Association of Accounting Technicians response to the Office of Tax Simplification:

“*OTS Depreciation and Capital Allowances review call for evidence*”

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1. Introduction

1.1. The Association of Accounting Technicians (AAT) is pleased to have the opportunity to respond to the Office of Tax Simplification's (OTS) paper "*OTS Depreciation and Capital Allowances review call for evidence*" published 3 October 2017 (the paper).

1.2. AAT is submitting this response on behalf of our membership and from the wider public benefit of achieving sound and effective administration of taxes.

1.3. AAT has focussed on the operational perspective, providing comment in order to add value or highlight aspects that need to be considered further.

1.4. At the request of the OTS, AAT undertook a limited survey of 100 of its most engaged members. The results are published in Annex 1 at the end of this document and the outcomes from this survey have been used to inform this response.

2. Executive summary

2.1. **AAT notes that during the OTS's recent corporation tax computation review, Capital Allowances (CAs) were flagged as an area of complexity in almost every meeting the OTS had with businesses and advisers.**

2.2. **AAT is supportive of any move to reduce uncertainty** arising at the boundaries around which assets qualify or not, or which writing down rate should be applied.

2.3. **AAT does not consider that there is much wrong with the current system**. Although it is highly rules-based at present, it is understood by most practitioners.

2.4. **Many of the rules have been designed to ensure that tax paying entities only receive the reliefs to which government feels they are entitled.**

2.5. **62.5% of those surveyed** (Q8) **indicated that there would be no meaningful administration cost savings** if depreciation replaced Capital Allowances as the means of giving tax relief for items of capital expenditure.

2.6. **Other rules have been designed to ensure that tax paying entities do not gain an unfair tax advantage.**

2.7. **69% of respondents anticipated that the rates of depreciation claimed would change** (Q9) in response to a move to a depreciation based method of tax relief for capital expenditure.

2.8. **It is hard to envisage government being persuaded to let go of any of the Capital Allowance policy levers** that it chooses to operate from time to time -or a situation whereby HMRC will find it acceptable for taxpayers to accelerate the tax relief claimed by selecting the most advantageous methods of depreciation.

3. AAT response to the consultation paper

3.1. The following paragraphs outline AAT's response to the proposals set out in the paper.

Question 1: What is your business activity, and if representing a group, how many members do you represent? What is the typical value of annual investment by your business in tangible fixed assets?

3.2. AAT is a professional accountancy body with approximately 50,000 full and fellow members and over 90,000 student and affiliate members worldwide.

3.3. Of the full and fellow members, there are over 4,250 licensed accountants who provide accountancy and taxation services to individuals, not-for-profit organisations and the full range of business types.

3.4. On the basis that AAT is responding to the call for evidence on behalf of our membership AAT will not respond to the question of "*What is the typical value of annual investment by your business in tangible fixed assets?*"

Question 2: Businesses submitting UK corporation tax or income tax returns base the returns on accounts prepared under one of alternative accounting regimes (IFRS, FRS 101, FRS 102, FRS 105) according to the nature and size of the business. If tax relief was given for depreciation what are the implications of businesses preparing their accounts under differing accounting regimes?

3.5. Any move to replace Capital Allowances with depreciation as a means of providing relief for capital expenditure will render businesses' taxable profits open to a greater level of manipulation.

3.6. For instance, one business might choose to depreciate a class of assets over a period of two years yet another business might opt to depreciate the same type over five. While over the life time of an asset the tax allowances will be the same. A company adopting an aggressive write down policy will be rewarded through an acceleration in the timing of the associated tax relief. A fact that is likely to drive behaviour in a way that government might not consider desirable.

3.7. While it can be argued that the current system is administratively cumbersome and highly rules based it is understood by most practitioners - as evidenced by the results of AAT's survey - 62.5% of respondents (Q8) said that there would be no meaningful administrative cost savings if depreciation replaced Capital Allowances as the means of giving tax relief in connection with items of capital expenditure.

3.8. Furthermore, many of the rules have been designed to ensure that tax paying entities only receive the tax relief to which government feels they are entitled.

Question 3: Within each acceptable accounting regime businesses apply accounting policies which may be mandatory or judgmental. When did your business last change the accounting policy applied to tangible fixed assets? What prompted this? What depreciation rates/asset lives are used in your business?

3.9. Due to insufficient member data AAT is unable to respond to question 3 from a wider member perspective. However, AAT can answer this question by drawing on its own operational experience:

3.10. AAT last changed the accounting policy applied to tangible fixed assets during the 2016 accounting period.

3.11. The need for change was identified as part of a formal annual review process to test whether a policy is still valid.

