Summary: Intervention & Options

Department /Agency: HM Treasury	Title: Impact Assessment of capital allowances changes announced in Budget 2007	
Stage: Final proposal stage	Version: 2.0	Date: 19 March 2008

Related Publications: Business tax reform: capital allowances changes consultation document

Impact assessment of provision to allow businesses to write off small amounts of unrelieved expenditure on plant and machinery

Available to view or download at:

http://www.hm-treasury.gov.uk/consultations_and_legislation/consult_fullindex.cfm
http://www.hm-treasury.gov.uk/media/E/5/bud08_impact_147.pdf

Contact for enquiries: Dan York-Smith Telephone: 0207 270 4424

What is the problem under consideration? Why is government intervention necessary?

The pressures of globalisation and changing patterns of domestic business activity mean that the business tax system needs to be reformed to remove tax-driven distortions which encourage inefficient allocation of resources in the UK economy. These distortions relate principally to the mismatch between the present rates of writing-down allowance and true economic depreciation. They are also caused by the existence of anachronistic buildings allowances which give relief selectively to certain sectors and are administratively complex.

What are the policy objectives and the intended effects?

The package of reforms announced in Budget 2007 is intended to enhance international competitiveness, encourage investment, promote innovation and ensure fairness across the tax system by changing the structure of the corporate tax system to remove distortions to the investment decisions made by businesses. The effect of these reforms is to increase the efficiency of the allocation of investment by business, increase overall investment and reduce the administrative burden of the capital allowances system.

What policy options have been considered? Please justify any preferred option.

1. Reform the system, as announced in Budget 2007, by:

   reducing the main rate of capital allowances from 25 – 20% and increasing the long-life asset allowance from 6 – 10%

   introducing a separate classification of features integral (IFA) to a building in the 10% pool

   introducing an annual investment allowance (AIA) of 100% for the first £50,000 of investment on plant and machinery (excluding cars) to all businesses and abolishing SME FYAs

   a phased withdrawal of the industrial and agricultural buildings allowances (IBA and ABA) from April 2008

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects? 1 – 3 years after implementation the Government will review the compliance cost impact of the package.

Ministerial Sign-off For final proposal/implementation stage Impact Assessments:

I have read the Impact Assessment and I am satisfied that (a) it represents a fair and reasonable view of the expected costs, benefits and impact of the policy, and (b) the benefits justify the costs.

Signed by the responsible Minister:

Jane Kennedy...Date: 19 March 2008

Summary: Analysis & Evidence

Policy Option: Reform	Description: Implementation of the package of reforms announced in Budget 2007

COSTS

ANNUAL COSTS		Description and scale of key monetised costs by 'main affected groups'
One-off (Transition)	1 Yr	The new rules for integral features will result in a small admin burden for firms not able to use their AIA (0.1m) For businesses above the SME FYA threshold, there will be a minor increase in admin costs from the additional calculation required for the AIA. (0.3m)
£ Nil		
Average Annual Cost (excluding one-off)		
£ 0.4m		Total Cost (PV) £ 0.4m

Other key non-monetised costs by 'main affected groups'
Nil.

BENEFITS

ANNUAL BENEFITS		Description and scale of key monetised benefits by 'main affected groups'
One-off	1 Yr	SME business save a total of £3.6m in internal costs and £10.7m in external costs (agents fees) from the introduction of the AIA The abolition of IBA and ABA saves £2.1m in administrative burden costs (ie the costs of claiming) for claimant businesses
£ Nil		
Average Annual Benefit (excluding one-off)		
£ 16.4		Total Benefit (PV) £ 16.4m

Other key non-monetised benefits by 'main affected groups'
Nil.

Key Assumptions/Sensitivities/Risks
Benefits from the AIA assume that savings made by agents are passed on to SME companies. One-off cost assessment assumes that the adjustments to the new rates and allowances will require software changes which cannot meaningfully be quantified.

