businesses and overseas property businesses which are already provided for in subsection 2.

6.12 **Paragraph 3(3)** removes the limitation to industrial buildings and the subsection now applies to a building.

6.13 **Paragraph 3(4)** introduces a new subsection that limits the scope of subsection 2 in that it does not apply to thermal insulation added to a dwelling house. There are already provisions in sections 312 to 314 of the Income Tax (Trading and Other Income) Act 2005 that make provision for persons carrying on property businesses who incur expenditure on installing thermal insulation in dwelling houses.

6.14 **Paragraph 3(5)** provides for subparagraph 3 to be omitted as it is no longer required following the change of scope of the relief.

6.15 **Paragraph 3(6)** changes the heading of the section to reflect that it applies to thermal insulation of buildings.

6.16 **Paragraph 4** inserts a new section 28A into CAA 2001. The new section makes provisions for integral features including those items removed from List C by paragraph 2(3) of the schedule. The new section applies where a person carrying on a qualifying activity has incurred expenditure on an integral feature of a building or structure with integral feature defined as one of 6 categories of assets. The section contains a power to only add to the list any feature of a building that would not be expenditure on plant or machinery apart from the new section. This does not mean other assets cannot be added to the list in the section.

6.17 **Paragraph 4(1)** explains who and what expenditure the section applies to. It applies to any person who carries on a qualifying trade and incurs expenditure on an integral feature. Integral feature is defined in subsection 2.

6.18 **Paragraph 4(2)** lists the 6 asset classes. They are:

- electrical systems (including lighting systems),
- cold water systems,
- space or water heating systems, powered systems of ventilation, air cooling, or air purification, and any floor or ceiling comprised in such systems,
- lifts escalators and moving walkways,
- external solar shading,
- active facades

6.19 **Paragraph 4(3)** ensures that as with section 23 the scope of the provision does not extend to any asset whose principal purpose is to insulate or enclose the interior of a building or to provide interior walls, floors or ceilings which are intended to remain permanently in place.

6.20 **Paragraphs 4(4) and (5)** give Treasury a power to add to the list any feature of a building or structure which would not apart from section 28A be expenditure on the provision of plant or machinery. However the power does not extend to assets which are plant or machinery such assets can only be added by primary legislation.

Chapter 10A

The special rate pool

6.21 **Paragraph 5** inserts a new chapter and five new sections into Part 2 CAA 2001. These new sections made provision for a new class pool to be included in Part 2, define a new category of expenditure (special rate expenditure) provide that the rate of writing down allowance in respect of special rate expenditure is to be 10 per cent and apply anti avoidance rules for certain transactions.

6.22 **New section 104A** makes provision for what special rate expenditure is and is not. It also makes special provision for certain long-life asset expenditure that may have

been incurred prior to the relevant day but not allocated to any pool prior to the relevant day.

6.23 **New subsection 1** gives four categories of expenditure that are to be treated as special rate expenditure. The categories are

- expenditure incurred on or after the relevant date to which section 28 applies
- expenditure incurred on or after the relevant date to which the new section 28A applies
- long-life asset expenditure incurred on or after the relevant date other than for the purposes of a qualifying activity that is an excluded activity. Excluded activity is defined in subsection (3)
- long-life asset expenditure which is within subsection (2)

6.24 **New subsection (2)** ensures if for whatever reason a person has not allocated long-life asset expenditure to a pool by the relevant date it can be allocated to the special rate pool post the relevant date subject to section 58(4) being met.

6.25 **New subsection (3)** defines excluded activity as a ring fence trade in respect of which tax is chargeable under section 501A of the Income and Corporation Taxes Act 1988.

6.26 **New subsection (5)** gives the relevant date for the purposes of the section. The relevant date is 1 April 2008 for corporation tax purposes and 6 April 2008 for income tax purposes.

6.27 **New section 104B** provides that expenditure on plant or machinery is partly special rate expenditure and partly other expenditure is to be to be apportioned and treated as two separate items of plant or machinery. The section provides that all apportionments are done on a just and reasonable basis. The section applies in exactly the same way as section 92 in Chapter 10 applies.

6.28 **Subsection (1)** gives the rule that where part only of the expenditure is on plant and machinery is special rate expenditure the two parts are to be treated as separate items of plant and machinery for the purposes of the Capital Allowances Act.

6.29 **Subsection (2)** provides that the apportionment required under subsection (1) is to be done on a just and reasonable basis.

6.30 **New section 104C** gives the rule that special rate expenditure to which the section applies must be allocated to a class pool. The class pool is called the special rate pool. The section only applies to special rate expenditure that is incurred wholly and exclusively for the purposes of a qualifying activity and is not expenditure which is required to be allocated to a single asset pool. The section mirrors section 101. Where the expenditure is not incurred wholly and exclusively for the purposes of the qualifying activity it falls to be considered under Chapter 15 and allocated to a single asset pool but section 104D will still apply in calculating the amount of the writing down allowance to which a person is entitled for a chargeable period.

6.31 **Subsection (1)** explains that special rate expenditure to which the section applies must be allocated to the new class pool the special rate pool.

6.32 **Subsection (2)** gives the conditions to be met if the special rate expenditure is to be allocated to the special rate pool.

6.33 **New section 104D** gives the rate of writing down allowance a person is entitled to for a chargeable period. The section follows the model in section 102. The rate of writing-down allowance is 10% of the amount by which AQE exceeds TDR. This follows the methodology in Chapter 5.

6.34 **Subsection (1)** confirms that the rate of the writing-down allowance a person is entitled to for a chargeable period in respect of expenditure that is special rate expenditure is 10% of the amount by which AQE exceeds TDR. This follows the methodology in Chapter 5.

6.35 **Subsection (2)** confirms that subsection (1) applies even if the expenditure is in a single asset pool.

6.36 **Subsection (3)** mirrors the rule in section 102.

6.37 **Subsection (4)** ensures that the rules for increasing or decreasing the allowances for chargeable periods of more than or less than a year apply for the purposes of section 104D as they do for section 56 as does the rule where the qualifying activity has only been carried on for part only of the chargeable period.

6.38 **New section 104E** is an anti-avoidance provision and follows the model in section 104. As with section 104 it applies where allowances have been given on special rate expenditure to a person (the taxpayer) under the special rate expenditure legislation, and:

- there is a disposal event for that asset;
- the disposal value to be brought into account is less than the notional written down value of the asset; and
- the disposal event is part of, or occurs as a result of, a scheme that has the obtaining of a tax advantage by the taxpayer as its main object, or as one of its main objects.

Where the above conditions apply the notional written down value is used in place of the disposal value in the capital allowance computations of the taxpayer. But this does not affect the computations of the purchaser, who can only claim capital allowances on the actual purchase price. A person obtains a tax advantage if that person

- obtains an allowance or a greater allowance than he would otherwise obtain, or
- avoids a charge or secures the reduction of a charge.

The application of section 104E will, as with section 104, only be considered by authorised officers of Revenue and Customs.

Minor and consequential amendments

6.39 Paragraphs 6, 7, 8, 9, 10 11, 12, and 13 all made minor and consequential amendments.

There follows the legislation on integrated features and the special rate pool:

1 Integral features and the special rate pool

Schedule 1 makes provision about expenditure on integral features and about the special rate pool.

