Office of
Tax Simplification

Accounting depreciation or capital allowances?

Simplifying tax relief for tangible fixed assets

June 2018

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Foreword

This report explores the possibility of replacing capital allowances with accounts depreciation as a way of giving tax relief on tangible assets, following up one of the main recommendations in the OTS's July 2017 review of the corporation tax computation.

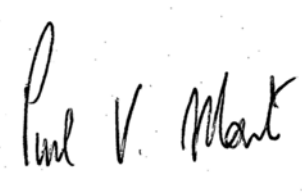
The main source of complexity which such a change could remove – if applied across the whole range of depreciating assets – is the task of determining which assets qualify for capital allowances, given that buildings do not generally qualify at present even though fixtures and other plant and machinery do.

If we were devising a system from scratch, depreciation could work perfectly well and would make eminent sense. However, our analysis has shown that the undoubted potential benefits are not worth the upheaval involved. Such an extension of the scope of relief would come with a big price tag, require lengthy transition periods, and involve all businesses in process change even though only around 30,000 businesses claim capital allowances in amounts exceeding the present Annual Investment Allowance of £200,000.

That said, we consider there are important improvements to capital allowances which should be considered, alongside those we recommended in last year's report, in particular that the scope of the Annual Investment Allowance be widened.

The OTS would like to thank Marian Drew who led the review, supported initially by Randeep Sidhu and later by Peter Allen and Peter Drummond, aided by some specific technical input from PwC and guidance from OTS Head of Office David Halsey. We are also very grateful to our HMT and HMRC colleagues, our Consultative Committee members and all those who have willingly given ideas, challenge and support.

Angela Knight CBE (Chair)



Paul Morton (Tax Director)

Executive summary

The Office of Tax Simplification (OTS) is the independent adviser to government on simplifying the UK tax system. The work of the OTS is rooted in improving the experience of all who interact with the tax system. The OTS aims to reduce the administrative burden - which is what people actually encounter in practice - as well as simplifying the rules. These are often of equal importance to taxpayers and HMRC.

This review explores the impact of giving tax relief for the costs of tangible fixed assets by using accounts depreciation rather than through the present capital allowances (CAs) system, following up one of the main recommendations of the OTS's corporation tax computation review.[1]

Summary Conclusions

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. The CA system should be improved. Ways of achieving this are set out in this report. Some can happen quickly, others will take longer to implement.

Introduction

Almost all business taxpayers buy or rent assets which they use in their business. Most of these assets lose value as they are used – they "depreciate". This commercial reality is reflected in a business's financial accounts, which include the assets owned by the business and the depreciation on those assets.

The tax regime recognises that investment in tangible fixed assets should be reflected in the taxation of business profits. That is the starting point for this report, which does not address the underlying economic rationale.

However, taxpayers cannot claim tax relief for the deprecation of the assets they use in their businesses as it is capital in nature. The capital allowances process provides

[1] https://www.gov.uk/government/publications/ots-review-on-simplifying-the-ct-computation

businesses with tax relief on specified tangible asset capital expenditure by allowing prescribed amounts to be deducted against their annual taxable profits.

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.

The use of accounts depreciation in place of CAs has often been put forward as a simplification.[2] The suggestion is that

- depreciation is a better representation than CAs of the underlying economic costs of an asset – and this is the right objective for the relief, and
- use of depreciation avoids the need to do two separate analyses – one for accounts and the other for tax (and the consequent accounting for the differences in "deferred tax")

As an example of the difficulties of CAs, a taxpayer wondering about tax relief for a door handle would find this explanation on HMRC's website:[3]

"A door handle would normally be an integral part of the door to which it is affixed, with the result that it would not qualify for PMA [plant and machinery allowances]. Any subsequent replacement of the door handle would then count as a repair of the door. However, you should not in practice refuse a PMA claim where this is the treatment adopted in the computations. Some mechanical handles can in any event constitute machines in their own right."

The purpose of this report is to explore the potential impact of replacing CAs with accounts depreciation, and reach a conclusion on whether such a change would be a simplification.[4] The report does not look at tax relief for assets in the wider business context of how those assets are financed.

From the Exchequer view, compared with the position if there was no relief for capital expenditure, CAs result in a considerable reduction (forecast to be £21.5bn in 2017/18)[5] in tax collected. Both taxpayers and the Exchequer will be sensitive to the impact which changes to the tax regime may have on the overall tax collected. They will also be concerned about potential shifts in the burden of tax between

2 The July 2017 OTS report "The simplification of the corporation tax computation" included recommendations about CAs https://www.gov.uk/government/publications/ots-review-on-simplifying-the-ct-computation

3 https://www.gov.uk/hmrc-internal-manuals/capital-allowances-manual/ca21200

4 The scoping document for this report is at Annex A.

5 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/675345/Dec_17_Main_Reliefs_Final.pdf

different types of taxpayer, whether by industry or size. This report explores some of these impacts.

So, is using depreciation practical, simpler than CAs and internationally competitive?

The OTS approach

A wide range of taxpayers and their advisers have given views to the OTS. It is fair to say that there are many different opinions. It became clear that one aspect most agreed on (but even then, not all) is that such a change is not a quick fix to the problems of CAs. There are significant practical concerns which cannot be ignored in the pursuit of theoretical perfection.

It is important to recognise that business taxpayers are not all the same. Compliance obligations may be easy for large organisations to cope with and are becoming easier still with technological changes to the way information is gathered. However, the same obligations may be very difficult for smaller businesses. So, the route to simplification may be different for different taxpayers.

The OTS looked at the approach taken in other countries and found that using accounts depreciation without adjustment would be unique internationally.

Early in the review it became clear that the number of taxpayers whose capital expenditure exceeds the AIA limit of £200,000 is small, being only about 30,000. These will be larger businesses, better equipped to deal with CAs. An extended AIA, or its depreciation equivalent, could continue to underpin capital asset relief for all other businesses. This has influenced the conclusions reached.

During the review the OTS has been drawn to look again at the potential for simplifying CAs. While most respondents were critical of using depreciation, almost all offered suggestions for better CAs. For smaller businesses, reform of CAs may offer a quicker route to simplification.

So, this report reviews what a depreciation based system could look like and, if that appears simpler than CAs, how the transition could be made. Overall is the end worth all the trouble of change?

Findings

This report explores the idea that using a single method of calculating depreciation (including the accelerated write down called an "impairment") both for the accounts and for tax will be simpler than using two methods.

However, a single method may not be feasible if accounts depreciation must be adjusted for this and for that, as these additional calculations may result in something far removed from straightforward accounts depreciation. There are no simplification reasons to move from the existing complicated system to another which is as difficult for taxpayers to process.

In principle depreciation is a practical approach

If designing this tax relief from scratch depreciation would be a good starting point. There are though significant implications, outlined below.

The use of depreciation for tax relief for tangible assets would have repercussions for other parts of the tax system

Depreciation is part of the process for accounting for an asset during its entire life. Perhaps using depreciation to give tax relief should be linked to the tax treatment of the asset during its whole life, revaluations, disposals and acquisitions included:

- in some circumstances accounting standards permit the **revaluation** of assets. The revalued amount is then depreciated. A tax regime could tax such an uplift and then allow relief for the depreciation of the revaluation
- accounting standards look at an asset in the particular circumstances of the business owner and do not require **symmetry** of treatment between a vendor and a purchaser. A tax regime could do the same

Each of these approaches are far removed from the present tax treatment of capital assets. They illustrate the potentially wide impact of using accounts depreciation for tax. This is explored further in Chapter 2.

Lifting depreciation straight from the accounts is not an option

The accounts depreciation figure cannot flow through directly to the tax calculation. Some modifications are necessary to maintain the coherence and attractions of the tax system. Two of these are illustrated below, others are set out in Chapter 2.

AIA – a necessary modification to depreciation

At present the **Annual Investment Allowance** (AIA) gives immediate tax relief for qualifying capital expenditure up to £200,000 each year.[6] HMRC forecast that AIA with a total tax value of £2.5bn[7] will be claimed in the current tax year. Although businesses must first determine what assets qualify for AIA, no further calculations are necessary for about 80% of company taxpayers. These spend less than £200,000 on assets for use in their businesses, as do almost all unincorporated businesses (self-employed and partnerships). These businesses can see the impact of the AIA on their reduced tax bills at their next tax payment.

The AIA is a simplification and perhaps an incentive to invest. It is possible to copy the AIA into a depreciation regime, and given the significance of the AIA to so many taxpayers, this should be done if a depreciation system were introduced.

Other incentive mechanisms are important to the delivery of the government's economic objectives. These include Enhanced Capital Allowances ("ECA" - to encourage investment in energy efficient products) and Research & Development

6 Some assets qualify for CAs, but do not qualify for the immediate tax relief available through the AIA. These assets include cars and leased assets not meeting ownership requirements.

7 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/675345/Dec_17_Main_Reliefs_Final.pdf

("R&D") allowances. Each could be copied into a depreciation regime …. but any hope of pure depreciation for tax is receding.

Properties held for investment are not always depreciated – would a parallel CA framework be needed?

Some businesses hold assets which are not depreciated. These include investors who hold property to earn rent or for capital appreciation. At present, they can claim CAs on the qualifying parts of their assets. With a depreciation based regime there is a clear policy question for the government as to whether tax relief for these assets is essential or desirable.

If tax relief is to be available, a parallel simpler CA regime could sit alongside depreciation. For example, there is a mass of experience of buildings used for property investment and standard percentages of qualifying assets could easily be determined. This would be contentious as some would gain and others lose compared with the current CAs.

Some modifications to depreciation would be essential and others may be desirable. These do not fatally compromise the overall improvement which a depreciation based approach could deliver. This improvement may particularly benefit the middle band of investors who spend more than the AIA but are not large enough for sophisticated internal or external tax advice.

Taxpayers' interpretation of accounting rules would drive tax relief

Accounting standards, whether issued by the Financial Reporting Council or the International Accounting Standards Board, set out the framework within which businesses determine the appropriate depreciation for their assets. One business may use an asset faster than another business using an identical asset. It would reflect this in faster depreciation.

Some people have argued that depreciation is open to manipulation to secure a tax advantage and has no place in a rigorous tax regime. In contrast the rates of CAs are set out in tax legislation and cannot be manipulated.

There is an alternative view. Businesses will have many reasons not to accelerate depreciation, such as not wanting to weaken the balance sheet or a wish to protect earnings per share. The larger businesses with the greatest investments may have most reason not to change their depreciation policies. Smaller businesses would have no incentive to hasten depreciation if the AIA remains in place.

It is clear though that direct control over the rates would be given up by the Treasury. Instead businesses would get relief matching the accounting view of the use of assets. It would always be open to the government to introduce restrictions, such as maximum rates of depreciation permitted for tax, but this would be a move away from the simplicity of using the accounts figure.

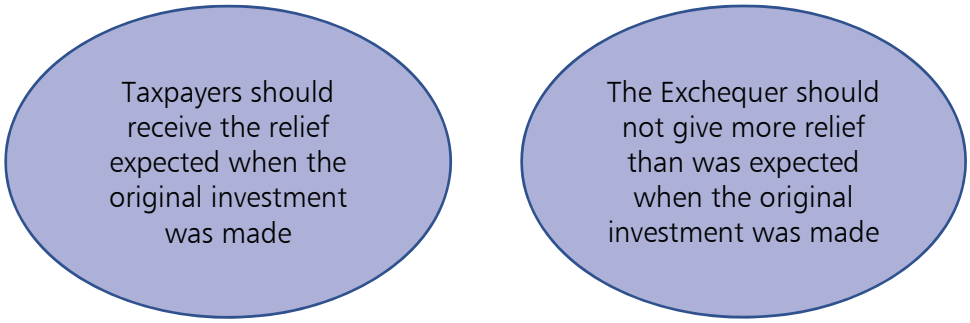
Transition involves difficult trade-offs

The core benefit of a depreciation based approach is reducing the effort needed to put capital assets into the correct category for tax. It would not be eliminated

though, because some effort may simply shift from perfecting a CA claim to making the depreciation calculation as robust (and some would argue as beneficial) as possible.

Even if tax relief based on depreciation is simpler, nevertheless it may not be sensible to move away from CAs if the transition is too complex or too lengthy. The OTS is always aware that change in itself may be a complication.

Transition will affect all assets which exist at the date a depreciation based approach is implemented. An effective transition mechanism delivers the reasonable expectations of taxpayers and the Exchequer:



Just turning off CAs and starting to use depreciation is not an option. Some assets might end up with double relief or no relief, even where relief is available under the current rules. Other assets might end up with relief, where no relief was intended. Transition mechanisms are explored in Chapter 3.

Assets which exist at implementation should continue to receive the CAs expected at that date. Taxpayers would not have to continue coping with the classification burden of CAs as new assets would not be within the CA regime. For existing assets the tax values (or "pools") established at implementation would simply be written down following the present CA rates, with any sales proceeds of those assets deducted. The depreciation associated with those assets would not be deducted in future. A disadvantage of this approach is that the pools may continue to exist for many years and in some cases decades. There would be practical advantages in shortening this period but only at a considerable cost to the Exchequer.

Cost and impact of a depreciation based approach

Basing tax relief on depreciation means widening the scope of relief. Depreciation rates are not the same as CA rates. Inevitably there will be a financial impact from such a change.

HMRC have modelled the impact of a depreciation based approach if an equivalent of the AIA (covering the same range of assets as at present), ECA and R&D allowances remain in place. The model also assumes a change in taxpayer behaviour so that depreciation is recorded faster. More information on HMRC's method is given in Annex G. With the transition described above, the model suggests that the negative impact for the Exchequer (less tax paid by taxpayers) would be about £1bn in the year of implementation, rising over 5 years to £6bn before reaching a steady state of £7bn. Information on the impact on individual industries is not available.

A cost-neutral position, without taking into account behavioural changes, could potentially be achieved if instead of giving relief for accounts depreciation only 80% of depreciation was relieved.

One purpose of simplification is to reduce the costs of complying with tax legislation. It has not been possible to assess the cash benefit of needing one process of analysis in place of two, although it seems intuitive that savings would result.

Alternative approaches

Although adoption of depreciation for tax relief could be the solution to the complexities of CAs, there is an alternative approach. This is to deliver substantial simplification gains by reforming the CA regime.

There is a range of suggestions. The OTS report of July 2017 included a number which are listed in Annex D of this report. Further ideas have been put forward during the preparation of this report prompted by considering the advantages which a depreciation based approach would bring. In other words, if a full-blown depreciation based approach is difficult to achieve, are there features of that approach which could be replicated, following full consultation, in the CA regime?

The more adventurous of these suggestions would bring CAs closer to familiar accounting concepts while not going down the route of using depreciation. It is called **Accounts based CAs** in the next steps diagram on page 12. The core structure of CAs would remain – separate pools for different kinds of assets, with writing down rates prescribed by the government. However, the accounting treatment would determine which pool an asset is allocated to. At its simplest the categories of assets disclosed in the accounts would be replicated for CAs and prescribed writing down rates applied. A more radical approach would be based wholly on accounting asset lives, as shown above. The OTS has no views on appropriate writing down rates and those above are just illustrations. Further variants on this are described in Chapter 5.

	Writing down rate, based on accounting asset life		
	<5 years	5-25 years	>25 years
Any business asset recorded in the accounts (not land, not dwellings)	25%	15%	5%

A shorter term and less radical change concerns the AIA. This suggestion is called **Widen AIA** in the next steps diagram on page 12. Qualifying capital expenditure up to the £200,000 limit can be written down in full in the year of acquisition. This allowance does make life easier for most business tax payers. Of the 2.3 million corporation tax payers, only 26,000 spend more than the AIA limit (and there are only about 1,000 income tax payers spending at that level).[8] The key problem with the AIA is that it is bolted on to the existing CA structure containing all the obscure distinctions as to what are and what are not qualifying assets, which a tax payer must navigate.

[8] HMRC CT600 and Self-Assessment data

Instead it is suggested that the AIA should cover all assets used in a business (including assets presently excluded from the AIA such as cars, but still excluding land and dwellings). Such a change could almost double the current £2.5bn cost of the AIA. Some have suggested that broadening the scope of the AIA could be paid for by lowering the limit. As with all such proposals there would be gainers and losers. The OTS suggests further work is done on this.

The final, alternative, idea for simplifying CAs is not a new one. It is called Full Scope CAs in the next steps diagram below. The common thread linking concerns about the complexity of CAs is that the boundaries within the CA system create a significant administrative burden. The most difficult boundary, because the consequences are more pronounced than for other boundaries, is the cliff edge between receiving some relief and receiving no relief. It is not surprising that the analysis of assets between those that do and do not receive relief receives a lot of attention in the compliance process.

The restricted scope of CAs is one of the aspects of UK tax which overseas investors find most puzzling. It also to an extent counteracts the international competitiveness of the UK's low rate of corporation tax.

If the CA system encompassed all assets used in a business a major compliance pressure would go away. This would require the creation of a new CA pool for new business assets (but not land or dwellings) which do not qualify under any of the existing CA provisions, written down at a prescribed rate. On its own an extension of relief would be costly, and if an extension was paid for by reducing other reliefs there would be gainers and losers.

OTS recommendations on depreciation

A depreciation based approach has attractions but its merits do not constitute an overwhelming case for rapid change. Simply using the accounts figure presents many difficulties and would require alterations to other parts of the tax system. While the AIA is not perfectly simple, the existence of it colours the view of depreciation, as it means that the greatest difficulties with CAs are confined to around 30,000 of the largest taxpayers. Those taxpayers are better equipped to deal with the complexities of CAs and they are not generally supportive of using depreciation (though there are exceptions to this negative view). The fairest transition to a depreciation based approach would take a long time to complete. During this time the Exchequer would be exposed to arbitrage risks.

While a depreciation based approach is not recommended now for all taxpayers, there are two reasons why it cannot be dismissed altogether. Firstly, in the longer term the challenges of depreciation may be overcome and the current problems with CAs may remain unaddressed, so that the use of depreciation becomes more attractive. Secondly, if a more far reaching simplification of the corporation tax computation were being considered, perhaps for a subset of taxpayers such as very small companies, then it would be natural to consider using depreciation.

OTS principles and next steps

In seeking to simplify the UK tax regime the OTS follows three principles. As set out below, these link to the conclusions of this report on replacing CAs with depreciation:

OTS Principles		Report conclusions
Focussing on areas where the OTS can positively impact the greatest number of taxpayers on the largest number of occasions	→	1.2m taxpayers have to calculate CAs. Depreciation has the potential to make compliance simpler
Achieving quick wins where the opportunity arises	→	Extending the scope of AIA would simplify calculations for 98% of those who calculate CAs
Addressing difficult areas where the case for change is compelling	→	Moving to a depreciation approach is challenging. The case for quick change is not compelling. Alternative suggestions are considered

The OTS has outlined a sequence for considering reform and recognises that the best balance between long term benefit and transitional difficulty would be achieved by moving progressively to reformed CAs rather than to full adoption of accounts based depreciation.

This work has confirmed the position taken in numerous previous OTS reports: the current CA regime is complex and uncompetitive and requires radical reform.

Next steps

In July 2017, the OTS made a number of recommendations for the simplification of Capital Allowances (CAs) including that "Further work be done to explore more fully the impact of replacing CAs with accounts depreciation…... This further work will recommend whether accounts depreciation should replace the current CAs regime" (see Annex D).

This report delivers that work.

The recommendation is that depreciation should not replace capital allowances and no further work should be done pursuing it, at this time.