Price Base Year 2008	Time Period Years 1	Net Benefit Range (NPV) £ 16m	NET BENEFIT (NPV Best estimate) £ 16m

Question	Answer			
What is the geographic coverage of the policy/option?	UK			
On what date will the policy be implemented?	1 or 6 April 2008			
Which organisation(s) will enforce the policy?	HMRC			
What is the total annual cost of enforcement for these organisations?	£ Negligible			
Does enforcement comply with Hampton principles?	Yes			
Will implementation go beyond minimum EU requirements?	N/A			
What is the value of the proposed offsetting measure per year?	£0			
What is the value of changes in greenhouse gas emissions?	£0			
Will the proposal have a significant impact on competition?	No			
Annual cost (£-£) per organisation (excluding one-off)	Micro £0	Small £0	Medium £65.88	Large £65.88
Are any of these organisations exempt?	No	No	N/A	N/A

Impact on Admin Burdens Baseline (2005 Prices) (Increase - Decrease)
Increase of£0.4mDecrease of £ 15.4m Net Impact £ 15m

Key: Annual costs and benefits: Constant Prices (Net) Present Value

Evidence Base

Package of changes

Budget 2007 introduced a major package of reforms to the business tax system, to enhance international competitiveness, encourage investment, promote innovation and ensure fairness between taxpayers. This package announced changes the main and small companies' rates of corporation tax, enhancements to the research and development tax credit and the introduction of a payable credit for loss-making companies investing in 'green technologies'. The package included extensive reforms to the capital allowance system. Commercial depreciation costs are not allowable for tax purposes. Capital allowances, in their place, allow businesses to write of investments certain in capital assets over time against tax. The reforms considered by the Impact Assessment are:

- reducing the main rate of capital allowances from 25 – 20% and increasing the long-life asset allowance from 6 – 10%, from April 2008
- introducing an annual investment allowance (AIA) of 100% for the first £50,000 of investment on plant and machinery (excluding cars) to all businesses and abolishing SME first year allowances, from April 2008
- introducing a separate classification of integral features of a building (IFA) in the 10% pool, from April 2008
- a phased withdrawal of the industrial and agricultural buildings allowances (IBA and ABA) from April 2008, to be completely withdrawn by April 2011, including withdrawing Enterprise Zone Allowances from April 2011

Exchequer impacts

The Exchequer impacts of these changes are set out in table A.1 of Budget 2007 Document (http://www.hm-treasury.gov.uk/media/D/0/bud07_chaptera_235.pdf) and tables A.2 and A.11 of Budget 2008 (http://www.hm-treasury.gov.uk/media/2/5/bud08_chaptera.pdf) Changes to capital allowances should be considered with the changes to the rates of tax announced in Budget 2007.

Estimates of effects on administrative burdens

That there are no implications for HMRC operating costs and the business compliance cost changes included in the assessment relate solely to administrative burdens as defined by HMRC's Standard Cost Model, meaning the costs to normally efficient and compliant businesses of providing HMRC with information. These costs are a subset of compliance costs, which could include business uncertainty costs, cash flow costs, business planning costs. The methodology for each type of allowance is explained below. Figures are in 2005 prices, reflecting the fact that these changes affect the baseline costs assessed in the model.

Reduction in the standard rate of plant and machinery writing down allowances from 25% to 20%

No effect, since with the reducing balance basis this will not significantly change the number of periods for which assets remain in the pool.

Increase in the rate of the writing down allowance for plant and machinery long life assets from 6% to 10%

No effect, since with the reducing balance basis this will not significantly change the number of periods for which assets remain in the pool.

Introduction of the Annual investment allowance (AIA)

The AIA will be available to all businesses with plant & machinery expenditure other than cars (estimated to be around 2 million companies and unincorporated businesses in total).