SCHEDULES

SCHEDULE 1

Section 1

INTEGRAL FEATURES AND THE SPECIAL RATE POOL

Integral features etc

1 CAA 2001 is amended as follows.

2 (1) Section 23 (expenditure unaffected by sections 21 and 22) is amended as follows.

(2) In subsection (2)—

(a) in the entry for section 28, omit "industrial", and

(b) after that entry insert—

"section 28A (integral features);".

(3) In List C in subsection (4)—

(a) in item 2, omit "Electrical systems (including lighting systems) and cold water,",

(b) omit item 3, and

(c) in item 6, for "Lifts, hoists, escalators and moving walkways." substitute "Hoists."

3 (1) Section 28 (thermal insulation of industrial buildings) is amended as follows.

(2) In subsection (1)—

(a) for "consisting of a trade" substitute "other than an ordinary property business or an overseas property business",

(b) for "an industrial" substitute "a", and

(c) for "the trade" substitute "the qualifying activity".

(3) In subsection (2), for "an industrial" substitute "a".

(4) After subsection (2) insert—

"(2A) Subsection (2) is subject to section 35 (expenditure on plant or machinery for use in dwelling-house not qualifying expenditure)."

(5) Omit subsection (3).

(6) In the heading, omit "industrial".

4 After section 28 insert—

"28A Integral features

(1) This section applies to expenditure if a person carrying on a qualifying activity has incurred it on an integral feature of a building or structure used by the person for the purposes of the qualifying activity.

(2) For this purpose "integral features" means—
  (a) electrical systems (including lighting systems),
  (b) cold water systems,
  (c) space or water heating systems, powered systems of ventilation, air cooling or air purification, and any floor or ceiling comprised in such systems,
  (d) lifts, escalators and moving walkways,
  (e) external solar shading,
  (f) active facades.

(3) The items listed in subsection (2) do not include any asset whose principal purpose is to insulate or enclose the interior of a building or to provide an interior wall, floor or ceiling which (in each case) is intended to remain permanently in place.

(4) The Treasury may by order add to the list in subsection (2) any feature of a building or structure expenditure on which would not (apart from the order) be expenditure on the provision of plant or machinery.

(5) An order under subsection (4) may make such incidental, supplemental, consequential and transitional provision as the Treasury thinks fit."

The special rate pool

5 After Chapter 10 CAA 2001 insert—

"CHAPTER 10A

SPECIAL RATE EXPENDITURE

Special rate expenditure

104A Special rate expenditure

(1) "Special rate expenditure" means—
  (a) expenditure incurred on or after the relevant date to which section 28 (thermal insulation) applies,
  (b) expenditure incurred on or after that date to which section 28A (integral features) applies,
  (c) long-life asset expenditure (within the meaning of Chapter 10) incurred on or after that date for the purposes of a qualifying activity which is not an excluded activity, and
  (d) long-life asset expenditure (within the meaning of that Chapter) which is within subsection (2).

(2) Long-life asset expenditure is within this subsection if—
(a) it is incurred before the relevant date for the purposes of a qualifying activity which is not an excluded activity, but
(b) it is not allocated to a pool for a chargeable beginning before the relevant date.

(3) "Excluded activity" means a ring fence trade in respect of which tax is chargeable under section 501A of ICTA (supplementary charge in respect of ring fence trades).

(4) The relevant date is—
(a) for corporation tax purposes, 1 April 2008, and
(b) for income tax purposes, 6 April 2008.

104B Application of Chapter to part of expenditure

(1) If part only of the capital expenditure on plant and machinery is special rate expenditure—
(a) the part which is such expenditure, and
(b) the part which is not,
are to be treated for the purposes of this Act as expenditure on separate items of plant or machinery.

(2) For the purposes of subsection (1), all such apportionments are to be made as are just and reasonable.

Rules applying to special rate expenditure

104C Special rate pool

(1) Special rate expenditure to which this section applies, if allocated to a pool, must be allocated to a class pool ("the special rate pool").

(2) This section applies to special rate expenditure if—
(a) it is incurred wholly and exclusively for the purposes of a qualifying activity, and
(b) it is not expenditure which is required to be allocated to a single asset pool.

104D Writing-down allowances at 10%

(1) The amount of the writing-down allowance to which a person is entitled for a chargeable period in respect of expenditure which is special rate expenditure is 10% of the amount by which AQE exceeds TDR (see Chapter 5).

(2) Subsection (1) applies even if the special rate expenditure is in a single asset pool.

(3) In the case of expenditure which is within section 107(2)(a) and (b) (overseas leasing which is not protected leasing), this section is subject to sections 110, 114 and 115 (allowances prohibited in certain cases etc).

(4) Subsections (3) and (4) of section 56 (proportionate increases or reductions in amount in certain cases) apply for the purposes of subsection (1) of this section as they apply for the purposes of subsection (1) of that section.

104E Disposal value of special rate assets

(1) This section applies if—

(a) section 104D (writing-down allowances at 10%) has had effect in relation to any special rate expenditure incurred by a person ("the taxpayer"),

(b) any disposal event occurs in relation to the item on which the expenditure was incurred,

(c) the disposal value to be brought into account by the taxpayer would (but for this section) be less than the notional written-down value of the item, and

(d) the disposal event is part of, or occurs as a result of, a scheme or arrangement the main purpose or one of the main purposes of which is the obtaining by the taxpayer of a tax advantage under this Part.

(2) The disposal value that the taxpayer must bring into account is the notional written-down value of the item.

(3) The notional written-down value is—

$$QE - A$$

where—

QE is the taxpayer's expenditure on the item that is qualifying expenditure, and

A is the total of all allowances which could have been made to the taxpayer in respect of that expenditure if—

(a) that expenditure had been the only expenditure that had ever been taken into account in determining his available qualifying expenditure,

(b) where the item is a long-life asset, that expenditure had not been prevented by the application of a monetary limit from being long-life asset expenditure, and

(c) all allowances had been made in full."

Minor and consequential amendments

6 CAA 2001 is amended as follows.

7 In section 54(5) (the different kinds of pools), after "section 101 (long life assets);" insert—

"section 104C (special rate expenditure);".

8 In section 56(2) (amount of allowances and charges)—

(a) omit the "and" at the end of paragraph (a), and

(b) after that paragraph insert—

"(aa) section 104D (special rate expenditure: 10%), and".

9 In section 65(1) (final chargeable period)—

(a) omit the "or" at the end of paragraph (a), and

(b) after paragraph (b) insert "or,

(c) a special rate pool,".

10 In column 1 of the table in section 84 (cases in which short-life asset

treatment is ruled out), after item 4 insert—

"4A The expenditure is special rate expenditure other than long-life asset expenditure (see Chapter 10A)."

11 In section 113(1)(c) (excess allowances: special provision for ships), after "long-life asset pool" insert ", a special rate pool".

12 In section 116(5) (mitigation of regime)—

(a) for "and 10" substitute ",10", and

(b) after "(long-life assets)" insert "10A (special rate expenditure)".