The qualification 'at this time' reflects the fact that the issue will never go away. Using depreciation instead remains an attractive idea in principle and in time the problems which impede it now may be overcome.

Only one change will conclusively put a stop to interest in using depreciation: the radical simplification of CAs. Until and unless that is achieved the use of depreciation will always be raised as a potential route to overcome the scope restriction and the administrative burden of CAs.

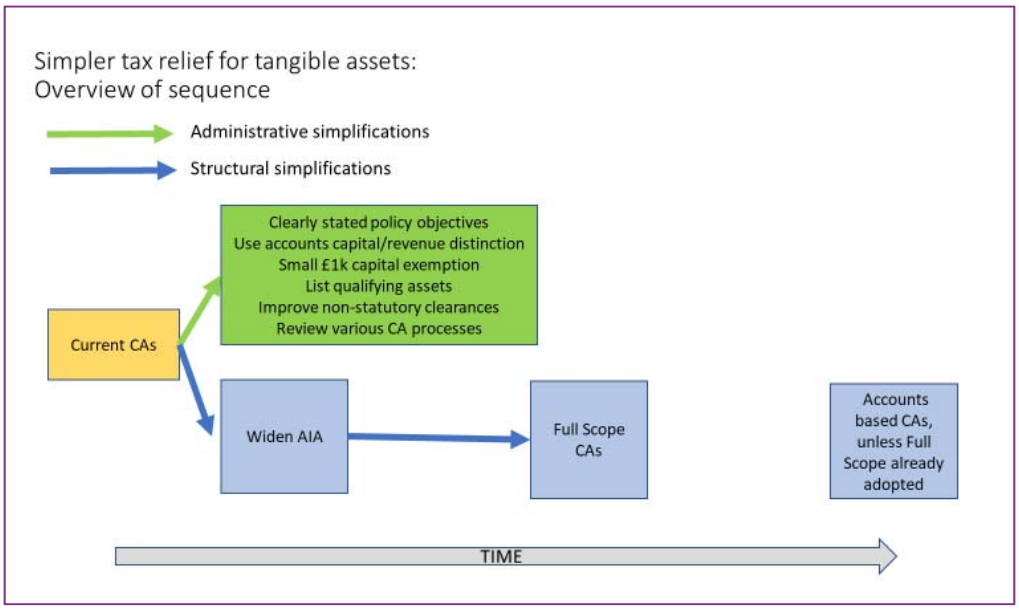
This report also includes new recommendations on the simplification of CAs, which could be delivered in a cost neutral way:

1 the scope of the Annual Investment Allowance (AIA) should be widened

2 the scope of CAs generally should be widened

3 a more radical reform of the structure of CAs should be considered if the scope of CAs cannot be widened, leveraging information used in accounts but not based on depreciation

The July 2017 recommendations, together with those in this report, can be combined into a sequence for reform, set out below:



Chapter 1
Introduction

1.1 Capital allowances (CAs) are a well-established part of the UK's mechanism for taxing businesses, both for companies and unincorporated businesses (including sole traders, trading partnerships and property businesses). CAs provide tax relief for the costs of assets used in a business.

1.2 Three core issues are involved:

1 the **scope** of the relief – what business assets are relieved and what are their costs?

2 the **timing** of the relief – what is the pace of relief?

3 the **calculation** of the relief – what is the administrative burden for businesses in determining scope and timing?

1.3 During previous OTS reviews of parts of the business tax system,[1] concerns have repeatedly been raised about the complexity of the current CA regime. The OTS has made a number of recommendations about this, most recently in July 2017 (see Annex D). One of these recommendations was to explore the potential for replacing CAs with a regime based on accounts depreciation. In September 2017, the Chancellor asked the OTS to look at this. The scope of the review[2] is set out in Annex A.

1.4 The use of depreciation instead of CAs has been considered before, for example in 2004[3] and more recently in relation to leased assets only[4] (in response to imminent changes to lease accounting).

Why depreciation?

1.5 Deprecation is the systematic writing down of a tangible fixed asset[5] to determine the carrying value of an asset in a business's financial accounts. Like CAs, depreciation considers scope and timing, and these are brought

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1 For example, 2017 Review on simplifying the corporation tax computation; 2016 Small company taxation review; 2014 Competitiveness of UK tax administration review.

2 https://www.gov.uk/government/publications/ots-starts-new-review-on-capital-allowances-and-depreciation

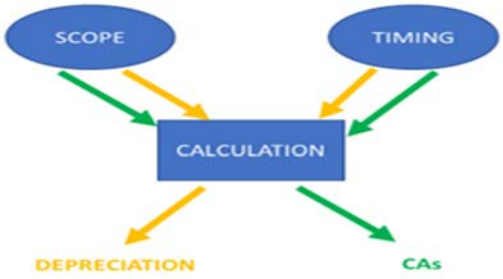
3 http://webarchive.nationalarchives.gov.uk/20100512164522/http://www.hmrc.gov.uk/pbr2004/sup_ct-reform-tech-note.pdf

4 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/664307/Leasing_-_Tax_response_to_accounting_changes.pdf

5 This report is concerned with depreciation on tangible fixed assets only (that is, it does not address depreciation, amortisation or other write-downs of intangible assets or of current assets such as inventories). In addition, the report does not address land because land is not depreciated and it does not attract CAs. For brevity, this report sometimes refers simply to 'assets'.

together in a calculation to produce a figure which can be recorded in the accounts. This is explored in more detail in Chapter 2.

1.6 At first sight there are overarching similarities between depreciation and CAs and it is these which prompt the idea that the two calculations that are necessary at present could be replaced with one:



1.7 Before plunging into more detail on depreciation, a brief reminder of its apparent attractions as an approach:

Scope: depreciation is generally applied to all assets used by a business, but not all assets used by a business attract CAs. So, switching to depreciation could remove a boundary in the system. There are though some limitations to the generalisation that depreciation applies to all assets (see chapter 2).

Timing: depreciation is determined by each business having regard to the way the asset is used in that business. While depreciation is granular, the timing of CAs is standardised in legislation – it is broad brush and may bear no relation to the individual circumstances of a business (see chapter 2).

Calculation: most businesses must prepare financial accounts, including fixed assets and depreciation, to comply with obligations imposed by company law, bank loans or indeed tax legislation. Depreciation is at present ignored for CAs and a separate calculation is required. The CA calculation must:

- categorise assets appropriately
- identify assets which have been capitalised in the accounts but which can be treated for tax as deferred revenue
- identify assets which have been written off in the accounts but which must be capitalised for tax
- identify amounts not paid within 4 months of the year end and defer relief on those sums

The use of the accounts calculation for tax purposes would eliminate, or at least considerably reduce, the administrative burden of complying with tax obligations.

1.8 Views on the merits of using accounts depreciation for tax (or objections to using depreciation) may reflect any or all of these three features and it is not always easy to distinguish them.

1.9 Accounting depreciation could be described as the measure of the wear and tear of an asset resulting from its use. Accounting depreciation is generally derived from the asset's original cost and estimates of its economic life and expected residual value. The asset's condition and status are reviewed annually, giving as accurate a picture of asset consumption as can reasonably be predicted in a cost-efficient manner.

1.10 It can be seen that a uniform calculation across different businesses is unlikely as accounting depreciation requires judgement, particularly concerning what an asset's useful life and residual value may be in a particular business. Compilers of financial statements for different businesses may come to different conclusions about comparable assets and so result in different annual depreciation charges, all of which may be valid.

1.11 Nevertheless, depreciation calculated by a business in accordance with accounting standards (see Chapter 2) gives an annual measure of the practical economic utilisation of an asset. Some would view this as the most appropriate figure on which to allow a tax deduction. It is also a concept easily understood by most people.

1.12 Tax simplification would be achieved if depreciation were used for tax because the calculation is undertaken as part of the ordinary accounts production process and no (or few) adjustments or reclassification of assets would be required to produce a separate tax deductible amount. So, a major parallel system would no longer have to be administered only for tax purposes.

Does debate about tax relief for fixed assets matter?

1.13 Tax relief for investment in tangible assets concerns all businesses except for those wholly reliant on personal capital. In 2015/16 around 1.2m businesses claimed CAs. Inevitably, a relief with such wide application is costly in terms of tax foregone. For 2017/18 it is forecast that, compared with the position if there were no relief for capital expenditure, CAs result in a considerable reduction (£21.5bn)[6] in tax collected. CAs are the 6th largest relief overall. The only other business tax relief which registers in HMRC's list of "Main Reliefs" is the threshold for Employers' National Insurance Contributions (£28.7bn).

1.14 From a business point of view this raises an immediate observation that it is curious that CAs are regarded as a specific relief at all, as businesses would regard the costs involved as a natural business expense, as fundamental to the calculation of business profit as deductions for wages.

1.15 At present an Annual Investment Allowance ("AIA" paras 2.62 and 2.63) successfully masks much complexity for most businesses. Fewer than 30,000 businesses regularly spend more than the AIA limit. 80% of companies claim only the AIA.

1.16 Across commercial sectors, CAs have a widely varying impact overall, see

6 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/675345/Dec_17_Main_Reliefs_Final.pdf

Chart 1.A below. For those sectors which have a "small" value of claim compared with other sectors, the relief may nevertheless be crucial within that sector.

Chart 1.A: For 2015/16, the total number of CA claims by companies and the total value of those claims, for selected sectors

Source: HMRC CT 600 data

Scope of this review

1.17 The context for this work is the existing structure of business tax. The review does not consider the economic justifications for giving tax relief or address fundamental shifts, for example to a cash based tax.[7] Neither does this review consider whether the present distribution of tax relief for tangible fixed assets achieves an appropriate balance across different commercial sectors.

1.18 However, the review does look at an important question about giving tax relief for tangible fixed assets: What are the merits of moving from CAs to depreciation?

[7] Preferred by some economists as eliminating the tax regime's favouring of debt financing, see, for example, Tax by Design, the Mirrlees Review, IFS 2011

The OTS Approach

1.19 A wide range of taxpayers and their advisers have given views to the OTS. This was valuable, covering many issues from various perspectives.

1.20 Those who gave their views had widely contrasting opinions on whether changing to a depreciation based approach would be sensible. While there were some strong opinions for and others equally strongly against, some were indifferent. Generally, though, the respondents were not keen on change. It is difficult to draw conclusions solely from the range of views given to the OTS: this was not a poll of all taxpayers but a self-selecting group. There is no means of weighting fairly between numbers of taxpayers or indeed the size of capital spend for which they are responsible. These are familiar problems for policy makers.

Box 1.A: What people said to the OTS about using depreciation

Frequently repeated themes were:

- reduction in administration burdens, and costs, by using only depreciation – very varied expectations
- wide spectrum of views on the degree to which CAs and depreciation are well understood by taxpayers
- adjustments to accounting depreciation must be kept to a minimum
- capital allowances are not a driver for capital investment but the tax relief is helpful
- AIA is a simplification for small businesses – makes capital v revenue analysis less important
- there is subjectivity with depreciation, and it means different things to different people
- ability to disclaim capital allowances is highly valued
- perception that HMRC are more likely to question depreciation figures
- effect on deferred tax liabilities

1.21 The OTS is keen to ensure that practical concerns are not ignored in the pursuit of theoretical perfection.

1.22 It is important to recognise in that context that business taxpayers are not all in the same position. Some may use assets in their own trade; others may hold assets for investment. Some may be large organisations with the resources to cope with complexity, in particular the benefits of sophisticated technology; others may be small and very keen to focus on their core business.

1.23 The pressures for simplification may be different for different taxpayers.

1.24 This review does not attempt to address all the matters which such a fundamental change would involve. Instead, by highlighting some difficult areas the review seeks to reach a rapid conclusion on whether a depreciation based approach is desirable, and point to some other areas where further consideration by HM Treasury and HMRC would be worthwhile.

International perspectives

1.25 Taxpayers and advisers were invited to suggest countries which have simple systems for giving tax relief for tangible fixed assets, putting aside the issue of scope and rates. No countries stood out (see Annex F). No country appears to have adopted an accounts-based approach, for while sometimes it may seem that tax relief follows accounts depreciation, in fact the flow is in the other direction, so that an acceptable deduction for tax is used as the basis for depreciation in the accounts.

1.26 The scope of relief for tangible fixed assets in the UK does not compare well with other countries, but it can be argued that the UK's competitive statutory corporation tax is adequate compensation (this point does not work so well for unincorporated businesses).

1.27 A "Tax Attractiveness Index"[8] compiled by the Institute for Taxation and Accounting LMU University of Munich looks at various features of tax regimes. Overall in the period 2007 to 2017 the UK rose up the ranking from 30th out of 100 countries to 18th out of 100. This was despite plummeting in the specific ranking of tax relief for assets, from 38/100 to 98/100 in the same period. This part of the ranking takes account of tax relief for commercial buildings, so the UK's poor showing is due to the abolition of tax relief for industrial buildings from 2008. The overall position of course masks the experience of particular sectors who may have gained or lost.

Principles for tax relief for tangible fixed assets

1.28 Useful general points about the desirable features of relief for tangible fixed assets were made by members of the Consultative Committee for this report (see Annex B) and by the taxpayers and advisers who gave views on the use of depreciation. These are presented in Table 1.A as principles, used in this report to gauge whether a depreciation based approach would be a simplification, but also put forward for wider use to assess other proposed simplifications to relief for capital expenditure.

1.29 As tax relief for assets sits within a wider tax framework, the principles touch on broader issues – recognising that there may be no benefit in achieving simplification through depreciation if some other aspect of the system is made more complex as a result. In addition, the policy aim of CA's is unclear.[9]

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8 Ludwig-Maximilians-Universität, Munich report: Tax Attractiveness Index http://www.tax-index.org/

9 See for example HMRC's explanation at https://www.gov.uk/government/statistics/main-tax-expenditures-and-structural-reliefs "The split between structural reliefs and 'tax expenditures' is inevitably broad and the distinction is not always straightforward: many reliefs combine both structural and discretionary components. For example, capital allowances can provide relief for depreciation at a commercial rate as well as an element of accelerated relief. It is the latter element that provides benefit to business which is 'tax expenditure'."

Table 1.A: Principles for tax relief for tangible fixed assets

Principle	What this means and why it matters
Supports the policy aim of the relief	If a relief does not apply across all taxpayers equitably there is a policy decision to favour or disfavour one group. Sometimes this is explicit, at other times not. Some observe that whatever the original aim of the current CA policy the reduction in CT rates means the value of CAs has been eroded.
Leverage the financial accounts, with minimal adjustments	Simplification suggests that the amount on which tax relief is given should be closely linked to information prepared for financial accounts. For depreciation this would be as close as possible to the annual charge in the accounts, with a minimum of adjustments.
Fairness, consistency and certainty for taxpayers	A starting point for fairness, in the absence of an explicit policy, is that tax relief should apply for all assets used in a business, regardless of the type of business, the type of asset and the form of ownership. Another aspect of fairness could be that an asset of a given type should be treated consistently for tax regardless of the way the asset is used by a business.
Transparency for taxpayers and fit for making investment decisions	A business asset relief system should be easily understood by ordinary taxpayers especially if it is intended to incentivise.
Internationally competitive	Investors are well aware of the advantages and disadvantages of tax regimes around the world.
Predictable exchequer impact	Relief can be measured with a good degree of certainty.
Capable of accommodating specific incentives or existing alongside them	Investment incentives (timing or bonus, temporary or permanent) are a useful tool for macroeconomic policy management.
Legisation, guidance (including anti-avoidance legislation) of moderate length	Any change should not result in an increase in legislation. Ideally the resulting legislation should be shorter, more succinct, using language that is easy to read, follow, interpret and operate.
Certainty in the long-term structure of tax	This supports business planning and UK competitiveness.
Ready fit with developments in technology, but not dependent on them	Technology is an essential administrative tool.
Fair and practical transition	A period of change always brings some difficulties and costs. In some circumstances it may even mean that a simpler end state ceases to be a desirable goal, if the final gain is not worth the pain of transition.

Source: OTS

Chapter 2

Is depreciation a feasible approach?

2.1 This chapter

- presents an outline of the nature and characteristics of accounts depreciation
- analyses the key differences between accounts depreciation and capital allowances
- and looks at how depreciation might need to be adjusted to sustain the coherence of the tax regime and accommodate basic policy requirements

2.2 Depreciation is not just a different way of writing down assets, compared with CAs. It represents a fundamentally different way of regarding an asset. This difference is crucial to understanding the implications of moving to an accounts based approach for tax.

The nature and characteristics of depreciation

2.3 Depreciation of tangible fixed assets is an element of the accounting that underlies the preparation of financial statements (accounts). The directors of every company are legally required to prepare and approve accounts for each financial year and, unless able to claim exemption as a small company, to have them audited. These accounts must give a true and fair view and, to ensure they achieve that, comply with relevant accounting standards.[1] For companies, therefore, depreciation is accounted for within an overall legal and accounting governance framework.

2.4 Except for those within the cash basis regime (see Box 5.A in Chapter 5), tax on the profits of unincorporated businesses is based on profit determined 'in accordance with Generally Accepted Accounting Principles ("GAAP")'. Although not necessarily presented in a set of accounts, these businesses must therefore also account for depreciation as required by accounting standards.

What is depreciation?

2.5 Depreciation in accounts is essentially a technique for systematically allocating the cost of a tangible fixed asset over those accounting periods

[1] The accounting frameworks generally applied in the UK and permitted for tax purposes are IFRS and UK GAAP. Within UK GAAP the principal accounting standards are FRS 102 (for the generality of companies) and FRS 105 (for micro-entities). Where relevant, significant differences between these frameworks and standards are referred to in this report.

that are expected to benefit from the use of the asset. It is not a mechanism for ensuring the carrying value of such assets in the balance sheet reflects their market value.

2.6 In essence, depreciation involves writing down the asset's carrying value in the balance sheet and charging the amount by which it is written down to profit or loss.[2]

2.7 The accounting rules over depreciation are part of the overall accounting standards which govern the treatment of tangible fixed assets. They are set out in the form of principles rather than detailed asset by asset rules. Within the principal UK GAAP accounting standard FRS 102, for example, the rules on depreciation and impairment together are covered in just 11 paragraphs. This compares with some 400 pages of CA legislation.

2.8 Depreciation is formally defined for accounting purposes as "the systematic allocation of the depreciable amount of an asset over its useful life".[3] This definition highlights that the depreciation charge in the accounts is determined by two core factors:

- the depreciable amount - that is, the carrying amount of the asset that is to be allocated over accounting periods
- the asset's useful life – that is, the period over which the depreciable amount is to be allocated

Components of the depreciable amount

2.9 A number of components, in addition to cost, can potentially determine the depreciable amount and hence the depreciation charge for an accounting period. Since depreciation is a method of allocating an asset's carrying amount over accounting periods, the depreciation charged in accounts inevitably includes amounts in respect of all components of that carrying amount (see below). Certain of these components need special consideration if depreciation were to be adopted as a basis for tax deductions in respect of capital expenditure.

2.10 The key components of depreciable amount are set out in the following paragraphs.

Cost

2.11 In broad terms the cost of an asset comprises its purchase price plus incidental costs of acquisition including fees and duties, plus any costs directly attributable to bringing the asset to the location and condition necessary for it to be used as intended. Such costs can include site preparation, delivery and handling, installation, assembly and testing costs.

2.12 Cost can also include future decommissioning costs. When a company has an obligation to restore a site or remove an asset at the end of its use, the accounting rules require the cost of the obligation to be provided for up front. The amount is recognised both as a liability (a provision) and as an

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[2] In some circumstances depreciation is required to be recognised as part of the cost of stock (see para 2.23).

