

## Basic Guide and Introduction to Capital Allowances

### Introduction

This basic guide and introduction to capital allowances is set out in the form of questions and answers. We have endeavoured to include most of the questions that could arise in the mind of the taxpayer, or the taxpayer's adviser, but this guide by its very nature is not comprehensive. More detailed information for different client types and scenarios is available on the main capital allowances page of the website and then utilising the orange navigation buttons.

### What are capital allowances?

Capital allowances are tax relief for certain capital expenditure. Depreciation of fixed assets is a non-allowable expense and is not, therefore, deducted from income when calculating taxable profits. Instead of depreciation, capital allowances are given for expenditure on certain capital assets as a tax allowable expense. Capital allowances reduce taxable profits (but not cash flow) and therefore, save money.

For example, if the annual profits of a business are £1,000,000 after adjustments for non-allowable expenses and the business has incurred capital expenditure that has resulted in an entitlement to capital allowances of £300,000 for the year, then the taxable profits will be reduced to £700,000. Even at a tax rate as low as 20%, this would save the business £60,000 in tax.

### What items of capital expenditure qualify?

As far as expenditure on property is concerned, the following types of capital assets can qualify for capital allowances:

- Plant and machinery (including both fixtures and chattels).
- Industrial buildings (abolished for expenditure incurred from April 2011).
- Renovation of a business premises in a disadvantaged area (originally available for a five year period ending on 10 April 2012, but now to be extended for another five years as announced in Budget 2011, subject to EU approval).
- Agricultural buildings (abolished for expenditure incurred from April 2011).
- Conversion of flats above shops.
- Capital expenditure on research and development.

Of the above types of expenditure, plant and machinery is by far the most common for capital allowances and is, therefore, the focus of this guide. The other types of qualifying expenditure are briefly mentioned later within this guide, although capital allowances will only be available in limited circumstances.

### What is plant and machinery?

There is no definition of what constitutes plant or machinery in the taxes acts, but certain items are specified in the Capital Allowances Act 2001 (CAA 2001) and other items have been held to be plant in various legal cases.

In accordance with CAA 2001, the following items are deemed to be plant and machinery qualifying for capital allowances:

- Electrical systems.
- Cold water systems.
- Heating, ventilation and air-conditioning installations.
- Lifts, escalators and moving walkways.
- External solar shading.
- Thermal insulation added to an existing commercial building.
- Demolition of plant or machinery.
- Safety expenditure at sports grounds.
- Personal security assets (but only where a special threat exists due to the business carried on by the individual).
- Alterations to existing buildings that are incidental to the installation of plant or machinery.
- Computer software and rights to computer software.

In addition to the above items deemed to be plant or machinery by legislation, there are many more items that have been held to be plant or machinery from case law. For example, there are 32 items listed at Section 23 of CAA 2001 that could be plant or machinery depending on how they are used within the business of the taxpayer. In addition, there are other items, such as mezzanine floors and artificial turf, which have been found to be plant in cases that have arisen since CAA 2001 was enacted.

What does or does not qualify as machinery is usually quite straight forward as the ordinary meaning of "machinery" is used for capital allowances purposes. "Plant," however, is a far more difficult concept to establish. It could include any asset that is used in the business of the taxpayer that is not trading stock or the premises in which the business is carried on. This is certainly an area where expert guidance is essential.

### What are capital allowances worth?

The value of capital allowances to a taxpayer is not always easy to establish and can often be affected by the profitability of the business, the future actions of the taxpayer, as well as the type of qualifying expenditure incurred.

Firstly, capital allowances save tax. There must be tax to save. Capital allowances cannot be claimed by non taxpayers, such as pension funds, but that is not to say that they have no value to a business that is temporarily without a tax liability. Even

where capital allowances cannot be fully utilised by the taxpayer because of insufficient profits, they may be of value to a future owner of the asset and that value is often reflected in the sale price of the asset. For example, a property with a high level of capital allowances attached to it would be worth more to a taxpayer, all things being equal, than a property without capital allowances.

Whilst capital allowances provide tax savings, there is generally the possibility that the tax relief is clawed-back when the taxpayer sells the asset that generated the capital allowances. For some types of assets, plant and machinery fixtures in particular, certain actions can be taken to avoid any claw-back of the allowances. For other types of assets, claw-back will only take place within certain time limits.

Different types of qualifying expenditure attract annual allowances at different rates. In the case of expenditure on renovating business premises (business premises renovation allowances — BPRAs), converting flats above shops (flat conversion allowances — FCAs) and research and development (research and development allowances — RDAs), the qualifying expenditure is 100% allowed in the year of expenditure. The tax saving for £1million of BPRAs, FCAs or RDAs will simply be £1m multiplied by the effective tax rate of the taxpayer for the year of expenditure.

