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Potential Reforms to UK's Capital Allowance Regime – Inviting views

Response by the Chartered Institute of Taxation

1 Executive Summary

1.1 The Chartered Institute of Taxation (CIOT) is the leading professional body in the UK for advisers dealing with all aspects of taxation. We are a charity and our primary purpose is to promote education in taxation with a key aim of achieving a more efficient and less complex tax system for all. We draw on the experience of our 19,000 members, and extensive volunteer network, in providing our response.

1.2 We welcome this review and hope that the result will be changes to the UK capital allowances regime that bring stability to the tax system and a sustainably supportive treatment of business capital investment for business income and corporation tax purposes. Businesses require consistent levels of relief to help them plan and grow. The overwhelming feedback that we have received is that stability and certainty is more important to businesses than any particular rate of relief.

1.3 The government should use this opportunity to decide on their longer term strategy in relation to business investment and capital allowances. This review should be broader than the options set out in the Spring Statement and policy paper and include a more strategic consideration by government around what business investment it wishes to encourage, resulting in changes that have clear policy aims around what is being incentivised.

1.4 In order to incentivise capital expenditure, the government should consider a broader reform of some aspects of the capital allowances regime, and other tools. For example, the government should consider introducing some form of 'above the line relief', upfront grants or subsidies for particular types of expenditure and an ability for loss making companies to surrender allowances for a payable tax credit, similar to the SME R&D tax relief scheme. The review also provides an opportunity for the government to ensure that capital allowances are given to assets and expenditure that will help achieve the government's broader policy objectives, such as levelling up, reduction in CO_2 and energy efficiency (net zero), promoting innovation and high tech (high productivity) R&D industries, or improved and increased house building.

1.5 Simplicity is important to the greatest extent possible and, for many businesses, simplicity will be at least as attractive, if not more so, than higher tax incentives and reliefs. However, we recognise that targeted relief that incentivises business investment is an important feature of the UK's tax regime, and this inevitably results in some complexity.

1.6 Smaller businesses that are least able to deal with the additional compliance burden of more complex rules should be protected by an appropriate level of the Annual Investment Allowance (AIA), which provides welcome simplicity for smaller businesses. We would welcome the re-setting of a permanent level of the AIA at an appropriate level in order to simplify the tax and capital allowances computations of businesses within its limits. The government should also consider broadening the expenditure that qualifies for the AIA to provide further simplification for smaller businesses.

1.7 An increase in the rate of Writing Down Allowances (WDAs) would be welcomed by businesses and may be considered necessary to ensure that the UK's capital allowances regime is perceived as internationally competitive. But any increases are unlikely to have a significant impact on businesses' investment plans and will reward all qualifying investment expenditure. In addition, the higher the level of the AIA, and the more generous First Year Allowances (FYAs) are made, the less important WDAs are for businesses.

1.8 The key factor when introducing FYAs is to ensure that there is a sufficient longevity for the relief as lead-in times for new capital projects can be significant. An FYA that was significantly higher than 100%, such as the super-deduction, but introduced for a longer period, could incentivise business investment, but could also have a detrimental impact for some taxpayers.

1.9 Full expensing would undoubtedly be costly to the Exchequer, but it is an interesting proposition to be considered. However, we do not know whether this option would have the effect of incentivising investment to any great extent. It also lacks the ability to target incentivisation at investment in line with the government's overall policy objectives.

2 About us

2.1 The CIOT is an educational charity, promoting education and study of the administration and practice of taxation. One of our key aims is to work for a better, more efficient, tax system for all affected by it – taxpayers, their advisers and the authorities. Our comments and recommendations on tax issues are made solely in order to achieve this aim; we are a non-party-political organisation.

2.2 The CIOT's work covers all aspects of taxation, including direct and indirect taxes and duties. Through our Low Incomes Tax Reform Group (LITRG), the CIOT has a particular focus on improving the tax system, including tax credits and benefits, for the unrepresented taxpayer.

2.3 The CIOT draws on our members' experience in private practice, commerce and industry, government and academia to improve tax administration and propose and explain how tax policy objectives can most effectively be achieved. We also link to, and draw on, similar leading professional tax bodies in other countries.

2.4 Our members have the practising title of 'Chartered Tax Adviser' and the designatory letters 'CTA', to represent the leading tax qualification.

3 Policy aims of and strategic approach to capital allowances

3.1 We refer to the policy paper document published on 9 May 2022 inviting views on *Potential Reforms to UK's Capital Allowances Regime* and also to the discussion we had with HMT and HMRC on this paper on 26 May 2022. We are pleased to submit the comments below which build on the discussions at that meeting. The policy paper is framed as aiming to kick start a conversation about how to reform the UK's capital allowances regime. It says that the government is considering options ahead of Budget later this year, and as part of this is continuing to review the latest evidence, including the impact of the super-deduction and views of businesses. The paper sets out various 'areas of interest', and asks for evidence and/or views around these,

before also asking for views on some possible changes to the capital allowances regime that were set out in the Spring Statement.

3.2 We welcomed[1] the announcement in the Spring Statement of potential reforms to the UK's capital allowances regime. We also welcome the further detail provided in the policy paper and hope that this review will result in changes that will bring stability to the tax system in this area and a sustainably supportive treatment of business capital investment for business income and corporation tax purposes.