13 In section 126(1) (minor definitions), after "102" insert ", 104D".

7 OTHER CAPITAL ALLOWANCES CHANGES

7.1 This chapter reiterates the Government's intention to withdraw the allowances for industrial and agricultural buildings and sets out the Government's intentions for the special industrial buildings allowances for buildings within Enterprise Zones. It also confirms the Government's intentions for the transitional arrangements for moving to the new rates of allowances for plant and machinery and long-life assets.

INDUSTRIAL AND AGRICULTURAL BUILDINGS ALLOWANCES

7.2 The Government has received a number of representations about the abolition of IBAs and ABAs as part of the package of reforms announced in the 2007 Budget, in addition to the responses received to *Business tax reform: capital allowance changes*. The chief concerns businesses have expressed have been that the withdrawal affects existing investments and that the allowances due on these investments should be grandfathered.

7.3 It remains the Government's intention to withdraw IBAs and ABAs, phased over 4 years, so that they will no longer be available from April 2011. The Government's assessment of IBAs and ABAs has shown that they are a significant distortion on commercial property investment. They were first introduced as an incentive for post-war reconstruction and agricultural recovery. IBAs and ABAs are now outdated: ostensibly, they are a depreciation tax relief, but they have now become a poorly focused subsidy, selectively available on a disparate range of assets, including many that appreciate in value. In effect, the tax system already recognises the depreciation of buildings and structures in other ways: through tax relief for the costs of repairs and insurance, and by directly recognising any actual depreciation (or appreciation) through the capital gains tax system at the point of a building's sale.

7.4 These issues are compounded by the significant compliance burden imposed by the complexity of the rules. Simplicity has been a central driver for these reforms and the decision to withdraw IBAs and ABAs from existing, as well as future, assets was taken to ensure an orderly transition to the new, simpler structure. Retaining IBAs and ABAs for existing assets would have run contrary to the aim of reducing compliance burdens: it would have ensured that the allowance and its rules remained a feature of the business tax system for the next 25 years. It would also extend the distortion to investment, by granting tax relief to selective sectors. Instead, the withdrawal of IBAs has been phased over four years, to give businesses certainty and the time to plan.

7.5 This is not a measure that should be viewed in isolation – it is an integral part of an important set of reforms to enhance the UK's overall international competitiveness. Since 95 per cent of the value of IBAs is attributable to main rate taxpayers, the Government believes that the reduction in the main rate of corporation tax will benefit companies affected by the withdrawal of IBAs. At 28 per cent, the UK's main corporation tax rate will be significantly lower than any other G7 country and will again be below the EU15 and OECD averages. This is an important step in ensuring the UK remains a global destination for new investment and business.

Transitional arrangements

7.6 The Budget announced that the rate of writing-down allowances 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.

7.7 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.

7.8 Thus, as set out in *Business tax reform: capital allowance changes*, 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.

7.9 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.

ENTERPRISE ZONE ALLOWANCES

7.10 As part of the consultation on the transitional arrangements for the changes to rates of capital allowances, the Government noted that there were a number of consequential issues arising from the withdrawal of industrial and agricultural buildings allowances.

7.11 One of these consequential issues relates to the 100 per cent industrial buildings allowance introduced in 1980 for expenditure on buildings within designated Enterprise Zones. These allowances are commonly known as Enterprise Zone Allowances (EZAs). EZAs were one of a number of levers intended to encourage regeneration Enterprise Zones areas, including exemption from business rates, relaxation of planning legislation and exemption from land development taxes. Research undertaken by the Department for Environment, Transport and the Regions in 1995 showed that EZAs were not the chief incentive for businesses to locate in Enterprise Zones, when compared to rates relief in particular.

7.12 The previous Government's intention at the time of introduction was that EZAs should be time-limited, as with the other reliefs available within the zones, to the 10-year period for which zones were designated. At the point of their introduction, qualifying Enterprise Zone expenditure was limited to construction expenditure incurred within that original 10-year designation period or incurred under a contract entered into within that period. In 1992, the Government amended this rule, to the effect that where a construction contract had been entered into during the 10 years of a zone's designation, construction expenditure under that contract would qualify for EZAs if it was incurred within 20 years of the zone being designated. This change was intended to ensure that the relief was limited to the period for which a zone was active. No zones have been designated since 1996. As such there are currently no live zones within their initial 10-year period.

Artificial extension of EZAs

7.13 The Government is concerned that businesses have sought to extend the availability of these allowances beyond the time originally intended, by entering into artificially constructed contracts designed to prolong access to the relief. This tax planning has enabled construction taking place in zones more than 20 years after their designation to continue to attract this relief. The Government is aware of instances in which zones have continued to attract significant relief through EZAs long after the 20-year anniversary of their original designation. In these cases, EZAs are the only relief that is still available for these zones. The Government is also aware of buildings that had previously received relief on their construction being demolished to make way for the construction of further buildings which will also attract EZAs. The Government believes that these arrangements have allowed businesses to benefit from EZAs far beyond the time limit originally envisaged.

7.14 In addition to this artificial extension of EZAs beyond the intended end point, HMRC has received disclosures under the new Disclosure Rules[1] relating to schemes intending to avoid tax using EZAs. The Government is concerned that this allowance should not be artificially extended and in particular that it should not be abused by those seeking to avoid tax.

Regeneration policy

7.15 Enterprise Zones policy were introduced under the previous Government in 1980. Speaking as Chancellor in 2002, Gordon Brown expressed his concern with the policy, when he made a speech describing Enterprise Zones as having "huge public cost, diverting economic activity from one area to another with no overall economic gain".

7.16 Since taking office in 1997, the Government has taken a different approach to regeneration, which has been focussed on addressing key market failures. Building on a period of macroeconomic stability, decision-making has been devolved as far as possible to regional and local levels to ensure interventions are more responsive to local conditions. The Government has also improved the targeting of funding, for example through the Neighbourhood Renewal Fund, New Deal for Communities and the Local Enterprise Growth Initiative, which are aimed at tackling problems in the most deprived areas.

7.17 The policy review of Sub-national Economic Development and Regeneration published earlier this year identified opportunities to go further in devolving powers and improving coordination. The review recommends stronger incentives for local authorities to promote economic development and regeneration, more streamlined regional arrangements and clearer accountability at all spatial levels.

7.18 To support these reforms to regeneration and renewal, the 2007 CSR provides over £2 billion for local and neighbourhood renewal, including reforms to the neighbourhood renewal funding with a stronger emphasis on tackling worklessness. Local authorities will be supported in their new role by the new Homes and Communities Agency, which will provide the skills, powers and resources to help regenerate some of the most deprived areas in the country.

Withdrawal of EZAs

7.19 In light of the withdrawal of IBAs, the artificial extension of EZAs beyond the previous Government's intention and the disclosure of schemes seeking to avoid tax through EZAs, as well as the different approach taken to regeneration since 1997, the Government believes the time is now right to withdraw EZAs. Whilst the withdrawal of

[1] These rules were introduced in Finance Act 2005 and expanded in Finance Act 2006. Under these rules 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.

