FINANCE BILL 2014: TEMPORARY INCREASE IN ANNUAL INVESTMENT ALLOWANCE

Response by the Association of Taxation Technicians

1 Introduction

1.1 Clause 10 and Schedule 2 of Finance (No. 2) Bill 2014 (‘the Bill’) provide for the temporary increase in the entitlement to Annual Investment Allowance (AIA) from £250,000 to £500,000 in respect of eligible expenditure incurred by a business between 1 (or 6) April 2014 and 31 December 2015. The measure effectively overwrites the Finance Act 2013 provision which provided for the temporary increase in the AIA limit from £25,000 to £250,000 in respect of eligible expenditure incurred in the two year period ending on 31 December 2014.

1.2 In the absence of either temporary measure, the AIA limit in a twelve-month chargeable period would be £25,000 in accordance with section 51A(5) of the Capital Allowances Act 2001.

1.3 AIA is a 100% allowance. It effectively permits eligible capital expenditure to be written off for tax purposes in the year of expenditure.

1.4 AIA is available to all qualifying businesses whether they are structured as limited companies (within the charge to Corporation Tax) or unincorporated businesses (where the proprietor or partners are charged Income Tax on the profits). For a business with a standard twelve-month chargeable period, the only difference in the calculation of the entitlement to the temporarily increased amount is that for a business within the charge to Corporation Tax the start date for the £500,000 limit is 1 April 2014 whereas for a business within the charge to Income Tax the start date is 6 April 2014. In the remainder of this note, we ignore the small resulting arithmetical difference.

1.5 Schedule 2 of the Bill contains detailed proposals for calculating the entitlement to AIA where a chargeable period of the business straddles either 1/6 April 2014 (‘the first straddling period’) or 31 December 2015 (‘the second straddling period’). All subsequent statutory references in this note are to paragraphs within Schedule 2 unless otherwise stated. We also refer to the numbered paragraphs within the official Explanatory Note relating to Schedule 2.

1.6 Our focus in this note is on what we believe to be an unintended consequence of the provisions relating to the second straddling period.
Our concerns in more detail

2.1 The AIA entitlement for the second straddling period is calculated under paragraph 4(2) as the aggregate of the time-apportioned allowance for the part of that chargeable period that falls before 1 January 2016 and the time-apportioned allowance for the part of that period that starts on 1 January 2016. However, paragraph 4(3) stipulates that so far as expenditure incurred in the part of the chargeable period commencing with 1 January 2016 is concerned, the AIA entitlement is restricted to the time-apportioned allowance for that part period. The effect of this is that the AIA limit in respect of expenditure incurred on or before 31 December 2015 is the aggregate for the whole chargeable period but for expenditure incurred on or after 1 January 2016 it is confined to the fractional part of the standard £25,000.

2.2 Explanatory Note 16 includes an example of how the aggregate maximum AIA is calculated for the second straddling period. In that example, the maximum AIA for the whole chargeable period to 31 March 2016 is £381,250. The company would therefore be entitled to AIA on expenditure of up to that full amount provided the expenditure was all incurred on or before 31 December 2015. In doing so, it would effectively have used the part of the AIA calculated for the period commencing on 1 January 2016. That is permitted by the statutory calculation and is consistent with the principle that a business has complete discretion as to when within a chargeable period it incurs eligible expenditure.

2.3 Explanatory Note 17 illustrates the restriction imposed by paragraph 4(3). In its three-month period from 1 January 2016 to 31 March 2016, the company’s AIA entitlement is restricted to only three months’ worth of AIA calculated by reference to the standard twelve-month allowance of £25,000. Its AIA entitlement is accordingly just £6,250 (being 3/12 of £25,000).

2.4 Explanatory Note 18 demonstrates clearly that the paragraph 4(3) restriction can operate to mean that a business with a theoretical maximum AIA entitlement of £381,250 for its chargeable period to 31 March 2016 can in reality be denied AIA on any expenditure over £6,250 if none of its expenditure is incurred before 1 January 2016.

2.5 For a business with a year end of 31 January 2016, the restriction works even more severely. Its maximum entitlement for the whole chargeable period would be £460,417 (being 11/12 of £500,000 plus 1/12 of £25,000) but, if its only expenditure in the period was incurred in the month of January 2016, its AIA limit would be £2,083 (being 1/12 of £25,000).

2.6 For a business that is able to take advantage of the greatly increased AIA limit in the period between 1/6 April 2014 and 31 December 2015 (or indeed the £250,000 limit up until 31 March/5 April 2014), the strange consequence of paragraph 4(3) in relation to post-31 December 2015 expenditure is likely to be seen as a price worth paying. Why worry about being restricted to £2,083 in the final month of a chargeable period to 31 January 2016 if the business had been able to make significant use of its overall maximum entitlement of £460,417 in the previous eleven months? However, there are many businesses which will have obtained no benefit at all from either the previous temporary £250,000 limit or the new temporary £500,000 limit which will nevertheless suffer from the paragraph 4(3) restriction. For them, the practical
effect of the temporary increase in AIA can be a very substantial decrease in their entitlement to AIA in the second straddling period. We demonstrate this below before suggesting a simple and effective remedy of what must be an unintended consequence of legislation designed to encourage capital expenditure by increasing AIA.

