

## Interaction of Capital Allowances and Capital Gains Tax

### A common misunderstanding

Time and time again, we come across a property investor who has not claimed capital allowances because it was believed that the benefit would be wiped out when the property is sold due to capital gains tax (CGT).

The mistaken argument goes something like this: A property acquired for £1 million has capital allowances for the inherent plant and machinery of £200,000. When the property is sold for a profit, the capital allowances are clawed-back because the disposal value of the plant and machinery will be at least £200,000. It is possible to elect with the purchaser under the Capital Allowances Act (CAA) 2001, Section 198, that the disposal value of the plant and machinery is as low as £2 (£1 for integral features and £1 for general plant and machinery), but that would simply result in the sale proceeds attributable to the other property components (the land and building) increasing by £199,998. The net result would be that the increased gain on the land and building would be equivalent to the loss (retained allowances) on the plant and machinery.

The above argument is based on incorrect assumptions and this document seeks to clarify the interaction between capital allowances and CGT when a property is sold at a profit or a loss.

### The property asset

The rules for taxing capital gains, or for giving relief for capital losses, arising on the sale of assets is set out in the Taxation of Capital Gains Act (TCGA) 1992. Section 21 states that “all forms of property shall be assets for the purposes of this Act.” The asset as far as property is concerned is an interest in land, whether freehold, leasehold or some other interest. In accordance with the Law of Property Act 1925, Section 205, the definition of an interest in land includes any buildings and fixtures attached to that land.

The sale of a property represents the sale of a single asset, rather than the sale of separate property components consisting of land, building and fixtures. It is not possible to sell property fixtures separately from the building and land to which they are attached. In the example given above, there has been a disposal of a property costing £1 million, not the sale of land and building costing £800,000 and the sale of plant and machinery fixtures for £200,000. Only one asset has been sold as far as CGT is concerned.

### Wasting assets

A wasting asset is defined as any asset that has a predictable life that does not exceed 50 years. As TCGA 1992, Section 44(1)(c), states that “plant and machinery shall in every case be regarded as having a predictable life of less than 50 years,” it is tempting to treat plant and machinery fixtures as wasting assets. This might logically lead to a split of the property asset between plant and machinery on which capital allowances have been claimed

and the land and buildings that does not attract relief. Section 44(1)(c) can only apply to plant and machinery chattels and not fixtures, as the latter will always become part of the land.

The above contention is supported by reference to HM Revenue & Customs Capital Gains Manual, particularly CG70207 that states:

“Chattels that have been brought onto land may become fixtures. This will normally occur when either the chattels are intended to remain permanently on the land or are attached to the land (or a building on it) in a permanent way. Where a chattel has become a fixture, it should not be treated as a separate asset unless it is physically detached from the land and sold independently.”

As plant and machinery fixtures cannot be sold separately from the land, the plant and machinery fixtures cannot be wasting assets. A property lease with a term of less than 50 years remaining when it is sold will be a wasting asset. In such a case, the allowable cost of the leasehold property for CGT is reduced in accordance with TCGA 1992, Schedule 8, paragraph 1. This has no effect on the capital allowances position, as the disposal value of the plant and machinery will either be based on a just apportionment of the sale price for the lease (restricted to the level of capital allowances claimed), or the disposal value will be fixed by an election under CAA 2001, Section 198.

### The sale of a property at a profit

In accordance with TCGA 1992, Section 41(1), no adjustment is made to the allowable cost in respect of capital allowances when calculating the chargeable gain that arises when a property is sold at a profit.

For example, a freehold property purchased for £1,000,000 might have £200,000 of plant and machinery fixtures forming part of the property on which capital allowances have been claimed. If the property is sold for say £1,250,000 and the seller enters into an election in accordance with CAA 2001, Section 198, with the buyer fixing the disposal value of the plant and machinery fixture at £2, then the seller will be taxed on a gain of £250,000, but will retain £199,998 of capital allowances.

### The sale of a property at a loss

The situation is rather different if the property is sold at a loss because, in accordance with TCGA 1992, Section 41(1) and (7), the loss is reduced by the amount of capital allowances retained.

Using the last example above, if the property was sold for say £850,000, there would be a loss of £150,000. This loss would be reduced to nil by the retained capital allowances of £199,998, but the retained capital allowances cannot change a loss into a gain.

### Tax planning opportunities

The interaction between capital allowances and CGT offers some interesting tax planning possibilities. Whilst companies are taxed at the same rate on income and capital gains, different rates are applicable for individuals and partnerships. A high net worth individual paying 50% top rate income tax is better off paying CGT at 28% on chargeable gains.

An individual selling a property at a loss might choose to retain all the capital allowances to maintain a higher pool of allowances to offset against income tax. Of course, where the balance of the allowances are not available in full in the year of disposal, the slower cash flow benefit from capital allowances needs to be compared to the immediate cost of higher chargeable gains.

As companies pay corporation tax at the same rate on both income and capital gains, there may not be any advantage to be gained from retaining capital allowances when a property is sold at a loss to a third party. The immediate benefit from a capital loss that can be set against capital gains could easily outweigh the cash flow benefits from higher capital allowances. If there are no capital gains with which to utilise the capital loss, then the retention of capital allowances for future use might be the better option. This is because capital allowances can be set against any income and gains of a company (by virtue of adding to or creating a loss), whereas capital losses can only be set against capital gains. Losses that are increased or created by capital allowances are more flexible than capital losses but, again, the potential timing differences must be considered.

Where a property is sold at a loss by any taxpayer that is unable to utilise the capital allowances, it may be more beneficial for both seller and buyer if the seller does not retain the capital allowances. Instead, the parties could agree to a payment by the purchaser in consideration of the seller passing on the capital allowances that would otherwise be wasted.

### Summary

There is no interaction between capital allowances and CGT if a property is sold at a profit. Plant and machinery fixtures are treated as part of the property and cannot be sold separately. This even applies to a leasehold property with less than 50 years remaining at the time of sale, which will be treated as a wasting asset. When a property is sold at a profit, the seller is able to retain the capital allowances with no effect on the CGT position.

If a property is sold at a loss, then the loss will be reduced by the amount of capital allowances retained, although a capital loss cannot then become a capital gain. As capital losses can only be set against capital gains, retaining capital allowances may not be the most tax efficient option when a property is sold at a loss. The timing differences between

capital allowances and CGT should also be considered. Whilst CGT crystallises immediately on the sale of the property (unless it is transferred to a group company), the benefit of capital allowances may take several years to be realised.

On the other hand, where the benefit of capital allowances can be realised on the sale of the property, lower tax rates on capital gains as compared to income may make the retention of capital allowances beneficial even when a property is sold at a loss. Each situation should, therefore, be considered on its own merits and it is therefore inadvisable for any taxpayer to adopt a standard policy on capital allowances when selling property.

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>.

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