IBAs will deliver significant simplification by removing the need to track IBA expenditure, cited as one of the most burdensome elements of the capital allowances system in terms of the Government's Standard Cost Model, it has the further benefit of allowing the Government to remove the legislation underpinning the allowances from the Capital Allowances Act 2001. If the Government were to retain EZAs, this legislative simplification would not be possible. Businesses that have already received EZAs will be unaffected by this change. In order to give businesses certainty and time to plan, the Government has decided that it will withdraw EZAs from 1 April 2011, the date when the other allowances for industrial and agricultural buildings will also cease to be available. Until this point, the full 100 per cent initial allowance will be available. This generous period of advance notice of withdrawal (in excess of 3 years) should enable most businesses to complete their building construction or acquisition plans, in order to access the relief in full before it is finally withdrawn.

7.20 In order to ensure that the advance announcement of the withdrawal of EZAs does not encourage artificial behaviour by businesses, the Government will retain balancing adjustments in respect of balancing events, such as the sale of a building on which EZAs have been given, for a period of 7 years. Businesses holding their investment in a building for 7 years after their entitlement to EZAs arose will not be affected by this provision.

Draft legislation on EZAs, IBAs and ABAs

7.21 The draft legislation for the phased withdrawal of IBAs (including the withdrawal from April 2011 of EZAs) and ABAs by 2011 will be published in the New Year, before the publication of the 2008 Finance Bill.

CHANGES TO THE RATES OF PMA AND LLA

7.22 As set out in July, the new PMA rate will apply from a fixed date for all companies and unincorporated business. 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

7.23 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.[2]

7.24 For example, if a company's chargeable period began on 1 January and ended on 31 December, one-quarter3 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:

¼ x 25% = 6.25%
Plus ¾ x 20% = 15.00%
Hybrid rate for transitional period = 21.25%

[2] 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 methodology easier to follow.

[3] 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 methodology easier to follow.

10 per cent pool

7.25 Expenditure to be allocated to the 10 per cent pool will be treated differently and will fall into two broad categories:

1. **Pre-existing long-life asset expenditure**, in the current 6 per cent pool, where a hybrid rate will be used in the same way as for the method for the change in the rate for the main P&M pool; and

2. **Expenditure incurred after April 2008 on long-life assets and on the new 'integral feature'** 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. Pre-existing expenditure in the main pool which would fall into the new integral feature class of plant and machinery will remain in the main pool and continue to receive the main rate of plant and machinery allowances.

Ready reckoner

7.26 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.

7.27 Legislation on the changes to these rates of allowances is set out in the next chapter.

8 CAPITAL ALLOWANCES DRAFT LEGISLATION FOR RATE AND OTHER CHANGES WITH EXPLANATORY NOTES

8.1 This section contains draft Explanatory Notes based on the current draft of the legislation changing the main rate of writing-down allowance from 25 per cent to 20 per cent.

8.2 The legislation describing the main rate change is drafted as if it was Clause 1 in the Finance Bill 2008.

8.3 **New subsection (1)** is introductory and explains that section 56 of the Capital Allowances Act 2001 is to be amended.

8.4 **New subsection (2)** makes the rate change in section 56.

8.5 **New subsection(3)** inserts a new subsection (1A) in section 56 that preserves the 25 per cent rate of writing down allowance for a ring fence trade where tax is chargeable under section 501A of the Income and Corporation Taxes Act.

8.6 **New subsection (4)** is a minor consequential amendment ensuring that subsection (2) applies to the new subsection 1A as well as subsection 1.

8.7 **New subsection (5)** provides that the amendments have effect in respect of chargeable periods (chargeable periods taking the meaning given to them by section 6 CAA 2001) beginning on or after "the relevant date" ("the relevant date is defined in subsection (8)) and beginning before and ending on or after "the relevant date". The subsection also makes provision that a hybrid rate of allowance will apply for businesses with a chargeable period that begins before "the relevant date" and ends after "the relevant date".

8.8 **New subsection (6)** gives the formula for calculating the hybrid rate and provides that the rate is to be rounded up to the second decimal place. The formula looks at the number of days before the relevant date and the number of days after compared to the length of the chargeable period and expresses the writing down allowance applicable before and after the relevant date as a fraction and the hybrid rate is the sum of those two fractions.

8.9 **New subsection (7)** gives the meaning of abbreviations used in the formula.

8.10 **New subsection (8)** gives the relevant date for corporation tax purposes (1 April 2008) and income tax purposes (6 April 2008).

There follows the legislation on Plant and machinery: change in main rate of writing-down allowance:

1 Plant and machinery: change in main rate of writing-down allowance

(1) Section 56 of CAA 2001 (amount of allowances and charges) is amended as follows.

(2) In subsection (1), for "25%" substitute "20%".

(3) After that subsection insert—

"(1A) But in relation to qualifying expenditure incurred wholly for the purposes of a ring fence trade in respect of which tax is chargeable under section 501A of ICTA (supplementary charge in respect of ring fence trades), the amount of the writing-down allowance to which a person is entitled for a chargeable period is 25% of the amount by which AQE exceeds TDR."

(4) In subsection (2), for "Subsection (1) is" substitute "Subsections (1) and (1A) are".

(5) The amendments made by this section have effect in respect of chargeable periods—

(a) beginning on or after the relevant date, and

(b) beginning before, and ending on or after, the relevant date,

but in a case within paragraph (b) they apply as if in section 56(1) the reference to 20% were to x%.

(6) For the purposes of subsection (5)—

$$x = \left(25 \times \frac{BRD}{CP}\right) + \left(20 \times \frac{ARD}{CP}\right)$$

Where x would be a figure with more than 2 decimal places, it is to be rounded up to the nearest second decimal place.

(7) In subsection (6)—

BRD is the number of days in the chargeable period before the relevant date,

ARD is the number of days in the chargeable period on and after the relevant date,

CP is the number of days in the chargeable period.

(8) The relevant date is—

(a) for corporation tax purposes, 1 April 2008, and

(b) for income tax purposes, 6 April 2008.

WRITING DOWN ALLOWANCES AND THE LONG-LIFE ASSET POOL FOR LONG-LIFE ASSETS

8.11 This section contains draft Explanatory Notes based on the current draft of the legislation preserving the current rate of writing down allowances and the long-life asset pool for long-life assets used in a ring fence trade. The section also explains the transitional provisions relating to long-life expenditure incurred by all other businesses.

8.12 The legislation preserving the existing treatment for long-life assets used in the ring fence trade is drafted as if it was clause 1 in the Finance Bill 2008. The legislation giving effect to the transitional provisions is drafted as clause 2.

Clause 1

8.13 Clause 1 makes provision for the long life asset pool to be confined to ring fence trades.

8.14 **New subsection (1)** explains that section 101 Capital allowances Act 2001 is to be amended. Section 101 is the provision that brings the long-life asset pool into existence as a class pool.

8.15 **New subsection (2)** replaces part of subsection (2)(a) so that the section only applies to long-life expenditure wholly for the purposes of a "ring fence trade". "Ring fence trade" means a trade in respect of which tax is chargeable under section 501A of Income and Corporation Taxes Act.

