

What now for capital allowances?

A discussion document¹

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1. Summary

The way in which large companies in the UK are provided with tax relief on their capital spending is cumbersome, out of date, and fails to provide timely relief on some of that expenditure.

The Adam Smith Institute (ASI) has noticed this and has begun a campaign that asks that these companies enjoy tax relief in full on their capital equipment expenditure in the year that the expense in question is incurred. The existing tax relief rules for smaller companies suggest it is likely that more than 95% of all UK companies enjoy tax relief on their capital expenditure in this way at present.

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The ASI calls describes their campaign as being against what they call a 'factory tax'. That is because it is their suggestion that businesses that invest in productive equipment that lose out because of the way in which the capital allowance system works. However, that is not true. All businesses, in whatever sector they operate, usually qualify for capital allowances on most of their capital expenditure. In fact, what is quite remarkable about this tax relief is just how indiscriminate it is, providing relief whether or not the assets acquired by businesses are of benefit to society or not, and whether or not the business itself is socially useful, or not. As a result, tax relief is given for expenditure on carbon producing assets, those assets used to support addictive gambling, and on assets used to facilitate the sale of tobacco related products, and often at rates no different to those available on assets available for significantly more socially desirable activities. The ASI's characterisation of capital allowances is in that case wrong.

So too is the ASI's claim that capital allowances are a disincentive to investment wrong, for which claim there is very little evidence of business support. The arrangement available to most large companies would undoubtedly be problematic if a similar type of tax relief was offered to smaller companies. However, the 40,000 or so largest companies in the UK who are likely to use the arrangement that the ASI objects to are subject to a significantly different scheme from that made available to most of the companies in the small and medium sized business sector, most of whom already get tax relief in the way that the ASI demands for larger businesses. The difference in arrangements can be justified firstly because the cost of borrowing for large companies is usually substantially lower than it is for smaller companies, and so large companies do not require state support for their business cash flow in the same way that smaller ones might, and which the tax relief that smaller companies enjoy provides. Secondly, this because of the way that large companies (but not smaller ones) are required to account for tax. Deferred tax accounting, which larger companies must use, means that any benefits from enhanced capital allowances provided to those larger entities do not flow through into funds available for payment to their shareholders and as such tax reliefs on capital expenditure should not impact on the business decision making processes of larger companies. The ASI's economic justification for increased capital allowances makes little sense in that case.

There is a third reason why the ASI's claims are also inappropriate. The rates of tax relief on capital expenditure in the UK might be low, but so too as are UK corporation tax rates. This is not by chance. Since 2008 there has been an explicit pact between UK governments and the large corporate tax lobby that accepted the argument that corporation tax rates for larger companies should be reduced, but on condition that their tax relief on capital

expenditure was curtailed. At the same time it was tacitly accepted that smaller businesses, who did not enjoy equivalent reductions in corporate tax rates, should have their capital allowance rates increased. The ASI demand breaks this agreement and would do so at particular cost to the smaller business community who would suffer even greater unfair competition from larger companies than they already do at present as a result.

For these three reasons the claim for reform made by the ASI is inappropriate. They would also be very costly, for reasons noted below.

However, it is apparent that some reform to the existing and archaic system of calculating capital allowances that is explained in this note is required. Its anachronistic nature is now overdue for replacement. A number of options for reform are available.

Attractive as the idea of allowing tax relief on depreciation might be there would be many complications arising from doing so that make this option unattractive in practice. The unpredictable nature of such charges continues to make them an unsuitable basis for tax relief. Depreciation is also as indiscriminate in its use as are current reliefs for capital allowances. This also rules out such charges as a basis for tax relief.

Of the remaining possible bases for reform, by far the best would be to permit large companies to pool their tax allowable assets acquired in any one year for capital allowance purposes and to then provide capital allowance relief on that spending at agreed rates on a straight-line basis so that relief is provided in full over a fixed period of time that should approximate to average assets lives, meaning that, broadly speaking, tax reliefs and actual costs incurred should be aligned for most companies. This will have the added advantage of significantly reducing deferred tax balances in many larger companies.

This method would, however, increase overall rates of tax relief, for reasons noted in this paper. The precise scale of that impact is not yet known, and may be the subject of further research, but given that capital allowances already cost around £18 billion per annum it is likely that the impact will be significant and an increase in the corporation tax rate for larger companies of several percentage points would be appropriate as a result.

This recommendation also has the advantage that the rate of relief that might be provided can be restricted in the case of activities that the government does not wish to support for policy reasons. This could be done by reducing the rate at which relief is calculated, or by doing that and simultaneously reducing the number of years over which the relief in

question might be claimed, leaving some capital expenditure wholly unrelieved in such cases.

This option is the only one identified that meets all the specified requirements, whilst also offering the UK a much more logical capital allowance for the future.