[3] This definition is the same in both UK GAAP (FRS 102 Glossary) and IFRS (IAS 16)

addition to the cost of the fixed asset. This is then depreciated along with all other costs. This means that cost – and hence depreciation – can include amounts for which no cash has yet been expended.

2.13 When grants are received in respect of the cost of fixed assets, the amount of the grant is often presented separately on the balance sheet and not deducted from the cost of the fixed asset. In such cases the grant received is an asset with an equivalent amount recognised as a deferred income liability which is released to income over the life of the asset. This means that the amount reported as the cost of the asset is stated gross and any related depreciation is therefore determined ignoring the grant receivable.

2.14 In some circumstances a business might receive a contribution to the cost of a fixed asset from a third party (perhaps as an incentive to invest, because the third party will benefit indirectly from the investment). For accounting purposes the amount contributed by the third party generally would reduce the cost of the asset for the business; the third party might be able to record the contribution paid as an asset of some sort.

2.15 Tax costs incurred directly on the acquisition of a tangible fixed asset are included in the cost of the asset for accounting purposes. This might, for example, apply to irrecoverable VAT or Stamp Duty Land Tax.

Residual value

2.16 The depreciable amount of an asset takes account of its residual value. The residual value is the estimated amount expected to be obtained from disposal of the asset at the end of its useful life in the business, less costs of disposal. The residual amount therefore reduces the total amount that is depreciated. In some circumstances, residual amounts can be significant.

Revaluations

2.17 Fixed assets are measured using either a cost model or a revaluation model. Whichever model is chosen, it has to be applied to entire classes of asset (for example 'motor vehicles' or 'office equipment'). The choice of model is likely to be influenced by factors such as the probability of the asset class increasing in value, the ease and cost of performing revaluations and the extent to which balance sheet values might be considered relevant by providers of finance. The choice of measurement model could be reversed in a future period, but only subject to the general and significant constraints imposed by accounting standards over voluntary changes in accounting policy.[4]

2.18 Depreciation is applied under both the cost and the revaluation models. This reflects the nature of depreciation as a cost allocation technique: an actual or expected increase in the value of an asset does not override the need to depreciate it in the future.

2.19 Under the revaluation model, assets are revalued to their fair value which then becomes the basis for future depreciation. (Revaluations should be made with sufficient regularity to ensure the carrying value does not differ

[4] For example, under UK GAAP an accounting policy change is permitted only if that results in the accounts providing reliable and more relevant information.

materially from the asset's current fair value.) Revaluations can be either up or down. The fair value of land and buildings is generally determined from market-based information by professionally qualified valuers. The fair value of plant and machinery generally represents an estimate of their market value made by the business.

2.20 Increases in the carrying amount of an asset are generally[5] recognised as gains in 'other comprehensive income', that is, they are not included in profit or loss. The related depreciation, however, is included in profit or loss as normal.

2.21 In certain circumstances (for example on transition to current UK GAAP from previous UK GAAP, or on first time adoption of IFRS) a revaluation may be treated for subsequent accounting purposes as the asset's 'deemed cost'. Under this option, an entity may elect to measure an asset at its fair value, or at a previous revaluation amount, on transition to the new accounting regime and use that value as the asset's deemed cost for the purposes of future accounting including depreciation. This option is available on an asset by asset basis. Where this option is taken, this means that what appears to be depreciation of the cost of an asset may in fact include depreciation of a revaluation amount.

Capitalised interest

2.22 In certain circumstances the cost of an asset can include the cost of interest on borrowings.[6] Where fixed assets take a substantial period of time to be ready for use, borrowing costs that are directly attributable to their acquisition, construction or production can be capitalised as part of the cost of the relevant assets. The capitalised interest then forms part of the total cost that is then depreciated.

Depreciation in stock

2.23 Depreciation (for example of production machinery) may be included in the cost of inventories manufactured by a business. Fixed assets are reduced by the amount of depreciation as normal, but this depreciation is then carried forward as part of the balance sheet value of inventories. The depreciation is therefore in effect only charged against profit when the inventory is sold.

Useful life

2.24 The depreciable amount of an asset is allocated to accounting periods over its useful life, that is, the period over which the asset is expected to be available for use. In determining useful life, considerations include the expected usage of the asset, wear and tear, technical or commercial obsolescence and any legal restrictions over the use of the asset.

2.25 The depreciation method and rate applied are intended to reflect the pattern of consumption of the future economic benefits embodied in the asset.

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5 An increase is recognised in profit or loss to the extent that it reverses a revaluation decrease of the same asset previously recognised in profit or loss, which would occur when a revaluation decrease takes the carrying down below depreciated historical cost.

6 In UK GAAP, capitalisation of interest is an option; under IFRS, capitalisation of interest on qualifying assets is mandatory.

Consumption of the economic benefits of an asset is generally mainly through use, but can also occur through technical or commercial obsolescence or through wear and tear. The most common depreciation method is straight-line, but other acceptable methods include diminishing balance[7] and the units of production method. If significant components of a single asset have different useful lives then each such component is depreciated separately over its useful life.

2.26 Depreciation starts when an asset is available for use, not only when it is actually used; nor does depreciation cease when an asset is idle. The notion behind these requirements is that accounts should reflect the consumption of an asset's service potential during periods when the asset is idle, and the fact that, as noted above, consumption of economic benefits occurs not only through use.

Impairments

2.27 Accounting rules require fixed assets to be written down when their carrying amount in the balance sheet exceeds their recoverable amount. An asset's recoverable amount is essentially the higher of the value that can be obtained from selling the asset and the value that can be obtained from continuing to use the asset in the business. An impairment might occur, for example, due to physical damage or to a technological change that impacts adversely on the business. Any additional write-down to recoverable amount is called impairment and is in addition to depreciation.

2.28 Impairments are therefore not 'ordinary depreciation' and are not systematic in the way that depreciation is. However, like depreciation, impairments represent the writing down of the asset in the balance sheet and the charging of the whole or part of the assets' depreciable amount, generally to profit or loss. Conceptually there is no reason why an impairment should be differentiated from depreciation for tax purposes.

Derecognition

2.29 Assets are derecognised (that is, eliminated from the balance sheet) on disposal or when no further economic benefits are expected to be generated from them. For example, a machine that is no longer used in production and is intended to be scrapped would be derecognised, even if it had not yet reached the end of its original useful life. No further depreciation can be charged on derecognised assets but there may be a gain or loss on derecognition; the gain or loss is the difference between the asset's carrying value at disposal and any disposal proceeds. The gain or loss is included in the profit or loss of the period.

Investment property – an exception

2.30 The exception to the general rule that all fixed assets must be depreciated relates to investment property carried at fair value.[8] Investment property is

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[7] The diminishing balance method is familiar from the CA system - the depreciation charge is a fixed percentage of the asset's net carrying value brought forward (such as after deducting depreciation for all prior periods). The depreciation charge therefore diminishes each period rather than being spread equally over the life of the asset.

[8] The fair value model for investment property is a choice in IFRS but mandatory in FRS 102. Under FRS 105 investment properties are depreciated.

property held to earn rentals or for capital appreciation or both, rather than for use in the production or supply of goods or services or for administrative purposes, or for sale in the ordinary course of business.

2.31 The fair value model for investment property is based on the notion that the fair value of the investment property provides more relevant information to users of the financial statements.

2.32 The non-depreciation of investment property reflects the fact that an asset's fair value would reflect any consumption of the economic benefits of the asset, whether through obsolescence, wear and tear or otherwise.

The role of judgement in depreciation

2.33 The depreciation charge in any period inevitably depends on the judgements made in relation to the useful life of the asset and the selected depreciation method. In the case of companies the directors are responsible for exercising this judgement; they need to consider how the asset is planned to be used in the business and what external factors will impact on the rate at which its economic benefits will be consumed. Identical assets in different businesses may therefore have different useful lives or be subject to different depreciation methods.

Rates of depreciation

2.34 The rates of depreciation applied reflect the expected useful lives of the assets. Businesses therefore apply a wide range of depreciation rates, with asset lives ranging from only two or three years for some IT assets to over 100 years for some infrastructure assets. The OTS has not identified any publicly available study or analysis of the rates of depreciation applied by business in practice. It is therefore not possible to make summary statements about rates of depreciation or asset lives other than in the most general terms.

2.35 Accounts generally do not disclose much detail on asset lives, typically disclosing only ranges of lives for broad classes of assets (for example, motor vehicles, or plant and machinery). Where respondents have shared more detailed information, however, the evidence suggests that businesses do differentiate between assets at quite a granular level. The OTS has also been told that in these cases the determination of useful life is subject to a significant degree of governance.

Fixed asset registers

2.36 There are no accounting standards or other rules which set out specific requirements for maintaining fixed asset registers. Their form and content, and the level of granularity of the accounting records over tangible fixed assets and their depreciation, are determined according to the particular needs of each business. In every case, however, they must be sufficient to ensure that the legal requirement to maintain adequate accounting records is complied with and that the requirements of accounting standards are met.

2.37 For example, accounting standards require reconciliations from one period end to the next of the gross cost and accumulated depreciation by individual class of asset (for example, plant and machinery). Records should also be

sufficient to distinguish between original cost and revaluation amounts, and between the related amounts of depreciation, and to track acquisitions and disposals of significant individual assets. However, some businesses, particularly perhaps very large businesses, may not maintain records with a degree of granularity which can track amounts in respect of individually immaterial assets.

Key differences between accounts depreciation and capital allowances

2.38 The main features of accounting depreciation which distinguish it from the CA system are outlined below. More differences are summarised after para 2.55.

Singe purpose depreciation – dual purpose CAs

2.39 Accounting depreciation has a single purpose – to be a measure of the consumption of the economic benefits embodied in an asset. In contrast CAs have a dual purpose, to provide relief for capital expenditure and, sometimes, to be an incentive to invest, whether generally or in particular types of asset.

2.40 CAs have been used as an incentive tool to further successive governments' economic policies. Sometimes this has been by giving accelerated allowances, originally with a higher rate of 'first year allowances' in the year of acquisition and now with the AIA of 100% on expenditure up to £200,000 in total in each financial year. Separately, more targeted (and uncapped) encouragement for acquisitions of 'green' and research and development assets provide 100% tax relief on their cost.

2.41 However, a move to using accounts depreciation to give tax relief would significantly enlarge the purposes for which depreciation was used. It too would then have a dual function, for accounts and for tax, but with the governance of depreciation beyond the direct control of the tax authority as taxpayers' interpretation of accounting rules would drive tax relief (see more on behavioural issues in Chapter 4).

2.42 The potential for overlaying tax incentives into a depreciation based approach is addressed at paras 2.62 to 2.71.

Identification and classification of assets

2.43 The figures used for accounting depreciation and capital allowances arise from two separate systems or processes and, except in the simplest circumstances, are usually calculated by different people. This results in additional administrative cost as well as complexity. This cost increases broadly in line with the size of the business concerned.

2.44 The main administrative issue for the depreciation system is to maintain fixed asset records identifying each asset (and sometimes its components) as to when it is purchased, active and sold and categorising them by reference to their useful economic life so that appropriate deprecation rates can be applied.

2.45 Under the capital allowance system (and based on a combination of legislation, case law and guidance) the main administrative issue is to

identify, analyse, and if necessary breakdown a purchase into its constituent parts, to enable allocation to the applicable capital allowance pool. The skills needed for this (particularly in the case of buildings and structures) are not necessarily the same as those used to categorise assets for depreciation. A specialised capital allowance consultancy industry has grown to address this. A move to a depreciation based tax approach could well prompt a transfer of some of these skills to the determination of depreciation.

2.46 Larger businesses are likely to have accounting systems which classify new assets (or in some cases their component parts) simultaneously for the accounts and for tax, bringing to bear the separate knowledge and skills needed for the two different approaches.

Writing down asset values: pools and single assets

2.47 With the CA system, the assets are collectively analysed into each of just a few groups ("pools") of assets. A set rate of writing down allowance (determined by the government through legislation) is applied to each pool on a reducing balance basis. Assets are generally categorised into different CA pools according to a combination of their function and their expected economic life. The three main types of CA pools are:

1 the general pool, all assets not in the pools below

2 special rate pool, consisting of long life assets - those asset acquisitions with an anticipated useful life of over 25 years, certain integral features of a building or cars with high CO_2 emissions

3 single asset pools for individual short life assets and for individual personal use assets. The latter are assets which have both a private and business use. These will only be seen in unincorporated businesses

2.48 The general and special rate pools have a significant administrative advantage in that assets are not required to be separately tracked after entering the pool. In practice though, assets which are part of a building do need to be separately tracked in order to ease the administration at any future disposal.

2.49 For accounts, generally only identical assets acquired at the same time are treated on a pooled basis.

Writing down assets value: rates

2.50 Accounting depreciation generates customised depreciation rates based on an asset's attributes in the context of a particular business. Assets within CAs are allocated to a pool and the pool is then reduced at a set single rate for the whole pool.

2.51 Tax writing down allowances are calculated on a reducing balance basis, with two key results:

1 for any asset within a particular pool, the amount of tax relief obtained after a given period of time is the same regardless of the actual life of the asset

2 assets can never be fully written off, because of the long tail of diminishing write downs. Using a 95% write down level as a near proxy for the end of the tax life, this is achieved after 15 years with the 18% writing down rate and 36 years with the 8% rate. There is an exception to this for assets with a life of less than 8 years, if the taxpayer makes an election[9]

2.52 Charts 2.A and 2.B below show how much of the cost of an asset is written off using different depreciation methods, and also compared with the two main rates of tax allowances (assuming the taxpayer's AIA has already been used), described in Box 2.A. The examples assume a cost of £1,000, a residual value of zero and a useful life of 5 and of 20 years.

2.53 The key point to draw from these charts is that the depreciation methods fully write off the cost of the asset by the end of the asset's life (indeed that is fundamental to the idea of depreciation – see para 2.5). In contrast, writing down allowances only achieve the same for assets which happen to have lives of around 15 or 36 years (see above), or if a short life asset election is made.

Box 2.A: Writing down methods

Depreciation

Straight line (SL): asset (cost less residual value) written off in equal amounts over the useful life, so 100/life = % rate pa

Declining balance (DB): asset written off at a constant percentage of the book value (cost of the asset less accumulated depreciation) at the beginning of the period. There are various ways of establishing the percentage write off. A frequently used method is based on double the SL rate. Amounts written off in early years will be much higher than in later years. The final year may have a kink in the pattern of depreciation as the asset is fully written down.

Capital allowances

Writing down allowances (WDA): at a constant rate of 8% or 18% of the tax written down value (cost less accumulated WDAs) at the beginning of the period.

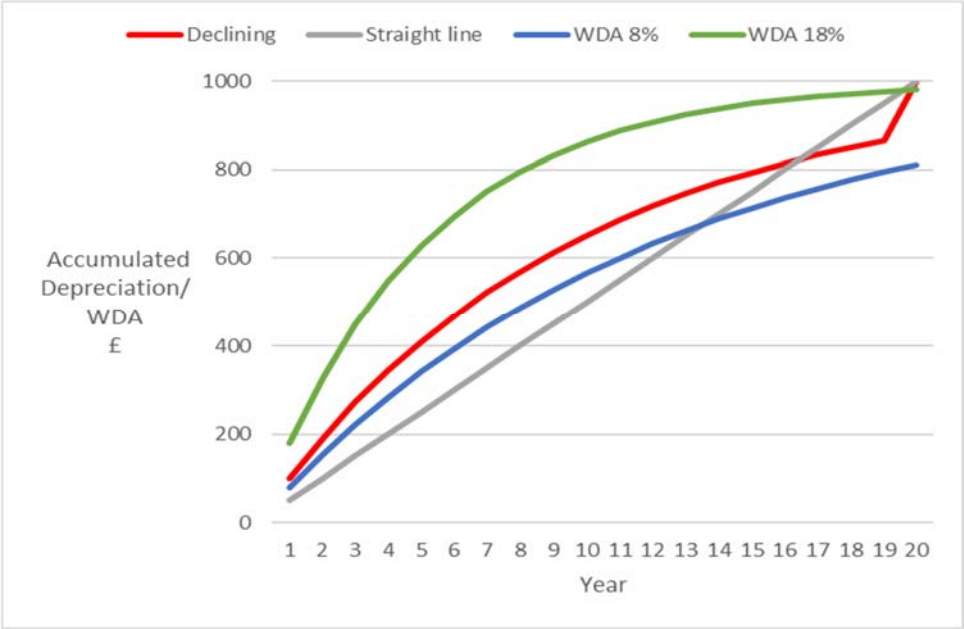
Short life assets (SLA): assets which cease to exist before they are 8 years old can be written down fully in their final year. Initially they are written off at 18%. In the final year there will be a kink in the pattern of CAs as the asset is fully written down.

[9] A taxpayer may elect to put into a separate pool an asset with a life of less than 8 years. If the asset is disposed of within that period any remaining allowances due are given at that point, rather than run off over time. During the work for the 2017 OTS report on "Simplification of the corporation tax computation" respondents commented that the record keeping obligations are onerous, though of course the election is voluntary.

Chart 2.A: Accumulated depreciation/WDA at year end: Asset with a 5 year life

Source: OTS

Chart 2.B: Accumulated depreciation/WDA at year end: Asset with a 20 year life



Source: OTS

2.54 Inevitably, the different speed of write off for depreciation and CAs, and the length of lives of key assets in different sectors, will influence business taxpayers' views on the merits of each approach.

Summary of differences between depreciation and CAs

2.55 The following table summarises the main differences between depreciation charged in the accounts and capital allowances.[10]

[10] The tax aspects are described in broad terms only. Particular circumstances may have different outcomes.

Table 2.A: Summary of differences between depreciation and CAs

Feature	Accounts depreciation	Capital allowances, where different
Scope	All tangible fixed assets	Specified assets only
Components of depreciable amount:		
- Cost	Includes incidental costs of acquisition	Depends on remoteness from asset
	Includes costs of bringing asset to location and condition for its intended use	SDLT excluded
	Includes future decommissioning costs	Decommissioning costs excluded
	Stated gross of grants received	Net of grants
- Interest	Included in some circumstances	Excluded
- Revaluations	Included where revaluation model adopted	Excluded
- Residual value	Taken into account in determining depreciable amount	Excluded. Disposal value reflected when asset ceases to be used
Asset lives	Determined by business, based on judgement and the asset's use in the specific business	Mainly determined by business but open to challenge from HMRC
Depreciation method	Commonly straight-line	Diminishing balance
Granularity of depreciation	As appropriate for the business	Broad asset types Identical assets used by different businesses have identical tax treatment
Impairments	Recognised where appropriate in addition to depreciation	No one off adjustments while asset remains owned
Commencement of write down	When asset is available for use	When expenditure is incurred
	Within an accounting period depreciation is restricted to reflect the time an asset is in use, unless the impact is immaterial	Within a tax year, the time when expenditure is incurred does not affect the amount of CAs
Cessation of write down	When asset is fully written down or otherwise derecognised (see para 2.29)	Pooling mechanism means allowances may continue to be available even if asset is no longer owned
Investment properties	Not depreciated	Some CAs may be available

Source: OTS

2.56 Using depreciation instead of CAs would clearly result in a different outcome for business taxpayers and the Exchequer. The scale of this is considered in Chapter 4. There are, however, some aspects of depreciation which cannot sit comfortably in the tax regime. There are also some aspects of CAs which may be desirable to replicate in a depreciation based regime. These are considered next.