3.3 Our stated objectives are for a tax system that includes a legislative process that translates policy intentions into statute accurately and effectively, without unintended consequences. The tax system should also have greater simplicity and clarity, so people can understand how much tax they should be paying and why and provide greater certainty, so businesses and individuals can plan ahead with confidence.

3.4 In supporting these objectives, our view is that whatever regime the government puts in place as a result of this review should be there for the long-term, to enable businesses to plan effectively. Business investments often take place over decades. Businesses need consistent levels of relief to help them plan. We need to move away from temporary levels of the AIA to a permanent high level, and away from short term measures like the current super-deduction to a stable investment regime. There has been too much tinkering with rules and rates of capital allowances in recent years. These frequent changes more often than not bring complexity and uncertainty, as well as some arbitrary cliff edges. Constant changes to the rules undermine investor understanding of, and confidence in, what is on offer at any one time.

3.5 The Spring Statement set out a number of possible options for changes, and the policy paper sets out in a little more detail the key considerations around these changes. However, the broader questions in the policy paper also raise the fundamental questions around capital allowances, what these are intended to do and the policy aims that flow from that. As is noted in the policy paper, capital allowances are the rules that set the rates and timing at which certain capital expenditure can be deducted to arrive at taxable <u>profits</u> (emphasis added). Thus part of the function of capital allowances is to be the mechanism by which the tax system arrives at profits subject to tax that reflect the fact that capital expenditure – business investment - is ultimately (if over time) a cost borne against income – the tax equivalent of accounting depreciation. Broadly, the tax regime recognises that investment in tangible fixed assets should be reflected in the taxation of business profits.

3.6 Whether capital allowances should be replaced by accounting depreciation as the most appropriate way of reflecting capital expenditure in arriving at taxable profits has been discussed from time to time over many years. This question was most recently considered by the Office of Tax Simplification (OTS) in their review of *Accounting depreciation or capital allowances? Simplifying tax relief for tangible fixed assets*, presented to Parliament in June 2018[2]. Although the OTS report says that '[i]f designing this tax relief from scratch deprecation would be a good starting point', broadly the OTS did not recommend a change to accounting depreciation, saying (in the key summary on page 3):

'*Replacing CAs with depreciation would be a radical change. It **could** be done and this report describes how. It is not clear that it **should** be done. The long term benefits it would deliver would not be enough to make the disruption worthwhile. However, nothing in this review has made the structure of the CA regime seem simple. It is complicated and at times unfair as between different businesses. The only benefit of the way that tax relief is currently given is that it exists already and some people are familiar with it.*'

3.7 As noted above, business investment is a cost against business profits. If no deduction is given for that cost, then corporation tax (or business income tax, and associated capital gains tax) becomes in effect a tax, not on profits, but on profits plus business investment. (Indeed, to the extent that there have been from time to time categories of expenditure falling outside the capital allowances system ('tax nothings'), there has been tax on

[1] Capital allowances - time to put in place a regime that will last (tax.org.uk)

[2] Accounting depreciation or capital allowances

business investment.) There are basically two ways of achieving a tax based on profits (rather than profits plus investment) that would, in our view, be more straightforward than capital allowances:

- allow accounting depreciation: that is to say, take the cost of investment into account as it is reflected in the accounts that most businesses are required to produce. It would then be possible to dispense with much of the capital allowances system, although possible to retain the AIA as an incentive of most proportionate benefit to smaller businesses, and maybe other specific targeted additional reliefs for expenditure which brings 'external' benefits, such as alleviating climate change. Such incentives would be justified in terms of 'externalities' and would not suffer from the confusion of purpose which the current regime suffers from (discussed further below). Notwithstanding the OTS's comments on transitional issues, this option is, at least, an important benchmark to consider and against which to assess alternative proposals.
- full expensing, an option put forward in the paper, which would bring a result close to a cash, rather than an accounts basis. This would be more expensive, although more favourable to business and to investment. It would still be possible to give further incentives in the case of expenditure bringing 'external' benefits, thought the case that would be required to justify such further incentives would need to be stronger.

3.8 The OTS statement cited above also implicitly recognises the second important function of capital allowances, which is to incentivise capital expenditure, and sums up the inherent tensions within the capital allowances regime arising from the two functions that it purports to serve within the UK tax system. The OTS says further in the executive summary (on page 4):

'*Although the purpose of CAs is to provide tax relief for investment in fixed assets, the way this is done varies. Some parts of the CA system seem to stand in the place of depreciation while in other areas the intention may be to provide an additional incentive to invest. CAs have little coherent commercial logic: only some of the assets used by a business qualify for CAs and the rate of tax relief is a crude reflection of the depreciation of the assets. The tax rules on how assets are recognised and categorised for CAs are complex and burdensome*.'

If a deduction were given as a baseline for accounting depreciation (that is to say, if there were no actual *disincentive* to capital expenditure), it would be open to the government to consider further *incentives* to capital expenditure to the extent that it, or particular types of it, produced positive benefits to the economy as a whole, over and above that to the business undertaking it (as with support for research and development). A 'full expense' basis would already contain an element of additional incentive, corresponding broadly to the business's cash outlay, but it would be possible to incorporate further, targeted incentives where the case was sufficiently strong.