For companies above the small- and medium sized enterprise (SME) threshold, this will involve claiming an AIA where only writing down allowances are claimed currently. It will mean an additional step to the calculation, similar to that currently undertaken by SMEs. An estimate of this can be made by identifying the cost per company of claiming the existing first year allowance for SMEs in the Admin Burdens baseline, and multiplying this by the number of large companies with plant & machinery claims. The number of such companies is estimated to be around 4,600. The admin burden of the current FYA regime for medium-sized enterprises (MEs) is about £59 per company, and given the typical size of claims of MEs this would be representative of the cost to a large company of making a claim involving expenditure up to £50,000. Thus the total AIA admin burden for large companies is estimated to be £271,400. Although only £50,000 of first year allowance will be available per group (rather than per company), because this allowance can be used against expenditure on long-life asset or integral features, there may be a small number of cases where groups will choose to split their AIA between companies within the group where this would allow them to use more of the allowance against LLA or IFA expenditure. We therefore estimate on a conservative basis that the total admin burden increase will be £300,000.

For SMEs, the AIA will replace the existing First Year Allowance. Whether the AIA will reduce the burden on SMEs will depend on their circumstances.

For most SME, singleton companies and unrelated unincorporated businesses, the AIA should be a simplification, as the £50,000 will cover all P&M expenditure in the vast majority of cases and so there should not be a need to maintain a P&M pool in the long run (unless for cars), unlike with the current 40% and 50% FYAs. We estimate savings in internal costs of £3.2m for these categories of businesses. Based on the proportional time reduction for internal work, the reduction in agents' costs would be £10m; the actual savings to business would depend on how much of this saving is passed on. Because it is a significant simplification to the tax return for a very small business, one would expect agents to be under pressure to reduce costs, especially as in some cases businesses may decide as a result of this change that their tax return is simple enough not to need an agent (in which case savings could actually be greater because of cost reductions for other obligations as well). These figures should be read considering the impact assessment on the Budget 2008 measure to allow businesses to write off small pools of unrelieved capital allowances, http://www.hm-treasury.gov.uk/media/E/5/bud08_impact_147.pdf.

For singleton companies and unrelated unincorporated businesses with eligible P&M expenditure in excess of £50,000 in a year, the burden will be similar, as with both the old and the new regimes, part of the expenditure will attract up-front relief and the remainder will be added to a pool.

For SME groups, there are currently complications in determining eligibility for FYAs which may be reduced under the AIA. With the existing system of FYAs, companies have to establish that they qualify for FYAs by virtue of being SMEs under the Companies Act definition. They may do this for non-tax reasons, for example if they file abbreviated accounts with Companies House, but many do not opt to file abbreviated accounts (they have to produce the full accounts for

shareholders regardless of their decision to file abbreviated accounts). If they do not determine their SME status for non-tax reasons, then they have to do so for the purposes of claiming FYAs. In the majority of cases, even for groups, this is fairly straightforward. However, in some cases, e.g. where there are connected parties and/or overseas interests, or where the entity is close to the threshold, this can be less straightforward.

Savings will be possible where the full AIA is claimed by one company within a group (resulting in the same admin burden as the FYA regime) but the other companies in the group now no longer have to claim FYAs. These group companies will save £59 per company. We estimate that there are 6,000 such companies. However, as with large groups there may be cases in which the group will choose to split the entitlement to the AIA between businesses where there is expenditure that would qualify for LLAs and IFA. On the basis that these groups' companies are likely to have lower levels of expenditure on IFA and LLA assets and therefore more likely to benefit from splitting their AIA across the group, we estimate approximately half of the companies will benefit from no longer having to claim FYAs, giving an admin burden reduction of £0.2m.

Therefore the total change in the admin burden arising from the AIA in external costs is £10m. For internal costs it is £3.1m, made up of:

- a £3.2m saving for singleton SME companies and unrelated unincorporated businesses with expenditure of less than £50,000 (excluding cars);
- a £0.2m saving from companies, in SME groups, with expenditure of less than £50,000 (excluding cars); and
- a £0.3m increase for companies outside of the SME definition who will now have to perform an FYA calculation for the AIA.

