Capital Allowances and the UK's zero carbon target

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Capital Allowances

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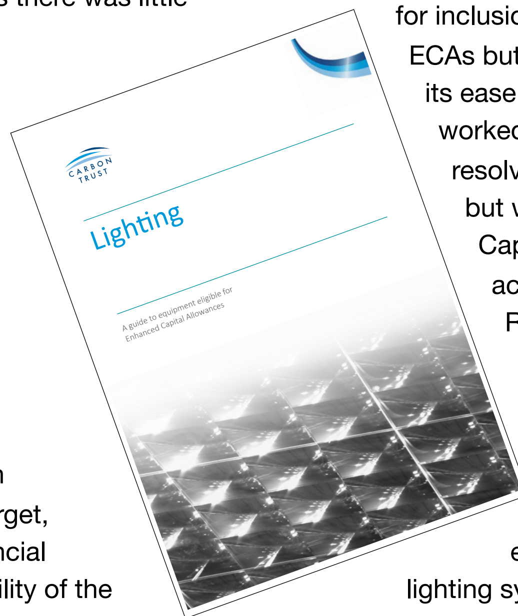
Removal of the Enhanced Capital Allowances scheme from 2020 - Commercial property will have no fiscal incentive to improve energy-performance - ECAs introduced in 2001 to support new energy and water-saving technologies - Carbon Trust and the Energy Technology List - Early difficulties of the ECA scheme - Lack of awareness by property professionals and adverse value engineering - Raised Minimum Energy Efficiency Standards could mean viability problems for secondary property - Accelerated plant & machinery allowances could replace ECAs

2018 Budget announces ECA removal

The UK government has stated that it intends to commit to a zero carbon target by 2050 - which is a strange contradiction with the discontinuation of the Enhanced Capital Allowances (ECA) scheme announced in last autumn's budget statement. This was unexpected - not just to advisers in the field of Capital Allowances - but even to some with close links to the Treasury. It appears there was little consultation on the decision.

It leaves the UK's commercial property sector with no fiscal incentive to achieve higher standards of building performance. For refurbishments not requiring Building Regulations approval, this will favour low-cost less energy-efficient solutions. It is therefore important that the government having now set an ambitious carbon reduction target, recognises the need for a financial framework to support the viability of the necessary improvements.



The history of ECAs

The ECA scheme was introduced in 2001 and is a targeted incentive to support the introduction of new technologies which achieve higher standards of efficiency in energy or water use in buildings. The benefit is a 100% tax write-off for the cost of qualifying equipment in the year of first use, offering generous savings, particularly to partnerships or individuals paying higher rate tax - effectively a 40% cost saving on the purchase and installation cost. In the case of a company where there may be no current year tax liabilities a payable tax credit is available.

The Carbon Trust's role

As a turnkey to the ECA scheme, the Carbon Trust was a charged by the government with the development of the Energy Technology List (ETL) - assessing and approving new technologies for inclusion. This became the bible for ECAs but suffered criticism in respect of its ease of use. It was a reference that worked well for engineers seeking to resolve the specification of a project - but was often seen as a minefield by Capital Allowances advisers and accountants.

Recognising this issue, some modest steps were taken to reduce the complexity of ECA qualification, and protocols were introduced based on performance standards that enabled air-conditioning or lighting systems to qualify as entireties based.

The weaknesses of ECAs

It is fair to say that ECAs struggled to achieve momentum in the early years, principally because manufacturers believed the tax savings would encourage buyers to pay a price premium for qualifying equipment. This proved unrealistic - demonstrated by the fact that in the first five years only 200 ECA claims were made in the entire UK.

The recession in 2008 paradoxically gave ECAs a boost as equipment manufacturers, watching their

declining sales, revisited their thinking on how tax savings could be used as a marketing tool. The pricing differentials between ECA-qualifying and non-qualifying equipment began to narrow which helped encourage more interest in the scheme.

But not on everyone's agenda

Traditionally Capital Allowances tax reliefs were treated as accountancy-based compliance, dealt with as post-project diligence for the compilation of tax computations and, as a result, construction project teams were rarely involved.