3.9 Of course the capital allowances system, as opposed to using accounting depreciation, already allows the government to be in control of which capital expenditure relief is given for, and the rates and timing at which that relief is given. This power is a two-edged sword, its regular exercise generates the very 'tinkering' changes which blunt the reliance that business is able to place on rules that are intended to be incentivising. But in theory at least, the government is able through the capital allowances system to drive the function of capital allowances of incentivising capital expenditure and the policy paper seems to be focussed on this. The policy aims set out in it are that the government wishes the reforms '*to [best] support business investment, …. to help foster a new culture of enterprise and growing the UK*.' The difficulty is that, as discussed in the paragraphs below around business decision making, the overall framework of capital allowances, devised also to fulfil the first function of relief for capital expenditure in arriving at taxable profits, means that the regime is often inefficient at the task of incentivisation. In addition, seeking to pursue both functions through the same system increases complexity and compliance cost. Finally, to the extent that there are 'tax nothings', there remain disincentives to investment. Even if such investment was not believed to generate positive externalities, disincentivising it could still be costly and distortive.

3.10 It would be helpful if the government could more clearly articulate its view of the policy aims of capital allowances both generally, and in relation to any specific changes that it considers should be made. The review is disappointingly narrow in its scope. It considers the options around rates and/or types of relief. This seems to be limiting the tools that might be available to achieve the policy aims of 'supporting business investment' and 'fostering a culture of enterprise and growth'. For example, the policy paper does not consider whether there should be changes to the types of assets that should qualify for capital allowances. (The OTS Review noted that a major contributor to compliance costs and complexity in the current system is classifying expenditure for tax purposes differently from what is required for the accounts.) We encourage the government to use this opportunity to consider their longer term strategy in relation to business investment and capital allowances more broadly than the options set out in the Spring Statement and policy paper. This review should include a wider, more strategic consideration by government around what businesses and what investment by those businesses it wishes to encourage. The resulting changes should have clear policy aims around what is being incentivised.

3.11 For example, is the government particularly keen on encouraging more investment by larger businesses and/or particular sectors? Is the government aiming to incentivise and accelerate spend that would occur anyway? Or is the principal policy aim to attract investment from other jurisdictions? The review also provides an opportunity for the government to ensure that capital allowances are applied with a more strategic and longer term view, that aligns to government's over-arching policy objectives and strategy for business growth; whether that is: levelling up, reduction in CO_2 and energy efficiency (net zero), promoting innovation and high tech (high productivity) R&D industries, or improved and increased house building.

3.12 In any event, as we say above, the end result should be long term stability so that businesses have consistent levels of relief to help them plan and grow. The overwhelming feedback that we have received is that stability and certainty is more important to businesses than any particular rate of relief.

3.13 Simplicity is also key to the greatest extent possible. For many businesses the benefits of a simpler tax system will be at least as attractive, if not more so, than increased tax incentives and reliefs. However, we accept that if the policy aim is to incentivise particular types of expenditure, there will inevitably be some complexity. In our view, it is appropriate that targeted relief should be a feature of the tax regime to encourage types of expenditure that the government considers important, and in order to achieve its overall strategic aims. The impact of this on smaller businesses that are least able to deal with the additional compliance burden of more complex rules can be countered by the AIA, which provides welcome simplicity for smaller businesses. We discuss below the AIA further below.

3.14 Targeted capital allowances can also help to increase the efficiency of the tax relief. Thus, the super-deduction, which was not targeted, was a blunt (albeit valuable) relief that rewarded all qualifying investment expenditure that occurred within the relevant period – whether of a particular type that the government wished to encourage or not, and whether or not it was going to occur anyway. Similarly, increasing WDAs for expenditure in respect of which the decision to spend has already been made is not fulfilling the policy aim of incentivisation for that capital expenditure. FYAs or enhanced capital allowances, or other types of relief, can be more specifically aimed at new, specific types of expenditure.

3.15 However, these considerations highlight the balance that must be struck between targeting reliefs to incentivise expenditure and providing capital allowances that compensate for capital expenditure in arriving at taxable profits. They also highlight the difficult balance between stability, certainty and simplicity versus complexity. In this regard we would note that there is also value in a simpler, more general and generous regime that, overall, would create an environment of incentivisation, as businesses have confidence in the government's support for business investment. If the UK's capital allowances regime was considered to be straightforward and stable, this would encourage inward investment and investment more generally.

3.16 We discuss below that there is a general low visibility of capital allowances in business investment decisions and that, generally, capital allowances are not a significant consideration when businesses make investment

decisions, although there is an expectation that relief will be given on a 'fair' basis. That could potentially change to some extent with a more strategic, targeted and long term capital allowances policy from the government. But the key question should be what does the government want to incentivise? Following on from this, consideration should be given as to how the tax system can best incentivise this. Are capital allowances a good tool? Are they the best tool? It is important to recognise the inherent limitations of the current capital allowances regime (as a result of its function as an approximation for accounting depreciation). If incentivising new or increased expenditure is the key policy aim, consideration should be given to alternatives to the capital allowances regime. For example, an 'above the line' type relief, as discussed below, is likely to increase the incentivisation aspect of a relief by bringing it closer to businesses' decision makers. Similarly, a relief structured as a tax credit would better incentivise investment by loss making companies, Currently many loss making companies fail to see the benefits of capital allowances, as they will merely add to tax losses that can be carried forward (subject to restrictions). Consequently, they have little or no impact on investment decisions. These issues are considered further in paragraph 7 below in relation to the discussion around the Spring Statement options.