3.12. The depreciation rates/asset lives applied to AAT's tangible fixed assets, are:

Plant and equipment	15%	-	25%
Office Furniture	20%	-	20%
Leasehold improvements	over the life of the lease		
Computer hardware	20%	-	50%

Question 4: There are various components of depreciation (for example, recognition, costs, revaluations, impairments, life, residual value). Would any of these present particular issues if depreciation is used to provide tax relief for capital expenditure?

3.13. As observed in the above response to question two, the useful life of an asset is subjective and is therefore, open to manipulation. With those willing to adopt and justify aggressive write down policies being rewarded with accelerated tax.

3.14. The only permissible accounting treatment for the depreciation of capital items available to a business (micro-entities) reporting under FRS 105 is the historic cost model.

3.15. Whereas a similar entity reporting under FRS 102 is free to choose between the historic cost and the revaluation model. While this is not a problem from an accounting perspective it could give rise to the potential for inconsistency in tax treatment whereby entities of a similar size and nature reporting under different standards could disclose different taxable profits.

Question 5: Although accounts prepared in accordance with GAAP form the basis for determining tax profits and losses HMRC may on occasion challenge the application of GAAP. On the other hand, in some respects corporation tax has moved closer to an accounts based approach (for example the intangibles regime introduced in 2002 and the standardised treatment of deferred revenue expenditure).

What do these examples (and any others you can provide) indicate about the merits or drawbacks of a depreciation based regime for relief for capital expenditure on tangible fixed assets?

3.16. The adoption of an accounts based approach offers the potential of a simplified tax compliance regime. However, as observed earlier in this document, the useful life of an asset is subjective, therefore, open to manipulation.

3.17. It is hard to envisage government choosing to let go of any of the Capital Allowance policy levers that it chooses to operate. If government cannot be persuaded to avoid using Capital Allowances for policy purposes, accounting profit will still need to be adjusted for tax purposes and an opportunity for simplification lost.

3.18. AAT is concerned that a change of basis could lead to an increase in HMRC enquiries, which would be seen as necessary to examine the appropriateness of entities' accounting policies to ensure that they are not overly aggressive.

3.19. A move to an accounting based approach for unincorporated entities with low profits could result in a wastage of allowance in the form of tax-allowable depreciation that could have been disclaimed under the Capital Allowance regime and carried forward for relief in a subsequent year when the business's taxable profits are above the level of an individual's personal allowance.

Question 6: In general, the fewer adjustments to accounts depreciation necessary to arrive at a tax deductible figure the greater, perhaps, is the potential tax simplification. This implies that assets currently non-qualifying (NQ) for CAs would, if depreciated, qualify for relief. However, some adjustments would be necessary, for example to ensure that capital expenditure would continue to be based on cost (and not on valuation) and to exclude certain assets such as land and dwellings. Please comment on the adjustments to accounts depreciation

which you consider may be necessary and yet consistent with delivering simplification.

3.20. AAT does not anticipate that the non-qualifying assets found under sections 21 (assets treated as buildings) and 22 (excluded structures, assets and works) of the Capital Allowances Act 2001 will change their status.

3.21. Therefore, where non-qualifying assets are depreciated to comply with a prevailing accounting policy it will be necessary for the accounting profits to be adjusted, as now, to arrive at the taxable profits.

3.22. Over 62% of those surveyed by AAT (Q8) could not see any, or only a marginal benefit, in basis change.

3.23. It is anticipated that many of the current restrictions to the rate of claiming Capital Allowances, such as in the case of agricultural buildings, motor cars, integral features will all remain in place. In so doing, they will significantly dilute if not actually negate any opportunity for simplification.

Question 7: Would a depreciation based approach present particular issues for income tax returns?

3.24. AAT cannot foresee any issues for income tax returns if a move to a depreciation based approach was to be adopted.

3.25. As now, if a change of basis is adopted, there would still be a need to adjust the accounting profits of an entity to arrive at its taxable profits.

Question 8: Overall would the use of accounts depreciation make preparation of the tax return simpler or more complex? What features of such an approach would tend to greater simplicity or complexity compared with the current CA system?

3.26. Overall AAT anticipates that the use of depreciation would have little impact on the preparation of a tax return. As previously observed (3.21) over 62% of those surveyed could not see any or only a margin benefit in a basis change.

3.27. On balance, any opportunity for simplification seems to be counter balanced by policy needs, which prescribe Capital Allowance rates incompatible with the likely rates of depreciation, resulting in a requirement to adjust a business's accounting profits to arrive at its taxable profits.