Features integral to buildings

The main effect of this measure is to reduce the rate of writing down allowance from the standard rate to 10% for a relatively small number of (high value) asset types. It does not involve redrawing of the boundary between buildings and plant & machinery, except in respect of certain electrical systems, mainly lighting.

The main cost will therefore be in identifying certain types of plant and machinery which have to be accounted for in a different pool. The pool for integral features will be the same pool that will be used for long life plant & machinery assets in the new regime. Thus for companies with LLAs currently, there should be no significant change in the admin burden; it only affects the allocation of assets between two existing pools. For companies without LLAs, the additional burden will be similar to that incurred by companies currently to comply with the LLA regime. The total burden in the standard cost model for the LLA regime is £44,258. There are 15,496 companies claiming it currently, so the cost per company is £2.86.

The number of companies with integral features is large, but the ability to use the AIA against integral features expenditure has a similar effect to applying a de minimis limit of £50,000 (for integral features and LLA expenditure combined). There are around 50,000 companies with total plant & machinery (including integral features) expenditure of more than £50,000 within their group, covering around 40,000 groups. Not all companies claiming allowances will have integral features expenditure; we conservatively estimate that approximately 35,000 companies will be affected, leading to an increase in the admin burden of approximately £100,000.

Abolition of Industrial Buildings Allowances (IBAs) and Agricultural Buildings Allowances (ABAs)

The admin burden for the IBA (including allowances for Enterprise Zones) is £1,519,617 and for the ABA it is £461,824. These figures include unincorporated businesses as well as companies, reflecting the scope of the measure. The admin burden will be reduced by the total amount of the current costs in the baseline, £1.98m, as these allowances are being withdrawn and will not be replaced by another allowance.

Summary

The reduction in burden from the IBA/ABA withdrawal is £1.98m. There will be a saving from the AIA for businesses whose annual expenditure is consistently within the £50,000 annual threshold of around £3.5m in internal costs and up to a further £10m in agents costs (depending on pass-through). For other large groups, there will be a modest increase in internal costs of £0.3m. There will be a modest increase in burden from integral features of £100,000 for companies whose expenditure on LLAs is not covered by the AIA.

Overall, the net annual reduction in burden from the package is estimated to be £5m, plus up to around £10m in agents' fees.

The above estimates are at 2005 prices, based on HMRC's Standard Cost Model of Administrative Burdens. These estimates are restated at 2008 prices in the Summary on Page 3.

Specific Impact Tests: Checklist

Use the table below to demonstrate how broadly you have considered the potential impacts of your policy options.

Ensure that the results of any tests that impact on the cost-benefit analysis are contained within the main evidence base; other results may be annexed.

Type of testing undertaken	Results in Evidence Base?	Results annexed?
Competition Assessment	No	No
Small Firms Impact Test	No	No
Legal Aid	No	No
Sustainable Development	No	No
Carbon Assessment	No	No
Other Environment	No	No
Health Impact Assessment	No	No
Race Equality	No	No
Disability Equality	No	No
Gender Equality	No	No
Human Rights	No	No
Rural Proofing	No	No

Annexes

Non-administrative impact of the Budget package

This annex sets out the evidence for the full package of reforms, including the reduction to the main rate of corporation tax, the phased increase in the small companies rate of corporation tax and the increase in the rate of the R&D tax credit, as well as the capital allowances changes set out earlier in this impact assessment.

The package has three central objectives:

- To promote investment and growth by removing distortions to decision making caused by the tax system, stimulating greater foreign direct investment and refocusing the tax system for small businesses
- To reduce administrative burdens and complexity by withdrawing burdensome and outdated elements of the capital allowances system while simplifying its operation for small businesses in particular
- To maintain the fairness of the tax system by ensuring businesses pay their fair share of tax and levelling the playing field between small businesses, regardless of legal form

Promoting investment

There is an extensive body of literature on the role of investment in driving productivity and long-term economic growth. Capital accumulation raises labour productivity both through direct and indirect effects. The direct impact is the increase in capital intensity; this means that labour is more productive, because it has more capital to work with. The indirect productivity effect of capital investment is felt when new investment helps labour to gain new skills and becomes more efficient at using that capital.