3.17 To the greatest extent possible, all tax reliefs should be sensible and easy to administer. If they are introduced with too much complexity, businesses will not bother to claim them. A charge of over-complication has been levelled at both the super-deduction and the Structures and Buildings Allowance (SBA), which we discuss further below. The complexity should be commensurate with the benefit. In addition, as we mention above, we support a reasonable level of the AIA to protect smaller businesses from the additional complexity of specific more targeted reliefs.

4 Investment decisions

4.1 The policy paper asks for information around how firms make investment decisions, the relative importance of capital allowances in those decisions, and how they are taken into account. Generally our members have reported that there is low visibility of capital allowances in the investment decision making processes of businesses.

4.2 Clearly the basis for investment decisions will be different for different businesses. Businesses undertaking specific long term projects, for example, in relation to real estate or other infrastructure projects, may undertake net present value calculations of after tax cash flows etc., which include capital allowances, and build these into their business models and investment decisions. But our understanding is that this is more by exception than the norm. More traditional businesses are more likely to make broad assumptions regarding the relief they can obtain for capital expenditure. Similarly, for smaller businesses, there is generally a view within businesses that they are entitled to some relief for capital expenditure, but how this might arise does not usually impact on the investment decision, other than, possibly, the timing.

4.3 In addition, capital investment decisions are made by different businesses on different time scales. For example, if a self-employed plumber (say) needs a new van because his is broken, he needs this tomorrow; he is not going to plan for it. Conversely, larger investment projects or business growth programmes by larger businesses will be planned for; they are unlikely to be able to change their capex program significantly to benefit from a short term relief such as the super-deduction. However, even longer-term capital projects by the largest businesses will be primarily driven by business needs and only once the decision to invest has been made is the financial and tax impact considered.

4.4 The feedback that we have received from businesses and advisers is that investment decisions are more usually done on an 'above the line' basis and also based on broader business need, thus resulting in a generally low level of consideration of capital allowances in investment decisions. (We recognise that this perspective conflicts with the economist's vision of a 'rational' decision-maker and with the perception that multinationals devote a great deal of attention to tax planning. However, the rules and rates of relief for business investment costs vary greatly, and change rapidly, both in the UK and other countries, so knowledge

of the overall relief that will be obtained is too imperfect for the model of the 'rational' decision-maker to pertain. As regards multinationals' tax planning, that typically focusses on larger and more predictable variables in the international tax scene. Of course both these factors could be mitigated by more predictable and reliable rules.) The availability of capital allowances – or changes in rates of them – may impact the timing of capital expenditure, but, we understand, would rarely impact on whether or not it takes place. In addition, larger groups often focus on 'earnings per share' as a key metric of their success, rather than on the impact on cash of tax. Thus while more generous capital allowances and, in particular, FYAs may improve cash flows, they do not impact on the group's overall tax charge because the accelerated capital allowances will be provided for in deferred tax and thus have no impact on earnings per share. This may not always be the case and for the longer term projects that are undertaken on the basis of detailed cash flow forecasts (of up to 50 years), the net present value of capital allowances on viability of the project, and the projected stakeholder value that sits alongside these projections can be quite sensitive to identifying whether things qualify – and to how quickly they will unwind given that the expenditure generally occurs in the early years that are loss making.

4.5 However, in all scenarios, stability in the tax system is what businesses would welcome the most. The recent seemingly constant chopping and changing of reliefs relating to capital allowances brings its own complexities and unintended consequences. It also acts to undermine investor confidence, as they feel unable to rely on the allowances being given for any long term investment (for example, the reduction to the Special Rate that had a retroactive effect). Our understanding is that most businesses cite certainty as more important than the precise amount of relief available and in this regard the continual changes to capital allowance reliefs are unhelpful. This is discussed further at paragraph 5 below in the comments around the current system in relation to multinationals, but is equally true for smaller businesses that fall within the AIA, as the changing of level of the AIA has brought significant cliff edge issues and complexities. We recognise that governments like the flexibility of being able to turn the tap of incentivisation on and off according to shifting public priorities. But surely there are some predictable things that the UK will want to incentivise at the public policy level for the foreseeable future? Global warming issues, for example, are not going away any time soon?

4.6 We have received consistent feedback from businesses that tax relief would be a greater incentive within investment decision making if the relief were 'above the line', so as to impact EBITDA – similar to the Research and Development Expenditure Credit (RDEC). This would ensure that the tax relief is closer and more visible to the decision makers in the businesses. The decision making parts of businesses are motivated by the more visible benefits that RDEC can provide to their profit and loss directly, rather than through the 'tax line' which is often a central cost/benefit to the business as a whole. The increased visibility may also help with efficient funding of business investment, as we understand that lenders can take into account the cash credits a business 'is likely to' generate when deciding on whether or not to lend to fund an R&D project.

4.7 The government could also consider other mechanisms to provide a more 'upfront' benefit from capital investment that could be a greater incentive for investment. For example, a grant that could be either paid or provided through a reduction in other taxes (PAYE and NIC) at the time expenditure is incurred would be more appealing and influential on investment decisions. Currently capital allowances provide an incentive through reduced tax payments, and, typically, following the submission of the tax computation with the capital allowances claim. Even with 100% FYA this could be up to two years after the expenditure is incurred. An enhanced relief, which is provided at the time the expenditure is incurred, would provide more stimulus.

