



Capital allowances

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What they are

A capital allowance is an amount that may be deducted from taxable income in respect of capital expenditure, usually buying an asset. The main law is Capital Allowances Act 2001.

Normal trading accounts will often include capital expenditure or depreciation. Neither is allowable for tax purposes. So if a profit and loss account shows net profit of £100,000 but it includes depreciation of £10,000, that figure is added back so the trade is taxed on £110,000.

Depending on what the expenditure was for, the business may be able to claim a capital allowance instead of depreciation.

This quick guide does no more than provide a superficial introduction to a complex area of taxation. This guide does not provide enough information to allow a capital allowance claim always to be made correctly.

What is capital expenditure?

Capital expenditure is money spent on something that is expected to last for some years. Examples include land, buildings, furniture, vehicles, machinery and computers.

In normal accounting terms these are called **fixed assets**. But the two terms are not quite the same.

First, a fixed asset in accounting is anything that lasts for more than one year. In taxation, a capital item is anything that lasts for at least *two* years. The test case concerned a shoe-maker some of whose knives were treated as capital and others (that had to be replaced within two years) as not capital.

Second, most businesses have a **capitalisation threshold**. This is a limit below which an item is not treated as capital expenditure. Coffee mugs, staplers and hammers all have an expected life of more than two years. An entity may set a limit of perhaps £100 below which it does not treat items as capital.

For tax, there is no lower limit. A set of coffee mugs, staplers and hammers are treated as a fixed asset. There was a rule that replacements of such low cost items could be treated as revenue expenditure, but that rule was abolished from April 2015.

What items qualify for a capital allowance?

Capital allowances may only be claimed for particular types of asset. If an asset is not included within the scope, no allowance may be claimed at all. So there is generally no capital allowance (or tax relief of any kind) for industrial buildings, fences, bicycle sheds and similar. A business should not assume that it will get tax relief for all its business expenditure.

Categories for which allowances are provided include:

- plant and machinery
- cars (which are a particular form of plant)
- features integral to a building (FITAB)
- business premises renovation
- patent rights and know-how
- research and development
- mineral extraction.

The most important of these, by far, is plant and machinery.

What is plant and machinery?

Machinery is equipment that has a moving part. It is not necessary for it to be powered, so a car jack is a piece of machinery. This definition has caused no problems in practice.

Plant is the equipment “with which” a person carries on a business. It is not necessary for plant to have any moving parts, so a grain silo is plant.

Tax law does not define the term “plant”. The definition has been left to the courts, starting with the case *Yarmouth v France* [1887] which held that a cart horse was plant. This was not even a tax case, but a claim for injury when the horse kicked and broke the driver’s leg.

Defining plant has been the subject of hundreds of court cases and is one of most litigated areas of tax law. The main issue has been to distinguish plant from premises “in which” a business is conducted. Huge sums of money can be at stake, as premises will usually not qualify for a capital allowance or any other tax relief.

Some of the differences can be marginal. For example, polythene pipes inserted into old iron gas mains have been held to be both plant and not plant. A canopy over a petrol station forecourt has also once been held to be plant and once not plant.

Capital Allowances Act 2001 ss21-23 provide some guidance. The courts have also provided some guidance, such as saying that something is plant if similar to something else that is plant, and size does not matter. Plant has been compared to a fruit tree rather than its fruit.

In addition, the courts have held that these items are plant (and so may qualify for a capital allowance):

- a dry dock
- partitioning to subdivide floor space
- grain silo
- decorative screening in the window of a building society
- a swimming pool at a caravan site
- murals and wall panels in a fast food restaurant
- mezzanine platforms erected in a shoe shop
- synthetic turf rolled out for an indoor football pitch
- a gazebo in a pub garden for smokers.

The following have been held *not* to be plant and machinery:

- a prefabricated building used as a school laboratory
- a false ceiling in a restaurant
- a floating ship used as a restaurant
- shop fronts and wall tiles used in a fast food restaurant.
- a “planteria” for growing plants for resale
- bus shelters and public toilets
- electricity substations
- putting green on a golf course
- artificial all-weather horse racing track.

The distinction between plant and premises is particularly difficult in restaurants. The case *JD Wetherspoon plc [2012] UKUT 42* considered in detail what items were plant in their premises.

Ordinary lighting is not plant but special lighting to create the right atmosphere can be. This in turn can create a problem as identifying the exact point between fuse box and light bulb where the wiring becomes plant.

In one case, a judge said that the difficulty of distinguishing between plant and premises can be so arbitrary that he might as well toss a coin.

What is included in the cost?

The cost of an asset is not just the price paid for the asset. The cost includes all expenditure related to its acquisition and bringing it into use.