Capital allowance reform requires careful consideration to align the goals of society with the reliefs provided to business. The proposals made by the Adam Smith Institute do not achieve that goal. The proposal made in this note does.

2. Introduction

The UK system of providing capital allowances for tax purposes to reflect the cost in use of capital equipment owned by a trading enterprise has a long history. It can be traced back³ to 1878, and has existed in something akin to its current form since 1946.

Capital allowances do, broadly speaking, replace the charge usually included in a set of accounts for the depreciation of an enterprise's fixed assets. Depreciation is an annual measure of the wearing out of the value of what are treated as tangible fixed assets⁴ for accounting purposes as a result of the use of those assets in the trade during a period. Because of the diverse range of possible depreciation charges a business could use these depreciation charges were historically considered to be too subjective for use in calculating taxable profits by HM Revenue & Customs and its predecessor, the Inland Revenue. As such capital allowances calculated according to fixed formulas were offered in their place.

That this system for providing tax relief on the cost of the capital equipment used by businesses has survived for so long is surprising. UK generally accepted accounting principles have been used as the basis for UK tax assessment of businesses since 2002, which arrangement was formalised⁵ and made a legal requirement from 2009. The continued use of capital allowances in place of depreciation is contrary to this general trend. Consideration of alternative methods for providing relief for capital expenditure incurred by taxable enterprises does, in that case, appear to be required.

³ <https://www.gov.uk/hmrc-internal-manuals/capital-allowances-manual/ca10040>

⁴ Such as machinery, vehicles, office equipment and buildings, or parts of them.

⁵ https://library.croneri.co.uk/cch_uk/btr/1071-420

There is also a need for reform to the system of capital allowance tax reliefs due to the anachronistic consequences of the way in which they are currently calculated.

This paper considers how these various issues might best be addressed.

3. Background

In February 2020 the Adam Smith Institute (ASI) launched a paper⁶ and campaign against what it called 'the Factory Tax'. This was summarised by the ASI's deputy director in City AM⁷ as follows:

When your business buys pens or paper or pays someone's wage, this is written off against revenue. When you buy a big piece of machinery or a building, it isn't — instead it is written off over time. You don't account for inflation or the real return on capital.

The UK's tax treatment of capital investment is in effect a factory tax, and it's holding Britain back. For every year since 1998, the UK had the lowest level of private investment in fixed capital as a share of GDP in the G7. If we changed tack and treated capital investment the same as running costs, research shows that Britain could increase investment by 8.1 per cent and boost productivity per worker by £2,214.

We should abolish the factory tax by allowing full expensing of capital in the first year. That way, we'd boost investment at the moment we need it most.

This paper suggests responses to this campaign, which it is suspected will attract the attention of the current government.

4. What capital allowances are

In essence capital allowances are the tax equivalent to depreciation charges that businesses are required to include in their accounts by both International Financial Reporting Standards and UK Generally Accepted Accounting Principles.

⁶ <https://www.adamsmith.org/about-factory-tax>

⁷ <https://www.cityam.com/tax-system-to-the-rescue-six-policy-tweaks-that-could-kickstart-the-economy/>

Depreciation is a measure of the wearing out of the asset over its useful life. It is a charge to the profit and loss account or income statement of a business that records that part of the cost of an asset that has been consumed in generating the profits of a business during a period.

Depreciation charges are required in accounts because accounting, and much of tax, recognises the difference between revenue expenditure – that is spending on items that are consumed entirely during a period in making the supply of the goods and services sold during that period – and capital expenditure, which is spending on items where the benefit of the expenditure incurred extends beyond the end of the period when the liability for that expense fell due.

The difficulty with giving tax relief on depreciation charges is that whilst a business is required to provide for that cost in its accounts by all currently accepted accounting standards in use in the UK, there is no fixed way in which it is actually required to estimate that expense. It is also perfectly permissible to change the basis on which a depreciation is charged is estimated during the course of an asset's life. In addition, it can also be decided for accounting purposes that equipment that had the characteristics of a fixed asset no longer has value to the business before its originally anticipated life comes to an end. This can then give rise to what is, in effect, depreciation of the remaining value of that asset in a single period, which may represent a charge above that which would normally have arisen but for the decision to treat the asset as life expired. The depreciation charged by an enterprise can, as a consequence be quite unpredictable. This has, historically, been considered unacceptable by tax authorities around the world, as well as by those in the UK.

