Afilia

Capital Allowances

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Capital Allowances - a perspective through the prism of 2019

Why fiscal incentives exist

We take the availability of tax reliefs in whatever form as given, and an intrinsic part of the tax system. It may help us when looking to the future to reconsider why we have them and what they are intended to achieve, linking this particularly to identifiable sectors where an acceleration of activity would be desirable.

In principle, the purpose of fiscal incentives in a modern economy is to encourage people, or organisations to make expenditure decisions that assist in the economic and equitable development of society. This is in contrast with the 'stick' of the imposed requirement to comply with legal or regulatory standards such as the Building Regulations.

Market weakness and societal need

A fiscal incentive will provide the stimulus to encourage expenditure that brings about change in a way that might otherwise may only be of marginal immediate financial benefit to the recipient. The judgment of government is that the sacrifice of tax revenues today is for a greater purpose. This can be measured either in the achievement of future economic growth - which recoups the lost tax revenues. Alternatively, its metric is less tangible, for example creating better workplaces or reducing carbon dependence - although both will also contribute indirectly to improvements in economic performance.

The objectives of fiscal incentives readily divide into two categories. The first is in addressing **market weakness** where the normal rules of supply and demand are failing to deliver desired outcomes. The second is using financial means to stimulate a private investment to support a **societal need**. Two examples are considered below although there will be arguments for other specific sectors that fall within either category.

Commercial offices

The clearest example of market weakness is in commercial property where market rentals have been insufficient to encourage investors to upgrade or replace existing assets. Outside of the M25 since the post-2008 recession, new office development has been sparse, leaving a large stock of ageing properties that over time become steadily less able to find tenants. Many of the older offices which are in use today are often soulless, unattractive places to work and, arguably contributing in some way to the UK's intractable problem of low economic productivity.

Unoccupied buildings in city centres also create issues as dead space which is unsupportive of the local economy. This is, of course, becoming an increasing concern for the retail sector with the well-publicised impact of online rather than footfall shopping.

If rental levels are insufficient to promote broad scale refurbishment, then complete replacement of these properties has to be an unrealistic hope. Perhaps the policies needed now are how to support the economic use of these properties, extending their working lives by perhaps by at least another twenty or thirty years.

Primary Care

One of the areas where societal need is most clearly identifiable is in primary healthcare where there is a significant requirement for new investment. Traditionally the majority of GPs have been independent contractors, owning or leasing their own premises with cost reimbursement from the government. There are approximately 2800 GP premises in the UK and it is estimated that up to 70% are below the standards needed for 21st century medicine. Numbers of them are being improved with the help the NHS Sustainabillity and Transformation Funding, although adding extensions onto older inadequate buildings will have benefits, it will inevitably fall short of what could be achieved in a new-build project.

A new surgery will typically cost around £3m to build and so if the public purse were to fund all the new surgeries required, this could run to perhaps as much as £6 billion. It seems unreasonable to expect that such a commitment could be forthcoming from government.

If the societal need is for more new surgeries which can cope with population growth, advances in treatments and service provision, and are also attractive places to work - then there must be a case for a fiscal incentive which will have a measurable affect over a 5-10 year period. As an aside, this might also help slow the worrying flow of older GPs who are quitting and retiring early. Their pension cap has meant that many are actually better off abrogating their responsibilities as partners, and either go over to part-time locum work, or head overseas for the last segment of their careers.

Grenfell Tower and fire regulations

Within the definition of societal need it may be appropriate to also refer to the anticipated changes to fire regulations in the wake of the Grenfell tragedy. Whilst the scope and scale of these measures are as yet unknown, it seems possible that many buildings will require costly retrofit upgrades, possibly even though only recently- constructed.

Accordingly there is a good case to argue for the reinstatement of s.29 of the Capital Allowances Act 2001 which related to fire officer's instructions and was deleted from the legislation in 2008. Under that section, alterations that were necessary at the instruction of the fire officer, would have been relieved as if plant & machinery, and so if it were to be re-introduced today these expenditures might be treated within the Special Rate Pool.

Annual Investment Allowance

Using the Annual investment Allowance as a policy lever to encourage investment seems logical, but the tendency to regularly change the annual amount is particularly unhelpful to the property sector where projects tend to have a long lead-in. For example, a £1million AIA for 2019 and 2020 is likely to benefit industrial manufacturers who can more readily purchase items of industrial plant, but not those considering property investments. A new GP surgery scheme will often take as long as five years or more from inception to delivery. The only beneficiaries of the £1m AIA will be projects that by pure coincidence are already en-route to completion before the time-out date of 31st December 2020.

A question to consider is the application of the AIA. If the UK tax system differentiates between private and corporate taxpayers, and between small and large taxpayers, it casts doubt on the rationale of an AIA that operates as a one-size-fits-all strategy with no differentiation between sectors or categories of taxpayers.

Targeting the AIA

It would seem relatively straightforward to introduce a more closely-targeted approach for the AIA which extends a number of years ahead, and thus accommodates the slow gestation of property schemes. It could be translated either as a 100% first year allowance for plant & machinery within the upgrade of, say, an office which has remained empty for more than a year, or go further with an offer of an allowance of the total project cost.