Modifications to depreciation

2.57 The basis of the tax depreciation proposal is that to obtain meaningful tax simplification the allowable claim for depreciation should be as close as possible to the annual depreciation charge figure in the financial statements. For greatest simplicity, it would be ideal to allow a business tax deduction for the depreciation figure as it is calculated for the financial statements, without any further work required for tax purposes. To the extent that any modifications from the accounts figure are essential, these should be kept to a minimum.

2.58 One important accounting feature which it is not essential to modify is impairment. Occasionally events may dictate that for a particular asset there will have been a material loss in value. The accounting consequence is set out in paras 2.27 to 2.28. Impairments are integral to accounting for fixed assets and should be allowed as part of a tax depreciation regime. The OTS does not advocate that an adjustment be made for them.[11]

Key modifications to a depreciation system

2.59 To maintain core aspects of the current tax regime three main modifications would be essential or highly desirable. Without these modifications to depreciation significant changes to the structure of taxation would take place.

2.60 Several other potential adjustments are mentioned for debate.

2.61 The essential adjustment modifications are:

Annual investment allowance (AIA): a simplification and possibly an encouragement of capital expenditure

2.62 A major feature of the current capital allowance regime is the facility to write off immediately against taxable profits, £200,000 of qualifying fixed asset capital expenditure each year. For 98% of UK businesses, their total capital expenditure is below that level, though some assets (such as cars) do not qualify for the AIA.

2.63 The AIA was introduced to encourage capital expenditure[12] and to simplify the tax return process for most business taxpayers. The AIA simply hastens the timing of tax relief which would otherwise be given through the CA pool system. It does not increase the overall amount of the relief or provide more relief than the cost of the asset.

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11 A by-product of HMRC's modelling work on a depreciation based approach (see Chapter 4) is the understanding that in 2015/16 impairments represented almost 4% of the combined depreciation and impairment figure.

12 To boost productivity and profitability.

2.64 The table below shows that for the great majority of business taxpayers all their expenditure is within the AIA limit (currently £200,000 annually).

Table 2.B: 2015/16[13] Level of capital expenditure qualifying for CAs

Capital Expenditure	Companies				Unincorporated			
	Number '000	Value £m	Number %	Value %	Number '000	Value £m	Number %	Value %
Zero	1,700	-	73.9%	-	6,930	0	91.2%	0.0%
Under £200,000	590	8,470	25.7%	7.5%	630	3,475	8.3%	86.9%
£200,000 to £399,999	11	3,135	0.5%	2.8%	1	375	0.0%	9.4%
£400,000 to £2m	11	9,430	0.5%	8.4%	0	228	0.0%	5.7%
Over £2m	4	91,235	0.2%	81.3%	0	0	0.0%	0.0%
All	2,300	112,195	100.0%	100.0%	7,600	3,999	100.0%	100.0%

Source: HMRC CT 600 and Self-assessment returns data. Totals may not equal sum due to rounding

2.65 HMRC's modelling of the impact of a depreciation based approach (described in Chapter 4) indicates that a switch to such an approach **without** an AIA equivalent, would increase the tax paid by small and micro companies by about £800m each year, deferring about 30% of the value of their tax relief for capital expenditure.

2.66 Capital expenditure incentives are acknowledged in all economies as an important commercial driver. The question that arises if a depreciation system were introduced is how this incentive could be retained while still achieving tax simplification.

2.67 Such is the desirability of the AIA and the impact it has on the vast majority of UK businesses, it is a feature which should, if practical, be adopted in any new system. Ideally, to maintain simplicity, this would be done in a way which maintained so far as possible the use of the financial statement annual depreciation charge figure without alteration.

2.68 Just as the AIA brings forward the timing of tax relief under CAs, a mechanism can be devised which brings forward (only for tax purposes) the relief for depreciation (called Depreciation AIA from now on). A key difference with the CA AIA is that with CAs the AIA does not have to be revisited, except for deferred tax calculations.[14] In contrast, a Depreciation AIA would require an ongoing adjustment to the accounts depreciation figure, to prevent a double deduction, as the asset is depreciated. The OTS has considered two means of achieving this:

[13] These figures are for one year only. Some businesses may have sporadic expenditure year by year and move between the different bands (see para 5.8)

[14] Companies accounting under FRS 105 do not account for deferred tax.

1 with a fully granular fixed asset register it would in principle be possible to specify the assets on which Depreciation AIA is claimed and in subsequent years identify the depreciation on these assets for reversal in the tax computation. Although some respondents indicated this is entirely practical,[15] it may not be appropriate to assume this would be feasible for all taxpayers. For this reason, a simpler approach was explored

2 rather than track and reverse (for tax) the actual depreciation for each asset for which Depreciation AIA is claimed, a standardised approach could be adopted across all such assets. The calculation of this would be entirely separate from the fixed asset register, and sit purely within the tax computation.[16] Clearly it would be very important that a single life was used for all assets, perhaps 4 years

2.69 A Depreciation AIA would be a significant departure from a pure depreciation approach. Except for the very largest businesses (for whom the AIA is not a material issue), responses stressed the importance of an AIA equivalent.

2.70 The AIA is not the only incentive in the structure of CAs. Enhanced Capital Allowances ("ECAs") and Research and Development Allowances encourage investment in particular kinds of equipment by hastening relief. Just as an AIA equivalent can be devised, so could versions of these other incentives. Alternatively, the effect of ECAs or R&D allowances could be achieved with a 'tax reducer' that reduces the final tax liability in the way that relief is given for an enterprise investment scheme (EIS) investment.

2.71 Already it may appear that the apparent simplicity of using accounts depreciation for tax is beginning to be muddied.

Revaluations

2.72 An asset owned by a business may be revalued (see paras 2.17 to 2.21). Accounting standards impose a number of specific requirements over revaluations and require the depreciation charge over the asset's remaining life to increase accordingly.

2.73 CAs however are based on the initial asset cost which cannot change unless the asset changes ownership. Therefore, there is a divergence here that needs to be considered.

2.74 The treatment of depreciation on revaluations has to be considered in conjunction with the tax treatment of the revaluation itself. At present revaluations are not taxed. It has been suggested by some that an asset revaluation could come into immediate tax charge and then the subsequent increased depreciation should be deductible for tax in future years. This might, when taken in isolation, seem a neat solution.

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15 This approach is assumed in the modelling described later.

16 In essence a standardised and simplified approach would involve imposing the assumption that all the assets on which Depreciation AIA was claimed had the same useful life for accounts purposes and hence the same annual depreciation to be reversed in the tax computation. For example, if Depreciation AIA of say £200,000 were claimed in year 1 and a standard assumed life of 4 years were adopted, then depreciation of £50,000 would be reversed in the tax computation in each of years 1 to 4.

2.75 However, taking a broader view this presents a scenario that begins to unpick some fundamentals of the tax system. One of these features is that generally no tax charge is generated if no cash is realised. The response to this situation in other areas of the tax code is to allow some form of deferment. For example, in partnership capital gains tax, a revaluation of partnership assets triggers a charge at the occasion of the next chargeable event. If taxation of the revaluation was deferred, relief for depreciation on the revaluation would introduce an asymmetry.

2.76 It is not appropriate in this report to stray into the deeper distinctions between taxing income and capital or to suggest that revaluations should be taxed. On that basis, depreciation on revaluations of assets would not be allowed.

2.77 This implies that the element of depreciation which relates to revaluations would need to be tracked to ensure that relief is not given for this part of the depreciation charge.

Investment properties

2.78 There are some assets which do not depreciate but on which CAs can be claimed (illustrated in Box 2.B). This is one area of accounting which stands out for particular attention. Under accounting standards, other than FRS 105, investment properties should not be depreciated and should be revalued each year (see paras 2.30 to 2.32). The nature of property values usually means that revaluations will be upwards although not necessarily always. The amount of the increase, or decrease, if taken to the profit and loss account would be reversed in the tax calculation and would ultimately be taxed when the building is sold and then generate a charge under the chargeable gains rules.

2.79 Any property that is rented out, or retained for growth in value, is an investment building. These buildings can either be dwellings or commercial in function. Dwellings never receive CAs. Neither do business premises, which include office buildings as well as buildings for more industrial undertakings like manufacturing, warehousing and laboratories.[17]

2.80 However, in the UK CAs are claimed by business taxpayers on the multitude of equipment and integral features and fittings within commercial buildings. Chart 4.A in Chapter 4 shows indicative ranges for costs qualifying for CAs in typical buildings. Some respondents argue that the removal of capital allowances would be damaging for the commercial viability of real estate investment and development projects.

[17] This is in marked contrast to the international situation where most countries do give relief for all commercial property, including office buildings.

Box 2.B: Illustration of the contrasting accounting and tax treatments of investment properties

An office building with a single lift is acquired by a property investor. Some years later the lift is completely replaced.

The accounting treatment is generally:

- the newly acquired building is treated as an investment property in its entirety and is not depreciated
- the value of the replacement lift is reflected in the next revaluation

The current tax treatment is:

- the element of cost that relates to the original lift will be identified and this will qualify for 'plant and machinery' (P&M) capital allowances
- the rest of the building will receive no tax relief
- if in replacing the lift the old one is scrapped, then any value received will be deducted from the P&M capital allowance pool
- the new lift, according to how much of an improvement it is on the old lift, will either be deducted as a renewal in the business tax profit calculation or receive capital allowances through the P&M capital allowance pool. Either way it will attract tax relief, but over a different timeframe

2.81 What needs to be considered is whether a modification should be made for investment properties so that tax relief continues, were a depreciation based approach adopted.

2.82 Some have suggested that the very fact that there is no depreciation is an indication that there is no loss in value to be relieved. An alternative view is that underlying loss in value of parts of a building (such as the lift in the example above) is masked by the uplift in value of the entire building.

2.83 One approach would be to say that the absence of depreciation should imply no relief and as a capital gain or loss will crystallise when the building is decommissioned, the matter is only a timing difference albeit a rather long one.[18] However, this overlooks the fact that parts of buildings do have finite lives. It would be fairer and more accurate for this dilapidation process to be represented by a substitute depreciation adjustment.

2.84 There are two potential ways of doing this:

1 retain CAs for those assets which are not depreciated in the accounts, with the considerable disadvantage (from a simplification point of view)

[18] The capital gains rules do though require that relieved expenditure must be reflected in the asset at the time of disposal.

of continuing with a large body of legislation and case law just for them, or

2 take the opportunity to introduce a less complex form of CAs designed with the nature of this sector in mind. For example, with the considerable knowledge of indicative proportions of qualifying assets for particular types of building (see for example Table 4.A) it may be possible to set allowable proportions of spend for those broad asset types. A specific relief of such a kind could potentially provide CAs, while replacing most of the current legislation

2.85 Many large quoted investment property companies are Real Estate Investment Trusts (REITs) which do not pay corporation tax on property income. A condition of taking REIT status is that 90% of property related profits must be distributed. The property related profits are calculated with a notional CA deduction, based on the complete current CA regime. The rules for REITS could follow whichever of the two suggestions above is adopted for investment properties generally.

2.86 The OTS acknowledges there would be both winners and losers in a change to a tax depreciation system. Observing the material nature of this type of investment and the size and importance of the property investing sector in the UK it has to be acknowledged that businesses centred around investment property could be disproportionally large losers without a parallel CA system. This suggests that specific consideration will need to be given to this sector.

2.87 However, from a simplification point of view, the introduction of a dedicated tax relief for investment properties, to sit alongside a depreciation based relief for assets which are not held for investment presents difficulties:

- some businesses hold investment assets and assets for use. Running two systems of tax relief would not be a simplification for them
- the sale of an asset by a taxpayer holding the asset as an investment property to another taxpayer who buys it for use, would create opportunities for tax arbitrage. This is likely to require specific anti-avoidance legislation
- some have suggested that an asset could be permanently "marked" for tax so that its tax nature would be permanently fixed. This could result in a complicated situation for a purchaser of an asset for use which was previously held by another business as an investment (with its tax status crystallised): this taxpayer would also have to run two systems even if all its assets were held for use

2.88 The tax treatment of properties held for investment, in a depreciation based regime, is challenging and the OTS has not found simple answers. This is an area where a clearer understanding of the policy objective of the current relief for these assets would assist in the design of a replacement relief or of the best mechanism for continuing with CAs for these assets only.

Other challenges of depreciation

The composition of relievable cost

2.89 As outlined already there are several differences between a capital allowance and a depreciation system. These include the subjective nature of the useful economic life of an asset which would give contrasting tax write off periods between different businesses. Another important difference is what constitutes the cost of the asset for the purpose of depreciation compared with the cost on which capital allowances can be claimed. Some of these points are highlighted next.

Capitalised interest

2.90 Borrowing costs incurred during the construction of an asset are sometimes capitalised into the cost of the asset in financial statements and depreciated over the life of the asset. Tax law identifies this as an interest payment of the business and it is accordingly adjusted for and deducted as a separate business expense as incurred.

2.91 With a move to tax relief for assets based on depreciation, there would be two possible approaches to the treatment of capitalised interest:

1 continue to exclude capitalised interest from the value of the asset relieved for tax, which would require an adjustment from the accounting fixed asset depreciation figure

2 more radically, achieve greater simplification by following the accounting treatment, making no adjustment to the interest debit and no adjustment to the depreciation. This would have a knock on impact into the way interest is currently relieved

Grants

2.92 For accounting purposes capital grants from local, national or international government may be presented in the balance sheet as deferred income rather than being deducted from the carrying value of the asset. The deferred income is then recognised as income on a regular basis over the expected useful life of the asset.

2.93 By contrast capital allowances legislation requires any such grant to be deducted directly from the acquisition cost. A depreciation based deduction will be based therefore on a higher cost than the corresponding cost for capital allowances purposes.

2.94 Minimising the modifications required on a move to a depreciation system would involve aligning the tax treatment with that of accounts, and then removing the need to adjust for the deferred income. This would in effect give an 'above the line' taxable income offset by the depreciation relief over the useful life of the asset.

Disposals and second hand assets

2.95 The treatment of asset disposals is another important area where a depreciation based approach would have challenging consequences. This is because of the interaction between different parts of the tax code and,

crucially, because disposals necessarily involve the interaction of separate taxpayers. (In addition, transactions will sometimes be between a taxpayer and a non-taxpayer, which presents other issues not addressed here.)

2.96 The discussion here is highly simplified and relates to disposals of property incorporating fixtures, not moveable property.

2.97 The treatment of disposals under the current CA regime includes elements of discretion as between the vendor and the purchaser which it would be difficult to replicate in a depreciation based regime (see para 2.102).

2.98 The core challenges regarding disposals are:

- what would be the implications of a depreciation based approach for the taxation of the vendor?
- would a depreciation based approach affect the tax position of the purchaser?

2.99 This section will briefly outline the accounting treatment of a disposal, the current tax treatment of disposals and the implications for tax of a depreciation based approach.

2.100 A simple example will be used to illustrate the issues:

Vendor's position	Selling at a profit £	Selling at a loss £
Acquisition cost of fixtures, assume nil acquisition cost for other assets	10	10
Accumulated accounting depreciation to date of sale	4	4
Net book value at sale	6	6
Sale proceeds	20	8
With current CA rules		
Capital allowances claimed to date of sale	3	3
Tax written down value at date of sale	7	7

2.101 The vendor would account for the disposal as follows:

Accounting for disposal	Selling at a profit £	Selling at a loss £
Sale proceeds	20	8
Less: net book value	(6)	(6)
Accounting profit on disposal	14	2

2.102 **Under current CA rules**, the accounting depreciation and profit on sale would be disregarded for tax purposes and the tax treatment at sale would depend on an agreement reached with the purchaser regarding the transferred tax value of the fixtures. This mechanism is often called a "section 198" election.

Box 2.C: Section 198 elections

The current version of the s198 Capital Allowances Act 2001 election procedure dates from 2014. The main advantage for all parties, including HMRC, is certainty.

The vendor and the purchaser agree the tax value at which assets pass between them. The election is an agreement on what part of the overall sales price should be attributed for tax to qualifying assets, distinguishing between the various asset pools.

Crucially, the elected amount cannot be greater than the lower of:

1 the amount the vendor has brought into the pools. It is therefore related to historic costs, not to the present value of the assets in the hands of the purchaser or the vendor, and

2 the actual sale price

There is therefore considerable latitude on the sum agreed, and negotiating the s198 election is an important part of the overall deal process. It is at this point that the vendor may seek specialist capital allowance advice to ensure that the amount brought into the pools is maximised, for if assets are not reflected in a s198 agreement the purchaser, and any subsequent purchaser cannot claim CAs in respect of them at any point in the future.

2.103 The vendor's tax position therefore depends on the value agreed in the s198 election:

Taxing the disposal with CAs, using different section 198 values	5	7	10	8
Sale proceeds	20	20	20	8
Less: cost	(10)	(10)	(10)	(10)
Capital gain (subject to roll over - see para 2.104)	10	10	10	Nil[19]
Tax written down value	(7)	(7)	(7)	(7)
Less: s198 value	5	7	10	8
Balancing (allowance)/charge	(2)	0	3	1
Total taxable amount at disposal (subject to rollover)	8	10	13	1
Allowances available to purchaser (equal to s198 value)	5	7	10	8

19 Capital losses are restricted if the asset qualified for CAs.

2.104 As regards that part of the overall tax outcome which is a capital gain, the vendor may have the further flexibility to rollover the gain into the acquisition of new assets, deferring the point at which tax is due.

2.105 With a **depreciation-based system,** without modification, the accounting profit on disposal would be taxed (at a value of 14 or 2 in the examples above). At this point the overall policy intent of the tax regime enters the discussion. At present the treatment on disposal divides the profit into two parts: any clawback of CAs is taxed as income, the rest is treated as a capital gain. In previous OTS reports the taxation of chargeable gains for companies has been proposed as an area of complexity ripe for review:[20]

2.106 In the context of this report on the implications of a depreciation based approach for relief for tangible fixed assets, there are two potential routes for taxing the vendor:

1 a whole-hearted accounts based approach, or

2 if the capital/income distinction is to be retained, an approach which delivers the same distinction as at present with CAs. This would not be difficult, assuming that the fixed asset registers which underlie the accounting carry information on historic cost (10 in the example above)

Using the example above:

Accounting for disposal	Selling at a profit £	Selling at a loss £
Sale proceeds	20	8
Less: net book value	(6)	(6)
Accounting profit on disposal	14	2
Of which,		
Taxed as capital: Excess of proceeds over original cost	10	(2)
Loss restricted		2
Leaving remainder taxed as income	4	2
Total taxed	14	2

2.107 Building on previous OTS reports, if depreciation were viewed as a desirable approach for giving tax relief for tangible fixed assets, the opportunity should be taken to reconsider the extent to which capital gains should apply

20 OTS reports: Tax reliefs review, March 2011 https://www.gov.uk/government/publications/tax-reliefs-review and Competitiveness of UK Taxation Administration review, December 2014 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/362302/competitiveness_review_final_report.pdf and the Simplification of the corporation tax computation review, July 2017 https://www.gov.uk/government/publications/ots-review-on-simplifying-the-ct-computation

to companies.[21] If this is too radical, the present capital/revenue distinction can readily sit within a depreciation based regime.

