BDO

Tel: +44 (0)20 7486 5888
Fax: +44 (0)20 7487 3686
DX 9025 West End W1
www.bdo.co.uk

55 Baker Street
London W1U 7EU

J Layzell
HM Revenue & Customs
CT Innovation & Growth
Business, Assets & International
3C/21, 100 Parliament Street,
London,
SW1A 2BQ

Ref SW/NB
30 June 2022

Dear Joe

Capital Allowances reform

It was good to meet with you and the team on 10 June 2022 and as discussed, BDO is pleased to be able to respond to this policy paper on Potential Reforms to UK's Capital Allowance Regime.

We have attached detailed comments below but in summary we believe that achieving the Government's objective of increasing business investment in the UK will require two key commitments:

1) Significant investment in the form of capital allowances that are eye-catching for both UK and Global businesses (acknowledging that this could be at a high cost to the exchequer).
2) A clear commitment to maintain the capital allowances available for a significant period (a minimum of five years) to give businesses certainty through their investment cycles that they can plan and use the allowances.

If you have any questions on our observations, please don't hesitate to contact me.

Yours sincerely

Steve Watts
Tax Partner / Real Estate & Construction

+44 (0)20 7893 3369 (DDI)

BDO LLP, a UK limited liability partnership registered in England and Wales under number OC305127, is a member of BDO International Limited, a UK company limited by guarantee, and forms part of the international BDO network of independent member firms. A list of members' names is open to inspection at our registered office, 55 Baker Street, London W1U 7EU. BDO LLP is authorised and regulated by the Financial Conduct Authority to conduct investment business

BDO

General comments on business investment trends

Investment decisions
In our experience as business advisers, the way businesses make investment decisions varies hugely depending on their size, complexity, ownership structure and sector in which they operate. However, one common factor that we observe frequently is that investment decisions have a long gestation period, and planning to implement them may take a number of years: in short business cycles for significant capital investments run at least 3 to 5 years and often longer. For example, in the hospitality sector, major refurbishments usually occur on a 7-to-10-year cycle.

This means that, in most instances, short lifespan incentives to invest, like temporary first year allowances (FYAs), have only a small effect at the margins, where businesses are able to advance or delay planned investment projects. In practice, the business will often plan what investments it needs to make, and see what capital allowances it can claim after the event. For start-ups and some larger businesses in capital intensive industries, the business may either have trading losses or have excess capital allowances that far exceed trading profits. For such business, changes in rates of capital allowance can be of very little significance, and do not affect investment decisions.

Of course, the availability of capital allowances will often be modelled in the cost/benefit analysis for an investment project, but this will always have a fair degree of uncertainty, as the reliefs available may have changed by the time the investment is made, or during the period of a project.

Naturally, investment decisions are not made on tax criteria alone; in the majority of cases, it is the wider economic situation of the UK that has the principal impact on large investment decisions. For example, there has been a marked downturn in UK businesses' investment since 2016, and the impact of the COVID pandemic has simply added to the uncertainty for businesses. The impending rise in corporation tax is also not attractive.

Globally, the attractiveness of the UK as a business investment location is based on many criteria beyond tax incentives. The government will be well aware that good transport and business infrastructure, the legal system, skills base and financial system all have an impact on business investment levels.

Providing stability and certainty are the most important things for a government to deliver to encourage business investment. In times of uncertainty, although sound capital allowances can help to redress the balance, that will only go so far. For example, an ongoing trade dispute with the EU would significantly undermine the likely success of any new capital allowances regime.

Returning to the scope of this capital allowances review, it is clear to us that providing long-term certainty as well as attractive rates of tax relief for capital investment will be key building blocks needed in helping to rebuild the UK's global reputation as a good place for business investment. Past governments have successfully used a tax "road map" to set out their long-term plans to support businesses – we believe that a similar plan setting out the long-term goals and plans for capital allowances would be greatly appreciated by businesses, and actually be taken into account in their investment decisions.

We suggest that the government considers creating a long-term corporation tax plan (we would suggest a 10-year period) focussing on investment incentives for businesses and setting out:

- What reliefs will be available, and when
- What the rate of corporation tax is expected to be
- Minimum rates of capital allowance relief businesses will obtain throughout the period
- Clear and simple qualifying criteria for the reliefs listed.

Without this type of comprehensive plan, we believe that uncertainty will undermine the impact of the reliefs that are on offer and, therefore, much of the impact that the government seeks to obtain from funding capital allowances will be lost and the funding effectively wasted.

It would also be helpful if the plan sets out when rates of capital allowance will be reviewed to assess their effectiveness (e.g. every 5 years), and how much notice will be given before tax changes are made. Barring emergency situations (such as another pandemic), we believe businesses should be given a minimum of 24 months' notice before any changes are made. We do not believe that constant changes in capital allowances will achieve the results that the government intends, and may instead lead to wastage of funding.

The Super Deduction
In our experience, the announcement of the super deduction created more interest from clients than any other capital allowance changes for many years. It is clear that the 130% rate of allowance caught the attention of businesses, and many have contacted (and continue to contact us) to check the qualifying rules and whether their planned investments will qualify.