#### **What is the value of plant and machinery allowances?**

The value of capital allowances for plant and machinery expenditure (plant and machinery allowances — PMAs) is dependant on the same factors as for other types of allowances, but different types of plant and machinery have different rates of capital allowances. The rates for PMAs are as follows:

- General plant; 20% per annum (reducing balance basis).
- Integral features; 10% per annum (reducing balance basis).
- Thermal insulation; 10% per annum (reducing balance basis).
- Long life assets; 10% per annum (reducing balance basis).
- Energy saving plant or machinery; 100% first year allowance.

The higher rate of capital allowances for expenditure on energy saving plant or machinery (and environmentally beneficial plant or machinery) are known as enhanced capital allowances (ECAs). Qualifying expenditure for ECAs is obviously more valuable than other types of PMAs because of the speed of write-off. The lower annual rates are known as 'writing down allowances'.

From April 2012 (6 April for income tax and 1 April for corporation tax), the writing down allowances reduce from 20% and 10% to 18% and 8% respectively. This should underline the importance to the taxpayer of identifying all ECAs available.

#### **How are the different types of plant and machinery recognised?**

Integral features are listed at CAA 2001, Section 33A, as follows:

- Electrical systems.
- Cold water systems.
- Heating, ventilation and air-conditioning installations.
- Lifts, escalators and moving walkways.
- External solar shading.

In addition, any demolition costs or incidental expenditure incurred on any of the above items will be included with the cost of the item concerned.

Thermal insulation is treated as plant and machinery expenditure for capital allowances if it is added to an existing commercial building.

Long life assets are items of plant or machinery with an expected economic useful life of at least 25 years (when new), but do not apply to plant and machinery within an office, showroom, hotel, retail shop or residential dwelling.

Expenditure on integral features, thermal insulation and long life assets is referred to as "special rate" expenditure, as the lower rate of 10% per annum applies.

Energy saving and environmentally beneficial plant and machinery is included on an approved list that is maintained by Government bodies on behalf of HM Revenue & Customs (HMRC). In order to qualify for ECAs, the item must either conform to a certain description (i.e., the model and reference number quoted on the list) or conform to a certain performance criteria. Identification of plant and machinery qualifying for ECAs is far from straight forward and the use of expert guidance is advisable.

General plant and machinery consists of any qualifying item that does not fall into any of the other plant and machinery categories.

#### **When are first year allowances (FYA) available?**

A FYA is available for plant or machinery qualifying for ECAs, as described above. They are also given from time to time to stimulate investment. For example, a temporary 40% FYA was introduced for one-year period for the tax year 2009–10 for expenditure incurred on general plant (i.e., not available for special rate expenditure). When a FYA has been claimed, the taxpayer cannot also claim a writing down allowance in the same year.

It should also be noted that BPRAs, FCAs and RDAs can all be fully claimed in the year of expenditure.

### What is an annual investment allowance and when is it available?

An annual investment allowance (AIA) is similar to a FYA in that it is granted in the year that the expenditure is incurred on plant and machinery. Unlike a FYA, the AIA is for a fixed amount and the taxpayer can also claim a writing down allowance in the same year. The AIA can be applied to expenditure attracting either a 20% or a 10% writing down allowance, but it is obviously preferable to apply the AIA to the special rate expenditure first.

The AIA is currently £100,000, but this will reduce to £25,000 for the tax year 2012-13. If, for example, the taxpayer has incurred £200,000 on special rate expenditure and £100,000 on general plant, the capital allowances available in the first year will be:

	£
AIA on special rate expenditure	100,000
Writing down allowance on special rate expenditure (£200,000 less AIA of £100,000) x 10%	10,000
Writing down allowance on general plant £100,000 x 20%	20,000
Total	<u>£130,000</u>

Tax saving in year 1 to 50% taxpayer =  
£130,000 x 50% = £65,000

### How is qualifying expenditure incurred?

Qualifying expenditure on plant and machinery fixtures can be incurred by the acquisition, construction or alteration/refurbishment of a building in which the fixtures form part of that expenditure, such as airconditioning, electrical installations, lifts, etc. Qualifying expenditure can also be incurred on chattels, such as furniture and equipment, situated within a building. Capital allowances are not available for plant and machinery within dwellings.

For expenditure incurred before April 2011, capital allowances are available for expenditure incurred on the acquisition, construction or alteration/refurbishment of industrial buildings and agricultural buildings that meet the qualifying criteria set out in CAA 2001.

Qualifying expenditure on plant and machinery can also be incurred by someone who makes a contribution to another person's expenditure. This is frequently relevant in the case of a property landlord who makes a capital contribution to qualifying plant and machinery forming part of the tenant's fitting out works. The landlord can then claim capital allowances on the plant and machinery covered by the contribution, even though the plant and machinery is owned by the tenant, rather than the landlord.

A taxpayer could also claim capital allowances for a contribution to another person's expenditure on an industrial building or agricultural building, but this will not be available for expenditure incurred from April 2011 when both these types of allowances are abolished.