Their clients would typically be unaware of ECAs and so would not instruct the project team to consider the opportunities. Despite the more realistic pricing of ECA qualifying equipment, with little or no promotion by government, it remained a peripheral subject.

The closest link to the property professions has been through the involvement of niche specialist surveyors (like Afilia) who deal with the complex issues of cost segregation within construction contracts - working with accountants to achieve a robust cost analysis to withstand scrutiny by HMRC. More often than not, however, the appointment of the CA adviser came too late in the project process to introduce ECA opportunities.

Tax relief and viability

The 2008 downturn did, however, kickstart an increase in awareness of, and interest in, the overall benefits of the bottom-line savings of Capital Allowances. Earlier advice began to be sought by those commissioning projects, with the aim of achieving some understanding of the quantum of relief and ensuring a tax-friendly approach. It led to some wider engagement with ECAs and in some instances a pre-planned approach. Nevertheless, in many projects 'value engineering' applied during the procurement process meant that if an ECA component cost even slightly more - then with a lack of understanding of the tax savings (and also the resultant economies in running costs) - it would be discarded. For many in construction the subject of tax relief was regarded as an unwelcome distraction. A reluctance to engage unless specifically required by the client, typically resulted in a zero score for ECAs in the post-project analysis.

A lack of visibility and promotion

An absence of publicity by the government was a key contributory factor to the weak performance of ECAs. Post-2008 austerity meant that anything viewed by the Treasury as 'tax leakage' was unlikely to be promoted. The Carbon Trust has worked continuously to improve the accessibility of the Energy Technology List - but the ECA scheme was withering for want of adequate promotion.

The 2018 autumn Budget statement set a two year run-off with ECAs now doomed to the margins of history on 31st December 2020. The same, however, does not apply to the Energy Technology List which the Carbon Trust will continue to update and publish. This is an important point in that although it was seen principally as a treasure map for tax relief, it is also used by non-taxpayers (such as local authorities) who are seeking higher standards of efficiency for a building project.

No incentive for higher building performance

Fundamentally, the removal of ECAs means there will be no incentive to do more than comply with Building Regulations which corresponds to the 'C' level of the EPC. No fiscal carrot will exist to encourage higher aspirations and one possible outcome will be that with less support for new products, equipment manufacturers will begin to scale back on innovation and product development. The unintended longer-term consequence of this can only be disadvantageous to the contribution by commercial property to carbon reduction.

At this point it is worth re-emphasising that many internal refurbishment projects do not require Building Regulations approval, and so will not necessarily be carried out to the standards that apply to new-build projects. With no incentives to do otherwise, decisions on specification will favour the cheapest solution, which will typically be the least energy-efficient.

It is very likely that as part of the drive towards the 2050 zero carbon target, Minimum Energy Efficiency Standards (MEES) will be used to push up building performance standards. Currently the regulations affect only the 'F' and 'G' EPC level, representing an uplift from dire to mediocre.

Higher MEES standards will need to be viewed against the viability in what will often be obsolescent buildings. The fundamental problem being that low rental returns will tend to restrict expenditure options. An unintended outcome of higher MEES sanctions might be more buildings slipping into disuse, in some areas adding to worsening urban decay.

There is an exemption register for properties where all possible energy improvements have been carried out but the EPC remains sub-standard, but this presupposes that the financial equation of the cost of the works and rental returns is positive.

A missing link for Ska Ratings

The RICS maintains the Ska assessment tool as a means of recognising excellence in refurbishment schemes. Part of the methodology for gaining the highest level Ska Gold award is that the ECA qualifying equipment be incorporated within the project. Presumably this will need a new approach with some other form of benchmarking applied.

An alternative to ECAs

One possibility could be to link writing-down rates of tax relief for plant & machinery (P&M) in buildings be linked to levels of energy performance achieved. Moving a step up the EPC ratings could be rewarded with 50% of the total P&M pool becoming a first year allowance. An incentive to excel might be if achieving two steps up the ratings doubled this to a 100% first year allowance.

Refurbishments that do not require building control or MEES targets would then have a direct incentive to pre-plan their EPC outcome. New-build projects that automatically achieve an EPC level 'C' rating would also have reason to consider going to higher standards.