Aside from a number of initial complexities around qualification for property owners, the main difficulty that client businesses have experienced surrounds the timing of their investments: many will not have been able to advance their investments or bring assets into account in sufficient time to claim the super deduction.

So, while many clients have or will be able to claim the super deduction, others will not, and it is difficult to say how much real impact the allowance will have in bringing forward expenditure – particularly as the overarching economic situation is not currently favourable (giving businesses strong reasons to delay making capital investments). We would expect that the final impact of the super deduction on overall business investment will be limited – perhaps a larger decline in investment may have occurred without it, but we would not expect to see a substantial increase in business investments in the UK in 2021/22 and 2022/23.

You will be aware that prior to the Spring Statement, many business organisations lobbied for the super deduction to continue. Although that is not the government's intention, it clearly illustrates that businesses prefer tax incentives that have long lifespans that are easier to work into their investment planning timetables.

The current system of capital allowances
The UK's system of capital allowances has evolved constantly over many years, and this evolution has, in practice, led to complexity in many areas: for example, the process for making elections on disposals.

For reasons of certainty (as set out above) we believe that the rules should not be changed on a frequent basis, but should rather be allowed to remain fixed for at least 5 years at a time, to allow businesses to be sufficiently familiar with them to be able to plan for them when making investment

BDO

decisions. Every change erodes certainty and, to some extent, the effectiveness of the allowances as business incentives.

As the Spring Statement illustrates, the UK's capital allowance regime is not the most attractive in global terms. Reforms to the current regime to make it the most advantageous in the world would obviously be welcomed by businesses, albeit only as part of the puzzle in increasing business investment in the UK.

In our view, the key differences between the UK's capital allowance regime (pre-COVID) and the others listed as more attractive in the analysis by the Tax Foundation centre on two issues:

- The absence of substantial first year allowances (or effective 'expensing' of investments), and
- The long write-down period for structures and buildings allowances (SBAs).

Full expensing of capital expenditure is rarely available in major jurisdictions, but we agree with the Tax Foundation that it should be seen as the 'gold standard' for business investment incentives, bringing much needed certainty to planning investments when it is available. We believe that where full expensing is available, it would have some impact on the investment decisions made by multinational companies – although it will be only one of many factors that they take into account for any given project.

The 33-year write-down period for SBAs is too long a time horizon for most businesses, and offers no real incentive to invest in a building or structure. However, we note that the recently introduced 10% rate of SBAs for new buildings and structures in Freeport locations is much more likely to act as an incentive.

Comments on specific options proposed

Increasing the permanent level of the Annual Investment Allowance (AIA)
The relative simplicity of the AIA makes it attractive to businesses, and since the annual limit became £1m in 2019, it has become widely used and relied on by businesses in all sectors – it is straightforward and generous, and it works well for businesses.

By the time the AIA is due to return to £200,000, the £1m limit will have been in place for four years, and we believe that many businesses will be expecting (or at least hoping) that this limit will be maintained or even increased when the super-deduction expires. Although the increased limit has been available for the last four years, the increased AIA was introduced initially for two years and then extended for additional years at subsequent Budgets. This does not provide the certainty required to encourage investment, and we would recommend that the AIA is set at a sufficient level and for a minimum period of five years.

Setting the limit at £500,000 for 2023/24 would clearly be a disappointment to many businesses, so it will be helpful to give businesses certainty on the new limit as far in advance as possible. We believe that reducing the limit would be a missed opportunity and send the wrong message to businesses.

Please also see our comments on full expensing below.

BDO

Increasing the rates of Writing Down Allowances (WDAs)
The small increases (2%) proposed may reduce the impact of increasing the rate of corporation tax from April 2023, but are unlikely to influence business investment decisions for reasons outlined above.

As illustrated in our comments on the super deduction above, to capture the attention of companies and their finance directors, the increase in the rate of relief will need to be high and guaranteed for a significant period to have a material impact on spending plans.

The proposed increases represent a minor adjustment which may leave companies no worse off than they expected. As they are unlikely to have a material impact on investment decisions, it could be reasoned that the taxpayer funding required for such an increase may be more effectively used in other ways.

Introducing general First-Year Allowances (FYAs) for qualifying expenditure on plant and machinery
Reintroducing a general FYA at 40% (and 13% for special pool assets), similar to the allowance that expired in 2010, will have the benefit of being familiar to many longstanding businesses. However, they are also likely to remember the temporary nature of the allowance - with the SME version changing frequently during its lifespan. At the levels suggested, particularly in relation to the special pool assets, it is questionable whether this would stimulate investment to the level required.

While we agree that an FYA will increase the speed of overall payback on business investments, unless it is guaranteed to be in place for 5 years or more, it may not offer sufficient certainty to effect investment decisions in practice. If the government does not want to make a long-term commitment to offering an FYA of this type, it may be more cost-effective to offer other reliefs instead.