2.108 There is then the further, linked, issue of the treatment of the asset in the hands of the purchaser.

The same asset in the purchaser's hands

2.109 How does the treatment of the vendor connect with the treatment of the purchaser? At present, the CA regime is indifferent as to whether the vendor or the purchaser receives the benefit of CAs, provided that the total CAs claimed over the chain of ownership does not exceed the original cost eligible for CAs.[22] The s198 process enables the purchaser to claim by reference to a value agreed with the vendor and that value can be within a wide range. The process also gives HMRC confidence that there is symmetry between the vendor and the purchaser: the vendor's disposal value for CA purposes will equal the purchaser's acquisition value.

2.110 A depreciation based approach would introduce two issues:

1 the purchaser may pay more for an asset than the seller initially paid for it, and then depreciate that higher amount

2 the purchaser may record an acquisition price for depreciating assets which does not relate to the disposal value for those assets recorded by the vendor, if, for example the asset purchased included non depreciating land

2.111 This may result in a loss of asset value symmetry between the vendor and purchaser. To the extent this is about the two businesses depreciating an asset at different rates, this is inherent in moving to a depreciation-based regime, as this involves respecting the different circumstances of different businesses. But there is also potentially an issue about moving value between assets which depreciate and those which do not.

2.112 These differences could simply be accepted as the natural consequence of a more accounts based approach. This is how the OTS views the issue.

2.113 Alternatively, if wanting to retain tax symmetry for the transaction, it would be necessary to have an election mechanism similar to s198 agreeing a tax transfer value. However, this would take one further away from the tax simplification aimed at by using the accounts depreciation figure, as for the purchaser the accounting and agreed tax transaction cost may vary in all subsequent years, requiring annual adjustment.

Anti-avoidance, including intra group transactions

2.114 Even in a depreciation system essentially governed by accounting standards there is likely to be a need for anti-avoidance legislation. There is nothing inherent to depreciation that suggests the issues addressed by anti-avoidance legislation will cease to exist.

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21 Para 3.53 Simplification of the corporation tax computation report, July 2017

22 Following reforms in 2014 the allowable costs must have been pooled, even if CAs have not been claimed.

2.115 Currently, capital allowance legislation contains less anti avoidance material relative to other tax areas. Those that do exist are largely directed at:

- combating structures that accelerate or maximise claims or alternatively minimise allowance claw backs, and
- transfers between 'connected parties'

2.116 By its nature, a depreciation based system may lend itself to reliance on an all embracing anti-avoidance regime. Accounting standards require accounts to represent faithfully the information they purport to represent and to account for and present transactions in accordance with their economic substance. If not, HMRC may have grounds for challenging the accounts as a basis for the tax computation. However, there could well be a need for some further more specific general anti-avoidance provisions on depreciation.

2.117 For transactions between businesses under common control, transfer values will be whatever they agree. This may or may not be at the open market value, alternatively called 'fair value', of the asset in question. It is common practice to transfer assets within a group at their carrying value in the accounts of the transferring company in order to simplify the accounting.

2.118 Current tax rules deem transfers between connected businesses to be at open market value, effectively taxing businesses on the true extent of any income or gain while owning the asset. A decision would need to be made as to whether this principle should continue within a depreciation system. If so something closely replicating the current legislation will need to be also explored.

2.119 This can only add to the disparity between the accounting treatment and the use of open market values as required by the current anti-avoidance rules.

Disclaiming tax relief

2.120 One feature available in the capital allowance regime which does not have a comparator in accounts depreciation, is the ability to disclaim CAs in part or whole. This enables some of the relief in a given period to be carried forward, to be claimed in a later period. The ability to disclaim is most commonly used when a full claim would result in the creation of tax losses in a year when they cannot be used to best advantage. The ability to disclaim is a flexibility which taxpayers find particularly useful in group situations.[23] Based on comments received by the OTS, this feature is highly appreciated and said to be used frequently. The point was also made that recent restrictions on the use of tax losses have enhanced the value of the ability to disclaim.

2.121 Disclaiming is a policy feature which runs counter to simplification. However, if the taxpayer flexibility it gives remains desirable from a policy perspective, it could be replicated within a depreciation based system with ease.

23 It should be emphasised that amongst all the business tax deductions, disclaiming is peculiar to CAs.

Conclusion on initial feasibility

2.122 This chapter has looked at the initial feasibility of using depreciation. There are considerable challenges in using depreciation to give tax relief for tangible fixed assets. In order to deliver basic policy requirements adjustments would be required to the accounts figure. Other parts of the tax regime would be affected, but if these areas can be addressed at the same time, so that depreciation is not adopted in isolation from the wider consequences, then a depreciation based approach could be feasible.

2.123 The next two chapters consider in turn how to transition from CAs and the consequences of using depreciation.

Chapter 3

How practical is transition?

Introduction

3.1 Around 1.2m taxpayers invest in tangible fixed assets and at present are engaged with the CA system. Replacing CAs with an accounts depreciation approach means a transition mechanism must be developed to move from one method to the other. This will affect all assets owned at the implementation date for which the tax written down value does not precisely match the accounts net book value. This will include taxpayers who have always only claimed the AIA, so have no capital allowance pool balances, but whose assets have not yet been fully depreciated, and those who have assets which do not qualify for the AIA such as cars. Transition is therefore potentially a widespread concern, not just something affecting the larger investors.

3.2 For taxpayers at present claiming only the AIA and likely to spend up to that level consistently in the future, the challenge of transition would be much reduced if the AIA were replicated in a depreciation based approach (as suggested in this report). This would confine the main practical problems of transition to about 30,000 business taxpayers, provided all depreciating assets were included.

3.3 For HMRC any transition will give rise to concerns about forestalling risks as taxpayers seek to maximise the advantages of the old or new regime.

3.4 There are various possible approaches to transition for assets owned at implementation. In each of these fairness and complexity are traded off: generally, the simplest method is the least fair. In this context fairness is regarded as the reasonable expectations of the taxpayer and the Exchequer when the investment was first made.

- taxpayers should receive the relief expected when the original investment was made
- the Exchequer should not give more relief than was expected when the original investment was made

Box 3.A: A simple illustration

To illustrate this with a simple example:

- identical assets costing £1,000 with a 10 year life are owned by two different taxpayers, using the same accounts depreciation method (straight line over 10 years)
- after 5 years both taxpayers have depreciated the same amount in their accounts and have an accounts net book value of £500
- for taxpayer A the cost was fully within the AIA and the tax relief received was £1,000
- for taxpayer B the asset is in the 8% pool and the tax relief received was £340

On a switch to a depreciation based method at the end of year 5 which of the following methods is most appropriate?

Method 1: Both taxpayers receive a further £500 of tax relief (being the amount of depreciation in the next 5 years), so that A receives £1,500 overall (£500 more than the original cost of the asset) and B receives £840 overall (£160 less than the original cost of the asset), or

Method 2: A receives NIL (because the asset has already been fully relieved for tax with the AIA) and B receives £660 because that is the amount of tax relief outstanding (with the 660 spread over future years in some way – see below)?

3.5 The situation in Method 1 above occurs if CAs are simply switched off and the depreciation based approach applies (this is called Cold Turkey in the alternatives below). It is demonstrably unfair:

- taxpayer A ends up with more tax relief than Taxpayer B, but neither expected this when the investments were made[1]
- the Exchequer (in effect other taxpayers) ends up bearing the cost of £340 more relief than expected when the investments were made (this is the difference between the £500 extra relief which Taxpayer A receives and the deficiency of £160 for Taxpayer B)

3.6 The example above assumes all the assets were fully qualifying for CAs. The distorted expectations at transition with a Cold Turkey approach are even greater for assets which do not qualify for CAs, but which do depreciate.

3.7 Various method of avoiding the distortions of Cold Turkey can be designed.

Transition to accounts based depreciation – alternative approaches

3.8 Alternative approaches to transition are set out below, with brief comments on each.

[1] Taxpayer A has of course received the timing advantage of up front relief by accessing the AIA.

Box 3.B: Cold Turkey

At implementation, the current CA system ceases and depreciation is used for all assets. Taxpayer administration of such a change would be straightforward.

Comments

- assets which are non qualifying at implementation date become qualifying from then on
- disclaimed allowances on assets held at transition are lost because the tax pool ceases to exist
- potential concern that forestalling behaviour would defer depreciation until implementation occurs

Box 3.C: New World

At implementation, the current CA system ceases and depreciation is used for new assets and existing qualifying assets. In contrast with Cold Turkey, existing non-qualifying assets are never relieved. Taxpayer administration is complicated by the need to track existing non-qualifying assets to ensure no relief given for depreciation on these assets.

Comments

- fewer distortions than Cold Turkey
- disclaimed allowances on assets held at transition are lost
- potential concern that forestalling behaviour would defer depreciation until implementation occurs

Box 3.D: Parallel Systems

At implementation, the depreciation system starts for new assets and from implementation the current CA system remains for assets currently qualifying for CAs. Relief for those assets runs out under the existing structure as pools are written down. Assets which are non-qualifying at implementation never qualify. Taxpayer administration is complicated by the need to track all assets existing at implementation for the remainder of the asset lives to ensure no relief is given for depreciation on these assets.

Comments

- disclaimed allowances are not lost
- potentially long run out of CAs

Box 3.E: Fixed Transition – has the same underlying approach as Parallel Systems, but seeks to compress the transition period

At implementation, the depreciation system starts for all assets, but from implementation the future depreciation on all assets previously allowed is taxed over a defined period, for example 10 years. At implementation, the current CA system remains for currently qualifying assets. Relief for those assets given in full over a defined period, for example 10 years.

Taxpayer administration could be regarded as easier as all adjustments are dealt within a defined period. Practically this would be managed by depreciation on all assets being allowed, offset by an adjustment over a defined period of the difference between net book value and tax written down value at implementation for assets currently qualifying for CAs.

Comments

- legacy period for all assets at implementation is restricted in all respects (CAs and depreciation)
- disclaimed allowances are not lost
- taxpayers with significant depreciating non qualifying assets are disadvantaged

Box 3.F: Modified Transition – also has the same underlying approach as Parallel Systems but seeks to compress the transition period for CAs only

At implementation, the depreciation system starts for new assets and from implementation existing CA pools on currently qualifying assets given in full over a defined period, for example 10 years. No depreciation is allowed on any assets held at transition for remainder of the asset lives. This means that taxpayers must track all assets held at implementation for the remainder of the asset lives to ensure no relief given for depreciation on these assets.

Comments

- legacy period CAs for assets qualifying at implementation assets is restricted

3.9 The key distortions which transition can cause for assets owned at the implementation date ("ID") of a new regime are illustrated in Box 3.A above. The table below sets out the extent to which these are addressed by the alternative transition mechanisms outlined above, for assets which do not qualify for CAs ("NQ") and assets which do qualify for CAs ("Q"):

Table 3.A: Summary of alternative approaches

Transition method	Treatment of assets owned at ID	Distortions	
		Future tax relief for NQ assets?	Potential excess /under relief for Q assets
Cold Turkey	Depreciation from ID	Yes	Yes
New World	Depreciation from ID on currently Q assets No depreciation on currently NQ assets	No	Yes
Parallel Systems	CAs for unlimited period No depreciation on any assets held at ID	No	No
Fixed Transition	CAs compressed into a 10 year period Transition period for depreciation on all assets held at ID compressed into a 10 year period	No	No
Modified Transition	CAs compressed into a 10 year period No depreciation on any assets held at ID	No	No

3.10 In summary:

- the distortions of **Cold Turkey** are not much improved with **New World**
- **Parallel Systems** is straightforward, but the CA pools and non deductible depreciation would linger for some taxpayers for many years (but taxpayers – and HMRC - have had to deal with lengthy legacy regimes[2] in other areas)
- **Fixed Transition** is an attempt to limit the length of the transition period. From a taxpayer point of view the mechanism for this would be fairly straightforward, essentially using deferred tax balances as the measure. For HMRC though the compressed period may introduce unacceptable risk. Discerning the consequences for taxpayers and the Exchequer is difficult and this method has not been modelled
- **Modified Transition** brings the CA regime to an end sooner but at a huge cost to the Exchequer (see Chart 3.A)

3.11 Most comments received on transition methods favoured Parallel Systems. Although speed was recognised as important and some were keen on Fixed Transition.

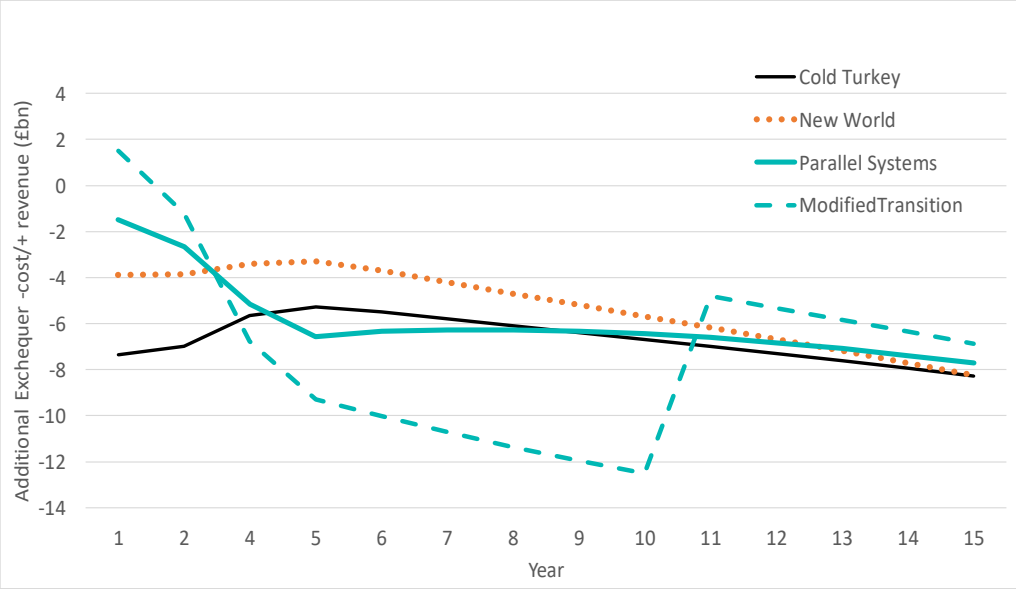
Cost of transition to the Exchequer

3.12 HMRC's modelling of a depreciation based approach (see Chapter 4 for more detail) included modelling four of the transition scenarios outlined above. One of the scenarios (Fixed Transition) was not modelled because too many assumptions would have had to be made about past depreciation.

[2] ACT is mentioned to the OTS with a grimace on occasion.

3.13 The chart below shows transition starting at year 1 and compares the transition position with an ongoing CA regime for the same overall asset base over the same period, giving the increased costs (in one case an initial reduced cost) to the Exchequer. The chart shows the differing impacts of the various scenarios and suggests the length of time to achieve some kind of steady state. The information is indicative only.

Chart 3.A: Transition scenarios – additional costs to those already arising from CAs



Source: HMRC ABD Model

3.14 The New World scenario is initially less costly to the Exchequer than the Cold Turkey scenario because of the long run in period for new assets which are not qualifying under current rules.

3.15 The dramatic curve in the Modified transition scenario is due to the compressed period in which existing CAs are run out. However, in the earliest years the Exchequer gains (compared with the current CAs position and all the other alternative transition mechanisms), reflecting assets at transition which would have received 18% writing down allowances (reducing balance) but are instead receiving 10% (flat rate).

3.16 From year 11 onwards all scenarios are broadly the same.

Further transition issues

3.17 For taxpayers making massive long-term investments there are further potential distortions. For them the tax conditions at the time of the investment decision are key. Capital expenditure may be incurred after the implementation of a depreciation approach under an investment decision that was made long before implementation. These taxpayers may also be significantly impacted by the different timing of depreciation (when an asset is in use) as compared with CAs (when expenditure is incurred).

3.18 Any transition will give rise to additional compliance costs for taxpayers as they switch from one system to another. Even Cold Turkey, which may be the easiest transition from a compliance point of view, (though as already

pointed out it has other significant drawbacks) would require taxpayers to put in place controls to ensure that excluded elements of depreciation, such as revaluations, will be identified and not allowed as a deduction. Comments on the costs of transition are included in the general discussion of compliance costs in the next chapter.

Conclusion on transition

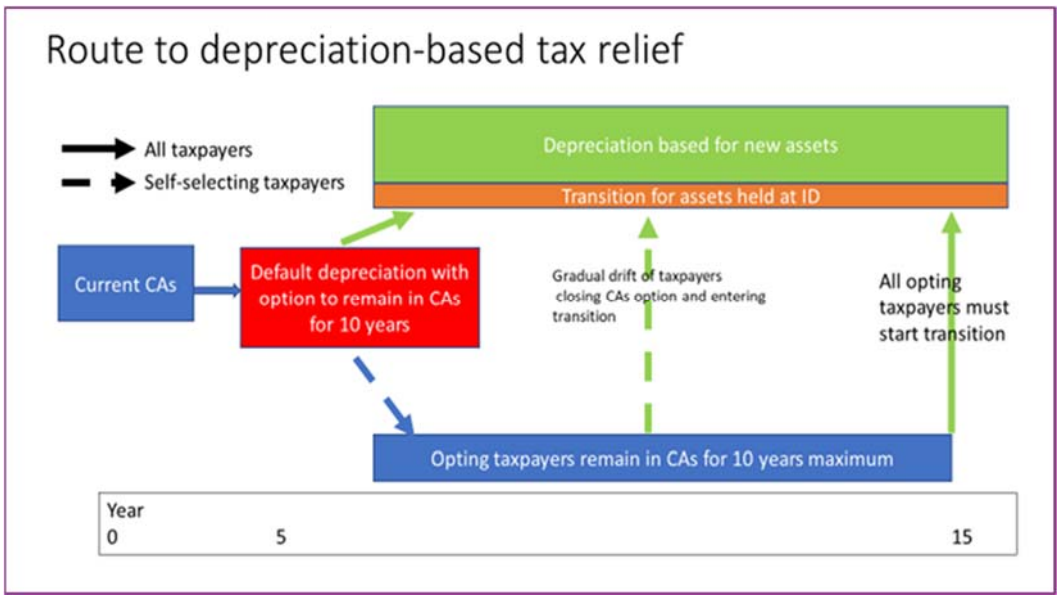
3.19 No transition mechanism combines fairness (as defined above) and simplicity in a wholly satisfactory way. The burden of running Parallel Systems over a period of time is a necessary price for the greater fairness it brings.

3.20 The number of taxpayers significantly affected by transition is reduced, by about 1m, if an equivalent of the AIA is adopted in a depreciation based system.