To take a simple example, suppose a business spends £1,000 on an item that is considered to be capital equipment. Then assume it has an anticipated four-year life. This can be written down in a number of ways for accounting purposes:

- Straight line, i.e. in equal instalments of £250 over its life;
- On the basis of use in the year as measured by a defined variable, e.g., hours in use, compared to total anticipated life measured in hours. For example, if anticipated life is 1,000 hours and the use per annum is 300 hours in the first year, followed by 500 hours in the second year and then 100 hours in years three and four the charge could be apportioned in this ratio;
- Reducing balance bases where the four-year life is reflected in a 25% charge on the depreciated value of the asset each year. It will be noted that this never writes off the cost of the asset reflecting an attitude once thought very commonplace in UK

business that assets could be made to last forever, which attitude is said to have fuelled the UK's industrial decline by not encouraging new investment;

- A 'sum of the digits method' which suggests that an asset has most value in the year acquired and this reduces over time using a formula where (in this case) a four year life gives rise to a sum of the digits of ten (4 + 3 + 2 + 1) with the appropriate proportion being charged in each year (i.e. 4/10 in year one, and so on).

The resulting depreciation charges might be:

Year	Straight line basis	Charge for use basis	Reducing balance basis	Sum of the digits basis
	£	£	£	£
1	250	300	250	400
2	250	500	187	300
3	250	100	141	200
4	250	100	105	100
Total depreciation	1,000	1,000	683	1,000
Net value at the end of four years	0	0	317	0

The sheer variety of possible charges, all arising from one transaction, plus the possibility that this asset could have been deemed technologically redundant in any year after its purchase and might as a result, under accounting conventions, have been subject to a full depreciation charge in respect of its remaining value in that year as a consequence, meant that tax authorities around the world did, many decades ago, almost universally decide that depreciation was not a tax deductible expense but was instead to be replaced by capital allowances calculated on the basis of the rules that they could determine⁸. The object was to replace the discretion in accounting with a formulaic set of tax related rules.

This policy of providing capital allowances can be traced back⁹ to 1878 in the UK and was formalised in a style still recognisable in 1946. Capital allowances do, as a consequence, date back to an era when there were almost no recognised generally accepted accounting policies. The 21st century trend of using accounting data as the basis for tax assessment has not yet caught up with this issue even though that approach has now changed policy on the allowable deductions available for tax purposes in many other areas. UK generally accepted

⁸ In a review in 2014 I found that this was true of almost all jurisdictions with a positive corporation tax rate, for example. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2633997

⁹ <https://www.gov.uk/hmrc-internal-manuals/capital-allowances-manual/ca10040>

accounting principles have been used as the basis for UK tax assessment of businesses since 2002, which arrangement has been formalised¹⁰ and made a legal requirement since 2009. The use of capital allowances in place of depreciation charges remains an exception to this trend.

5. The UK capital allowances scheme

a. 100% allowances

The UK runs a myriad of capital allowance schemes¹¹. This is typical of the UK tax system. The legislation is to be found in the Capital Allowances Act 2001, as amended many times since then¹². The system is complicated by extensive rules on what expenditure on assets is considered to qualify for capital allowances, and which does not, most of which is based on tax case law.

This having been said, the vast majority of businesses now enjoy 100% tax relief on their qualifying capital expenditure in the year in which it is incurred. This is because they fall within one of the following categories:

- The business is that of a sole trader or partnership accounting on a cash basis, which requires that it has turnover of less than £150,000 per annum¹³.
- The business spends less than £1 million on qualifying capital equipment in a period¹⁴ (this limit is fixed¹⁵ until 1 January 2022). This is called the Annual Investment Allowance;
- The business is in an enterprise zone¹⁶ and spends less than €125 million year on qualifying capital expenditure;
- The expenditure is on electric car charging points;
- The expenditure is on an electric car or a car with CO2 emissions of 50g/km or lower.

¹⁰ https://library.croneri.co.uk/cch_uk/btr/1071-420

¹¹ <https://www.gov.uk/capital-allowances>

¹² <https://www.legislation.gov.uk/ukpga/2001/2/contents>

¹³ <https://www.gov.uk/simpler-income-tax-cash-basis>

¹⁴ <https://www.gov.uk/capital-allowances/annual-investment-allowance>

¹⁵ <https://www.gov.uk/government/publications/temporary-increase-in-the-annual-investment-allowance/temporary-increase-in-the-annual-investment-allowance>

¹⁶ <https://enterprisezones.communities.gov.uk/enterprise-zone-finder/>

The significance of these exemptions cannot be ignored: most businesses do qualify for them with regard to all their expenditure.

It is likely that businesses located in UK freeports will qualify for 100% first year capital allowance relief on expenditure within the freeport in the way that businesses located within enterprise zones do at present.

Example

To provide an example of what this means in practice, presume that there is a business with profits after depreciation for a year of £95,000, which had a depreciation charge of £5,000 in that year and which spent £20,000 on capital equipment during the year in question. This business is then required to add back the depreciation charge of £5,000 to its profit to give a taxable income before capital allowances of £100,000 for the year in question. It can then however reduce that income by £20,000 as a consequence annual investment allowance relief available on the capital expenditure incurred on which 100% first year allowances are available. This means that tax is actually paid by that business on profits of £80,000 for the year in question.

b. Writing down allowances – the ‘pool’ basis

There are, however, businesses that do not qualify for these tax reliefs. These are, in the main, larger companies. For them most capital allowances are provided in a very different way through what are called writing down allowances (WDAs).