5 The super-deduction

5.1 Although another super-deduction is not one of the options set out in the Spring Statement, the policy paper asked for views of the super-deduction's impact on investment decisions, to inform the government's thinking around potential reforms. The super-deduction had two elements – the enhancement at above 100% and the FYA element. Our understanding is that the super-deduction did not affect businesses' investment

decisions to any significant degree, although it may have prevented some businesses from deferring planned capex during the pandemic, or accelerated some planned expenditure. Without the super-deduction, but given the announcement of an increased rate of tax two years ahead, there would, of course, have been a perverse incentive to defer capital expenditure. However, the short two year window prevented many businesses from benefiting from the enhanced relief for any significant investments due to the required planning and lead times. In addition the rules around the dates of expenditure and contracts before the 3 March cut-off date made it difficult for some businesses already within long term or complex projects to benefit. Our understanding is that most businesses viewed it as welcome where they were able to claim it, but not a significant investment lever.

5.2 Clearly the temporary nature of the super-deduction had a large impact on its effectiveness as an investment incentive. Thus, a more permanent super or 'enhanced' relief could have a different impact and would probably be welcomed by businesses that are either only based in the UK, or are of a size where they invest in excess of the AIA, but are not so large as to be affected by the proposed new global minimum tax rules (Pillar 2). This is discussed further below in relation to the options in the Spring Statement around FYAs.

5.3 For the largest, multinational businesses that will be affected by the proposed new Pillar 2 rules, if the impact of a super-deduction is to increase losses, it may result in tax being paid elsewhere by the group (or in the UK if a domestic minimum tax is implemented in line with the income inclusion rules of Pillar 2). This will be particularly true for businesses that are in the investment phase of a project and are not yet profitable. A regime that provided quicker expensing of capital expenditure, rather than a super-deduction would be more helpful for businesses that are subject to the Pillar 2 rules.

5.4 We would also note that not all taxpayers can benefit from the super-deduction; for example, real estate investment trusts (REITs) cannot benefit by virtue of their specific tax regime (although RIETs do, overall, have a very favourable tax regime). The super-deduction was also only available to companies. It is not clear why this is the case, other than on the basis of overall cost of the relief.

6 Current system of capital allowances (and how they influence multinationals)

6.1 That the permanent capital allowances available in the UK compare unfavourably to some international peers is acknowledged. This is to some extent due to the rates of allowances available. However, our experience is that it is also the complexity of the UK system, and the recent frequent changes to it, that mean it is also viewed as comparatively administratively burdensome.

6.2 We suggest that the way to improve the international perception of the UK's capital allowance regime would be to simplify it to the greatest extent possible and indicate that the rates and allowances offered will be in place for a reasonable amount of (fixed) time.

6.3 For example, the SBA was introduced in 2018/19 with the policy intention of improving the UK's international competitiveness and to stimulate business investment. We supported these policy objectives, and agreed that a relief for the expenditure that the SBA is aimed at was welcome. However, we questioned whether the relief would achieve these objectives, as it is overly complicated and introduced yet another type of asset classification for solely tax purposes. It also requires an extensive record keeping exercise by businesses that wish to claim it. In 2018 we said that we agree that competitiveness is better served by having fewer categories of unrelieved expenditure. But we suggested that it would be feasible to do this by reducing the extent of categorising expenditure solely for tax purposes. The SBA did the opposite and introduced another type of asset classification required only for tax purposes - something cautioned against by the OTS in its review of capital allowances.

6.4 A simpler, more general and generous regime of capital allowances that has clearly been introduced for the long term would provide businesses with confidence in the government's support for business investment and encourage inward investment. However, businesses considering whether to invest in the UK, as opposed to

another territory, will, in our experience, consider a much wider range of factors that the tax system and any reliefs that may be available.

7 Spring Statement options

7.1 With regard to the options set out at Spring Statement, we reiterate that clarity and certainty are more important to businesses than the precise level of the rates. We hope that this review and any resulting reform will signal an end to the recent chopping and changing of rates and AIA levels etc. that have been seen in recent years. In our view it would be beneficial for the UK's overall global competitiveness, and a more positive message to business generally, if any changes that are made are introduced on a permanent basis. If they are intended to change or influence investment behaviours, it should be clear that measures are being introduced for a longer time frame.

7.2 With regard to the general consideration of increasing the permanent level of the AIA, increasing rates of WDAs, introducing general FYAs, or additional FYAs, we assume that the government is in a position to establish which businesses would benefit from any particular approach. As is acknowledged in the policy paper, it is clear that some businesses would benefit more than others from any particular change in rate or approach. For example, if the AIA is going to be set at £1m, a business that is spending more than £1m on capex per annum will be in a very different position from a business that is spending less. To this extent, changes to the rates and levels and types of relief available will, without clear strategic thought sitting behind them, be fairly arbitrary. We reiterate, therefore, the comments in paragraph 3 above around the importance of the government formulating its overall strategic approach. The decisions around what changes to make should reflect:

- who the government wishes to incentivise (e.g. larger businesses spending significant amounts and/or smaller businesses and/or domestic businesses or inward investment to the UK),
- what the government wishes to encourage investment in (e.g. focus on productivity and identify what assets would drive productivity and provide greater reliefs for these, identify expenditure that is linked to the government's broader policy aims of levelling up, net zero etc.), and
- the extent to which government wishes to target the relief on specific expenditure or create a generous, more general regime, thus balancing incentivising specific policy aims with the benefits of (relative) simplicity – and the answer here may be different for the largest and smallest businesses.