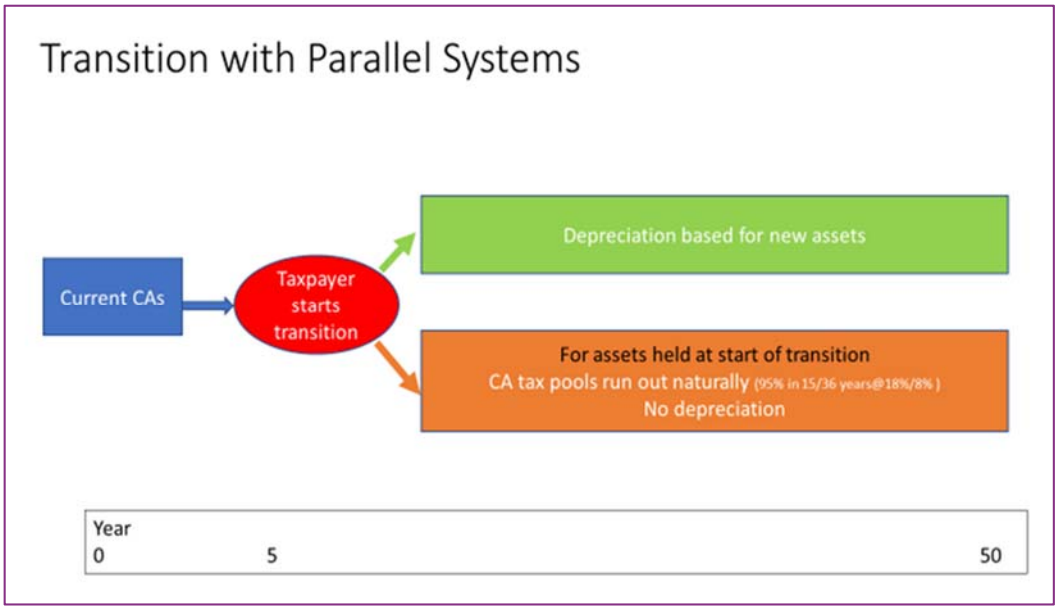
3.21 Recognising that the taxpayer population is widely varied, an additional possibility would be a phased transition to depreciation. This would enable taxpayers to travel at the pace suited to their different circumstances. From a given date depreciation would be the default approach but taxpayers could elect to remain wholly within the CAs for a maximum period, perhaps 10 years, before they start the transition of existing assets described as Parallel Systems. This would address the concerns of taxpayers with long-term projects, and could, perhaps, be confined to them. However, it would also introduce the potential for forestalling behaviour as taxpayers used the option to their greatest advantage. Linked to this, for investment assets, the potential problems associated with assets transferred on sale from one regime to another (see para 2.87 above), suggest that the option of a flexible transition period mooted here should not be available.

3.22 The diagrams below illustrate how the overall transition mechanism set out above (the Parallel Systems scenario plus 10 year opting period) could look, if there were a 5 year lead in time to the start of depreciation-based relief. It is not straightforward.

3.23 Firstly, the decision to transition to depreciation:



3.24 Secondly, when the decision to transition has been made:



3.25 The very lengthy transition period indicated above is an extreme position. It reflects both the longest delay before a taxpayer starts transition (10 years as mooted above) and the entire writing down period for an asset acquired just before transition starts.

3.26 In conclusion, it is possible to transition from CAs to a depreciation-based approach and for most business taxpayers there would be limited practical issues if an equivalent to the AIA is retained. However, the legacy of CAs would continue to linger for many thousands of business taxpayers, limiting and delaying the simplification benefits of a depreciation based approach.

Chapter 4

Key consequences

4.1 This chapter

- looks at the potential financial impact of a move to accounts depreciation
- considers some more subjective issues concerning taxpayers and HMRC's responses
- gives an initial view of whether depreciation delivers simplification

Financial impact

4.2 The massive scale of CAs was noted in the Introduction. This affects all taxpayers, either directly or indirectly through the impact on the Exchequer.

4.3 HMRC have modelled the effect of switching from the current CA system to a depreciation based approach. The method and assumptions used are set out in Annex G. The challenge faced by HMRC was considerable and required the construction of a new model. HMRC used information provided by companies in their XBRL returns. It should be commended as the first large scale use of XBRL data for modelling a potential policy change.

4.4 It should be noted that HMRC's model has not been considered by the OBR as currently this is not a policy measure being taken forward. It would be subject to OBR sign off at the appropriate fiscal event if in the future there were to be a policy change.

4.5 Except where stated, all the figures provided in this report assume that an equivalent to the AIA would continue with a depreciation approach and at the current level of £200,000 each year, covering the same range of assets as now.

4.6 HMRC's modelling indicates that when fully established (as discussed in the previous chapter, a transition from CAs to a depreciation based approach is likely to take a long time), the annual cost to the Exchequer of providing relief for tangible fixed assets may increase by about £7bn in the longer term compared with the current CAs system. £3bn of that increase is due to adopting an AIA within the depreciation based regime.

4.7 An alternative approach would seek to achieve neutrality for the Exchequer (and for taxpayers overall, though not individually). With a simple mechanism, if the proportion of allowable depreciation were reduced from 100% to 80% there would be negligible gain or loss to the Exchequer on a switch from CAs to depreciation. This is an initial estimate and does not take

into account any behavioural change that may result from such a policy change.

4.8 A different approach to secure neutrality would be to restrict the scope of depreciation (for example, only giving relief for assets currently qualifying for CAs) but as this is not consistent with the overall concept of a depreciation approach it has not been explored.

4.9 The cost to the Exchequer is of course mirrored by taxpayers paying less tax. About 80% of the benefit to taxpayers would go to companies and 20% to unincorporated businesses.

4.10 The incidence of depreciation and CAs are not in line with each other on a granular level. There will be gainers and losers in various ways:

- between different industry sectors – if industries use assets with significantly different lives or if one industry has a greater proportion than another of depreciating assets which do not qualify for CAs
- between businesses of different sizes

4.11 Detail on the impact of depreciation is not available, but some broad inferences can be made.

4.12 Broadly, large companies would receive about half of the benefit (increasing the overall relief they receive by about 20%) while relief received by other companies would increase by about 50%.

4.13 In the same broad terms, the value of the benefit is spread very unevenly across industrial sectors, with the proportion ranging from nil for the water industry to a 100% increase for construction and health and social care.

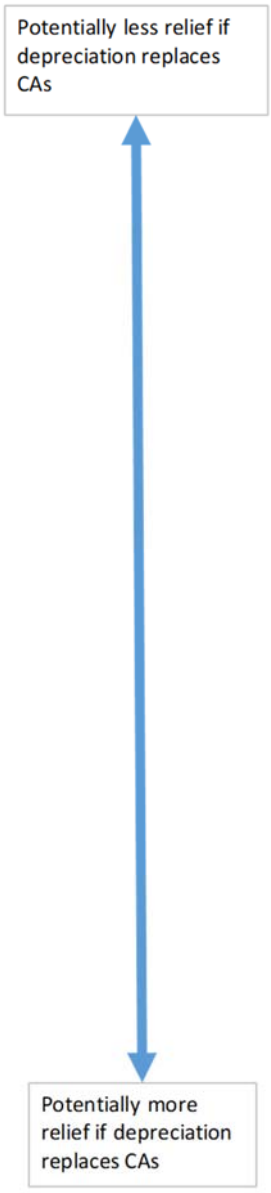
4.14 One impact which HMRC's model cannot address is the varying impact on investment appraisals for projects constructed over a long period. These of course are prepared on a net present value basis, discounting future streams of cash flows (including the tax impact of the investment) to the present. Even if a project were not impacted by the implied extension of scope in a move to depreciation, the timing of relief would change (see Table 2.A – Commencement of write down) as would the overall value of the investment. While these impacts may be concentrated in certain industries, for example some infrastructure activities, they cannot be gauged on a macro basis.

4.15 In the long term the impacts indicated by the model primarily flow from the extension of scope which is implied in a move to a depreciation based approach.

4.16 Further indications of the impact of moving to a depreciation based approach have been given by some of the respondents for this report. The following table provided by Grant Thornton shows the potential range of CA claims for newly built buildings. Buildings towards the top of the list would potentially receive less relief if CAs were replaced with depreciation; buildings towards the bottom of the list would potentially receive more relief if CAs were replaced with depreciation.

Table 4.A: Indicative ranges for plant and machinery (P&M) content of typical buildings

	Typical P&M content NQ = not qualifying			
Example types of investment	**Low**	**High**	**Mid**	**NQ**
Gas Fired Power Stations	85%	95%	90%	10%
Waste & Water Treatment Works	85%	95%	90%	10%
Windfarms (on and offshore)	80%	90%	85%	15%
Biomass and CHP (inc infrastructure)	75%	90%	83%	17%
Factory (High Tech) fit-out only	55%	85%	70%	30%
Factory (Hi-Tech with clean rooms) fully fitted	40%	70%	55%	45%
Retail unit (fit-out)	35%	65%	50%	50%
Public Houses	40%	60%	50%	50%
Restaurant fit-out	40%	60%	50%	50%
Hotels - Luxury City Centre	35%	55%	45%	55%
Factory (High Tech) fully fitted	30%	60%	45%	55%
District Hospitals	38%	48%	43%	57%
Hotels - Mid Range	30%	50%	40%	60%
Prisons	35%	45%	40%	60%
Secondary School	28%	48%	38%	62%
Conference Centres	25%	50%	38%	62%
Prestige Offices High Rise	30%	45%	38%	62%
Call Centres	25%	45%	35%	65%
Leisure centres - wet and dry	25%	45%	35%	65%
Primary School	25%	45%	35%	65%
Prestige Offices Medium Rise	28%	42%	35%	65%
Nursing Homes (excluding furniture)	30%	40%	35%	65%
Hotels - Budget	25%	36%	30%	70%
Retail warehouse (fit-out)	20%	40%	30%	70%
Offices High Rise (A/C) - Owner Occupied	25%	35%	30%	70%
Offices Low Rise (A/C) - Owner Occupied	25%	35%	30%	70%
Offices Medium Rise (A/C) - Owner Occupied	25%	35%	30%	70%
Health Centres (excludes furniture and equipment)	22%	34%	28%	72%
Residential Homes (excluding furniture)	20%	34%	27%	73%
Leisure centres - dry	18%	35%	27%	73%
Offices High Rise (A/C) - For Letting	20%	32%	26%	74%
Offices Low Rise (A/C) - For Letting	20%	32%	26%	74%
Offices Medium Rise (A/C) - For Letting	20%	32%	26%	74%
Car Showroom (excluding equipment)	17%	34%	26%	74%
Students Residences (small schemes)	18%	32%	25%	75%
Car Showroom and Workshop (excluding equipment)	14%	28%	21%	79%
Students Residences (large budget schemes)	14%	28%	21%	79%
Offices High Rise (Non A/C) - Owner Occupied	16%	26%	21%	79%
Offices Low Rise (Non A/C) - Owner Occupied	16%	26%	21%	79%
Offices Medium Rise (Non A/C) - Owner Occupied	16%	26%	21%	79%
Shopping centres (covered)	14%	25%	20%	80%
Offices High Rise (Non A/C) - For Letting	16%	22%	19%	81%
Offices Low Rise (Non A/C) - For Letting	16%	22%	19%	81%
Offices Medium Rise (Non A/C) - For Letting	16%	22%	19%	81%
Factory/warehouse (owner occupation) - light industrial	8%	18%	13%	87%
Factory/warehouse (with 10% offices) for letting	8%	16%	12%	88%
Car Workshop (excluding equipment)	8%	16%	12%	88%
Multi-storey car parks	6%	12%	9%	91%
Factory/warehouse (shell and core only) for letting	2%	6%	4%	96%
Retail unit (shell)	2%	6%	4%	96%
Retail warehouse (shell)	2%	6%	4%	96%



Source: Grant Thornton

Impact on compliance costs

4.17 The overall impact on compliance costs is difficult to determine from the responses received, which may of course not be wholly representative of taxpayers. Some have suggested there would be no impact on these costs (for example, because there would be a simple shift of compliance effort from the calculation of CAs to depreciation). Others are emphatic that they would fall, and for some large companies by hundreds of thousands of pounds (which may not be a large sum in the overall context of these companies). It would seem strange if taxpayers at present determining depreciation with appropriate diligence and incurring the cost of CA compliance, did not see reduced costs.

4.18 Even amongst those who expected compliance costs to fall eventually, there was a degree of concern that the challenges of transition would delay these benefits. Transition burdens will be a combination of gaining familiarity with the use of depreciation for tax and the cost of whatever record keeping mechanisms are required during the transition period.

Summary conclusion on financials

4.19 The key financial impact of a depreciation based approach is the significant "gain" to business taxpayers triggered by the extension of scope. It would be mechanically easy to achieve overall neutrality by scaling back allowable depreciation.

Taxpayer and HMRC responses to depreciation

A new approach

4.20 The capital allowance system was introduced in 1945, assuming more identifiably its current form as early as 1962, and so it has become well recognised and understood, which results in a degree of confidence or certainty for both tax professionals and HMRC. It is possible that long-standing views related to the operation of the current system would not be appropriate to a depreciation relief system, if introduced.

4.21 This may, for example, require taxpayers or their agents to acquire greater familiarity with processes for estimating reasonable asset lives and residual values. This would be a move away from more surveyor type skills necessary for identifying and classifying acquired assets in the capital allowance system. Depreciation methodology is undertaken in the accounts production process under the guidance of GAAP. Perhaps with more resting on these figures in a depreciation based tax system taxpayer working papers will need to be even more robustly substantiated than is currently the practice.

4.22 Two particular concerns relate to the potential behavioural responses of taxpayers and HMRC to depreciation. These can be seen as two sides of the same coin.

Taxpayer behaviour

4.23 Chapter 2 set out the principles which have to be applied in calculating depreciation. Accounting standards, whether issued by the Financial Reporting Council or the International Accounting Standards Board, set out the framework within which businesses determine the appropriate depreciation for their assets. The standards are not a set of prescriptive rules which give the "right" depreciation to charge for all individual assets in all circumstances. Businesses make judgements when applying the accounting standards. One business may use an asset faster than another business using an identical asset. It would reflect this in faster depreciation.

4.24 Some have argued that that because of the judgement involved the depreciation charge in the accounts is open to manipulation, and that some businesses would accelerate depreciation beyond what was economically justified. There is a view that the extent of judgement involved in determining depreciation is inappropriate in what should be a rigorous tax

regime. In contrast the rates of CAs are set out in tax legislation and cannot be manipulated.

4.25 Those with the most sceptical view of taxpayer behaviour, that rules will always be stretched to the taxpayer's tax advantage, would be concerned that the latitude in interpretation which is inevitable in a principles based regime may mean that businesses will maximise depreciation in order to hasten tax relief.

4.26 There are various reasons why these risks may not materialise:

- businesses are often also under pressure not to accelerate depreciation, to maximise the profit and net assets reported to shareholders and lenders
- reported profit after depreciation may contribute to determining individuals' performance measures
- where appointed, auditors exercise constraint on the freedom of management to manipulate depreciation
- directors of company accounts have a legal duty to prepare accounts which give a true and fair view

4.27 The larger businesses with the greatest investments in tangible fixed assets may have most reason not to change their depreciation policies in pursuit of a tax advantage.

4.28 On balance, it seems that the constraints on the freedom of businesses to manipulate depreciation are sufficiently robust to make accounts depreciation an acceptable basis for tax relief. This is particularly the case for public companies and for private companies which obtain financing on the basis of their financial statements, though it is recognised that some private businesses have more flexibility.

4.29 It is also clear that, even if the rate of writing down allowances cannot be changed by the taxpayer, CAs are open to overall manipulation to affect the cash tax rate. An example of this is the ability to disclaim allowances for use at a more advantageous time. Indeed, many have cited this flexibility as an advantage of CAs the loss of which would be regretted.

4.30 HMRC's model includes assumptions about taxpayer behaviour. This of course is not unique to the present exercise but is considered in all HMRC's models. For the depreciation based relief model, HMRC have assumed that total depreciation will be accelerated each year.

4.31 Linked to taxpayers' behaviour, another issue is taxpayers' understanding of the tax return. Clearly, CAs are well understood by professionals. However, feedback from some taxpayers is that they understand what depreciation is but that CAs is something specialist that advisers are required for. Potentially the use of depreciation would increase taxpayers' sense of ownership of the tax return.

HMRC's response to depreciation

4.32 Different businesses and their advisors will properly make different judgements in different situations in relation to depreciation and so by its

very nature the result will be subjective as noted at para 4.23. In a range of submissions and discussions, a common concern was that HMRC would be more likely to undertake investigations into depreciation calculations than they currently do for capital allowances. This would potentially undermine the greater simplicity that the new approach is intended to achieve.

4.33 There are reasons why this will not necessarily occur, including:

- HMRC have clear guidance and governance around the circumstances when a taxpayer's interpretation or application of GAAP may be challenged
- HMRC have adapted to the application of accounting rules in other areas of GAAP (for example loan relationships and intangibles)
- anecdotal evidence of experience of challenges in other areas of GAAP does not suggest that HMRC initiate arguments on GAAP particularly often
- for large businesses,[1] HMRC's compliance approach includes an assessment of overall risk, only part of which would be consideration of the company's approach to depreciation

4.34 It is worth repeating at this point that an essential precondition for a depreciation based approach would be acceptance of the accounting view on what is, and what is not, capitalised.

4.35 Some taxpayers might welcome challenges being made to other taxpayers. Materiality in accounts can be a contentious issue. What is immaterial for a large business may be very material for a smaller business. With the use of accounts based depreciation, materiality would be relevant to more aspects of the tax return, potentially giving larger businesses faster relief than smaller businesses.

4.36 What this all highlights is that a change to a depreciation system may need a root and branch change, as to outlook, attitude and appraisal of depreciation calculations, by all those involved and affected.

Does this look like simplification?

4.37 At this point, with some understanding of the nature of depreciation, how it could be incorporated into the calculation of business tax and some idea of the consequences, an initial assessment can be made of whether it would represent a simplification.

4.38 It is important to acknowledge that change is itself a complexity. Even if depreciation were the right approach if designing a tax regime from scratch, it might not be right to move to it if the level of disruption outweighed the benefits of the end result.

4.39 Depreciation is part of an overall, coherent approach to accounting for fixed assets. The use of depreciation for tax relief for tangible assets would have

[1] Turnover greater than £200m each year.

repercussions on other parts of the tax system. It is difficult to isolate the simplification arguments for using depreciation from that wider context.

4.40 The fundamental simplification argument in favour of depreciation is that one system for determining the scope, timing and calculation for accounts depreciation and tax relief for tangible fixed assets must be better than two. For particular businesses, this may not be the case (usually if the scope or timing of depreciation is to the taxpayer's disadvantage), but the overall proposition cannot be refuted.

4.41 The main simplification points against moving to a depreciation based approach are:

- accounts depreciation could not be adopted without modifications – this damages the one system argument, though not necessarily fatally
- the main benefit of likely compliance costs savings, assuming an AIA equivalent is adopted, would be to around 30,000 larger businesses
- an element of control would cease to be with HMT/HMRC, instead it would be in the hands of accounting standard setting authorities. This may not be considered appropriate for fiscal issues. The simplification point here is while control could be wrested back (for example, by imposing maximum permitted rates for tax depreciation – as in many other countries), that itself involves further change. The on-going development of the right tax response to imminent changes in lease accounting standards is instructive on this point
- a fair transition would involve maintaining CA pools for many years

4.42 Apart from simplification issues, the apparent cost to the Exchequer of a move to a depreciation based system and degree of uncertainty of the financial consequences for businesses introduce difficult issues beyond the remit of the OTS.

4.43 These are all potent reasons not to move to depreciation. However, it is clear that it could be done and it would be simpler than the CA regime, even though unquestionably it would be very challenging. Meanwhile, the problems with CAs remain, which indeed was the trigger for this report. An alternative to using depreciation is the radical improvement of CAs. If this could be achieved, then the attractions of depreciation would fall away.

4.44 This is considered in the next chapter. After that it will be possible to conclude on whether a depreciation based approach should be taken forward.

Chapter 5
Revisiting Capital Allowances

5.1 If the case for depreciation is not overwhelming (see the previous chapter), can simplification for tax relief on tangible fixed assets be delivered in another way, by improving CAs?

