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CAPITAL ALLOWANCES CLAIMS UNDER THE SPOTLIGHT

Introduction

The recent news that HM Revenue and Customs (HMRC) have set up a new unit to handle the tax affairs of high-net-worth individuals, should be of particular interest to property investors and their tax advisers. HMRC has stated that any wealthy taxpayer with complex tax affairs could come under the spotlight, so it is logical to assume that property investors and their Capital Allowances claims will be subject to an increased level of scrutiny from now on.

Our comments are restricted to claims for plant and machinery allowances, the main type of relief likely to be of interest to property investors.

HMRC have said: "The new high-net-worth unit will ensure an integrated and consistent approach to this customer group". Rather than the current inconsistent approach where many Capital Allowances claims are not queried, it may become much more the norm for any sizeable claim to be investigated. This being the case, what then are the risks for the taxpayer?

The risks of getting a Capital Allowances claim seriously wrong can be considered under the following:

- (1) Valuation risk.
- (2) Entitlement risk.

Valuation Risk

This is likely to involve the Valuation Office Agency (VOA), whereas the second category is the domain of the individual Tax Inspectors.

Valuation risk relates to the method of establishing the qualifying expenditure. This can either involve the identification of qualifying costs for a construction or refurbishment project, or it can involve the apportionment of expenditure for a property acquisition. In the case of the later, it will be necessary to apportion the price paid for a property between the non-allowable land and building and the qualifying plant and machinery as required by the Capital Allowances Act 2001 (CAA 2001), Section 562. This is usually achieved by adopting a formula method that is approved by VOA and HMRC.

It is the standard HMRC approach to refer claims to the VOA for input by the District Valuer (DV) and the Regional Building Surveyor (RBS). In the case of a claim on a property acquisition, the DV will check the amount apportioned to land, as well as the method of apportionment itself. The RBS, on the other hand, will check the cost data utilised for the building components and the plant and machinery items. For construction and refurbishment claims, the RBS will look at how certain items have been apportioned, usually preliminaries and professional fees. The VOA will usually provide the Tax Inspector with a 'non negotiated' valuation of what the VOA believe is reasonable in respect of a Capital Allowances claim, often significantly lower than the taxpayer's claim. The taxpayer could then be faced with a prolonged negotiation.

One way for the taxpayer to mitigate against valuation risk is to ensure that the Capital Allowances claim is based on very sound data, which can be readily supported. The taxpayer should, therefore, have excellent comparables to support the land value used, the cost data should be within industry standards or supportable for exceptional circumstances and the method of valuation should accord with HMRC's approved approach. In the case of claims on construction or refurbishment projects, the method of apportioning on-costs should be legally defensible, i.e. based on case law.

Entitlement Risk

Entitlement risk relates to rules within CAA 2001 that specify whether a taxpayer is entitled to any Capital Allowances and if there is an entitlement, whether that entitlement is restricted below the cost incurred by the taxpayer. This necessitates far more than deciding whether an item is plant and machinery, which in itself involves a consideration of both statute and case law, but rather the legal aspects that dictate the level of allowances available. In the case of a property acquisition, these legal aspects include the interest being acquired, the long funding lease rules, anti-avoidance legislation and probably most importantly, claims by previous owners.

The level of plant and machinery allowances for a property acquisition is restricted to the most recent disposal value of the previous owners of the property in accordance with CAA 2001, Section 185. This is a complicated piece of legislation that basically requires the taxpayer to have knowledge of any Capital Allowances claim made by any previous owner who disposed of the property on or after 24 July 1996.

It will be appreciated that such information is not always readily available. Some of the previous owners may be resident outside of United Kingdom, or their whereabouts may not be known, or they may have ceased to do business, or may simply not co-operate in providing the necessary information to the current owner.

The following quote taken from HMRC's Capital Allowances manual at CA26400 should leave the property investor in no doubt as to the necessity of providing confirmation of any claims by previous owners:

"It is the responsibility of the taxpayer to obtain and provide details of the past owner and the disposal value. Where it seems likely that Section 185 will apply but the taxpayer does not provide details of the previous disposal value, no allowances should be given as the previous disposal value may be nil or negligible".

In the past, HMRC has often assisted the taxpayer by investigating the tax returns of previous owners when the above information is not readily available. This policy, however, may in future be considered at odds with HMRC's new focus on compliance for high-net-worth individuals. If reports that HMRC aims to collect an additional £7 billion in tax over the next three years are true, it seems highly likely that the property investor will be required to 'prove it, or lose it' as far as Capital Allowances claims are concerned.

So where does this leave the property investor?

Well, there should be an acceptance that Capital Allowances claims are more likely to be scrutinised in future. Claims will therefore fail without the essential legal support, or be subject to very large reductions if the valuation data cannot be substantiated. This will lead to increased tax charges, interest on late payments of tax and even penalties of up to 100% of the tax due in cases of negligence.

In addition, the property investor could suffer increased compliance costs in the future as HMRC are more likely to investigate future Capital Allowances claims when previous claims have been successfully challenged.

For further advice concerning any of the issues raised in this briefing, please contact one of our key individuals detailed overpage, or alternatively call our helpline on 0800 526262. Information on other property tax related topics can also be found on our website at <http://bankingtaxfinance.davislangdon.com>.