The following are examples of items that are included as part of the cost of an asset:

- architect’s plans
- legal fees
- site clearance
- delivery
- installation
- connection, such as to power supply or drainage

- accommodation.

Types of capital allowance

There are now four main types of capital allowance:

- first year allowance (FYA)
- the annual investment allowance (AIA)
- writing down allowance (WDA)

Historically there have been other forms of capital allowance.

The above is the order in which the allowances should normally be claimed.

There is also the balancing charge or allowance.

Since 2008, **first year allowance** is now only available at 100% for a small range of products, namely:

- energy-saving plant and machinery
- cars with very low carbon dioxide emissions
- zero-emission goods vehicles
- plant and machinery for certain refuelling stations
- plant and machinery for use in a ring-fence trade
- environmentally beneficial plant and machinery
- plant and machinery for use in designated assisted areas.

The exact scope of these categories is set out in Capital Allowances Act 2001 ss45A-45K. Care needs to be taken to ensure that an item comes within the exact scope. Many businesses will have no assets that come within this limited scope.

In effect, the first year allowance means that a business may claim the whole cost of the asset in the year of acquisition.

For periods up to April 2008, smaller businesses could claim a first year allowance on all plant and machinery up to a limit. There have been periods between 1970 and 1993 when businesses of all sizes could claim a first year allowance.

Annual investment allowance (AIA)

The annual investment allowance (AIA) was introduced in 2008 for the first £50,000 of capital expenditure. The allowance is an annual maximum that may be claimed. Any used AIA cannot be carried forward or back to another accounting period; it is lost.

Since then the limit has fluctuated wildly:

=From	AIA limit
6 April 2008	£50,000
1/6 April 2010	£100,000
1/6 April 2012	£25,000
1 January 2013	£250,000
1/6 April 2014	£500,000
1 January 2016	£200,000

Where an accounting period spans a change in limit, two pro rata calculations must be done:

- a limit for the whole accounting period
- a limit for the part of the accounting period where the lower limit applied.

The AIA allows a business of any size to claim the whole cost of assets up to the limit. This will often be sufficient to cover the whole cost of plant and machinery acquired by many smaller businesses.

The AIA may be claimed for all types of plant and machinery except:

- cars
- items used for another reason before starting to use them in a business
- items donated to the business or its owner.

The cars restriction does not apply to other motor vehicles. So AIA may be claimed for lorries, vans, motorcycles, bicycles, aircraft and boats.

AIA may also be used for long-life assets, short-life assets and features integral to a building.

Writing down allowance

Where a business has expenditure on plant and machinery that is not covered by the first year allowance or annual investment allowance, the excess qualifies for a writing down allowance.

This is done by using a pool, except for:

- long-life assets
- thermal insulation
- features integral to a building
- some cars.

Those items must be “depooled” either by using a special pool or by treating them individually. In addition, a business may voluntarily elect to depool short-life assets (and usually should do so).

For all other assets, the writing down allowance (WDA) is 18% a year on the **reducing balance method**. This means that each year a capital allowance is claimed equal to 18% of the balance.

If a business buys an asset for £10,000, an 18% WDA produces these figures for the first ten years:

Year	Written down value at start	Writing down allowance
1	10,000	1,800
2	8,200	1,476
3	6,724	1,210
4	5,514	992
5	4,521	814
6	3,707	667
7	3,040	547
8	2,493	449
9	2,044	368
10	1,676	302

The 18% rate was set in April 2012. It is 20% from 2008 to 2012, and is 25% for earlier years.

The **pool** operates by adding new acquisitions in the year, subtracting the proceeds of any disposals, and applying the 18% rate to the balance.

Example: A business has plant and machinery with a written down value of £345,000 at the start of its year. It spends £37,000 on new plant and sells some old plant for scrap at £1,000.

Written down value at beginning of year	£345,000
Acquisitions	£37,000
less disposals	<u>(£1,000)</u>
Value after acquisitions and disposals	£381,000
18% writing down allowance	<u>£68,580</u>
Written down value at end of year	<u><u>£312,420</u></u>

There are some points worth noting.

First, the business soon loses track of what assets are represented by the written down value carried forward from one year to the next. In the example above, we know that the figure of £312,420 includes 82% of the £37,000 acquired that year (which is £30,340). The rest can include small amounts of assets acquired decades ago and which may have long been scrapped.

Second, the reducing balance method means that the written down value never reaches zero. In the example of a £10,000 asset, it takes:

- 13 years to reduce below £1,000

- 25 years to reduce below £100
- 36 years to reduce below £10
- 48 years to reduce below £1.
- 60 years to reduce below 10p
- 75 years to reduce below 1p.