5.2 This chapter takes the initial OTS review in July 2017 on 'Simplification of the corporation tax return' a step further and

- considers the type of business taxpayer where administrative problems with CAs may be concentrated, to narrow down potential solutions, in the section 'Whose problem is it anyway?'
- suggests additional improvements to those identified in 2017, in the section 'Alternative approaches'

5.3 When seeking views on the use of depreciation to give tax relief for investment in tangible fixed assets the OTS did not invite views on reforming CAs. Many constructive suggestions on this were nevertheless offered by respondents who felt that CAs are not beyond repair. As the case for moving to depreciation is not clear cut it is right to refer to reforming CAs briefly in this report to encourage the debate on CAs to be taken forward.

5.4 In the July 2017 report the OTS concluded on tax relief for capital expenditure with the recommendations listed in Annex D of this report. Other than the recommendation to review the potential for using depreciation as the basis for tax relief (delivered in this report), those recommendations were very much in the context of the current CA regime. The suggestions which follow are also within that context but are somewhat wider in scope. Clearly wide consultation would be needed in their development.

5.5 Before looking at potential changes to the CA regime, the efforts already made to simplify tax relief for some unincorporated businesses are acknowledged in the box below:

Box 5.A: Are there any lessons from the Cash Basis for small enterprises which could be applied across the board to larger businesses?

When looking at ways to simplify the structure of CAs it is instructive to look at the steps already taken by the government in relation to "Cash Basis" businesses.

The Cash Basis was introduced in 2013 following OTS recommendations on the tax treatment of small businesses. As developed since then, there are two parallel regimes:

- unincorporated trading businesses with a turnover of less than £150,000[1] may elect into the Cash Basis (and they must leave the regime the year after turnover exceeds £300,000), while
- unincorporated landlords with a turnover of less than £150,000 are automatically within the Cash Basis but may elect out of it each year

The general structure of the Cash Basis is to tax income and allow expenses as paid, without the need to calculate debtors, creditors and stock. There are some restrictions to the expenses. About 1.1 million taxpayers use the Cash Basis each year.

The expense that is relevant for this review is capital expenditure on tangible assets. Here the Cash Basis regime allows an immediate cash deduction for assets which are **depreciating assets** (defined as assets with a useful life of less than 20 years)[2] **acquired or created for use on a continuing basis in the trade**, but excluding cars and land. Fixtures are included unless they are specifically excluded.[3]

The treatment of fixtures means the regime is not yet a wholehearted simplification. However, the aspects highlighted above do provide an interesting pointer to how a simplified CA regime might be structured. Of course, a regime applying to larger enterprises would need a much extended useful life definition, say 100 years.

Whose problem is it anyway?

5.6 HMRC have provided interesting information on CA claimants in recent years. The latest year for which this is available is 2015/16 and the most detailed information concerns corporate taxpayers rather than unincorporated businesses.

5.7 Chart 5.A is based on data from corporation tax returns over a 4 year period.[4] It shows that most companies do not invest in assets which qualify for CAs. Of those which do invest, most always spend less than the current

[1] Universal credit claimants have an entry threshold of £300,000

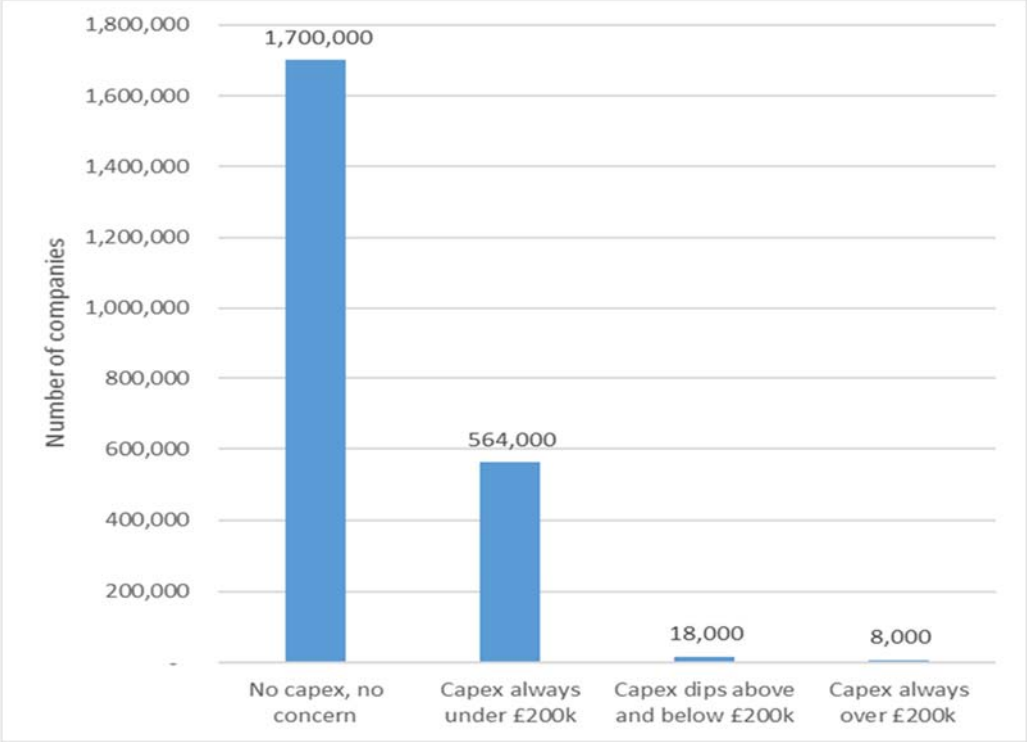
[2] Or where the value of the asset will decline in value by at least 90% in 20 years.

[3] Items not eligible include a building, gate, waste disposal system, "a shaft …in which a lift….may be installed"

[4] Companies within a group are combined together and treated as a single company

AIA limit (£200,000), about 18,000 sometimes spend above the AIA limit, and just over 8,000 consistently spend over the limit.

Chart 5.A: Number of companies with expenditure ("capex") qualifying for CAs, at different levels of spend



Source: OTS based on HMRC data

5.8 Looking at larger scale spending, the table below shows the consistency of capital expenditure (qualifying for CAs) at certain levels.

Table 5.A: Consistency of qualifying capital expenditure over a 4 year period

No. of years within the 4 year period 2012/13 to 2015/16	No. of companies spending > £200K	No. of companies spending > £2m	No. of companies spending > £20m
1	19,000	3,500	600
2	11,100	1,700	300
3	9,300	1,300	200
4	7,800	1,000	100

Source: HMRC CT 600 data, number of companies rounded to 100

5.9 Although the current AIA limit of £200,000 is a useful benchmark for the analysis above, there are caveats to the inferences that can be drawn from the chart and figures:

- during the 4 year period 2012/13 to 2015/16 the AIA was volatile, changing regularly and was never at the current level of £200,000 (see

previous OTS comments on this in the July 2017 report).[5] Consequently spend shown above £200,000 may have qualified for the AIA

- spending under the AIA limit, qualifying for CAs, does not necessarily qualify for the AIA. In particular, cars and assets previously owned for private use

5.10 However, the information about past years' corporate spending pattern does suggest the potential direction of simplifications to the CA regime.

5.11 **If an asset qualifies for the AIA and if total spend does not breach the AIA limit, no further computational work has to be done.** This suggests that determining whether an asset qualifies for the AIA should be made as easy as possible. This affects the great majority of corporate taxpayers with capital expenditure. Extending the scope of the AIA would achieve this – see paras 5.21 to 5.27.

5.12 **If an asset does not meet the test above**, either because the AIA limit has been breached, or because the asset does not qualify for the AIA, computational work must be done to allocate the asset to the correct pool. The process of classification for new assets can be onerous. Analytical templates used in-house or by advisers may cover 300 different asset types. As expressed in HMRC's Capital Allowances Toolkit, with an apt sense of mystery, "…you may also find machinery in places where you might not expect."[6]

5.13 For second-hand fixtures, the tax value of which is embedded in a property at acquisition, the s198 process described in Box 2.C in Chapter 2 means that no further allocation process is needed.

5.14 Subject to understanding more about the frequency of different types of claim the allocation process may or may not be an area where simplification matters. Two arguments are put forward as to why it might not matter:

1 the issue affects few taxpayers, and these are larger taxpayers well able to cope with complexity

2 technological change is reducing the impact of complexity

5.15 HMRC have provided information on companies, giving the breakdown between different types of claim, shown in Table 5.B. This information is approximate only, because of the AIA variation in 2015/16 noted above, and all the figures are rounded:

5 The government is committed to maintaining the AIA at £200,000 for the life of the current Parliament.

6 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/613234/Cap_All_P_M_toolkit_17.pdf

Table 5.B: Companies with qualifying capital expenditure > £200,000 in 2015/16

Companies claiming	Number of companies	Percentage of total
AIA + 18% pool	11,500	45%
AIA + 18% + 8% pools	10,000	35%
AIA + 18% + 8% + other allowances	1,500	5%
Not claiming AIA, but claiming pool/other allowances[7]	4,000	15%

Source: HMRC CT 600 data

5.16 The number of companies which need to classify assets beyond the main 18% pool is about 15,000. Linking this with other data (Chart 5.A) perhaps half of them regularly face these issues (as they consistently have qualifying expenditure greater than £200,000). For the other half, it is a less frequent, and therefore perhaps a more challenging occurrence. Better guidance especially in the form of extended lists of current asset capital allowance classifications would be most useful to this group.

5.17 For companies with smaller capital expenditure the pattern of CA claims is markedly different (see Table 5.C below). The dominating role of the AIA is not surprising. However, a significant number of companies either cannot access the AIA because of its restricted scope or have to address the difficulties of allocating assets into precise pools.

Table 5.C: Companies with qualifying capital expenditure < £200,000 in 2015/16

Companies claiming	Number of companies	Percentage of total
AIA only	490,000	83%
AIA + 18% pool	35,000	6%
AIA + 18% + 8% pools	9,000	2%
AIA + 18% + 8% + other allowances	1,000	0%
AIA + other allowances	3,000	0%
Not claiming AIA, but claiming pool/other allowances	52,000	9%

Source: HMRC CT 600 data

[7] Why would companies not claim AIA, but instead claim other allowances? This may be because the asset does not qualify for the AIA (cars, or leased assets not meeting the ownership requirement) or because of the taxpayer's circumstances (loss making companies) or because the taxpayer chooses to claim another allowance with the same effect as the AIA (Enhanced capital allowances).

Role of technology

5.18 The CAs system requires the classification of assets into different pools of expenditure. For businesses with complex construction projects or with multiple projects, or those which only have to address CAs infrequently, the responsibility to analyse accurately is onerous. However, the way that this responsibility is carried out is changing as business technology develops. Where previously manual analysis was essential, some taxpayers can now apply sophisticated techniques. These include:

- simultaneous, but separate, classification for the accounts and for tax, using highly detailed templates embedded in the accounting system
- analytical software applying set rules for most asset types, with increasing coverage as new rules are "learnt"

5.19 Manual analysis is also easier with the widespread use of templates and flow techniques to guide the delivery of information.

5.20 As access to these tools is not free taxpayers will choose the most cost effective approach for the size of the analytical task they face. Technology may make it easier to manage complexity but it does not eliminate it. The suggestions below concern making the underlying rules simpler.

Approaches to simplified tax relief

Widen AIA

5.21 The AIA is a useful relief and a simplification. Qualifying capital expenditure (see below) within an annual limit (currently £200,000 each year) can be written off in the year the expenditure is incurred. Compared with the standard CA regime this has two advantages for the taxpayer:

1 the time relief at which relief can be claimed is brought forward[8]

2 no further CA calculations are required until the asset is sold

5.22 About 30,000 businesses spend more on capital expenditure than the AIA limit and about 1.2 million businesses spend less than the AIA limit. For the latter the AIA eases some aspects of compliance with the CA regime: the initial allocation of assets between the categories qualifying for relief (classifying between the general and special rate pools) which though still needed, does not need to be carried out with full rigour, and the carry forward and writing down of tax balances.

5.23 The AIA does not help in a key area: the initial allocation into qualifying and non-qualifying assets. The entire burden of qualifying/non-qualifying classification, which is the core complication issue within capital allowances and remains so for all businesses.

5.24 Further simplification would be achieved for businesses investing less than the AIA limit if the scope of the AIA extended to all assets acquired for the business (excluding the usual categories of land and dwellings) without the

[8] A feature of the AIA is that the taxpayer can choose which assets the allowance is used against. Usually a taxpayer will choose for the AIA assets which would otherwise be written off at a slow rate.

need for further categorisation. In general, it complicates matters where boundaries and thresholds exist. It is suggested that the extension in scope of the AIA should apply to all business taxpayers, so that there are no boundaries and thresholds. Although those spending above the AIA limit may need (for their deferred tax accounting) to distinguish between "extended scope assets" which fall within the AIA and those which do not, it is a complication they might be willing to bear.[9]

5.25 The timing benefit of the AIA to taxpayers is reflected in a cost to the Exchequer. In forecasting by HMRC, this cost is treated as recurring and not simply a shift from one period to another. This treatment assumes that the AIA acts as an incentive for extra expenditure.[10] AIA in the year 2017/18 is forecast to cost £2.5bn[11] (companies £2bn and unincorporated businesses £0.5bn).

5.26 Extending the scope of AIA to assets which do not qualify at present would increase the cost because of the interaction of two factors:

1 for those taxpayers currently spending within the AIA limit, more spending would qualify and fall within the AIA limit. For example, a taxpayer spending £100,000 on currently non-qualifying assets and £100,000 on currently qualifying assets, would be able to relieve the entire spend of £200,000

2 for those taxpayers currently spending more than the AIA limit, there would be a choice to make about which spend was allocated to the AIA

   a) under the current rules, under which taxpayers can choose which assets to allocate to the AIA, such a change would lead to currently non-qualifying spend displacing currently qualifying spend. For example, a taxpayer spending £10m on currently qualifying spend (receiving the AIA for £200,000 of that and placing £9.8m in the appropriate writing down pools) and £10m on currently non-qualifying spend, would be able to claim relief by the AIA for £200,000 of the non-qualifying spend and place £10m in the appropriate pools

   b) alternatively, if it were desired to mitigate this effect – at the cost of introducing an additional complication - the rule could be changed so that currently qualifying spend had to be allocated to the AIA in priority

5.27 The current cost of the AIA is £2.5bn. HMRC estimate that the cost of an extended AIA would be less than £5bn. This is an indicative cost due to the difficulties in estimating the cost of widening the scope of the AIA, as HMRC

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9 If too onerous, the claim does not have to be made.

10 See for example, The January 2016 Oxford University Centre for Business taxation report "The impact of investment incentives: evidence from UK corporation tax returns" https://www.sbs.ox.ac.uk/sites/default/files/Business_Taxation/Docs/Publications/Working_Papers/WP1601.pdf

11 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/675345/Dec_17_Main_Reliefs_Final.pdf

do not have access to the cost of assets which do not qualify for capital allowances. Potentially, neutrality could be achieved by reducing the £200,000 limit for AIA claims, though the OTS's general view[12] is in favour of maintaining the limit at a constant level. Another approach to reducing this cost would be to continue to exclude certain assets, such as cars.

Full scope CAs

5.28 Continuing the issue of scope, the next idea for simplifying CAs is not a new one. The common thread linking concerns about the complexity of CAs is that the boundaries within the CA system create a significant administrative burden. The most difficult boundary, because the consequences are more pronounced than for other boundaries, is the cliff edge between receiving some relief and receiving no relief. It is not surprising that the analysis of assets between those that do and do not receive relief receives a lot of attention in the compliance process. The restricted scope of CAs is one of the aspects of UK tax which overseas investors find most puzzling. It also to an extent counteracts the international competitiveness of the UK's low rate of corporation tax.[13]

5.29 If the CA system encompassed all assets used in a business a major compliance pressure would go away. This would require the creation of a new CA pool for new business assets (but not land or dwellings) which do not qualify under any of the existing CA provisions, written down at a prescribed rate. Some have suggested that a widening of scope could be directly linked to the attainment of other government objectives, for example by linking the writing down rate to the energy rating of the associated building.

5.30 On its own an extension of relief would be costly. An extension could be paid for by reducing other reliefs. For example, HMRC estimate that a 2% flat rate allowance for assets which do not at present qualify for CAs, would be cost neutral if the main 18% rate was reduced to 16% and the special 8% rate was reduced to 7%. In the longer term, as the value of newly qualifying assets builds up, a greater reduction in other rates may be necessary to achieve neutrality. There would be gainers and losers with this approach. These indicative rates do not take account of any behavioural impacts triggered by the rate changes.

Accounts based CAs

5.31 Although there was not a wholly positive reaction to the potential for using depreciation as the basis for tax relief, it was recognised that some features of depreciation could form the basis for a useful simplification of the current CA regime. The suggestions below develop this approach, described as "accounts based CAs".

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12 OTS report 2017 Review on simplifying the corporation tax computation
https://www.gov.uk/government/publications/ots-review-on-simplifying-the-ct-computation

13 The June 2012 Oxford University Centre for Business Taxation report; CBT Corporate tax ranking 2012 https://www.sbs.ox.ac.uk/sites/default/files/Business_Taxation/Docs/Publications/Reports/cbt-tax-ranking-2012.pdf & Ludwig-Maximilians-Universität, Munich report: Tax Attractiveness Index http://www.tax-index.org/

5.32 The current CA regime operates by classifying assets into types and then applying writing down allowances to each type. This results in the following structure (this is a simplified version, ignoring small pools, ring fence):

Table 5.D: Capital allowances: asset types and writing down rates

	Asset type	Writing down rate
1	Land	Nil
2	Building, unless 4 below	Nil
3	Structure, unless 4 below	Nil
4	Specific assets listed in legislation, treat as 5 below	
5	Plant & machinery generally, unless 6, 8, 9 or 10 below	18%
6	Plant & machinery in dwelling house	Nil
7	Deferred revenue	Follow accounts
8	Environmetally beneficial, energy and water saving assets etc	100% FYA[14]
9	Single asset types: ships, contributions, Short Life assets, personal use assets	8% or 18%
10	Class based 'special rate pool': integral features, long life assets 25 years, thermal insulation, high CO_2 cars	8%

5.33 The accounting treatment for depreciable fixed assets (described in Chapter 2) follows the path:

1 **Recognition** Does an asset exist? Identify the major components

2 **Initial measurement** What are the costs?

3 **Depreciation** When the asset is available for use, spread the cost less residual value over the useful life using a depreciation method which reflects the pattern in which the business expects to consume the benefits of the assets

5.34 Accounts based CAs would use the categorisation and lives determined for the accounts. With this regime, there would be CA pools for the accounting categories with writing down allowances (all reducing balances) given for each pool, at a rate determined by the government.

5.35 Some assets would remain unrelieved: land because it is generally recognised as not reducing in value through use and other assets, for example dwellings, where there is a policy reason not to give relief.

5.36 To illustrate what this might look like, three alternatives are set out below. The writing down rates are merely illustrative, the OTS does not have views on appropriate rates.

5.37 One approach would replicate the asset types in the accounts and apply a writing down rate, as shown below:

[14] FYA: a 100% capital allowance given without a maximum cap on a selection of environmentally beneficial assets.