8.16 **New subsection (3)** inserts a new subsection (3) into section 101 that signposts that new section 104C makes provisions for all other long life expenditure.

8.17 **New subsection (4)** explains that section 102 CAA 2001 is also to be amended. Section 102 is the provision that sets the rate of writing down allowance to be applied to the long-life asset pool.

8.18 **New subsections (5) and (6)** amend subsections (1) and (2) of section 102 by inserting "relevant " into each subsection.

8.19 **New subsection (7)** inserts two new subsections into section 102 immediately following subsection 2. The first subsection (subsection 2A) explains what is meant by "relevant long-life asset expenditure" following the insertion made by the subsections (5) and (7). The second subsection (2B) signposts that new section 104D makes provision about the writing down allowance a person is entitled to in respect of long-life asset expenditure that is not "relevant long-life asset expenditure".

8.20 **New subsection (8)** gives the commencement dates for the section.

8.21 **New subsection (9)** draws attention to Clause 2 which makes transitional provision.

Clause 2

8.22 Clause 2 makes transitional provisions including the application of a hybrid rate of writing down allowance for businesses (other than Ring fence trades) with long-life asset pools that

8.23 **New subsection (1)** gives the formula for calculating the hybrid rate for chargeable periods beginning before and ending on or after "the relevant date" ("the

relevant date" is defined in subsection (8) below) and provides that the rate is to be rounded up to the second decimal place. The formula looks at the number of days before the relevant date and the number of days after compared to the length of the chargeable period and expresses the writing down allowance applicable pre and post the relevant date as a fraction and the hybrid rate is the sum of those two fractions.

8.24 **New subsection (2)** gives the meaning of certain abbreviations used in the formula.

8.25 **New subsections (3) and (4)** give the rules for allocating any unrelieved qualifying expenditure in a long-life asset pool at the end of a "relevant chargeable period" ("relevant chargeable period" is defined in subsection (7)) into the new special rate pool and categorising the unrelieved expenditure as if it were special rate expenditure.

8.26 **New subsections (5) and (6)** give the same rules for long-life asset expenditure in a single asset pool.

8.27 **New subsections (7)** explains what is meant by "relevant chargeable period"

8.28 **New subsection (8)** gives the commencement dates for the section.

8.29 **New subsection (9)** makes it clear that the clause does not apply in relation to long-life asset expenditure incurred by a ring fence trade.

There follows the legislation on Long-life asset pool confined to ring fence trades:

1 Long-life asset pool confined to ring fence trades

(1) Section 101 of CAA 2001 (allocation of long-life asset expenditure to long-life asset pool) is amended as follows.

(2) In subsection (2)(a), for “wholly and exclusively for the purposes of a qualifying activity” substitute “wholly for the purposes of a ring fence trade in respect of which tax is chargeable under section 501A of ICTA (supplementary charge in respect of ring fence trades)”.

(3) After subsection (2) insert—

“(3) Section 104C makes provision about the allocation to a pool of long-life asset expenditure to which this section does not apply.”

(4) Section 102 of CAA 2001 (writing-down allowances at 6%) is amended as follows.

(5) In subsection (1), after “which is” insert “relevant”.

(6) In subsection (2), after “the” insert “relevant”.

(7) After subsection (2) insert—

“(2A) Relevant long-life asset expenditure is long-life asset expenditure incurred wholly for the purposes of a ring fence trade in respect of which tax is chargeable under section 501A of ICTA (supplementary charge in respect of ring fence trades).

(2B) Section 104D makes provision about the writing-down allowance to which a person is entitled in respect of long-life asset expenditure which is not relevant long-life asset expenditure.”

(8) The amendments made by this section have effect—

(a) for corporation tax purposes, in relation to expenditure incurred on or after 1 April 2008, and

(b) for income tax purposes, in relation to expenditure incurred on or after 6 April 2008.

(9) Section 2 makes transitional provision.

2 Long-life asset expenditure: transitional provision

(1) In relation to a chargeable period beginning before, and ending on or after, the relevant date, section 102(1) (writing-down allowances for long-life asset expenditure) has effect as if the percentage figure specified in that section were x%, where—

$$x = \left(6 \times \frac{BRD}{CP}\right) + \left(10 \times \frac{ARD}{CP}\right)$$

Where x would be a figure with more than 2 decimal places, it is to be rounded up to the nearest second decimal place.

(2) In subsection (1)—

BRD is the number of days in the chargeable period before the relevant date,

ARD is the number of days in the chargeable period on and after the relevant date, and

CP is the number of days in the chargeable period.

(3) Any unrelieved qualifying expenditure in a long-life asset pool at the end of a relevant chargeable period is to be carried forward to the special rate pool (see Chapter 10A of Part 2 of CAA 2001).

(4) Any expenditure so carried forward is to be treated for the purposes of Part 2 of CAA 2001 as if it were special rate expenditure carried forward in the special rate pool from a previous chargeable period.

(5) If at the end of a relevant chargeable period there is any unrelieved qualifying expenditure in a single asset pool to which this subsection applies, for subsequent chargeable periods the expenditure in the single asset pool is to be treated for the purposes of Part 2 of CAA 2001 as if it were special rate expenditure.

(6) Subsection (5) applies to a single asset pool to which long-life asset expenditure incurred before the relevant date has been allocated.

(7) A "relevant chargeable period" is one which—

(a) ends immediately before the relevant date, or

(b) begins before, and ends on or after, the relevant date.

(8) "The relevant date" means—

(a) for corporation tax purposes, 1 April 2008, and

(b) for income tax purposes, 6 April 2008.

(9) This section does not apply in relation to long-life asset expenditure incurred wholly for the purposes of a ring fence trade in respect of which tax is chargeable under section 501A of ICTA (supplementary charge in respect of ring fence trades).

A How to respond

A.1 The Government welcomes comments on the legislation contained in this technical note 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 Due to the Finance Bill cycle, the Government is providing 8 weeks in which to make comments on this draft legislation and would welcome comments by 15 February 2008.

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.

8.30 This document is available at:

http://www.hm-treasury.gov.uk/consultations_and_legislation/consult_fullindex.cfm

B CONSULTATION STAGE IMPACT ASSESSMENT

Summary: Intervention & Options

Department /Agency: HM Treasury	Title: Impact Assessment of capital allowances changes announced in Budget 2007	
Stage: Consultation	**Version:** 1.0	**Date:** 17 December 2007
Related Publications: Business tax reform: capital allowances changes consultation document		

Available to view or download at:

http://www.hm-treasury.gov.uk/consultations_and_legislation/consult_fullindex.cfm

Contact for enquiries: Dan York-Smith **Telephone:** 0207 270 4424

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

The pressures of globalisation and changing patterns of domestic business activity mean that the business tax system needs to be reformed to remove tax-driven distortions which encourage inefficient allocation of resources in the UK economy. These distortions relate principally to the mismatch between the present rates of writing-down allowance and true economic depreciation. They are also caused by the existence of anachronistic buildings allowances which give relief selectively to certain sectors and are administratively complex.

What are the policy objectives and the intended effects?