WDAs are claimed if a business has already used up its AIA, or if the items it has acquired do not qualify for the AIA (e.g. most cars), or if there is a balance of such unrelieved expenditure brought forward from previous years. Writing down allowances permit the taxpayer to deduct a percentage of the value of an item acquired from their profits in each year after doing so.

The percentage that can be deducted varies. However, for the vast majority of assets that are subject to WDA the appropriate rate is 18%. These assets are lumped together in what is called a ‘pool’. The value of the pool is calculated in a fashion that makes little accounting sense. The steps are as follows:

- Bring forward the unrelieved expenditure from previous years;
- Add the cost of additions not qualifying for AIA or to which only WDAs apply, net of VAT, if appropriate;

- Deduct the sales value of items disposed of during the year and which had been subject to previous WDA claims;
- Then claim 18% of the remaining balance;
- Carry the unclaimed balance over for relief in future years.

Example

HMRC's own example¹⁷ illustrates how WDAs are claimed:

- The opening balance in your main pool is £9,000. You buy a machine worth £1,200. The total for this pool is then £10,200 (£9,000 plus £1,200).
- You sell a desk for £200. The total for this pool is then £10,000 (£10,200 minus £200).
- Apply the rate for the main pool (18%). The amount you can claim for this pool in this period is £1,800 (18% of £10,000).
- The rest (£8,200) is your closing balance or tax written down value. This is carried over and becomes your opening balance in this pool for your next accounting period.

Issues arising

It is apparent that this scheme reproduces the reducing balance basis of depreciation charge, noted previously. This means it has two significant flaws within it. The first is that the relief can, literally, take forever to provide, and the actual rate of relief turns out to be much lower than the 18% headline rate in all but the first year of ownership. The accounting logic of this relief is, as a consequence, deeply flawed.

c. Other writing down allowances

The alternatives to the 18% pool are what are called the special pool assets. These special pool assets are:

- parts of a building considered integral - known as 'integral features';
- items with a long life;
- thermal insulation of buildings;
- cars with CO2 emissions over a certain threshold.

¹⁷ <https://www.gov.uk/work-out-capital-allowances/work-out-what-you-can-claim>

These assets are subject to WDA claims at the reduced rate of 6% per annum.

It is also possible to have 'single pool assets' for items with a short life, which can then be taken out of the main pool and be subject to separate claims. This can accelerate the 18% claim on these assets. There is ample opportunity for tax planning in this area and offering advice on it is a lucrative business for some specialist tax advisors.

d. The number of companies and self-employed people likely to be claiming WDAs

This information on capital allowances needs to be put in context. According to HM Revenue & Customs¹⁸ 1,533, 570 companies paid corporation tax in the tax year 2018-19 (the latest for which data is available). Of these 1,491, 710 paid less than £100,000 in tax, meaning that they were likely to have retained profits of less than £500,000 to finance capital expenditure. It should be noted that the £1 million AIA allowance was only in use for part of this year; for the remainder it was £200,000.

Businesses do of course, borrow to invest but forthcoming academic research on which I have been engaged shows that there is a marked correlation between capital investment and retained reserves, as asset financing is not that easy to secure in significant amounts and profitability has, in any case, to usually be demonstrated to suggest capacity to repay loans.

If this pattern continues (and data suggests that it has been persistent) then it case it is likely few of these companies with smaller corporation tax liabilities will have invested more than £1 million in capital equipment and most will, therefore, at present enjoy AIAs at 100% on the cost of all the qualifying capital equipment that they acquire at this moment.

It also follows that the remaining 41,860 companies (2.7% of the total) are likely to be most of the companies suffering the WDA capital allowance regime. These larger companies paid 60.3% of the total corporation tax in 2018-19.

In total there were 2,820,000 capital allowance claims¹⁹ in the tax year 2018-19 at a total cost of £18.4 billion. Taking the above data on the number of companies paying corporation tax into account it is likely that at least 1.3 million of these claims were made by self-employed people. A small number of these self-employed people might have invested sums in excess of the AIA limit (for example, the partners in large firms of lawyers and

¹⁸ <https://www.gov.uk/government/statistics/corporation-tax-statistics-2020> Table 11.6

¹⁹ <https://www.gov.uk/government/statistics/minor-tax-expenditures-and-structural-reliefs>

accountants are included in the self-employed data), but the vast majority will not have done so. The conclusions drawn on the number of businesses likely to be making WDA claims is not likely to be materially altered by this evidence on the potential number of claims for capital allowances within the income tax system.

e. Conclusions

It is apparent that by number, the vast majority of companies and self-employed people do at present enjoy 100% first year tax allowances on their capital expenditure. Alternatively, it can be said that maybe 97% of all companies currently enjoy a deduction for their capital expenditure in full in the year in which it is incurred. For these companies the demand for capital allowance reform made by the ASI is not relevant; they are already enjoying the relief that the ASI is demanding. The issue with regard to capital allowances does, in that case, come down to the WDA regime and the relatively small number of companies that this impacts.