3.28. Businesses currently able to claim a 100% write off in the year of purchase under current Annual Investment Allowance (AIA) rules are unlikely to appreciate a simplification measure, which might result in avoiding the need for a Capital Allowance computation but results in their having to pay more tax in the short term.

Question 9: Would tax compliance costs change if CAs were replaced with a depreciation based approach? By how much?

3.29. For reasons such as government policy prescribing different rates of capital write down for tax purposes when compared to accounting depreciation, many of the existing adjustments to accounting profit will still be required. As a result, AAT does not believe that tax compliance costs will change significantly.

3.30. It is difficult to estimate the likely monetary value of any change in compliance costs but considering most AAT survey respondents saw little or no benefit in a switch of basis, this is likely to be negligible, especially when considering that many capital items are pooled.

3.31. Whilst not directly a compliance cost, the impact on cash flow arising from a loss of ability to claim AIAs should not be ignored.

3.32. As previously observed (3.21 and 3.25) over 62% of those surveyed could not see any or only a marginal benefit in a basis change.

Question 10: The current CA regime has timing incentives for capital expenditure, such as the Annual Investment Allowance (which accelerates tax relief). Assuming such a timing incentive remains desirable, a means of preventing double deduction (for depreciation and the allowance) would be necessary. Would this significantly compromise any potential simplification benefits of a deprecation based approach?

3.33. Combining the need to make a timing adjustment with a need to make other adjustments to comply with government policy, AAT considers the potential simplification benefits offered by a deprecation based approach will be significantly eroded if not lost altogether.

3.34. The value of claiming AIAs is greatest for nano, micro and SME businesses. Ignoring possible restrictions, the fact that they are only available on the first £200,000 of capital expenditure (in a year), means they are going to be of minimal interest to larger businesses or those with large capital outlays.

Q 11: Would there be other impacts of a depreciation based approach, for example the encouragement or discouragement of investment?

3.35. The loss of AIAs and the arising accelerated tax offset on any move to an accounting basis could, potentially, result in a deferment of an investment decision.

3.36. The removal of generous Capital Allowances could result in a move to leasing.

3.37. Apart from the two examples given above, AAT cannot foresee other impacts arising out of an adoption of a depreciation based approach.

3.38. 69% of respondents anticipated that the rates of depreciation claimed would change (Q9). The likely inference being, any move to a depreciation based approach would result in an increase in the rates of depreciation applied to accelerate the timing of the claiming of the available tax relief.

Q12: Should businesses be differentiated by size, or in any other way, when considering whether using accounts depreciation as the basis for relief for capital expenditure would be a simplification? If so, what distinctions would be appropriate?

3.39. AAT strongly urges the OTS to resist any calls for differentiation. in the interests of avoiding further complexity.

3.40. Not only would differentiation require businesses and their advisers to be aware of different sets of rules, depending on the size of a business. It could result in distorting behaviour or clustering around a margin or at "*cliff edges*" as is often stated to be the case with VAT, where many business owners find ways to ensure their business does not exceed the mandatory VAT registration threshold.

3.41. At its very worst, differentiation could lead to greater complexity where for reasons of policy many of the old adjustments required to translate accounting profit into taxable profit are retained at the same time as a business is required to consider new rules of differentiation.

Q13: Are there useful lessons from other countries which use a depreciation based approach?

3.42. AAT has no comment to make on other countries approaches.

Q 14: Changing from one form of relief to another is potentially complex in respect of assets owned at the implementation date (ID) and a number of solutions are

possible, including those below. Do you have views on any of there and are there further alternatives which should be considered?

3.43. The problem with all but the first transition method (A) is that they introduce varying levels of complexity, which if possible should be avoided.

3.44. AAT's preference would be for method A, it is by far the most straightforward option available. However, AAT anticipates that HMRC could face a problem with previously non-qualifying assets held at the time of change qualifying in the future.

3.45. The problem with all the other options is that for a least some time in the future, businesses would be required to continue making many of the adjustments to accounting profit that they currently make to arrive at their taxable profit.

3.46. AAT does not wish to suggest further alternatives for OTS to consider.

Q15: Long term projects may present particular issues, for example if they are commissioned on the basis of current rules but not commenced at the ID. What concerns should be address and how?

3.47. AAT has no comments on question 15.

Q16: How much notice of a change of CAs to a depreciation based approach do businesses need?

3.48. The answer to question 16 will be dependent on the size of business.

3.49. Many small business owners will not be aware of the significance of any change of basis. They will merely expect their advisers to take care of such matters.

4. About AAT

4.1. AAT is a professional accountancy body with over 50,000 full and fellow members and 90,000 student and affiliate members worldwide. Of the full and fellow members, there are over 4,250 licensed members who provide accountancy and taxation services to individuals, not-for-profit organisations and the full range of business types.