The package of reforms is intended to enhance international competitiveness, encourage investment, promote innovation and ensure fairness across the tax system by changing the structure of the corporate tax system to remove distortions to the investment decisions made by businesses. The effect of these reforms is to increase the efficiency of the allocation of investment by business, increase overall investment and reduce the administrative burden of the capital allowances system.

What policy options have been considered? Please justify any preferred option.

1. Do nothing
2. Reform the system by:
   - reducing the main rate of capital allowances from 25 – 20% and increasing the long-life asset allowance from 6 – 10%
   - introducing a separate classification of features integral (IFA) to a building in the 10% pool
   - introducing an annual investment allowance (AIA) of 100% for the first £50,000 of investment on plant and machinery (excluding cars) to all businesses and abolishing SME FYAs
   - a phased withdrawal of the industrial and agricultural buildings allowances (IBA and ABA) from April 2008

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects? 1 – 3 years after implementation the Government will review the compliance cost impact of the package.

Ministerial Sign-off For consultation stage Impact Assessments:

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:

.... Date: 17 December 2007

Summary: Analysis & Evidence

Policy Option: Do nothing	Description: No change to current policy. Loss making companies unable to benefit from the incentive

COSTS

ANNUAL COSTS		Description and scale of **key monetised costs** by 'main affected groups'
One-off (Transition)	**Yrs**	In a do nothing scenario, there are no additional costs or benefits to business beyond those included in the admin burdens baseline.
£ Nil		
Average Annual Cost (excluding one-off)		
£ Nil		**Total Cost** (PV) **£ Nil**

Other **key non-monetised costs** by 'main affected groups'

Nil

BENEFITS

ANNUAL BENEFITS		Description and scale of **key monetised benefits** by 'main affected groups'
One-off	**Yrs**	
£ Nil		
Average Annual Benefit (excluding one-off)		
£ Nil		**Total Benefit** (PV) **£ Nil**

Other **key non-monetised benefits** by 'main affected groups'

Nil

Key Assumptions/Sensitivities/Risks

No change from current system.

Price Base Year	Time Period Years	**Net Benefit Range** (NPV) **£ N/A**	**NET BENEFIT** (NPV Best estimate) **£ N/A**

What is the geographic coverage of the policy/option?	UK
On what date will the policy be implemented?	N/A
Which organisation(s) will enforce the policy?	HMRC
What is the total annual cost of enforcement for these organisations?	£
Does enforcement comply with Hampton principles?	Yes

Will implementation go beyond minimum EU requirements?			N/A	
What is the value of the proposed offsetting measure per year?			£ 0	
What is the value of changes in greenhouse gas emissions?			£ 0	
Will the proposal have a significant impact on competition?			No	
Annual cost (£-£) per organisation (excluding one-off)	Micro **£0**	Small **£0**	Medium **£0**	Large **£0**
Are any of these organisations exempt?	N/A	N/A	N/A	N/A

Impact on Admin Burdens Baseline (2005 Prices)						(Increase - Decrease)	
Increase of	£ N/A	Decrease	£ N/A		**Net Impact**	**£**	N/A

Key: Annual costs and benefits: Constant Prices | (Net) Present Value

Summary: Analysis & Evidence

Policy Option: Reform	Description: Implementation of the package of reforms announced in Budget 2007

COSTS

ANNUAL COSTS		Description and scale of **key monetised costs** by 'main affected groups'
One-off (Transition)	**1 Yr**	The new rules for integral features will result in a small admin burden for firms not able to use their AIA (0.1m)
£ Nil		For businesses above the SME FYA threshold, there will be a minor increase in admin costs from the additional calculation required for the AIA. (0.3m)
Average Annual Cost (excluding one-off)		
£ 0.4m		**Total Cost** (PV) **£ 0.4m**

Other **key non-monetised costs** by 'main affected groups'

Nil.

BENEFITS

ANNUAL BENEFITS		Description and scale of **key monetised benefits** by 'main affected groups'
One-off	**1 Yr**	SME business save a total of £3.6m in internal costs and £10.7m in external costs (agents fees) from the introduction of the AIA
£ Nil		The abolition of IBA and ABA saves £2.1m in compliance costs (ie the costs of making claims) for claimant businesses
Average Annual Benefit (excluding one-off)		
£ 16.4		**Total Benefit** (PV) **£ 16.4m**

Other **key non-monetised benefits** by 'main affected groups'

Nil.

Key Assumptions/Sensitivities/Risks

Benefits from the AIA assume that savings made by agents are passed on to SME companies. One-off cost assessment assumes that the adjustments to the new rates and allowances will require software changes which cannot meaningfully be quantified.

Price Base Year 2008	Time Period Years 1	**Net Benefit Range** (NPV) **£ 16m**	**NET BENEFIT** (NPV Best estimate) **£ 16m**

What is the geographic coverage of the policy/option?	UK
On what date will the policy be implemented?	1 or 6 April 2008
Which organisation(s) will enforce the policy?	HMRC
What is the total annual cost of enforcement for these organisations?	£ Negligible

Does enforcement comply with Hampton principles?			Yes	
Will implementation go beyond minimum EU requirements?			N/A	
What is the value of the proposed offsetting measure per year?			£ 0	
What is the value of changes in greenhouse gas emissions?			£ 0	
Will the proposal have a significant impact on competition?			No	
Annual cost (£-£) per organisation (excluding one-off)	Micro £0	Small £0	Medium £65.88	Large £65.88
Are any of these organisations exempt?	No	No	N/A	N/A

Impact on Admin Burdens Baseline (2005 Prices)					(Increase - Decrease)	
Increase of £	0.4m	Decrease	£ 15.4m	**Net Impact**	**£**	15m

Key: Annual costs and benefits: Constant Prices | (Net) Present Value

Evidence Base

ESTIMATES OF EFFECTS ON ADMINISTRATIVE BURDENS

Changes in compliance costs have been estimated using HMRC's Standard Cost Model of administrative burdens. The methodology for each type of allowance is explained below.

Reduction in the standard rate of plant and machinery writing down allowances from 25% to 20%

No effect, since with the reducing balance basis this will not significantly change the number of periods for which assets remain in the pool.

Increase in the rate of the writing down allowance for plant and machinery long life assets from 6% to 10%

No effect, since with the reducing balance basis this will not significantly change the number of periods for which assets remain in the pool.

Annual investment allowance (AIA)

For companies above the small- and medium sized enterprise (SME) threshold, this will involve claiming a an AIA where only writing down allowances are claimed currently. It will mean an additional step to the calculation, similar to that currently undertaken by SMEs. An estimate of this can be made by identifying the cost per company of claiming the existing first year allowance for SMEs in the Admin Burdens baseline, and multiplying this by the number of large companies with plant & machinery claims. The number of such companies is estimated to be around 4,600. The admin burden of the current FYA regime for medium-sized enterprises (MEs) is about £59 per company, and given the typical size of claims of MEs this would be representative of the cost to a large company of making a claim involving expenditure up to £50,000. Thus the total AIA admin burden for large companies is estimated to be £271,400. Although only £50,000 of first year allowance will be available per group (rather than per company), because this allowance can be used against expenditure on long-life asset or integral features, there may be a small number of cases where groups will choose to split their AIA between companies within the group where this would allow them to use more of the allowance against LLA or IFA expenditure. We therefore estimate on a conservative basis that the total admin burden increase will be £300,000.