6. The politics of the UK's current capital allowance arrangements

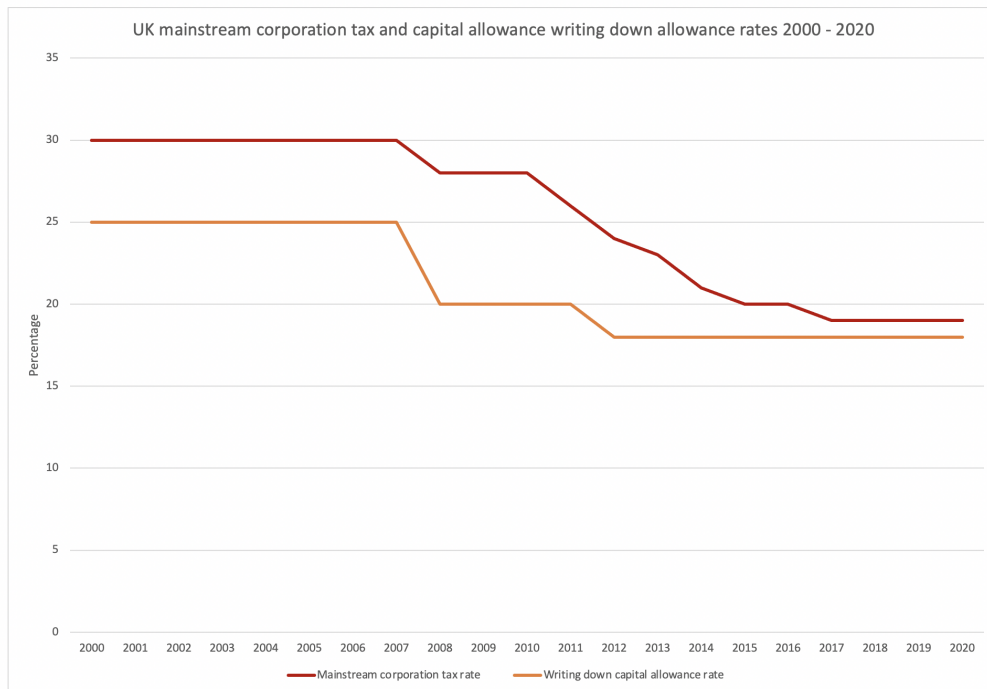
There are political rather than economic or accounting reasons for the current structure of capital allowances available in the UK.

Until 2008 the UK had maintained a corporation tax system that recognised that there were markedly different tax rates due by what were described as mainstream and small companies. This was a difference that was actually defined by the size of their profits rather than by the scale of their activities. Companies that made more than £1.5 million in profits were always treated as mainstream, or large, and those with profits of less than £300,000 were always treated as small, and between the two a marginal form of relief on tax rates was provided.

The Labour government that was in office from 2005 came under considerable pressure from business to reform corporation tax during its term. One of the pressure points was the UK mainstream (or large company) corporation tax rate, which it was claimed was becoming uncompetitive. In 2008 the then Chancellor of the Exchequer, Alistair Darling, gave way to pressure and reduced the headline rate of UK corporation tax from 30% to 28%. There was, however, a compensating measure taken, which was that the rate of writing down allowances for capital allowance purposes was reduced²⁰ from 25% to 20%. Subsequent

²⁰ <https://www.gov.uk/hmrc-internal-manuals/capital-allowances-manual/ca23220>

changes in corporation tax rates by the Conservative led coalition government from 2010 onwards retained this apparent link between reducing WDA rates and reduced corporation tax rates:



Sources: HMRC web site, various pages

The cuts in rates delivered by the Conservatives were also matched by reduced WDA rates.

At the same time (2008) that WDA rates were reduced AIAs were introduced to basically compensate smaller businesses for the reduced rate of WDA when they had enjoyed no cut in their corporation tax rate (which was 21% at the time), and to also reflect the additional cost of capital that many smaller businesses suffer when it comes to financing asset investment. AIA rate bands have fluctuated since then, with an underlying tendency to increase, but the principle has remained that they exist to compensate smaller businesses for the additional costs that they might have otherwise incurred as a result of reducing WDA rates that were in turn linked to reducing mainstream corporation tax rates that they did not (minor exceptions apart) enjoy.

There is, in that case, an implicit, significant and openly acknowledged political bargain inherent within the current UK capital allowance system David Cameron was quite explicit on this issue and the implied pact made with big business when in 2013 he set out his plans

to cut their tax rate to equal that of small businesses²¹: the rate cuts required an end to tax abuse, and the cut in the WDA rate at that time was a related part of the package.