Qualifying expenditure for BPRAs and FCAs can only be incurred on the construction or alteration/refurbishment of a qualifying building. No BPRAs or FCAs are available for the acquisition of a building.

Qualifying expenditure for RDAs can be incurred on the acquisition, construction or alteration/refurbishment of a building used for research and development, but the allowances are only available to the taxpayer that actually carries on the research and development activities.

### What is the value of PMAs on a property acquisition?

The value of capital allowances in respect of the plant and machinery fixtures with a property acquisition will depend on certain factors, including the specification of the building, the price paid and whether the seller or a previous owner has claimed capital allowances.

As an example, the purchaser of an air-conditioned office building, where no capital allowances claim has previously been made, could be entitled to capital allowances of between 10% and 25% of the price paid. No capital allowances are available in respect of the land component and therefore, the level of capital allowances for any situation will also depend on the property location. The higher the land value, then the lower the capital allowances and vice versa.

### What happens to the capital allowances when the property is sold?

In the case of PMAs, the seller is able to retain the capital allowances claimed (and even the unclaimed allowances) by entering into an election with the purchaser in accordance with CAA 2001, Section 198.

Capital allowances for most other types of qualifying expenditure are either retained regardless of the period of ownership (as in the case of industrial buildings and agricultural buildings), or else they are retained provided the property is not sold within seven years in the case of BPRAs and FCAs. The exception is RDAs, where the capital allowances will be clawed-back on the sale of the relevant property.

It is important to note that claiming capital allowances on the plant and machinery within a property and then retaining those allowances on sale has no relevance to the taxpayer's capital gains tax position provided the property is sold without loss.

### Why are capital allowances not automatically claimed by accountants or tax agents?

Claiming capital allowances requires specialist knowledge that is generally outside the general experience of most accountants and tax agents. To successfully claim capital allowances requires not only detailed knowledge of the relevant statute and case law, as well as the policies and methodologies of HMRC, but also necessitates valuation expertise. For example, making a successful capital allowances claim for the plant and machinery fixtures within a property acquisition will involve the identification and valuation of both the qualifying and non-qualifying components of the property, including the building, the land and the plant and machinery. Such expertise is not usually provided in-house by accountants and tax agents.

### How can Davis Langdon help?

Probably the most meaningful way Davis Langdon can help any taxpayer that has incurred capital expenditure on property is by providing an initial assessment of the potential capital allowances available at no cost and without commitment. This assessment would set out the potential value of the capital allowances and also highlight the various factors that should be considered in making a successful claim.

### Why choose Davis Langdon?

Choosing Davis Langdon for the provision of capital allowances advice is the low risk solution. The origins of our capital allowances expertise can be traced back to the 1970s, way before any of our competitors became interested in this specialist area of taxation. We have spent over 20 years in constant dialogue with HMRC on capital allowances issues to ensure that the potential for conflict is minimised, whilst at the same time acting in the best interests of our clients.

For example, before we started formulating capital allowances claims on property acquisitions in the late 1970s, it was not generally recognised that such claims could be made. This was followed by a period where different methods of valuation were adopted until we agreed the current approach with HMRC over 20 years ago. No other specialist has this depth of knowledge at their disposal.

Finally, we have the largest team of capital allowances specialists in the country. Just ask HMRC who prepares most of the capital allowances claims that they see and you will hear our name mentioned as the largest service provider in this field. Bigger is not always better, but when it comes down to the quality of capital allowances advice, then experience really is everything.

For further advice concerning any of the issues raised, please contact one of our key individuals detailed below or alternatively call our helpline on 0800 526262. Information on other property tax related topics can also be found on our website at <http://bankingtaxfinance.davislangdon.com>.

#### London

Paul Farey  
+44 (0)20 7061 7139  
paul.farey@  
davislangdon.com

#### Scotland

Michael Murray  
+44 (0)131 550 9473  
michael.murray@  
davislangdon.com

#### North

Christine Weaver  
+44 (0)161 819 7600  
christine.weaver@  
davislangdon.com

#### Midlands

Tim Beresford  
+44 (0)121 710 1333  
tim.beresford@  
davislangdon.com

#### South

David Rees  
+44 (0)23 8068 2801  
david.rees@  
davislangdon.com

#### Ireland

Lois Stirling  
+44 (0)28 9024 9800  
lois.stirling@  
davislangdon.com

#### Program, Cost, Consultancy

<http://bankingtaxfinance.davislangdon.com>  
[www.davislangdon.com](http://www.davislangdon.com)  
[www.aecom.com](http://www.aecom.com)

Whilst every effort has been made to ensure accuracy at time of publication, dated November 2010 [revised July 2011], information may be subject to legislative changes and may not reflect individual circumstances. Recipients should, therefore, not act on any information without seeking professional advice.