The reduction in the corporation tax rate from 30 per cent to 28 per cent will lower the cost of capital and, one would expect, generate an increase in domestic investment. On the basis of the model developed by Hall and Jorgenson (1967) and King and Fullerton (1984), across the whole economy, the changes are projected to lead to additional investment. The primary impact on domestic investment comes through the reduction in the CT rate, which acts as an incentive for additional investment – even after the reduction in capital allowances.

Large firms enjoy a positive investment effect from the CT reduction that offsets the changes to the rates of capital allowances and the withdrawal of IBAs.

For small firms, the change in the small companies rate is more than offset by the incentive effect of the introduction of the annual investment allowance. Overall, our analysis shows that there will be additional investment amongst small firms. Medium sized firms face a small decrease in investment incentives.

Unincorporated firms unambiguously benefit from the introduction of the annual investment allowance, creating a clear additional incentive for additional investment.

Improving the UK's international competitiveness

The Government recognises the importance of attracting high quality inward investment and ensuring the UK is seen as an attractive investment location internationally. Foreign Direct Investment (FDI) by multinational companies can provide a channel through which new ideas, working practices and technologies can arrive in host economies, as well as a means by which domestic companies are exposed to greater competitive pressures. The existence of positive

externalities flowing from FDI via boosts to economy-wide productivity provides a role for public policy in encouraging FDI to come the UK.

There is a substantial body of literature which finds a relationship between levels of FDI and corporation tax rates. The influence of tax on inward investment is akin to that on domestic investment, via its effect on the post-tax rate of return. De Mooij and Ederveen (2005) provide a comprehensive meta-analysis of the empirical literature on taxes and FDI.

Therefore, the reduction in the main rate of CT and the fall in the cost of capital faced by large firms are likely to make the UK a more attractive location for inward investment, and complement the UK's existing wide range of tax and non-tax advantages.

The new rate of corporation tax from 2008 will mean that the UK has the lowest headline rate of CT in the G7, below the OECD and EU 15 averages.

Promoting innovation

The Budget announced an increase in the relief available for business R&D. This includes an increase in the large company R&D tax credit from 125 per cent to 130 percent from April 2008 and an increase in the enhanced deduction element of the SME and mid-sized R&D tax credit from 150 percent to 175 per cent also from April 2008. This is a significant increase in the generosity of the scheme for SME and mid-sized companies, providing relief for companies with up to 500 employees.

With innovation being recognised as one of the five key drivers of productivity, R&D forms a major part of the UK Government's strategy for growth. This is recognised in the Government's target to increase R&D to 2.5 per cent of GDP by 2014.

R&D fiscal incentives are widely accepted to be efficient tools to encourage business R&D without the need for direct Government intervention on a project-by-project basis. A recent independent feasibility study concluded that it is still too early to conduct a full econometric evaluation of the UK R&D tax credits scheme. However, research commissioned by the UK Government and other research undertaken indicates that the scheme is having a positive impact on business R&D investment. This evidence has supported the UK Government's desire to continue and strengthen the scheme.

Even in the presence of the current incentives available to businesses, the UK still faces a major challenge, with large increases in business R&D needed to move towards the 2014 target.

Given the academic consensus that lowering the user cost of R&D will increase R&D spend, increasing the rate of relief provided will be an efficient tool to approach this target.

Table 1 provides a summary of the studies estimating the impact of tax incentives on R&D. The evidence generally shows that decreasing the cost of R&D by £1 will lead to a £1 increase in R&D undertaken.