2.7 We refer above to the maximum and restricted AIA entitlements where the second straddling period is for twelve months to either 31 January 2016 or 31 March 2016. In the table below, we show the relevant amounts for chargeable periods ending on each month from January to November 2016.

<table>
<thead>
<tr>
<th>Second Straddling Period Year End of:</th>
<th>Maximum AIA Entitlement for full 12 month period</th>
<th>Maximum AIA Entitlement in period from 1 January 2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>31 January 2016</td>
<td>£460,417</td>
<td>£2,083</td>
</tr>
<tr>
<td>29 February 2016</td>
<td>£420,833</td>
<td>£4,167</td>
</tr>
<tr>
<td>31 March 2016</td>
<td>£381,250</td>
<td>£6,250</td>
</tr>
<tr>
<td>30 April 2016</td>
<td>£341,667</td>
<td>£8,333</td>
</tr>
<tr>
<td>31 May 2016</td>
<td>£302,083</td>
<td>£10,417</td>
</tr>
<tr>
<td>30 June 2016</td>
<td>£262,500</td>
<td>£12,500</td>
</tr>
<tr>
<td>31 July 2016</td>
<td>£222,917</td>
<td>£14,583</td>
</tr>
<tr>
<td>31 August 2016</td>
<td>£183,333</td>
<td>£16,667</td>
</tr>
<tr>
<td>30 September 2016</td>
<td>£143,750</td>
<td>£18,750</td>
</tr>
<tr>
<td>31 October 2016</td>
<td>£104,167</td>
<td>£20,833</td>
</tr>
<tr>
<td>30 November 2016</td>
<td>£64,583</td>
<td>£22,917</td>
</tr>
</tbody>
</table>

2.8 The table in 2.7 shows that the more months in the second straddling period that fall after 31 December 2015, the less severe is the impact of the paragraph 4(3) restriction. This is because each month in the post 31 December 2015 period attracts AIA of £2,083 (being 1/12 of £25,000). However, in every case the AIA available in respect of post 31 December 2015 expenditure is less than £25,000.

2.9 When Finance Act 2011 reduced the standard AIA limit from £100,000 to £25,000 with effect from 1/6 April 2012, it was done so in the light of the Chancellor’s statement on 22 June 2010 when he announced: ‘I have also decided to reduce the Annual Investment Allowance to £25,000 a year, to ensure support is focused on investment by smaller firms. Over 95 per cent of businesses will continue to have all of their qualifying plant and machinery expenditure fully covered by this relief.’ On that basis, the vast majority of businesses would not be adversely impacted by the reduction as their AIA-eligible expenditure was unlikely to exceed £25,000 in any chargeable period of twelve months. They would be able to incur expenditure of up to £25,000 at whatever point in the year that they chose and obtain AIA on the whole of that expenditure.
2.10 The temporary increase in the AIA limit from £25,000 to £250,000 that was introduced by Finance Act 2013 was ‘designed to encourage and incentivise business investment in plant and machinery, particularly among SMEs’. (Source: Autumn Statement Green Book paragraph 1.134.) HMRC’s Tax Information and Impact Note (TIIN) published on 19 March 2014 in relation to the temporary increase to £500,000 reinforces that message by expressing the policy objective as:

“This measure is designed to stimulate business investment in the economy by providing an increased time-limited incentive for businesses to invest in plant or machinery.”

2.11 As noted in 2.9 above, the level of eligible capital expenditure by the majority of businesses was (as of June 2010) such that the standard £25,000 AIA was sufficient to enable them to obtain AIA on the whole of their eligible expenditure. Unless the level of expenditure by such businesses has increased significantly since then, both of the temporary increases in AIA will have a wholly neutral impact on them. If their eligible expenditure in a twelve month period is less than £25,000, it is irrelevant for them whether the AIA limit is £25,000, £250,000 or £500,000.

2.12 The businesses for which the temporary increases in AIA are irrelevant will include very many of the smaller firms to which the Chancellor referred in June 2010 (see 2.9 above). Such businesses tend to have a less structured approach to capital expenditure than larger businesses. They tend to incur capital expenditure on a more ad hoc basis when a piece of equipment needs replacing or when funds are available rather than by reference to a planned programme of expenditure. For many, the precise timing of their expenditure within a chargeable period will be determined by circumstances that are not wholly within their control (for example an opportunity to expand the business which necessitates the purchase of an additional van).