What the ASI proposes ends this implicit compact, with a consequence that significantly enhances the financial well-being of larger companies. This happens for two reasons. The first is that the ASI proposal only benefits larger companies, as noted. Smaller companies will gain nothing from it. The result will be the further unlevelling of the UK business playing field which is already heavily biased in favour of large businesses, and has been especially so since corporation tax rates for all companies have been aligned. Second, in effect large businesses enjoy would enjoy an effective tax cut as a result of any change.

Estimating precisely what this tax cut might be is hard, as the example noted in section 7 helps makes clear. That is because eventually the tax relief provided on WDAs might almost equal the tax relief on a system that only provided AIAs, as the ASI proposes. However, over a period of five years the example shows that AIAs might provide more than 80% additional tax relief to larger companies than existing WDAs. How much that might mean in effective reduction in tax rates depends in part on the amount of capital expenditure a business undertakes. What is beyond question is that the amount of tax relief would increase under the ASI proposal, and so effective tax rates for larger companies would fall as a result.

There is a further concern with the ASI proposal. Implicit within it is the assumption that all WDAs are used to finance 'factories' which is the metaphor that they use to describe the claimed tax charge that they suggest WDAs create. This is not true. The vast majority of businesses can claim WDAs on their expenditure, irrespective of their business activity. As a result accountants are as eligible as factories, and gambling concerns qualify just as much as science labs do. The presumption that all capital allowances are related to activity of equal social value implicit in the ASI proposals is, in that case, wrong. The assumption that useful business activity will be promoted as a result is, therefore, not justified. Indeed, the assumption that any tax relief encourages real investment or worthwhile additional economic activity has been questioned, including by the UK House of Lords²².

There is a final reason for doubting the relevance of the ASI proposal. Although it would improve the cash flow of the larger businesses who would benefit from it that is insufficient reason to introduce it, because it is the supposed job of business to maximise profit, and

²¹ <https://www.telegraph.co.uk/finance/economics/9876773/David-Cameron-launches-broadside-at-tax-avoidance.html>

²² <https://publications.parliament.uk/pa/ld200708/ldselect/ldeconaf/117/11708.htm>

that is different from maximising cash flow. For large companies tax reporting requires that deferred tax accounting take place, and this largely removes from corporate reporting the supposed benefits of enhanced capital allowances, meaning that they should have little real impact on actual corporate behaviour because these allowances do not result in any significant enhanced profit reporting or increased funds being made available to shareholders. The most these enhanced allowances might actually do for shareholders is to save very small amounts in interest financing costs, and these are now exceptionally low for most large companies. To understand this the nature of deferred tax accounting has to be appreciated, and this is dealt with in section 7.

7. Capital allowances and deferred tax accounting

Capital allowances have a significant impact upon deferred tax accounting.

Deferred tax accounting is not a simple concept, and calculating a deferred taxation charge or credit is, in practise, quite often complex. What a deferred tax charge or credit within the tax expense of a company seeks to do is reconcile the tax expense that is recorded that actually arises as a consequence of the transactions undertaken in a period and that tax expense which would have arisen if there had been no adjustment to the accounting profits of the company when computing its tax liability. So, in the case of capital allowances, the deferred tax charge seeks to equate the tax that is actually due having taken actual capital allowances into consideration with the tax that would have been due if the depreciation charge included in the company's accounts for the period had instead been allowed as a deduction for taxation purposes.

It is important to note that this issue is not as significant as it was: reform to the UK generally accepted accounting principles that apply to the accounting of smaller companies means that most of these companies no longer have to account for deferred taxation and can therefore ignore this issue. As the data previously noted implies, this may well mean that the vast majority of companies do not now have to undertake deferred tax accounting.

However, for those companies that continue to be impacted by the relationship between capital allowances and deferred taxation this is a matter of significance. When Tax Research UK last investigated the composition of UK deferred taxation balances of the UK's FTSE 100 companies, which was in 2012, by far the biggest contributor to both deferred tax assets and liabilities were provisions for capital allowances. A review of many sets of accounts over the intervening years suggests that this is still true.

Two examples of deferred tax accounting may help explain how this works, and what the impact might be on the companies involved. In both cases the example used previously, as noted in Section 4, will be used. For ease of calculation and presentation a tax rate of 20% is assumed. In the first example it is assumed that the company qualifies for the AIA in the year in which the asset is acquired and in the second it is assumed that the asset in question does instead qualify for WDA treatment in the year in question. For ease it is assumed that profits remain constant, as do the depreciation charges, which are provided on a straight-line basis to write off the cost of the £20,000 asset investment incurred in year one over the following four years. It is assumed that no further assets are bought or sold, and that there were no WDA balances brought forward. None of these assumptions is very realistic, but they are important for the benefit of illustration.