For SMEs, the AIA will replace the existing First Year Allowance. Whether the AIA will reduce the burden on SMEs will depend on their circumstances.

For most SME, singleton companies, the AIA should be a simplification, as the £50,000 will cover all P&M expenditure in the vast majority of cases and so there should not be a need to maintain a P&M pool (unless for cars), unlike with the current 40% and 50% FYAs. We estimate savings in internal costs of £3.2m. In addition, there should be some reduction in agents' costs for businesses that outsource their tax returns. Based on the proportional time reduction for internal work, the reduction in agents' costs would be £10m; the actual savings to business would depend on how much of this saving is passed on. Because it is a significant simplification to the tax return for a very small

business, one would expect agents to be under pressure to reduce costs, especially as in some cases businesses may decide as a result of this change that their tax return is simple enough not to need an agent (in which case savings could actually be greater because of cost reductions for other obligations as well).

For singleton companies with eligible P&M expenditure in excess of £50,000 in a year, the burden will be similar, as with both the old and the new regimes, part of the expenditure will attract up-front relief and the remainder will be added to a pool.

For SME groups, there are currently complications in determining eligibility for FYAs which may be reduced under the AIA. With the existing system of FYAs, companies have to establish that they qualify for FYAs by virtue of being SMEs under the Companies Act definition. They may do this for non-tax reasons, for example if they file abbreviated accounts with Companies House, but many do not opt to file abbreviated accounts (they have to produce the full accounts for shareholders regardless of their decision to file abbreviated accounts). If they do not determine their SME status for non-tax reasons, then they have to do so for the purposes of claiming FYAs. In the majority of cases, even for groups, this is fairly straightforward. However, in some cases, e.g. where there are connected parties and/or overseas interests, or where the entity is close to the threshold, this can be less straightforward.

Savings will be possible where the full AIA is claimed by one company within a group (resulting in the same admin burden as the FYA regime) but the other companies in the group now no longer have to claim FYAs. These group companies will save £59 per company. We estimate that there are 6,000 such companies. However, as with large groups there may be cases in which the group will choose to split the entitlement to the AIA between businesses where there is expenditure that would qualify for LLAs and IFA. On the basis that these groups' companies are likely to have lower levels of expenditure on IFA and LLA assets and therefore more likely to benefit from splitting their AIA across the group, we estimate approximately half of the companies will benefit from no longer having to claim FYAs, giving an admin burden reduction of £0.2m.

Therefore the total change in the admin burden arising from the AIA in external costs is £10m. For internal costs it is £3.1m, made up of:

- a £3.2m saving for singleton SME companies with expenditure of less than £50,000 (excluding cars);
- a £0.2m saving from companies, in SME groups, with expenditure of less than £50,000 (excluding cars); and
- a £0.3m increase for companies outside of the SME definition who will now have to perform an FYA calculation for the AIA.

Features integral to buildings

The main effect of this measure is to reduce the rate of writing down allowance from the standard rate to 10% for a relatively small number of (high value) asset types. It does not involve redrawing of the boundary between buildings and plant & machinery, except in respect of certain electrical systems, mainly lighting.

The main cost will therefore be in identifying certain types of plant and machinery which have to be accounted for in a different pool. The pool for integral features will be the same pool that will be used for long life plant & machinery assets in the new regime. Thus for companies with LLAs currently, there should be no significant change in the

admin burden; it only affects the allocation of assets between two existing pools. For companies without LLAs, the additional burden will be similar to that incurred by companies currently to comply with the LLA regime. The total burden for the LLA regime is £44,258. There are 15,496 companies claiming it currently, so the cost per company is £2.86.

The number of companies with integral features is large, but the ability to use the AIA against integral features expenditure has a similar effect to applying a de minimis limit of £50,000 (for integral features and LLA expenditure combined). There are around 50,000 companies with total plant & machinery (including integral features) expenditure of more than £50,000 within their group, covering around 40,000 groups. Not all companies claiming allowances will have integral features expenditure; we conservatively estimate that approximately 35,000 companies will be affected, leading to an increase in the admin burden of approximately £100,000.

Abolition of Industrial Buildings Allowances (IBAs) and Agricultural Buildings Allowances (ABAs)

The admin burden for the IBA is £1,519,617 and for the ABA it is £461,824. These figures include unincorporated businesses as well as companies, reflecting the scope of the measure. The admin burden will be reduced by the total amount of the current costs in the baseline, £1.98m, as these allowances are being withdrawn and will not be replaced by another allowance.

Summary

The reduction in burden from the IBA/ABA withdrawal is £1.98m. There will be a saving from the AIA for businesses whose annual expenditure is consistently within the £50,000 annual threshold of around £3.5m in internal costs and up to a further £10m in agents costs (depending on pass-through). For other large groups, there will be a modest increase in internal costs of £0.3m. There will be a modest increase in burden from integral features of £100,000 for companies whose expenditure on LLAs is not covered by the AIA.

Overall, the net annual reduction in burden from the package is estimated to be £5m, plus up to around £10m in agents' fees.

The above estimates are at 2005 prices, based on HMRC's Standard Cost Model of Administrative Burdens. These estimates are restated at 2008 prices in the Summary on Page 3.

Specific Impact Tests: Checklist

Type of testing undertaken	***Results in Evidence Base?***	***Results annexed?***
Competition Assessment	No	No
Small Firms Impact Test	No	No
Legal Aid	No	No
Sustainable Development	No	No
Carbon Assessment	No	No
Other Environment	No	No
Health Impact Assessment	No	No
Race Equality	No	No
Disability Equality	No	No
Gender Equality	No	No
Human Rights	No	No
Rural Proofing	No	No

Annexes

NON-ADMINISTRATIVE IMPACT OF THE BUDGET PACKAGE

This annex sets out the evidence for the full package of reforms, including the reduction to the main rate of corporation tax, the phased increase in the small companies rate of corporation tax and the increase in the rate of the R&D tax credit, as well as the capital allowances changes set out earlier in this impact assessment.

The package has three central objectives:

- To promote investment and growth by removing distortions to decision making caused by the tax system, stimulating greater foreign direct investment and refocusing the tax system for small businesses
- To reduce administrative burdens and complexity by withdrawing burdensome and outdated elements of the capital allowances system while simplifying its operation for small businesses in particular
- To maintain the fairness of the tax system by ensuring businesses pay their fair share of tax and levelling the playing field between small businesses, regardless of legal form

Promoting investment

There is an extensive body of literature on the role of investment in driving productivity and long-term economic growth. Capital accumulation raises labour productivity both through direct and indirect effects. The direct impact is the increase in capital intensity; this means that labour is more productive, because it has more capital to work with. The indirect productivity effect of capital investment is felt when new investment helps labour to gain new skills and becomes more efficient at using that capital.

The reduction in the corporation tax rate from 30 per cent to 28 per cent will lower the cost of capital and, one would expect, generate an increase in domestic investment. On the basis of the model developed by Hall and Jorgenson (1967) and King and Fullerton (1984), across the whole economy, the changes are projected to lead to additional investment. The primary impact on domestic investment comes through the reduction in the CT rate, which acts as an incentive for additional investment – even after the reduction in capital allowances.