Assets in a pool keep reducing regardless of the current value of the asset or even if it still exists. If the £10,000 asset was scrapped after 10 years, it would still continue to be written down year after year.

From 2008, if a pool reduces below £1,000, the writing down allowance for that year is the whole amount. The written down value is then zero.

Third, the writing down allowance can be applied to an asset for which the first year allowance or annual investment allowance (or both) has been applied. The WDA is calculated on the amount after FYA and AIA have been subtracted.

Example: In 2018 a new business acquires £1 million worth of plant of which £20,000 qualifies for a first year allowance. Its capital allowances are:

first year allowance:	£20,000
annual investment allowance	£500,000
writing down allowance (18% x £480,000)	<u>£86,400</u>
total capital allowance	<u>£606,400</u>

The written down value at the end of the year is:

acquisition cost	£1,000,000
less capital allowance	<u>£606,400</u>
written down value	<u>£393,600</u>

Similarly, if a business acquires £500,000 worth of allowable plant, in its first year, it can claim:

annual investment allowance	£200,000
writing down allowance on £300,000	<u>£54,000</u>
total capital allowance for year 1	<u>£254,000</u>

The asset now has a written down value of £246,000 on which 18% writing down allowance may be claimed in year 2.

Fourth, whatever capital allowances are claimed, eventually the whole acquisition cost will be offset against tax. If someone acquires an allowable asset for £1 million, they will get tax relief

on the whole £1 million. All that capital allowances do is to allocate that acquisition cost over successive years.

This has two effects on the business. First the capital allowance attracts tax relief at the corporation tax rate in force for that year. As rates have fallen since 2010, it is preferential to claim as much allowance as possible in the earlier years. £1,000 worth of capital allowance at a rate of 28% tax is worth £280 as against just £200 when the tax rate is 20%. Second, there is a cashflow disadvantage in having tax relief in a later year.

Fifth, a business may choose not to claim capital allowance or may choose to claim an amount less than the maximum. The commonest reason for not claiming the full amount was to allow a claim for sideways loss relief. This is now less likely since the rules on sideways loss relief were relaxed. There are other situations, such as a sole trader who does not wish to lose his personal allowance.

Where capital allowances are claimed, a business's accounts will usually need to calculate a figure for **deferred taxation**.

Balancing allowance

A balancing allowance arises when either:

- a business ceases to trade, or
- a depooled asset is disposed of.

Example: in 2016 a business disposes of a depooled asset for £100. It has a written down value of £369.

Written down value	£369
proceeds of disposal	<u>£100</u>
Balancing allowance	<u>£269</u>

If, exceptionally, the disposal proceeds exceed the written down value, there is a **balancing charge**. This is subtracted from other capital allowances.

Special pool

From 6 April 2008, a business may need to operate a special pool where the writing down allowance is only 8%. Before 6 April 2012, the rate was 10%. From 10 March 1984 to 5 April 2008, the writing down allowance was 6%. Before 2008, the allowance was only given for long-life assets.

A **long-life asset** is an asset is one which costs at least £100,000 (total for all long-life assets) and which has an expected useful life of at least 25 years when new. This category does not include cars, or plant in dwelling, shop, showroom, hotel or office.

Since 2011, it is no longer possible to claim a capital allowance for an industrial building or an agricultural building. However, from 2008 it has been possible to claim an allowance for **features integral to a building** (FITAB, pronounced fie-tab).

FITAB includes:

- electrical systems, including lighting
- cold water systems
- space and water heating systems
- air ventilation and purification
- air cooling
- lifts, escalators and moving walkways
- external solar shading.

Expenditure on thermal insulation and certain cars is also included in the special pool.

Cars

Cars are plant and machinery but subject to particular rules. These rules apply from 2009, one year after the main changes to capital allowances for other assets

Capital allowances are given under three sets of rules.

Low-emission cars qualify for a 100% first year allowance. A low-emission car is one with these maximum emissions of carbon dioxide in gm/km:

- 2015-2020: 75 gm/km
- 2013-2015: 95 gm/km
- 2009-2013: 110 gm/km

If the whole first year allowance is not taken, the balance is written down at 18%.

From 1 April 2015, low-emission cars acquired to be leased no longer qualify for the first year allowance.

Medium-emission cars do not qualify for any first year allowance but do qualify for a writing down allowance of 18%. This is car with emissions up to:

- from 1 April 2013: 130 gm/km
- previously: 160 gm/km.

High-emission cars attract only the 8% writing down allowance.

Before 2009, a different system of capital allowances applied for cars whereby the maximum allowance was capped. Although this system has ended, cars already subject to that treatment were allowed to continue with it for up to another five years. If the business still had the car in 2014 when the old scheme ended, the written down value of the car was added to the main pool.