Example 1

The tax effect of depreciation and capital allowance charges in the first case, where an AIA is claimed, is as follows:

Year	Depreciation charge	Capital allowance	Difference	Difference at 20% tax rate being deferred tax (charge) / credit included in the tax charge for the year	Deferred tax (liability) / asset on balance sheet at year end date
	£	£	£	£	£
1	5,000	20,000	(15,000)	(3,000)	(3,000)
2	5,000	0	5,000	1,000	(2,000)
3	5,000	0	5,000	1,000	(1,000)
4	5,000	0	5,000	1,000	0
Total	20,000	20,000	0	0	

In this scenario it can be seen that a deferred tax liability is required in the first year because the amount of expenditure on which tax relief is provided is £15,000 greater than the depreciation charge in the year in question. This reverses over the following three years leaving no deferred tax provision left to account for at the end of the fourth year.

In the first year the tax charge included in the accounts is inflated by £3,000 to compensate for the excess capital allowance in that year. In the following years the tax charge is reduced by £1,000 a year until the entire deferred tax liability on the balance sheet has been utilised. By the end of the fourth year the tax relief on expenditure on assets subject to capital allowances and depreciation charges have equalised.

Example 2

The second example uses the same basic accounting facts but assumes that a WDA at 18% is due on the asset in each year. The calculations are rather more complicated:

Year	Depreciation charge	Capital allowance	Difference	Difference at 20% tax rate being deferred tax (charge) / credit included in the tax charge for the year	Deferred tax (liability) / asset on balance sheet at year end date
	£	£	£	£	£
1	5,000	3,600	1,400	280	280
2	5,000	2,952	2,048	410	690
3	5,000	2,421	2,579	516	1,206
4	5,000	1,985	3,015	603	1,809
5	0	1,628	(1,628)	(326)	1,483
6	0	1,335	(1,335)	(267)	1,216
7	0	1,095	(1,095)	(219)	997
8	0	898	(898)	(180)	817
9	0	736	(736)	(147)	670
10	0	604	(604)	(121)	549
Total	20,000	17,254	2,746	549	

The process does not end after ten years; the example has simply been curtailed at that point as to continue it would add little to the illustration. In practice when the remaining value of a pool reduces below £1,000 the residual balance can be written off. In this case

that would only happen if no new assets were acquired, and after several more years of calculation.

As is apparent, this process produces deferred tax assets which are now much more commonly seen on the balance sheets of larger companies, at least partly as a consequence of this arrangement.

The comparative illustration demonstrates that:

- The AIA does provide upfront tax relief to companies for their capital expenditure costs, albeit that this will not be reflected in their profit and loss tax accounting charge if they have to provide for deferred taxation;
- The WDA system does not provide tax relief over the useful lives of many assets. Whilst some assets will have considerable lives these are the exception in the modern UK economy, and in industries using modern technology the available relief is often considerably less than the depreciation cost incurred by a business over the useful lives of the assets that it has acquired. As a system for providing tax relief this is inadequate. It can also result in accumulating deferred tax assets that a company may not be able to use over time, creating accounting issues as a consequence.

8. The change the ASI is proposing and its impact

In effect the ASI is proposing one very simple, and straight forward, change to the UK capital allowances scheme. Their proposal is that all capital expenditure should, subject to it qualifying for tax relief purposes, be deducted from taxable profits in the year that the expenditure is incurred.

In doing so the ASI is exploiting a genuine concern that the example in this paper demonstrates, which is that for larger companies current systems of capital allowances do not provide effective tax relief for the costs businesses genuinely incur when investing in capital assets for use in their activities.

9. Possible responses to the ASI proposal

The obvious question that then arises is whether there might be better options for reform available than those proposed by the ASI that meet three criteria:

- They remove the defects within the current WDA capital allowance system;

- They do not breach the understanding that larger companies enjoyed lower tax rates as a result of the quid pro quo that they also have reduced capital allowances;
- Capital allowances are not indiscriminately provided to those entities whose business activities have negative externalities for society at large.

There are a number of such options available:

a. Adopt the ASI proposal for 100% capital allowances

This does address the problems with the WDA regime, but does also provide a substantial additional subsidy to big business as the AIA calculation noted previously shows, and as such is an unacceptable option for resolving the problems with WDAs. This proposal also fails to address the indiscriminate nature of capital allowance tax reliefs.

b. Allow the depreciation charge included in the accounts

In principle this sounds like a straightforward idea but may not be as easy to use in practice as the principle seems to be in theory. Problems will arise because:

- If the idea of WDAs survives, as is suggested to be appropriate in this note, there will still be opportunity for a company to claim an AIA as well, and that would mean that depreciation on assets that had been subject to an AIA claim would have to be identified and have their depreciation charge disallowed before the balance of depreciation might be allowed;
- Not all assets are subject to capital allowances, and some are subject to WDAs at reduced rate. There are policy reasons for this. The depreciation charge would in that case have to be analysed for this purpose as well;
- The tax treatment to be provided on the writing off of assets for accounting purposes before the end of their useful lives would have to be agreed so that tax relief might still be given, even if not at the time that provision was made.