Annual investment allowance (AIA)

7.3 Generally we are supportive of the AIA as a concept, as it brings significant simplicity for smaller businesses whose thinking is also more likely to be focussed on cash rather than accounting results. We would welcome the re-setting of a permanent level of the AIA as there has been a great deal of complexity arising as a result of the chopping and changes in the level of the AIA in recent years arising from 'temporary' extensions. The AIA simplifies the tax / capital allowances computations of businesses within its limits. Although businesses must first determine what assets qualify for AIA, no further calculations are necessary for expenditure on such assets that falls within the AIA limit. To this extent, as we say above, setting the AIA at an appropriate level gives the government more leeway in targeting capital allowances to incentivise specific types of expenditure as only larger businesses will, in reality, have to deal with the additional complexity that targeted reliefs will bring.

7.4 Many small companies pay no corporation or business income tax as a result of the AIA, for the good reason that they are reinvesting their profits. However, the smallest businesses earn profits below the existing level of the AIA, and setting it at a higher level benefits larger businesses, including (to an extent) the largest companies for whom the impact is relatively immaterial. There are thus diminishing returns from increasing it to higher levels. We accept that the right level for it is a matter of political judgment.

7.5 We understand that for smaller businesses, there is generally a view within businesses that they are entitled to some relief for capital expenditure, and how this might arise does not usually impact on the investment decision, other than, possibly, the timing. However, given that the AIA is not available for all capital expenditure, the taxpayer must deal with the general, sometimes complex rules around what are and are not qualifying assets. For smaller businesses this is where the complexity arises. Thus, if the government wishes to provide more support for business investment for smaller businesses, it should consider broadening the scope of what can qualify for the AIA, and including assets that are currently excluded (such as cars). It would also be beneficial for such businesses if expenditure that qualifies for the SBA were included within the AIA.

7.6 Recognising that there will be winners and losers from an approach that broadens the qualifying expenditure for the AIA, and the level at which it is set, the additional cost to the Exchequer of an extended AIA could be offset by setting the AIA at a lower level.

Writing down allowances (WDAs)

7.7 WDAs are currently given in relation to qualifying expenditure in respect of either the main pool (at 18%) or the special rate pool (at 6%). The special rate applies to long-life assets, integral features and cars with CO_2 emissions over a certain threshold. WDAs are the mechanism by which the capital allowances regime most closely gives relief akin to accounting depreciation by spreading tax relief over multiple years. The policy paper considers increasing the rates of WDAs from 18% and 6% to, for example, 20% and 8% respectively.

7.8 An increase in the rate of WDAs would be welcomed by businesses but those increases are unlikely to have a significant impact on their overall investment plans. We recognise that it may be considered necessary in order to ensure that relief for capital expenditure in the UK sits at an appropriate level when compared to international competitors. However, in our view, a modest change in the rate of WDAs is unlikely to incentivise increased investment. The changes may impact the timing of the related expenditure. For example, an increase WDA rates may encourage businesses to defer planned expenditure until the increased rates come into force, but that expenditure would have happened anyway. The result would be that it has become more expensive for the government to reward it. As noted above, an increase in rates will reward all qualifying investment expenditure, and not only expenditure on assets that the government may wish to particularly encourage, but the effectiveness of promoting new investment may be minimal.

7.9 In addition, the higher the level of the AIA, and the more generous FYAs are made, the less important WDAs are for businesses.

7.10 As well as simply considering the rates of WDAs, the government should also consider whether the rates are being applied to appropriate categories of assets in the existing pools in line with the government's general policy agenda. For example, currently, expenditure on new energy efficient assets such as ground source energy efficient heat pumps or LED lighting systems fall within the special rate pool attracting rates significantly lower than the more generous main pool.

First Year Allowances (FYAs)

7.11 FYAs allow businesses to deduct a percentage (usually a high percentage of 100% or 50%) of qualifying expenditure in the year that the expenditure is incurred, and are allowed in addition to the AIA. They are often intended to be more targeted on either specific new plant and machinery or for specific regions. Currently there are FYAs in place for zero-emission goods vehicles and for plant and machinery primarily in use in a Freeport tax site. However, they have also been used as a more general incentive, for example the recent super-deduction (and the 50% special rate allowance). Unlike WDAs, FYAs only apply to new expenditure. As such, they should be more effective in promoting new and potentially targeted investment, which is a key issue for the policy paper.

7.12 The Spring Statement options consider introducing a general FYA for a proportion of qualifying expenditure on plant and machinery in a particular year (a rate of 40% on main rate and a 13% FYA for special rate expenditure is suggested as an example). This would effectively accelerate the relief given for qualifying

expenditure. The policy paper also suggests what is called an 'Additional FYA'. An Additional FYA would operate so as to allow both a percentage of qualifying expenditure to be claimed in the year the expenditure is incurred and 100% of that expenditure would still be available to be pooled with WDAs claimed in the normal way. Thus, overall, relief would be provided above the amount of the expenditure over time.

7.13 As discussed above in relation to the super-deduction, it is important when introducing FYAs that there is a sufficient longevity for the relief as lead-in times for new capital projects can be significant. Although the general conclusion around business decision making is that capital project appraisals do not take into account the impact of capital allowances, an exception to this may well be an FYA that was significantly higher than 100%, such as the super-deduction, but with a much longer 'shelf life'.