Table 5.E: Approach 1, using accounts asset types

Example asset type disclosed in the accounts	Writing down rate
Buildings/structures	2%
Plant & machinery	10%
Fixtures, fittings, tools & equipment	15%
Payments on account and assets in course of construction	Nil

5.38 The approach above could be refined using the lives determined for the accounts:

Table 5.F: Approach 2, using accounts asset types and asset lives

Example asset type disclosed in the accounts	Writing down rate, based on accounting asset life		
	<5 years	5-25 years	>25 years
Buildings/structures	N/A	4%	2%
Plant & machinery	25%	18%	8%
Fixtures, fittings, tools & equipment	25%	18%	8%
Payments on account and assets in course of construction	N/A	N/A	N/A

5.39 Or more radically, an approach based wholly on lives, without regard to any other aspect of the asset. This is perhaps more appropriate in the future world where asset descriptions are likely to become more difficult to interpret as tangible and intangible assets morph.

Table 5.G: Approach 3, using accounts asset lives

Example asset type disclosed in the accounts	Writing down rate, based on accounting asset life		
	<5 years	5-25 years	>25 years
Any business asset recorded in the accounts (not land, not dwellings)	25%	15%	5%

5.40 The key differences between CAs and accounts based CAs are set out in Table 5.H below:

Table 5.H: Key differences between CAs and accounts based CAs

	CAs	Accounts based CAs	Comments on accounts based CAs
Which assets?	Specified classes of assets only, not universal coverage of business assets	All assets used by a business recorded in its accounts	Boundary issues recede Re-classification of assets for tax no longer required
What WDA?	Rate determined by government	Rate determined by government	Control remains with the government, able to incentivise chosen asset types at will

5.41 At first sight there is little difference between the categories used for tax and for accounting so (other than the extension of scope) the advantage of accounts based is not immediately apparent. However, the similarity of names masks the very detailed exercise needed to categorise some assets for CAs. As one respondent said "most time is spent aligning expenditure to the tax definitions and separating out qualifying and non-qualifying expenditure".

5.42 There would still be a difference between the timing of CAs and the timing of accounts depreciation, so there would be an on-going need for deferred tax calculations.

5.43 For accounting purposes a business may reconsider the useful life of an asset and reset the life if something changes, for example if a technological change makes an asset obsolete. There could be an argument that such a change should be reflected in the rate of tax relief (and this of course would occur naturally with a depreciation based approach). However, the driver for accounts based CAs is simplicity so the accounting life determined when the asset is first capitalised should trigger the allocation into a CA pool and that allocation should remain unchanged.

5.44 As with a depreciation based approach, the ideas above would only deliver simplification if HMRC accept the view on asset categories and lives implicit in the accounts. See the discussion on this at paras 4.32 to 4.33.

5.45 Taking a broad view of the suggestions outlined above, they clearly have one aspect in common as a route to simplifying CAs: they all to a greater or lesser degree involve extending the scope of CAs.

Conclusion on revisiting capital allowances

5.46 The focus of this report was to consider whether it would be a simplification to use accounts depreciation instead of CAs to give tax relief for tangible fixed assets. Although feasible, it would not be straightforward, particularly as it is difficult to isolate depreciation from wider tax considerations. Respondents did not give a wholly positive reception to the idea.

5.47 This report was prompted by concerns about the administrative burden of compliance with the current CA regime. During the OTS review into the corporation tax return in 2017 and, unprompted, as part of the consultation for this review, suggestions have been made for the simplification of CAs.

5.48 The recommendations put forward by the OTS in 2017 and the further three areas outlined in this chapter show that there is considerable potential to simplify CAs. If that is done, there is no conclusive case in favour of using depreciation.

Annex A

Scoping document

The use of accounts depreciation instead of capital allowances as a way of giving tax relief for investment in tangible assets

Introduction

A.1 Corporation tax (CT), being a tax on net profit rather than turnover, allows relevant expenditure to be deducted.

A.2 Both for accounting purposes and for CT, capital expenditure on tangible assets is not deducted as the expenditure is incurred but, rather, over time - to reflect the way in which the value of the asset will fall over time.

A.3 However, while in accounts the expense is recognised in the form of depreciation, for tax purposes companies obtain relief in the form of capital allowances (CAs).

Background

A.4 During the OTS's corporation tax computation review, CAs were flagged as an area of complexity in almost every meeting the OTS had with businesses and advisers.

A.5 The review found that a major source of this complexity is the uncertainty around the 'boundaries', for example, working out whether an asset qualified or not or which writing down rate should be applied. It also found that businesses feel there is a disproportionate administrative burden in classifying assets when claims are made, in relation to the value of the tax relief. Other feedback received indicated that businesses were sometimes unclear as to the broader policy intention of the CAs regime as the rules are not consistent with the commercial reality as reflected in their accounts.

A.6 The report, published in July 2017:[1]

- concluded that to reduce the current burden, and to create a simpler system, these issues of uncertainty as regards boundaries and policy objective are important ones to address
- proposed a number of practical steps towards simplifying the current CAs regime, which if implemented, could simplify the current CT system, and
- proposed consideration of broader and more radical approaches, including replacing CAs with accounts depreciation (and extending their

[1] https://www.gov.uk/government/publications/ots-review-on-simplifying-the-ct-computation

scope in the process), but cautioned that the impacts of this would need to be carefully considered

A.7 Replacing CAs with a deduction for accounts depreciation would align the tax position with the accounts, removing the need for separate calculations.

A.8 This is the work to which this document relates. The question of how the cost of financing expenditure on capital tangible assets should be relieved for tax purposes is outside the scope of this review.

A.9 The use of accounting depreciation instead of capital allowances would be dependent upon resolving a number of significant issues arising from the change, including the potential for fiscal cost, avoidance opportunities and likely winners and losers.

A.10 The Chancellor, responding to the CT review on 14 August 2017, requested a review to further the debate in this area. The OTS aims to publish its report in Spring 2018.

Scoping for the further review

A.11 The Chancellor has asked the Office of Tax Simplification (OTS) to undertake a review exploring the impact and challenges of replacing CAs with accounts depreciation, following on from its CT computation review.

Aims and objectives

A.12 To explore the impact and challenges of moving to accounts depreciation, as a potentially simpler system, with a view to setting out various options as to how this may be achieved and their impacts.

A.13 The work will need to set out who might be better off or worse off (the 'gainers and losers'), including ways in which such a change could be made revenue-neutral, and the benefits and challenges involved including implementation and transitional issues. The work will include consideration of options which distinguish businesses by size and sector.

A.14 The report is dependent on the availability of new data analysis within the timescale, either based on deeper analysis of existing sources or on commissioning new data sets.

A.15 The report will enhance understanding and engagement within this area and prepare the ground for further debate.

Framework for the review

A.16 The review will consider evidence already available, and commission and publish new analysis and data to encourage an informed debate on the issue. This will include consideration of a combination of technical and administrative questions and related non-tax issues including:

- the nature of accounts depreciation and the role of judgement in its quantification
- the current practices of companies in deciding on rates of depreciation and typical rates used for different types of assets

- the industry/sectoral impact of adopting accounts depreciation and whether this impact varies on region or size of a company
- the potential to mirror the effect or accommodate certain existing tax reliefs (such as the Annual Investment Allowance) within an accounts depreciation model
- the legislative, administrative and exchequer impacts of the options proposed, including in response to avoidance risks
- the transition arrangements required to move to a new system and their impact
- to what extent the proposed changes would impact unincorporated taxpayers
- the impact on the administration burdens on business and the operational impact on HMRC.
- international considerations and comparisons

Resources and methodology

A.17 The OTS will work closely with data specialists, including HMRC's Knowledge, Analysis and Information ("KAI") experts. The OTS will also engage with HM Treasury, BEIS and policy specialists from HMRC. The team will work with the Administrative Burdens Advisory Board (ABAB) which advises HMRC.

A.18 The OTS will consult with representatives from impacted stakeholder groups and take account of relevant international experience. However, the nature of this project means that the emphasis will be on data analysis and testing and evaluating potential impacts. As always, the OTS will welcome contributions from interested parties.

A.19 A consultative committee will provide specialist guidance and challenge.

Annex B

Consultative Committee

We are very grateful for the time and support of our Consultative Committee members.

Stephen Dowers	BDO
Simon Goldie	Finance & Leasing Association
Neil Harris	BT plc
Ian Mackie	FTI Consulting
Helen Miller	Institute for Fiscal Studies
Lynne Oats	University of Exeter
Michael Parker	National Union of Farmers
Katie Selvey-Clinton	EY
Margaret Stephens	Infrastructure Forum

Annex C

Who we met

We are very grateful to the wide range of bodies and businesses who gave their time to meet with us and for the submissions we have received. We have listed them below and apologise to any that we have inadvertently omitted.

Association of Accounting Technicians

AECOM Ltd

Affinity Water Ltd

ALDI

Anglia Water Group

Association of Licensed Multiple Retailers

Association of Tax Technicians

BDO

British Property Federation

Association of British Independent Oil Exploration Companies

Bristol Water

BT

Capital Allowances Partnership

Cadent Gas Ltd

CBI

Chris Doyle

Chartered Institute of Taxation

Co Op

Cook Partners

Dairy Crest

David Rees & Co

Electricity Tax Forum

Energy Companies (Joint Submission by 12 companies)

Johnston Carmichael

Knight Frank

KPMG

Lovell Consulting

Mazars

Mently Farm

Mercia Group

Moore Stephens

National Grid

National Farmers Union

Ørsted (UK) Ltd

PKF Cooper Parry

Primary Care Premises Forum

Ray Chidell

Royal Mail

RSM

Savills

Scottish Power

Scottish Water

Sky

Stanley Tax Associates Ltd

Stuart Rivers Associates

Tesco

Thames Water

Engineering Employers Federation

Environmental Services Association

Eversheds Sutherland

EY

Federation of Small Businesses

Finance & Leasing Association

Furasta Consulting

Gateley Capitus Ltd

RJ & AE Godfrey

Grant Thornton

Grosvenor Group

Haren Visavadia

Heathrow Airport Ltd

Henry Consulting

HOW2

ICAEW

IMH Advisory LLP

Institute for Family Businesses

Investment Property Forum

The British Vehicle Rental and Leasing Association

The Capital Allowance Partnership Ltd

R Torrance & Son

UK 200 Group

UK Green Building Council

UK Oil Industry Taxation Committee

UK REITS (Joint Submission)

Unite Students

United Utilities Group

URENCO

Utilities Tax Group (Joint Submission by 5 companies)

Veritas Advisory

Water UK

Welsh Water

Wessex Water

Wilmot Dixon

Winmark

Annex D

2017 OTS Capital Allowances recommendations

Summary table

	Aligning corporation tax with the accounts: Recommendations	Short term	Medium term, link to MTD	Long term
4	Tax to follow accounts for capital / revenue distinction to reduce the burden of having to analyse capital expenditure for tax purposes. Also consider allowing abortive capital expenditure.		✓	
	Capital Expenditure: Recommendations	**Short term**	**Medium term**	**Long term**
1	Changes to the CA regime should be accompanied with clear statements of the policy objectives	✓		
2	Further work be done to explore more fully the impact of replacing CAs with accounts depreciation.	✓		
3	Introduce a small capital exemption to allow 100% deduction for capital expenditure worth less than £1,000 per item	✓		
4	Develop a proposal to provide specific guidance, by way of a list, of all assets qualifying for CAs as a single point of reference		✓	
5	Improve current non-statutory clearance process in regards to CAs regime.	✓		
6	Review the effectiveness and compliance process for making a s198 election	✓		
7	Review the effectiveness and compliance process for making a ECA claim	✓		

Source: OTS Review of CT Computation, July 2017

Annex E

Tax relief for fixed assets since 1945

E.1 Before 1945 tax relief for expenditure on plant and machinery was given as a 'wear and tear allowance'. In practice relief was based on the historic cost of the asset being replaced.

E.2 Income Tax Act 1945 introduced, with effect from 6 April 1946, a system of capital allowances designed with the intention to encourage the reconstruction of post war British industry. The new system introduced features that we would recognise today in having initial allowances and writing down allowances (WDA), plus balancing charges and allowances when the asset was sold or decommissioned.

E.3 Originally the rate of initial allowance was set for plant and machinery at 20% in the year of purchase plus an annual writing down allowance at 25% in each later year of active ownership. These rates were applied on an asset by asset basis.

E.4 Different rates of WDA's soon proliferated to such an extent that in 1962 these were reduced to just 3 rates of 15%, 20% and 25%. Assets were also pooled within these rate categories for annual allowance purposes, although not for balancing charge or allowance calculations. On disposal, figures for individual assets had to be unscrambled from the pool totals, so complications remained.

E.5 This was rectified from 1972, when the three pools were combined and balancing charges and allowances largely eliminated. This was a considerable simplification which materially reduced the administrative burden and number of calculations required. At the same time, initial allowance, now called 'First Year Allowance' for plant and machinery was increased to 100% on all new purchases.

E.6 Except for the phasing out of First Year Allowance from 1984, the introduction of different arrangements for short life (< 4 years) and long life (>25 years) assets and additional rules to encourage socially desirable expenditure, the system remained much the same until 2008.

E.7 The main features of the major 2008 reforms were:

- the introduction of an Annual Investment Allowance (AIA)
- this provided a 100% deduction on the first £50,000 of capital expenditure on plant and expenditure
- AIA has subsequently been changed to £100,000 (2010), £25,000 (2012), £250,000 (2013), £500,000 (2014) and £200,000 (2016 to date)

- a small pools allowance which writes off all pool balances less than £1,000
- a payable credit if business have losses resulting from reliefs for capital expenditure on environmentally friendly plant and machinery
- reduction in plant and machinery pool rate to 20%. Subsequently reduced to 18% in 2012
- creation of a new 'Special Rate Pool' (initially with a writing down rate of 10%, later reduced to 8%) for long life assets and cars with high CO_2 emissions
- creation of a new asset classification for 'Integral Features', being functional systems within buildings, to be included in the special rate pool. Expenditure on integral features qualifies for inclusion within the AIA

E.8 Finally, but importantly in the context of this review, capital allowances were introduced for industrial and agricultural buildings and structures in 1948. Apart from a few changes of rates, including the removal of high initial allowances, the system remained largely unchanged until phased out in 2011 as part of the 2008 reforms mentioned above. In consequence, the overall scope of tax relief for tangible fixed assets was significantly reduced.

E.9 The changes to the CA regime in 1984 and 2008 were linked to reductions in the rate of corporation tax (but not income tax).

Annex F

Tax relief on business capital expenditure - an international view

F.1 Capital expenditure relief systems used by other national taxation regimes were reviewed as part of the research for this project. What became apparent is that by whatever name the relief is known the framework is set by the government and not by an accounting authority. They are quite different from the UK pooled category approach.

F.2 Generally, national tax capital expenditure relief systems have the same general characteristics:

- calculated on a unit basis
- standard government-dictated depreciation rates, or asset lives, are used
- straight line depreciation dominated, although declining balance methods can be claimed in some jurisdictions
- business buildings were usually depreciated
- land is not depreciated

F.3 For further details of capital expenditure relief given in a selection of other countries refer to table E:B in OTS report 'Simplification of the corporation tax computation', page 97, published July 2017.

F.4 However, within that general picture, the level of prescription, in particular as regards depreciation rates, varies. However, importantly, the OTS is not aware of any system which is wholly based on accounts rather than being government directed to some extent.

F.5 Where governments largely determine the rate of tax depreciation, this generally runs alongside a prescriptive approach to accounts preparation internationally, which is quite different from the culture in the UK and Ireland where reporting is on the basis of the substance of transactions.

F.6 The rates set and how rigidly they are applied by respective governments vary considerably.

F.7 In Germany, the official position is that tax deductions follow the accounting treatment but the tax authorities issue guidelines of approximately 300,000 depreciation rate categories. For accounts preparation, it is common place to use these guideline depreciation rates and so in reality accounts treatment follows the tax treatment, potentially to the detriment of the accuracy of the accounts.

F.8 France has a similar policy of the depreciation rates officially being only for guidance but there are so many adjustments to make that asset capital expenditure calculations are time consuming.

F.9 The USA has particular complexity, as the approach to asset depreciation in financial statements and for taxable profits are both prescribed, but in different Acts of Congress. This throws up some unnecessary complications, for example buildings being depreciated over 40 years in accounts but over 39½ years for tax purposes. In addition, as the tax depreciation is determined by legislation framed in 1986 and takes no account of subsequent technological developments, taxpayers are forced to classify a device to its nearest 1986 equivalent. American practitioners informed us that they and most businesses are reliant on specialised asset software as only the simplest depreciation affairs can be managed manually.

F.10 In Turkey, there are 760 different asset depreciation rates. If an asset does not fit into any of these categories, then the taxpayer must obtain a finance ministry rate ruling for the asset in question.

F.11 In Argentina, tax write off periods are set by government. However, a taxpayer can make a technical submission for a quicker write off period if it would be more appropriate to their situation.

F.12 The Netherlands appears to have a particularly light touch. Much freedom is given to the depreciation methodology allowed but the government sets maximum allowable deductions.

F.13 Although not quite the same thing these last two approaches are the closest systems the OTS is aware of to an approach where accounts depreciation is wholly allowable for tax.

F.14 What is plain is that while a depreciation system is superficially simple there is an additional layer of hidden complexity. The practical reality is that even for a modest-sized business, having to record, monitor ownership history, classify and negotiate with the tax authorities on an individual asset basis, is a considerable administrative burden.

F.15 The only other country which has a capital expenditure relief system that has developed away from the international standard approach is Australia. The system there is part asset-by-asset recording and part a pooling structure. In the OTS paper 'Simplification of corporate tax computation', page 58, it was noted that the Australian tax authorities publish an extensive list detailing the effective lives of depreciating assets.[1] This demonstrates that that such extensive guidance is possible.

[1] http://law.ato.gov.au/atolaw/view.htm?locid=%27ITD/EF20171%27&PiT=99991231235958

Annex G

Data source for modelling tax relief for tangible fixed assets using accounts depreciation

Accounts depreciation data

G.1 The data is based on information submitted to HMRC within the Corporation Tax (CT) accounts, via the eXtensible Business Reporting Language (XBRL) format.[1] The total depreciation charge for the year along with any impairment losses are extracted from the CT accounts, where available. The latest full year of data available to HMRC relates to accounting periods ending within the financial year 2015-16.

Data limitations

G.2 XBRL data is dependent on companies tagging the required information within the CT accounts. An estimate has been made of the proportion of companies not tagging the required information and an uplift has been applied to the tagged depreciation data to account for this.

G.3 Other sources of data have been considered by HMRC, however even though XBRL data is dependent on companies tagging the depreciation information, it was still found to be the most representative and relates to what companies actually submit in their accounts.

G.4 Unincorporated businesses do not submit the same level of information to HMRC therefore depreciation data is not available. Depreciation data for unincorporated businesses is estimated using the proportion of total capital allowances claims they represent and is therefore only indicative.

ABD Model

G.5 The ABD model uses the Office of Budget Responsibility's (OBR's) latest published economic forecasts to project the 2015-16 data into the longer term.

G.6 Costs of the accounts depreciation regime are compared to costs of the current capital allowances regime. The exchequer impact is modelled as the difference between these two costs.

1 https://www.gov.uk/government/publications/xbrl-guide-for-uk-businesses/xbrl-guide-for-uk-businesses

G.7 A behavioural adjustment is made to account for the possibility of businesses depreciating assets faster under the accounts depreciation regime.

G.8 Oil and gas companies that are part of the ring fence CT regime are excluded from the HMRC ABD model.

G.9 It should be noted that HMRC's model has not been considered by the OBR as currently this is not a policy measure being taken forward. It would be subject to OBR sign off at the appropriate fiscal event if in the future there is to be a policy change and would therefore be subject to change.

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