The old scheme depooled cars. This had the advantage of triggering a balancing allowance when the car was disposed of. This advantage is lost now that cars are pooled with other assets.

A car is a mechanically propelled vehicle weighing up to 3.5 tonnes that is primarily designed to carry people rather than goods or burden. Other vehicles, such as lorries and vans, count as plant.

Short-life assets

Short-life assets are those which have an expected life of up to eight years (four years before April 2011). This category includes computers and most electrical appliances.

A business *may* elect to depool short-life assets. This means that a business may claim a balancing allowance when the item is disposed of, rather than leaving it in the pool. In other words, more capital allowance may be claimed when the asset is disposed of.

Enterprise zones

Enterprise zones are designated areas of the country where special provisions apply to promote business activity. The original zones were designated between 1981 and 1996. They allowed 25% writing down allowance on construction work. If started within the first ten years of the zone's life, the allowance may be claimed for a further ten years. This means that the last enterprise zone allowance may be claimed in 2016.

Enterprise zones were revived in 2012. Those so designated are entitled to 100% enhanced capital allowance on expenditure incurred before 31 March 2020.

By December 2017, there were 48 enterprise zones in the UK, including 12 new ones in 2017, plus some old ones given an extended life.

Enterprise zones also qualify for business rate relief.

Claiming the allowance

A capital allowance must generally be claimed no later than 12 months after the due date for filing the tax return for the tax year in which the expenditure was incurred. HMRC has said that simply including a capital allowance in a tax computation counts as a claim. Elections, such as

for short-life assets, must generally be made within two years of the end of the accounting period in which the expenditure was incurred.

Where a business has a choice, it is preferable to use the annual investment allowance against 8% assets rather than 18% assets.

Example: a business in 2018 makes acquisitions of £600,000 of plant that attracts the 18% allowance and £600,000 that attracts the 8% allowance. Both its pools are empty. It needs to decide how to allocate the annual investment allowance of £500,000.

	<i>18% assets</i>	<i>8% assets</i>
Assets that attract 18% WDA	£600,000	£600,000
less annual investment allowance	<u>£200,000</u>	<u>-</u>
After AIA	£400,000	£600,000
WDA at 18%	<u>£72,000</u>	<u>£108,000</u>
written down value	<u>£328,000</u>	<u>£492,000</u>
Assets that attract 8% WDA	£600,000	£600,000
less annual investment allowance	<u>-</u>	<u>£200,000</u>
After AIA	£600,000	£400,000
WDA at 8%	<u>£48,000</u>	<u>£32,000</u>
written down value	<u>£532,000</u>	<u>£368,000</u>
Annual investment allowance	£200,000	£200,000
writing down allowance at 18%	£72,000	£108,000
writing down allowance at 8%	<u>£48,000</u>	<u>£32,000</u>
Total capital allowances	<u>£320,000</u>	<u>£340,000</u>

By using the AIA against the 8% assets, we have generated another £20,000 in capital allowances. This represents the 10% difference in rates applied to the £200,000 AIA.

Other capital allowances

While plant and machinery is the main category for capital allowances, there are some other categories of assets that qualify.

Assured tenancies on dwellings where expenditure was incurred between 10 March 1982 and 31 March 1992 continue to attract a 4% writing down allowance.

Business premises renovation relief where expenditure was incurred from 11 April 2007 qualifies for a 100% initial allowance, and a 25% writing down allowance if the initial allowance is not fully claimed.

Dredging where expenditure incurred from 1 April 1986 attracts a 4% writing down allowance.

Flat conversions where the expense was incurred between 11 May 2001 and 31 March 2013 qualified for a 100% initial allowance. If that allowance was not fully claimed, the balance is subject to a 25% writing down allowance.

Know-how is commercial knowledge. If the expense is incurred from 1 April 1986, it attracts a writing down allowance of 25% for income tax only. For companies, this comes within the scope of a new regime for intangible assets from 2002.

Mineral extraction where expenditure incurred from 1 April 1986 attracts a 10% writing down allowance for mineral extraction and 25% for other expenditure.

Patents where expenditure incurred from 1 April 1986 attract a 25% writing down allowance for income tax only. For companies, this comes within the scope of a new regime for intangible assets from 2002.

Research and development expenditure incurred from 5 November 1962 qualifies for a 100% initial allowance. It also qualifies for other generous tax relief.

Although strictly not a capital allowance, **cemeteries and crematoria** may claim a similar deduction for the percentage of burial or cremation plots used during the year in relation to the total number available at the beginning of the year.