In summary, a replacement system of capital allowance would be significantly easier to use than any system of tax relief based on depreciation charges unless all blanket relief for all assets acquired is to become a government's policy, and that has never been the case to date.

c. Create annual pools for WDA purposes

As noted in the WDA deferred tax calculation, once a pool has new assets added to it on a regular basis the consequence is that the chance that tax relief will ever be effectively provided is close to zero. This issue can be resolved by creating new pools of assets for each year. In that case whilst many of the problems of WDAs persist at least there is a chance that tax relief will eventually be provided. This is not technically difficult to do; it is merely a change in the basis of calculation splitting one pool into a number of parts.

d. Provide straight line capital allowances on annual pools

If annual pools of assets are created as suggested in the previous section then the next obvious step is to provide straight line depreciation on each pool, guaranteeing that tax relief is provided in full over a specified period determined by the percentage rate used. This method will also ensure that each pool has a finite life, which is desirable.

To ensure the correct tax treatment of asset sales, proceeds would need to be deducted from the value of the pool in which relief was first granted. If, however, that pool was now closed then proceeds would need to be deducted from the oldest available pool until offset against cost still to be subject to relief.

e. Allow varying rates of WDA depending upon the assets subject to relief

If the previous recommendations for annual pools subject to relief on a straight line writing down allowance basis were adopted it would logically follow that multiple pools could be created for differing types of asset to which different rates of WDA relief could be applied if that was consistent with the industrial policy that the government wished to pursue.

If this policy was applied without time limit then the only difference that would result as a consequence of different rates of relief being used would be in the time period over which full relief was provided. Another available option would be to curtail the time period over which reduced rates of relief would be provided. So, for example, if the standard rate of WDA was 20%, and a reduced rate of 10% was desired for some assets, then that could be provided over a period of five years, but with nothing being due thereafter, which would, as a consequence, provide relief on only 50% of the asset expenditure on investment in plant and equipment which was not deemed to be for the overall benefit of society. This would improve the targeting of the relief.

f. Varying corporation tax rate

The previous three recommendations do, together, provide a better alternative for the provision of tax relief on capital expenditure by businesses than that proposed by the ASI. They do also meet the criteria set out for an improved capital allowance system in this note, excepting one thing, which is that they would reduce the overall effective rate of corporation tax paid by larger companies because the relief that they would provide would be more generous than the existing scheme. As the calculations in section 7 imply, the proposed arrangements might provide relief that could be 80% more generous than existing relief arrangements. The impact of this on any particular company would be hard to predict, because it would depend upon its capital asset investment profile, but there would, inevitably, be an overall reduction in the effective corporation tax rate paid by larger companies. This issue requires further research, but it would be appropriate, if the compact that was agreed with regard to reduced corporation tax rates matched by reduced capital allowance rates is to be adhered to, that corporation tax rates due by larger companies in the UK should be increased as a consequence. Given that capital allowance tax reliefs do, in total, cost approximately £18 billion a year in revenue foregone²³ it is likely that the required adjustment might amount to several percentage points on the mainstream corporation tax rate.

10. Conclusion

The ASI are right to highlight the fact that the UK capital allowance system is not providing either appropriate or adequate relief for capital expenditure incurred by the UK's larger companies.

The ASI proposal for reform, which would in essence give the UK's largest companies the tax relief provided to smaller companies, is inappropriate. It breaches the terms of the compact successive governments made with big business when cutting cut their tax rate to equal that of small businesses²⁴.

However, reform is needed. Attractive as the idea of allowing tax relief on depreciation might be there would be many complications arising from doing so that make this option unattractive in practice.

By far the best alternative option to the arrangements now in force would be to permit large companies to pool their tax allowable assets acquired in any one year for capital

²³ <https://www.gov.uk/government/statistics/minor-tax-expenditures-and-structural-reliefs>

²⁴ <https://www.telegraph.co.uk/finance/economics/9876773/David-Cameron-launches-broadside-at-tax-avoidance.html>

allowance purposes and to then provide tax relief on that spending at agreed rates on a straight-line basis so that relief is provided in full over a fixed period of time that should approximate to average assets lives, meaning that broadly speaking tax reliefs and actual costs incurred should be aligned for most companies. If it was considered appropriate to identify varying types of asset to which different rates of relief might be applied, as has been the policy of successive governments, then this could be easily accommodated within this proposal, with the advantage that restriction of relief for socially undesirable activities would become much easier as a consequence.

An adjustment to the corporation tax rate to ensure that unfair competitive advantage is not provided to large businesses as a consequence of this change would be necessary, but that is a price worth paying for a better, more directed, and more appropriate system for providing tax reliefs for those types of business activity that society should now want to promote in the UK.