What now for capital allowances? A note on UK tax refor...

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One of the roles that I now sometimes take on is to write technical notes on tax justice issues that other organisations might use, if they wish. I did those for the Fair Tax Mark with regard to freeports, for example, last year, and I have just prepared a note funded by Tax Justice UK, but published by Tax Research LLP, on reform of the UK capital allowance system. That note is 22 pages long, [and is to be found here](). The summary is as follows, but I hope the whole document may of interest, addressing as it does some of the much broader dimensions of this issue, including its accounting consequences.

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The way in which large companies in the UK are provided with tax relief on their capital spending is cumbersome, out of date, and fails to provide timely relief on some of that expenditure.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

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 nor 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.

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.