4.2. AAT is a registered charity whose objectives are to advance public education and promote the study of the practice, theory and techniques of accountancy and the prevention of crime and promotion of the sound administration of the law.

5. Further information

If you have any questions or would like to discuss any of the points in more detail then please contact AAT at:

E-mail: consultation@aat.org.uk and aat@taxpolicyadvice.co.uk

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ANNEX 1 - Association of Accounting Technicians response to the Office of Tax Simplification call for evidence: "*OTS Depreciation and Capital Allowances review call for evidence*"

Introduction

At the request of the OTS a limited survey of AAT's one hundred most engaged members was undertaken.

Nine questions, supplied by the OTS, were circulated and sixteen responses were received and used to compile this annex.

Summary of survey questions

6. Do your clients account for depreciation in financial accounts?

All	43.75%
Some	43.75%
None	12.50%

Comments returned by those who responded "*some*" to question 1

- Some do depending on how much they have to capitalise compared to overall turnover.
- If it is a small amount they will just use Capital Allowances - same for incorporated and unincorporated businesses.
- Incorporated – Yes. LLPs – yes, some sole traders.
- Ltd. Companies – yes, sole traders and other unincorporated entities, usually no.
- It depends on the size of the client. Very small businesses tend to want Income and Expenditure accounts without depreciation.
- Rarely these days unless they are selling the business.

7. **Do your clients account for depreciation in monthly/quarterly management accounts?**

Yes	18.75%
Some	25.00%
No	56.25%

Comments returned by those who responded "*some*" to question 2.

- Yes, most clients do account for depreciation in the monthly/quarterly management accounts.
- Again, some do depending on how much of an effect it will have on their profit
- If completing monthly/quarterly management accounts, but the vast majority of our client-base do not complete them.
- Incorporated clients do usually in the quarterly accounts and unincorporated business do not generally.

8. **For what kind of client is depreciation at present irrelevant?**

Free form comments received in response to question 3.

- Personal Service clients i.e. consultants.
  Generally, clients with no fixed assets and clients whose accounts do not need to show a 'true and fair view'.
  Clients who are not quoted on any stock exchange.
- Annually as part of the accounts is sufficient.
- Personal service companies.
- Service businesses tend not to have much equipment to depreciate.
- Clients operating in retail sector.
- Small sole traders, service business.
- Only very small sole traders – almost hobbyists.
- Small sole-traders such as window cleaners. A very small percentage of our clients.
- Small sole trader builder plumbers etc.

- Small sole traders with a turnover of less the £100k.
- Unincorporated clients. Sole traders, small partnerships, freelancers and even some smaller Ltd. companies.
- Clients that do not have any fixed assets i.e. the smallest of the micro businesses.
- None, any client of any structure with assets have depreciation present.
- The smaller clients, especially gardeners, building, personal services, consultants.
- Sole traders.

9. What rates of depreciation are generally used; in what circumstances and in relation to which asset categories?

Respondees suggested a range of rates of depreciation from 2% for land and buildings, 15, 20% and 25% percent for fixtures, fittings and motor vehicles to 33%, or even 50% for short-life assets such as computers.

No clear preference emerged for the use of straight-line, reducing-balance, or revaluation methods for depreciating capital items.

10. **Are different rates of depreciation employed by entities for the same assets operating in different environments i.e. manufacturing, retail, healthcare or another sector?**

Yes	31.25%
Sometimes	25.00%
No	25.00%
N/A	18.75%

Free form comments received in response to question 5.

- Only if we have inherited something different
- There are small variances, but these usually only relate to plant & equipment
- Sometimes.
- Not usually but it does depend on the useful economical life of the asset.

11. **How do smaller businesses decide whether to expense items of expenditure - or to capitalise and depreciate?**

Respondents suggested a range of approaches including materiality, useful life, according to accounting standards. A common theme (43.75%) was "*advice from their accountant*"

In common with responses to question 4, no clear preference emerged for how businesses decide on whether to expense items of expenditure.

12. **Do small business owners take Capital Allowances (including AIAs) into account when deciding whether to invest in fixed assets?**

Yes	68.75%
Some	6.25%
No	25.00%

13. **If instead of Capital Allowances tax relief was given for accounts depreciation would there be any meaningful administration cost saving for a small or micro entity?**

Yes	25.00%
Some	6.25%
No	62.50%
No comment	6.25%

14. **If instead of Capital Allowances tax relief was given for accounts depreciation would you expect the rates of depreciation you described in earlier questions to change?**

Yes	68.75%
Some	25.00%
No comment	6.25%