Table 1

Impact of R&D fiscal incentives on R&D spend [1]

Country	Author	Main findings	Period of analysis
UK and 8 other OECD countries	Bloom et al (2000)	A 10 per cent reduction in the cost of R&D leads to 1 per cent increase in the level of R&D in the short run, and a 10 per cent increase in the long run	1979-97
UK(Northern Ireland)	Harris et al (2006)	Own price elasticity found to be –1.36. A 10 per cent decrease in the cost of R&D leads to a 13.6 per cent increase in the level of R&D.	1998-2003
USA	Hall (1992)	Unit elastic short run responsiveness of R&D to the after-tax price of undertaking R&D. In the short run a 1	1980-91

		per cent decrease in the cost of R&D will increase R&D by 1per cent.	
USA	Hines (1993)	Own tax price elasticity found to vary between –1.2 and –1.8. A 10 per cent decrease in the user cost of R&D leads to between 12 per cent and 18 per cent of additional R&D.	1984-89

The evidence quoted above indicates that decreasing the user cost of R&D through the UK tax credit will increase investment in R&D. For instance, as is summarised in Table 1, the evidence suggests that a 10 per cent decrease in the cost of R&D is likely to lead to a 10 per cent increase in R&D spend in the long run. As the level of relief is increased and the private cost of R&D is pushed down even further it is expected that this will lead to additional increases in R&D. The incentive effect is directly proportional to the aid intensity as provided by the rate of relief – the higher the relief the higher the incentive effect. Hence, providing additional support is likely to make the R&D tax credits even more effective.

Fairness

The Government's discussion paper: Small Companies, the self-employed and the tax system set out a framework for discussion on the incentives for small business investment in the current tax system.

Successive Governments have tried to encourage greater investment through low rates of tax for small companies with the Small Companies Rate (SCR). However:

- It has become apparent that the SCR can be taken advantage of by people incorporating with the main aim of reducing their personal tax and national insurance liability by extracting labour income as dividends. This results in an unfair difference between the overall tax and NICs paid by the incorporated and the unincorporated, even where they are engaged in the same economic activity. This tax-motivated incorporation, if left unaddressed, would pose a growing risk to the Exchequer; and

- The SCR is not well targeted. As companies qualify according to their taxable profits, not their size, around one third of tax paying large companies benefit from the SCR.

The staged increase in the SCR from 2007 is intended to reduce the differential between the incorporated and unincorporated and was introduced in conjunction with the new Annual Investment Allowance to refocus the investment incentives for small businesses. The Government's analysis shows that the effect of the AIA will encourage greater investment by small businesses

Sectoral impact

The package of business tax reforms announced in Budget 07 was designed to achieve the objectives set out above for the UK economy as a whole. The impact of the package was not intended to be directed at any particular sector. Instead it was intended to reduce sectoral distortions, resulting in inefficient investment allocation, caused by the existing structure of the tax system.

Reducing the value of capital allowances on plant and machinery impacts most on capital-intensive sectors (energy, transport and communication and distribution). This is – in part – due to the fact that capital-intensive sectors have for some time enjoyed capital allowances that are higher than the actual rate of economic depreciation.

However, a reduction in the rate of capital allowances is primarily a timing effect. The lower rate means that an asset will be written-off over a longer period – lower allowances in the early years, but greater allowances later.

HMRC produces data of total claims for allowances by sector, including industrial buildings allowances, which can be found here:

http://www.hmrc.gov.uk/stats/corporate_tax/table11-10.pdf

These tables show that industrial buildings allowance claims make up only a small part of the total allowances due to businesses.

These changes must be set against the reduction in the main rate of corporation tax from 30% to 20%, which will be of significant benefit to main rate payers in all sectors. Data shows that 95% of the value of industrial buildings allowances claims are made by large businesses, who are likely to benefit from this reduction in the rate of tax. For smaller businesses, the AIA will be available to businesses in all sectors, offsetting changes to the rates of capital allowances.