Introducing an additional FYA (on top of full writing down allowances)
In addition to the points we make above on predictability of FYAs, we suspect that such a ‘top-up’ allowance at just 20% may be seen as a very small incentive (especially in relation to the super deduction that is expiring). As the timing difference is often more important than the amount of allowance, a year one allowance is likely to be more of an incentive than an enhanced deduction spread over many years. This option may also increase complexity when considering interaction with the AIA and future disposals, etc. For this and other reasons already stated, we would not expect an allowance on this scale to have any material impact on business investment decisions.

Introducing permanent full expensing
The Policy Paper and Spring Statement both refer to the high cost of full expensing, and we would agree it seems likely that the cost, in pure cashflow terms, will be significant. However, if full expensing is agreed to be the “gold standard” for business investment incentives, there must also be opportunity costs of not offering a globally competitive incentive.

Until the precise impact and cost of the super deduction is known, it will not be possible to make sensible forecasts for the costs of full expensing. Indeed, we would argue that the cost of full expensing during difficult economic times is likely to be less than the cost during favourable times when investment levels are naturally higher. However, it would be possible to progressively move

towards full expensing as a long-term goal in a controlled way that allows HM Treasury to build up a better picture of the likely costs.

One way to cap costs would be to increase the AIA to a substantial amount – say £5m a year: this would effectively provide full expensing for most SMEs and some larger companies in many sectors. Fixing the AIA at a minimum of £5m for at least five years would provide certainty to businesses and give the government the option to increase the threshold to expand full expensing if the policy is successful and deemed to be cost-effective, as more data on uptake is gathered.

We recognise that this would not have a significant impact on capital intensive business sectors until such point as the capped amount had increased substantially, however, we believe that this is a relatively simple way to limit the tax reliefs given to companies that would make business investments regardless of the reliefs available.

Other options to consider

Surrenderable tax credit

The R&D tax credit scheme for SME has been very successful, and is widely used by start-up businesses. A key feature of its attractiveness is the facility to surrender the relief for a repayable tax credit - which is now capped to prevent potential abuse.

We believe that introducing a similar system for capital allowances would offer a considerable incentive for some businesses (e.g. hi-tech SMEs) to invest in plant and machinery where the business is a going concern but initially loss-making. We accept that there would need to be anti-avoidance rules to prevent potential abuse: these might be set around trading criteria - perhaps limiting the payable credit to a certain volume of turnover (excluding intra group / connected party trade), with clawbacks in certain circumstances.

Environmental issues

The Enhanced Capital Allowances (ECAs) for energy and water saving equipment were very popular with businesses, but since their abolition, the only capital allowances designed to help reduce CO2 emissions in line with the government's net zero strategy relate to zero emission cars and vans. We believe that it is time to set a clear direction for business investment in favour of zero carbon plant and machinery.

Apart from vehicles, most business CO2 emissions are linked to production or buildings, through use of energy to power/ heat them. The government could consider offering an attractive 10% WDA on new commercial buildings/refurbs where the finished building meets certain well-understood environmental standards – e.g. BREEAM Level 5 certification.

With renewable energy and energy security in mind, we believe the government should also consider creating a specific 100% FYA for zero emission power generation equipment (e.g. solar panels with battery storage) installed in commercial buildings by trading companies and property businesses (excluding businesses whose main trade is the generation or supply of power). This

would generate cost savings for businesses, reduce carbon emissions and help to increase UK energy security. A similar relief may be considered for the installation of hydrogen-powered heating and power systems installed in commercial buildings. Part of the costs of these reliefs could be recouped by eventually phasing out capital allowances for certain carbon-emitting power generation in most commercial business settings (e.g. gas and oil-fired heating/power systems for offices, shops and factories) in stages by 2050.

We appreciate that some of this investment would happen anyway, but if the government wants to achieve a step change in zero carbon energy, such a policy could achieve rapid results. However, as with all our suggestions, we believe that the government will see the biggest overall return on the tax reliefs given if they are guaranteed for the long term – for example, at least 10 years for commercial buildings, and five years for solar and battery storage installation.

Patient capital – deduction for equity funding

In our experience, most capital investments that businesses make are funded by borrowing. This puts pressure on the business to ensure that the payback period for the investment is rapid to ensure that financing costs are kept to a minimum. We believe that the overriding need for short payback periods limits the range of capital investments that many businesses are prepared to make.

Businesses that can use equity finance to fund capital investments may be prepared to accept longer payback periods in some circumstances and allow them to undertake a wider range of investment projects for the long term – a patient capital approach. However, at present, using debt financing offers the tax advantage of deductions for interest paid on the borrowing, whereas there are no tax deductions for equity financing.

You will be aware of the EU's Draft Directive on a debt-equity bias reduction allowance – effectively a tax deduction for equity financing. Clearly there is no obligation for the UK to adopt such principles, but we believe that the idea should be investigated to see if offering a tax deduction (for example, in relation to newly raised equity where the funds are used to invest in business assets such as plant and machinery) may be attractive to UK business. Businesses that adopted such an approach would be less affected by changes in interest rates, perhaps making their business investments less sensitive to economic cycles.

While we do not suggest that tax deductions for equity funding would remove the need for capital allowances, they may reduce the need to offer immediate full expensing of capital investments as an incentive to businesses.