7.14 However, the point around the impact under the proposed Pillar 2 rules for some multinationals should also be noted. In addition, FYAs would also impact other types of taxpayers, such as REITs, if the FYAs were given/claimed automatically (and could not be disclaimed). The property income distribution requirement would be significantly reduced in the year an FYA was claimed and increase in other years. Significant fluctuations such as these are not compatible with investors' expectations of consistent returns (distributions). In conclusion, the government should consider all types of taxpayer as part of this review and in deciding on any changes to the UK capital allowances regime that may be made.

7.15 *Full expensing*

7.16 Full expensing is in essence an unlimited AIA for all businesses, or an uncapped general FYA, allowing all qualifying expenditure to be written off in the year the expenditure is incurred, although possibly excluding expenditure that is currently excluded from the AIA (for example, cars). We also assume that it would only apply to plant and machinery and that SBAs would remain for structures and buildings. As noted, introduced on a permanent basis, this would be very generous relief and would put the UK at the top of the G7 tables.

7.17 Although this would undoubtedly be costly to the Exchequer, it is an interesting proposition to be considered. This option would give the greatest simplification to the business tax system out of all those suggested (although it is arguably less simple, at least for incorporated businesses, and less costly to the public revenue, than allowing a deduction for accounting depreciation). Although under 'full expensing', it would still be necessary to use case law to distinguish between plant and machinery and buildings, if an item is considered to be plant, it would not be necessary to determine whether the expenditure on it is capital or revenue. This would create considerable benefits for businesses, advisers and HMRC. As we understand it, the economic view is that full expensing will result in increased business investment because it lowers the cost of capital. Investments that were previously not profitable can become profitable under full expensing, due to the reduction in the cost of capital. Consequently, the cost to the Exchequer in terms of corporation tax and income tax on business income should be weighed against the expected growth to the economy, and with it the number of jobs and level of wages. However, we do not know whether this option would have the effect of incentivising investment to any great extent, particularly if it was not believed that it would last. It is of course somewhat akin to the system that prevailed for much of the 1970s when 100% FYAs were in force, under which corporation tax receipts were typically relatively and absolutely much lower than now.

7.18 This option also lacks the ability to target incentivisation at investment in line with the government's overall policy objectives and would, as noted, encourage inefficient, low-return, debt-financed investment, as well as investment that could be more highly productive.

7.19 *Putting together the package*

7.20 All of the options in the policy paper would improve the overall generosity of the UK's capital allowances regime. As we say above, and setting aside the full expensing option for the moment, there would be winners and losers from any one of the other approaches at the expense of the other, and different businesses will benefit to a greater or lesser extent depending on the final package of changes and the rates of relief that are chosen. As we say above, there is value in what is perceived to be a generous regime of capital allowances,

particularly if this can be considered to straightforward and stable. In itself such a regime will to some degree help to create an environment of incentivisation, as businesses have confidence in the government's support for business investment and would encourage inward investment and investment more generally.

7.21 But, as discussed above, our understanding of the investment decision making process of businesses means that none of the proposals outlined in the policy paper (other than, arguably, the full expensing option) would significantly incentivise investment. All would also carry significant 'dead weight' due to rewarding expenditure that would have occurred anyway and rewarding all qualifying expenditure, regardless of its value in terms of improving the productivity of UK plc and/or achieving the government's broader policy aims.

7.22 In fact, more generous general allowances, for example, the AIA, the super-deduction or a general FYA, erodes the benefit of more specific, targeted reliefs, for example, the 100% Research & Development Allowances. Therefore, if there are key strategic aims of the government (and part of the government's 'tax plan' is encouraging innovation and R&D), care should be taken to ensure that the tax system maintains appropriate support and encouragement for specific types of investment such as R&D related investment, that could lead to higher productivity business and growth. A balance must be struck between targeted relief and general support for business investment. As discussed above, a key consideration should be targeting capital allowances to the government's objectives.

7.23 We also note that the capital allowances regime is currently structured to provide relief for the depreciation of an asset between the date it is acquired and the date it is sold or scrapped by the business (acquisition price minus proceeds), rather than the expenditure itself. This is the case even in relation to the super-deduction as the proceeds from the disposal of an asset falling under the regime need to be uplifted in certain circumstances to reflect the initial 30% additional deduction. There are also oddities arising from the pooling rules; for example in relation to the rules in respect of fixtures where a buyer cannot have allowances in relation to the money it has spent on a building with fixtures in it, because someone else has already claimed them. This does not seem commercial for the buyer. A regime that was focussed more on providing an incentive for the gross expenditure incurred (ignoring disposal receipts) may be more impactful. In any event careful thought will be required as to how any changes impact on specific rules such as those around the fixtures election (Capital Allowances Act 2001 section 198) to ensure that there are no unintended consequences.

7.24 *Other options and considerations*

7.25 We would welcome greater consultation and discussion around how the UK's capital allowances regime could be better focussed on achieving the government's strategic aims and think that a wider range of options should be considered. Some of these are discussed below.