The EPC has been viewed with suspicion through reported poor application of procedures by some assessors. If EPC ratings were to be used as a qualifier for tax relief, HMRC would look to the Ministry of Communities and Local Government for new assurances on the robustness of the system.

A key advantage of using first year allowances is that it would not require new primary legislation. To succeed, however, a new incentive will require the oxygen of publicity to create an awareness that was sadly missing with ECAs.

The impact of the £1m AIA

The upgraded £1m Annual Investment Allowance introduced for 2019 and 2020 is a big tax saving benefit and for many projects will mean all Plant & Machinery allowances will be entirely claimed in the first year. The increased AIA forms part of the government's strategy to ease the UK through Brexit, but it is a one-size-fits-all measure that fails to replace or substitute for Enhanced Capital Allowances.

What it does not do is create an incentive specific to energy performance and if, after 2020, the AIA is reduced to the rates more typically seen in the past - then this would be a compelling reason to introduce an energy performance-based relief.

Achieving change in urban centres

Take a look around the centres of most of our cities and see tired Victorian, inter-war, and post-war commercial buildings. Office workers have been migrating to peripheral business parks since the 1990s, leaving many centres fighting long-term economic decline.

With weakened rental demand since 2008, particularly in the retail sector, and an uncertain post-Brexit economic outlook, the possibility of a

boom in city centre new-build seems remote. Commercial property expenditure is likely to focus on extending the working lives of existing assets - providing that there are viable market rentals.

Occasionally a newly-refurbished building will set a new rental benchmark and break through the established market ceiling - but it would be wishful thinking expect this to quickly become the norm. To support commercial property investment, public money will also be needed to be spent on local infrastructure and improved townscapes which are key to underpinning any sustained uplift of rental levels.

Tax relief for more tax revenue

Governments have a love-hate relationship with tax reliefs, seeing them politically as important vote-winners but at the same time as 'tax leakage'.

Perhaps the best way to measure this is to balance the value of the tax relief against the tax receipts generated from a new-build project.

A short list would include:-

-Income tax & national insurance from the project team
-VAT raised on the materials used
-Business rates on the completed project
-More income tax and NI from the occupiers
-VAT receipts on their activities

Building a theoretical model of this relationship suggests that the tax lost through Capital Allowances represents only around 5% of the value of the new tax revenues created.

The need for tax relief

If the only strategy adopted by government to achieve the zero carbon target is to impose incremental uplifts to MEES then with very limited rental uplift available commercial property will do little towards achieving the zero target.

The Enhanced Capital Allowances scheme was a world-leading initiative when introduced, but needed to evolve during its implementation in order to improve its effectiveness, and to receive adequate publicity to ensure its establishment as a cornerstone to a more sustainable approach in commercial property.

Over the years, however, it remained in its prototype form and is now discarded as having failed. It leaves a system predicated on regulation through Building Regulations and Minimum Energy Efficiency Standards - and from 2021 with no fiscal incentives to offer a carrot and contribute to the viability of upgrades in existing buildings.

The world of property is a poorer place without appropriate fiscal incentives to create aspirations and reward exemplar behaviours. Capital Allowances are an established tool of the government's fiscal regime and as stated previously, making changes to the writing down rates of the relief is a flexible and readily useable policy tool available within the existing system.

Looking forward to zero carbon in 2050

The stated aim of a zero carbon status by 2050 is a praiseworthy headline but to be achievable will require meaningful underlying strategies. Commercial property owners, investors, and occupiers will need valuable and well-publicised incentives if they are going to contribute to the journey.

Commercial property is driven by bottom-line numbers and without the support of an adequate financial framework - it is difficult to see any great transformation taking place. Without some financial engineering to deliver viability for our ageing stock of buildings, low-cost solutions will remain the baseline approach for many projects. A system based upon accelerated tax savings as a reward for achieving higher energy performance would be relatively straightforward to introduce and could make a real contribution.

About us

Our new corporate identity as Afilia has been good for our profile with the past twelve months being our best yet for high value projects across a number of sectors. As ever, all preliminary advice and guidance is provided at no cost.

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