A similar approach could be applied to the Primary Care sector with all plant & machinery allowances being claimed in the year of expenditure. What is crucial is that the relief has a forward time projection which is sufficient for property projects to factor in the tax savings and know that this will still be available to them at the time of completion.

The basic AIA can remain as now, available to all taxpayers and subject to annual review, but it could also be used as a policy tool which is more closely targeted at sectors or classes of building. It might be set at differing amounts and with a fixed duration of adequate length to encourage its use.

Removal of the ECA scheme

The removal of the Enhanced Capital Allowances scheme from 31st December 2020 is a measure that is hard to reconcile with a commitment to carbon reduction. The failings of the ECA scheme are widely-recognised, but in recent time it has been gaining ground. The fundamental flaw of the ECA is that it is an engineering-based tax relief; while most of the work undertaken in preparing tax computations is undertaken by accountants assisted by specialist quantity surveyors. The time-consuming complexities of the Energy Technology List and often a lack of good information to hand have been a deterrent to its interrogation.

A significant failing of the scheme has been the lack of its promotion by government. Low levels of public awareness have meant that ECAs are seldom on the wish-list of clients undertaking commercial property expenditure. Unless their mechanical & electrical consultants receive a clear instruction to consider ECA opportunities, then the subject is usually quietly ignored as an unnecessary diversion during the procurement process. The culture in the construction industry towards value-engineering has also tended to favour the cheapest equipment solutions, even though only slightly more expensive ECA options may quickly produce ongoing valuable energy savings which recoup the differential.

Easier routes to ECA qualification

Recent changes such as qualifying complete lighting installations with support from the manufacturer, or heating and cooling systems on the basis of their calculated efficiency, have been helpful simplifications. If this approach could be more widely applied across building systems to achieve ECA qualification, it could have achieved a wider integration into building design.

A disincentive for innovation

With the expiration of the ECA scheme there is no fiscal incentive to do more than comply with basic Building Regulations on a new-build - which will automatically achieve an Energy Performance Certificate (EPC) rating at the ‘C’ level. This undermines the market for energy-saving technologies and more importantly, the incentive for equipment manufacturers to invest in new research and product development.

Linking EPCs to incentives

While increases in required standards in the Building Regulations in the past decade have set much improved benchmarks, approval is often not needed for internal refurbishments of ageing commercial premises, and many will continue to be energy sieves - even if nicely decorated.

An alternative to ECAs may be to consider accelerated plant & machinery relief where a project achieves notable improvements in the EPC rating; on a new-build construction going above the standard ‘C’ level, or in the refurbishment of an older building the achievement of an upgrade of one or two steps up the ratings, could be rewarded with a 100% first year allowance for plant & machinery - or perhaps all of the project cost for such refurbishments being relieved. A tiered approach could be applied related to the level of improvement achieved measured on EPC rating points.

Such an system would require the assessment of Energy Performance Certificate ratings to be reliably robust and whereas they were considered to be of rather dubious provenance when first introduced, presumably by now the less capable assessors have now been weeded out. Or, it could perhaps be linked to a requirement that for tax relief qualification, the EPC assessor should also be a member of one of the recognised institutions of the property professions.

The Structures & Buildings Allowance and Brexit

In the autumn 2018 Budget statement, a new relief was introduced - the Structures & Buildings Allowance. It has been a longstanding anomaly that the UK lacked an overall commercial buildings depreciation regime, which is commonplace in other developed economies. The new relief provides for expenditures on qualifying commercial buildings to be written down over 50 years at 2% per annum. Whilst any addition to the available reliefs on offer will not be unwelcome, this very gradual write-down is unlikely to be of sufficient value to seriously influence the viability of financial modelling for new projects. It is usually the short term which is fatal and requires support - rather than the longer term economics.

What seems more unexpected is the introduction of the new SBA contemporaneously with the UK's departure from the EU. With anticipated uncertainty in the post-Brexit era which could extend some years into the future, it is likely that various sectors of the economy will be adversely affected in some way. This might simply be issues around the fluidity of trade with the EU, or it might be a change in the regulatory envelope, for example for agriculture outside the Common Agricultural Policy. It may well become necessary to introduce specific new measures to support business sectors that encounter difficulties; a need that would seem to lend support to a flexible and adaptable approach to the provision of fiscal incentives rather than a new one-size-fits-all relief.

Summary

We can identify issues with sectors such as commercial offices outside London, primary healthcare, and the regulatory changes to come post-Grenfell, each of which present arguments for special treatment within the system of fiscal incentives.

The application of broad scale measures such as the £1m Annual Investment Allowance without any certainty of its availability beyond 2020 will not provide the level of comfort needed for many, and because of long lead times can only be of limited value to the property sector.

The removal of the Enhanced Capital Allowances scheme now leaves value-engineering as the mantra of equipment procurement - which produces average performance, and offers no incentive for the exemplary project, or for new thinking in building products. Simplification of the qualification for ECAs would be worthy of consideration as an argument for the retention of the scheme.

Another possible way of incentivising higher standards of buildings performance might be to link accelerated Capital Allowances, or complete project costs, to upgrades achieved in Energy Performance Certificate ratings.

The introduction of the Structure & Buildings Allowance is to be welcomed, but as the UK takes its first uncertain steps outside the EU, the economy will require careful and close management and to that end, targeted fiscal incentives which are sector-specific could have an important role to play.

January 2019

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