7.26 As highlighted above, if the government wishes to incentivise capital expenditure, it should consider a broader reform of some aspects of the capital allowances regime, and other tools. For example, we suggest the government considers:

- introducing some form of 'above the line' relief in order to impact the investment decisions. It may be possible to introduce this for the permanent FYA part of the overall package, rather than the balance to which WDAs apply;
- providing upfront grants or subsidies for particular types of expenditure. As grants are taxable, the government would recoup some of the cost over time by way of increased tax receipts;
- introducing an ability for loss making companies to surrender allowances for a payable tax credit, similar to the SME R&D tax relief scheme.

7.27 The area that our members most often cited as being 'missing' from the UK's capital allowances regime in response to this consultation is in relation to environmental expenditure. Until recently there were Enhanced Capital Allowances (ECAs). ECAs were a type of first year allowances available for environmentally beneficial plant and machinery. There were significant problems with ECAs, in particular around establishing which assets qualified and maintaining the lists, and we are not suggesting that these are re-instated. However, since these

have been phased out, there is nothing in the capital allowances regime that encourages or incentivises expenditure on things that would benefit the environment, particularly in relation to achieving net zero and the broader targets around ensuring that the built environment is able to contribute to this.

7.28 We have previously suggested that capital allowances, or some form of 'enhanced allowance' should be given that is linked to building environment performance requirements using established and already applied metrics used in the construction sector. New building methods tend to take a holistic view and look at the whole building design and concepts rather than its component parts. For example, every time a building is constructed, altered or refurbished, it requires a new EPC assessment and certificate and must meet environmental requirements under Part L of the building regulations. The EPC gives a rating (A to F), and that rating is backed by a number of fairly detailed tests and scoring requirements. Achieving certain benchmarks, or improvements, could be used as a metric to award higher 'enhanced deductions' (on top of standard capital allowances). Alternatively, higher capital allowances could be linked to buildings verified as being sustainable, such as those with the highest rating tiers within schemes such as BREEAM. This would incentivise investors to use the latest technology available and produce better-quality buildings.

7.29 A similar principle could be applied to new manufacturing or process equipment that improves energy efficiency. This could be tested by a metric compared to an existing position or benchmark. Alternatively, a test could be devised that identifies that the purpose of the expenditure is, at least in part, to achieve sustainability, or improve energy efficiency, and such qualifying expenditure would then be entitled to relief, in a similar way to the expenditure qualifying for R&D Capital Allowances is expenditure on assets identified as being used for R&D purposes, or on providing facilities for carrying out R&D.

7.30 A related consideration is whether elements of residential capital investment should qualify for capital allowances, considering the government's home building targets? For example new (larger) build to rent developments could qualify for certain enhanced reliefs, for example, the environmental relief mentioned above for the most efficient buildings?

7.31 In this regard, we also draw your attention to a submission by the CIOT on land remediation relief (LRR). The purpose of LRR is to provide a financial incentive to developers to bring land back into use that had been contaminated by previous industrial use or land containing derelict structures that would be prohibitively expensive to remove. We are concerned about one aspect of the LRR derelict land remediation scheme: the qualifying date of 1 April 1998 for land in a derelict state. Due to the passage of time, evidence is often not available for the entire period necessary, thus prohibiting a claim that in all other respects meets the qualifying conditions and the underlying policy intent. We have suggested a review of the current statutory date (1 April 1998) from which the condition of dereliction must be demonstrated. We mention this here to reiterate the importance of tax reliefs and tax law being coherent and effective with regard to the underlying government policy.

7.32 It is also important that changes to the UK's capital allowances regime take into account the different types of taxpayer. For example, REITs are impacted differently by capital allowances to other companies, by virtue of their specific tax regime. In addition the most significant infrastructure projects in the UK are generally carried out by organisations that are regulated by the government (for example, energy, water and oil companies and airport operators). If the intention is to incentivise organisations in these sectors, the government may need to consider other ways of encouraging investment. Due to the regulations imposed on them, these businesses probably have even less scope than most to flex their capex plans to react to short term changes to the tax system.

7.33 We would also like a consideration of the strategy around which types of businesses are able to obtain the reliefs that are available. Recently partnerships and individuals have been excluded from enhanced reliefs such as the super-deduction. It is not clear why this is the case, other than on the basis of overall cost of the relief. Going forward, we suggest long term reliefs that are put in place are available to incorporated and

unincorporated businesses to minimise the distortion in the tax system arising from different types of business vehicle.

7.34 In reviewing the overall impact of the capital allowances regime on businesses and business investment the government could also consider the distinctions currently drawn between different types of financing and, in particular, the barriers to allowances in respect of leasing. As mentioned above, businesses that are unprofitable are unable to utilise capital allowances, and this will reduce their ability and incentive to grow. If leasing or rental businesses were able to access the capital allowances and pass on the savings to their customers, this could help these businesses to grow and become profitable.

7.35 Finally, in considering any reliefs, and in particular, enhanced allowances (for example, the super-deduction), the effect of the proposed Pillar 2 rules should be taken into account. The GloBE effective tax rate (ETR) calculation does not generally include adjustments for reliefs and incentives, but the mechanism by which they are given, and the rate of them, will affect this. If an incentive reduces a group's ETR in the specific jurisdiction below the 15% minimum rate that will result in a top-up tax which will effectively remove some of the benefit of the incentive.

8 Acknowledgement of submission

8.1 We would be grateful if you could acknowledge safe receipt of this submission, and ensure that the Chartered Institute of Taxation is included in the List of Respondents when any outcome of the consultation is published.

The Chartered Institute of Taxation
30 June 2022