

CASE STUDY

LONG FUNDING LEASES OF PLANT OR MACHINERY

For leases of property from 1 April 2006, it is necessary to consider whether any of the machinery or plant within the property will be treated as leased on a long funding lease. A long funding lease of machinery or plant is defined in the Capital Allowances Act 2001, (CAA 2001) Sections 70A to 70YJ. The rules apply to specialist equipment leases and also to property leases where machinery or plant is leased together with a building.

If an item of machinery or plant is covered under a long funding lease, then the lessor is denied Capital Allowances on that item, but can claim depreciation instead. The types of property that are most likely to be affected by this legislation are those that are commonly leased together with loose items, such as hotels.

Background

A UK resident property company (Propco) acquired a two-storey hotel for a consideration of £6,350,000 in May 2008. The hotel had been completed in September 2006 and let out to an operator for 35 years from August 2006. The interest acquired was freehold and the specification consisted of 75 letting bedrooms (all with en-suite facilities), a restaurant, a bar and meeting and conference facilities. The hotel had been fitted out to a good standard and included air-conditioning throughout, fire alarms, emergency lighting and a passenger lift serving both floors.

Propco acquired the property from a property trader, who had acquired the property direct from the developer in September 2006. Neither the developer, nor the property trader had claimed Capital Allowances. Propco instructed Davis Langdon to prepare a Capital Allowances claim in respect to the company's financial period ended 30 June 2008.

Breakdown of purchase price

There was no apportionment of cost within the purchase contract, but utilising valuation methods accepted by HM Revenue & Customs, the purchase price was broken down into the following components:

Land	£1,460,000
Building	£2,768,104
Fixed plant and machinery	£1,928,867
Loose furniture	£193,029

Hotel Allowances

The hotel qualified for hotel allowances on the building fabric based on the development expenditure of £1,611,588, rather than the price paid. As hotel allowances are being phased out, only 9% of the qualifying expenditure (£145,043) would be relieved before the balance is lost from April 2011. Of more importance, therefore, are the plant and machinery allowances that are not being phased out.

Background plant and machinery

As the lease term is 35 years, which represents a significant proportion, if not all, of the expected life of the plant and machinery, the lease has all the attributes of a long funding lease. There is a specific exclusion for 'background plant and machinery', however, which is not treated as leased on a long funding lease. Background plant and machinery must be fixed to a building and is defined in the legislation at CAA 2001 s70R and The Capital Allowances (Leases of Background Plant or Machinery for a Building) Order 2007.

Of the fixed plant and machinery of £1,928,867 only the carpets were not background plant and machinery. The expenditure on carpets of £109,452 was, however, within the allowed limits for items that are fixed to land or buildings, but are not background plant and machinery, as set out at CAA 2001, s70U. The carpets were, therefore, included in the Capital Allowances claim for Propco.

Loose furniture

Loose plant and machinery is not background plant and machinery and neither is it covered by CAA 2001, s70U. Due to the length of the lease, therefore, the loose furniture is treated as leased on a long funding lease of plant and machinery. In accordance with CAA 2001, s34A, Propco did not claim Capital Allowances on the £193,029 incurred on the loose furniture, but instead claimed a revenue deduction for depreciation in accordance with the Income and Corporation Taxes Act 1988, Section 502E.

Cash flow considerations

From April 2008, expenditure on plant and machinery on a second hand building is allowed at 10% or 20% annually on a reducing balance basis for integral features and general plant respectively. Of the £1,928,867 incurred on fixed plant and machinery, £1,127,027 was incurred on integral features, as listed at CAA

2001, s33A(5) and the balance of £801,840 was incurred on general plant. If the loose furniture of £193,029 was not caught by the long funding lease rules, then allowances would be available to Propco as general plant.

The total allowances on the general plant that would be available to Propco as a percentage of the qualifying expenditure are as follows:

Year 1 21.25%

(Based on hybrid rate for transitional year of new rates)

Year 5 67.74%

Year 10 89.43%

If the loose furniture was depreciated on a straight-line basis over say ten years, then the allowable depreciation would generate lower tax savings than Capital Allowances for the first eight years. It would not be until the ninth year that the cumulative depreciation exceeded the cumulative Capital Allowances.

Conclusions

As the level of plant and machinery expenditure that had to be treated as leased on a long funding lease was not material, the effect of the long funding lease rules was not too dramatic in this case. In the case, however, of a much larger five star hotel with swimming pools, gymnasiums, squash courts, etc (non of which would be background plant) combined with a much higher level of loose furniture and equipment, the cash flow consequences of CAA s34A would be much more significant. That being the case, tax planning measures should be considered to reduce or negate the loss of allowances to the lessor.

Finally, by not claiming Capital Allowances on the loose furniture, Propco avoided the risk of having its tax liability increased by HM Revenue & Customs. At the same time, Propco has benefited from a tax deduction for depreciation instead of Capital Allowances.

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