2.13 For such (generally) smaller businesses, the paragraph 4(3) restriction in the second straddling period will mean that unless they incur capital expenditure in the period up to 31 December 2015, they may well be denied AIA on a significant part of their expenditure even if their total expenditure for the full twelve month period does not exceed £25,000. As demonstrated in the table above, the fewer the number of months in the period that fall after 31 December 2015, the more severe will be the impact of the restriction. Their AIA limit will be between £2,083 and £22,917 rather than the standard £25,000. Thus, the temporary twentyfold increase in AIA (from £25,000 to £500,000) will for all the businesses in this position have the unintended consequence of reducing their AIA entitlement in the second straddling period to between one twelfth and eleven twelfths of £25,000.

2.14 One answer to our concern about the severely limited availability of AIA in the post-31 December 2015 months is that the businesses in question should ensure that they have made best use of the greatly enhanced AIA limit in the pre-1 January 2016 months. That, however, would be impractical and imprudent advice. We have already indicated that smaller businesses tend to have a more ad hoc approach to capital expenditure. Additionally, many smaller businesses have their greatest cash inflow at Christmas and in January and February. That is when they can most readily afford to make improvements and replacements without having to depend on costly borrowings. It would be very unwise for such businesses to incur debt in order
to avail themselves of the high level of AIA available up to 31 December 2015 in anticipation of unpredictable profits and cash inflow.

2.15 As indicated above, we consider that the potential impact of paragraph 4(3) that we have described above must be an unintended consequence. A series of measures designed to encourage eligible capital expenditure and focus support on smaller firms would not be expected to discourage such expenditure by significantly reducing such entitlement. We have therefore considered how it might be possible to address the apparent anomaly in relation to businesses with lower levels of capital expenditure without undermining the essential calculation of the AIA entitlement for businesses with expenditure in excess of £25,000 in the second chargeable period.

2.16 We consider that the simplest and most effective way of enabling businesses with lower levels of eligible expenditure to avoid the unintended consequence of paragraph 4(3) would be to include an election facility whereby a business could within a specified period following the end of its second straddling period irrevocably opt out of any entitlement to the temporarily increased AIA for the whole of that chargeable period. The effect of such an election would be that its AIA entitlement for the particular period was determined solely by reference to section 51A(5) of the Capital Allowances Act 2001. This would mean that:

- The business had no entitlement to AIA beyond the standard £25,000 for the whole of the second straddling period regardless of when the eligible expenditure was incurred within the period;
- The business would be entitled to AIA on eligible expenditure of up to £25,000 regardless of when it was incurred within the period.

2.17 We note that HMRC’s impact assessment at the time of the announcement of the temporary increase in AIA to £250,000 stated:

‘Small firms impact test: precise data on the impact on small firms (those with less than 20 full-time employees) is not available as businesses are not required to give this information on tax returns. However, as the qualifying expenditure of most small firms is already fully covered by the current AIA threshold of £25,000, most small firms are unlikely to be affected. Small firms investing over the current AIA threshold are expected to benefit from the temporary increase in the AIA, as it will potentially provide them with a tax timing benefit. Other impacts have been considered and none have been identified.’

2.18 We also note that HMRC’s impact assessment published on 19 March 2014 in relation to the temporary increase in AIA to £500,000 stated:

‘Small and micro business assessment: the temporary increase in the AIA is not expected to have any material impact on small firms (those with up to 49 employees).’
Other impacts have been considered and none have been identified.’

2.19 We consider that the election facility which we recommend above enables the two HMRC statements to be correct. Without such a facility, we consider that both statements would have failed to identify an unintended consequence.

3 Conclusions

3.1 We have in this note identified what we consider to be a significant anomaly in relation to the availability of AIA in the second straddling period. We have also offered what we see as a simple and effective remedy.

3.2 We would be pleased to discuss how the opt-out facility that we recommend could best be designed and implemented.

Yours sincerely

Paul Hill

Chairman, ATT Technical Steering Group
4 Note

4.1 The Association is a charity and the leading professional body for those providing UK tax compliance services. Our primary charitable objective is to promote education and the study of tax administration and practice. One of our key aims is to provide an appropriate qualification for individuals who undertake tax compliance work. Drawing on our members' practical experience and knowledge, we contribute to consultations on the development of the UK tax system and seek to ensure that, for the general public, it is workable and as fair as possible.

Our members are qualified by examination and practical experience. They commit to the highest standards of professional conduct and ensure that their tax knowledge is constantly kept up to date. Members may be found in private practice, commerce and industry, government and academia.

The Association has over 7,500 members and Fellows together with over 5,000 students. Members and Fellows use the practising title of 'Taxation Technician' or 'Taxation Technician (Fellow)' and the designatory letters 'ATT' and 'ATT (Fellow)' respectively.