Large firms enjoy a positive investment effect from the CT reduction that offsets the changes to the rates of capital allowances and the withdrawal of IBAs.

For small firms, the change in the small companies rate is more than offset by the incentive effect of the introduction of the annual investment allowance. Overall, our analysis shows that there will be additional investment amongst small firms. Medium sized firms face a small decrease in investment incentives.

Unincorporated firms unambiguously benefit from the introduction of the annual investment allowance, creating a clear additional incentive for additional investment.

Improving the UK's international competitiveness

The Government recognises the importance of attracting high quality inward investment and ensuring the UK is seen as an attractive investment location internationally. Foreign Direct Investment (FDI) by multinational companies can provide a channel through which new ideas, working practices and technologies can arrive in host economies, as well as a means by which domestic companies are exposed to greater competitive pressures. The existence of positive externalities flowing from FDI via boosts to economy-wide productivity provides a role for public policy in encouraging FDI to come the UK.

There is a substantial body of literature which finds a relationship between levels of FDI and corporation tax rates. The influence of tax on inward investment is akin to that on domestic investment, via its effect on the post-tax rate of return. De Mooij and Ederveen (2005) provide a comprehensive meta-analysis of the empirical literature on taxes and FDI.

Therefore, the reduction in the main rate of CT and the fall in the cost of capital faced by large firms are likely to make the UK a more attractive location for inward investment, and complement the UK's existing wide range of tax and non-tax advantages.

The new rate of corporation tax from 2008 will mean that the UK has the lowest headline rate of CT in the G7, below the OECD and EU 15 averages.

Promoting innovation

The Budget announced an increase in the relief available for business R&D. This includes an increase in the large company R&D tax credit from 125 per cent to 130 percent from April 2008 and an increase in the enhanced deduction element of the SME and mid-sized R&D tax credit from 150 percent to 175 per cent also from April 2008. This is a significant increase in the generosity of the scheme for SME and mid-sized companies, providing relief for companies with up to 500 employees.

With innovation being recognised as one of the five key drivers of productivity, R&D forms a major part of the UK Government's strategy for growth. This is recognised in the Government's target to increase R&D to 2.5 per cent of GDP by 2014.

R&D fiscal incentives are widely accepted to be efficient tools to encourage business R&D without the need for direct Government intervention on a project-by-project basis. A recent independent feasibility study concluded that it is still too early to conduct a full econometric evaluation of the UK R&D tax credits scheme. However, research commissioned by the UK Government and other research undertaken indicates that the scheme is having a positive impact on business R&D investment. This evidence has supported the UK Government's desire to continue and strengthen the scheme.

Even in the presence of the current incentives available to businesses, the UK still faces a major challenge, with large increases in business R&D needed to move towards the 2014 target.

Given the academic consensus that lowering the user cost of R&D will increase R&D spend, increasing the rate of relief provided will be an efficient tool to approach this target.

Table 1 provides a summary of the studies estimating the impact of tax incentives on R&D. The evidence generally shows that decreasing the cost of R&D by £1 will lead to a £1 increase in R&D undertaken.

Table 1			
Impact of R&D fiscal incentives on R&D spend4			
Country	Author	Main findings	Period of analysis
UK and 8 other OECD countries	Bloom et al (2000)	A 10 per cent reduction in the cost of R&D leads to 1 per cent increase in the level of R&D in the short run, and a 10 per cent increase in the long run	1979-97
UK (Northern Ireland)	Harris et al (2006)	Own price elasticity found to be –1.36. A 10 per cent decrease in the cost of R&D leads to a 13.6 per cent increase in the level of R&D.	1998-2003
USA	Hall (1992)	Unit elastic short run responsiveness of R&D to the after-tax price of undertaking R&D. In the short run a 1 per cent decrease in the cost of R&D will increase R&D by 1per cent.	1980-91
USA	Hines (1993)	Own tax price elasticity found to vary between –1.2 and –1.8. A 10 per cent decrease in the user cost of R&D leads to between 12 per cent and 18 per cent of additional R&D.	1984-89

The evidence quoted above indicates that decreasing the user cost of R&D through the UK tax credit will increase investment in R&D. For instance, as is summarised in Table 1, the evidence suggests that a 10 per cent decrease in the cost of R&D is likely to lead to a 10 per cent increase in R&D spend in the long run. As the level of relief is increased and the private cost of R&D is pushed down even further it is expected that this will lead to additional increases in R&D. The incentive effect is directly proportional to the aid intensity as provided by the rate of relief – the higher the relief the higher the incentive effect. Hence, providing additional support is likely to make the R&D tax credits even more effective.

Fairness

The Government's discussion paper: *Small Companies, the self-employed and the tax system* set out a framework for discussion on the incentives for small business investment in the current tax system.

Successive Governments have tried to encourage greater investment through low rates of tax for small companies with the Small Companies Rate (SCR). However:

- It has become apparent that the SCR can be taken advantage of by people incorporating with the main aim of reducing their personal tax and national insurance liability by extracting labour income as dividends. This results in an unfair difference between the overall tax and NICs paid by the incorporated and the unincorporated, even where they are engaged in the same economic activity. This tax-motivated incorporation, if left unaddressed, would pose a growing risk to the Exchequer; and
- The SCR is not well targeted. As companies qualify according to their taxable profits, not their size, around one third of tax paying large companies benefit from the SCR.

The staged increase in the SCR from 2007 is intended to reduce the differential between the incorporated and unincorporated and was introduced in conjunction with the new Annual Investment Allowance to refocus the investment incentives for small businesses. The Government's analysis shows that the effect of the AIA will encourage greater investment by small businesses

Sectoral impact

The package of business tax reforms announced in Budget 07 was designed to achieve the objectives set out above for the UK economy as a whole. The impact of the package was not intended to be directed at any particular sector. Instead it was intended to reduce sectoral distortions, resulting in inefficient investment allocation, caused by the existing structure of the tax system.

Reducing the value of capital allowances on plant and machinery impacts most on capital-intensive sectors (energy, transport and communication and distribution). This is – in part – due to the fact that capital-intensive sectors have for some time enjoyed capital allowances that are higher than the actual rate of economic depreciation.

However, a reduction in the rate of capital allowances is primarily a timing effect. The lower rate means that an asset will be written-off over a longer period – lower allowances in the early years, but greater allowances later.

HMRC produces data of total claims for allowances by sector, including industrial buildings allowances, which can be found here:

http://www.hmrc.gov.uk/stats/corporate_tax/table11-10.pdf

These tables show that industrial buildings allowance claims make up only a small part of the total allowances due to businesses.

These changes must be set against the reduction in the main rate of corporation tax from 30% to 20%, which will be of significant benefit to main rate payers in all sectors. Data shows that 95% of the value of industrial buildings allowances claims are made by large businesses, who are likely to benefit from this reduction in the rate of tax. For smaller businesses, the AIA will be available to businesses in all sectors, offsetting changes to the rates of capital allowances.

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