



PRESS RELEASE

Thermally insulated cladding - a tax comparison

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The addition of thermally insulated cladding to existing commercial buildings - a comparison of the tax treatment between revenue and capital expenditure.

Energy efficiency usually comes at a cost and this is certainly the case when thermally insulated cladding is added to an existing commercial building. The energy savings will likely take several years to repay the cost of installation; however, tax savings associated with the installation will help to mitigate the cost. On the one hand, the whole cost of replacement cladding, together with thermal insulation, could be treated as a repair for tax purposes. On the other hand and this seems more likely, the new cladding would be an improvement or alteration, which must be treated as capital expenditure. (Of course, this assumes that the building is held as an investment or for owner occupation, rather than as trading stock). This brief paper explores the pros and cons of each type of tax treatment and some readers might be surprised by the conclusion.

The case for treating the cost of thermal insulation as revenue expenditure is inextricably linked to the replacement of an existing cladding system. If it is just thermal insulation that is being added to the existing building, then it would be extremely unlikely that the cost could be treated as revenue in nature. Whereas if the thermal insulation is added as part of a cladding system, then it is possible that the whole cost of the complete cladding system could be a repair

on the basis that the existing cladding was in need of replacement.

Obviously the usual caveats in respect of repairs would apply, i.e. the price paid for the property must not have reflected the dilapidated condition of the cladding, the installation must be a modern equivalent of the existing cladding (which lacks thermal insulation) rather than an improvement and it must not be an alteration to the existing building.



If the cost of the thermally insulated cladding can be treated as a repair, then the cost can be deducted against taxable profits in the year of expenditure. This would effectively reduce the tax adjusted cost of the installation by an amount equal to the effective tax rate on a single year basis. If, therefore, a company is paying tax at 28% and incurs £1,000,000 on a replacement cladding system, the treatment of the installation as a repair would reduce the tax adjusted cost to £720,000. For an individual paying

tax at 40%, the tax adjusted cost after one year would be £600,000. So it looks very tax efficient to treat the cost as revenue expenditure. There is, however, likely to be a price to pay when the property is sold, as discussed later; but what about the tax position if the cost is capitalised?

Since April 2008, capital expenditure on the addition of thermal insulation to an existing commercial building qualifies for Capital Allowances at the rate of 10% per annum on a reducing balance basis in accordance with the Capital Allowances Act 2001 (CAA 2001), Section 28. If the thermal insulation was added together with a cladding system, then the cost of the remainder of the cladding system could also qualify for Capital Allowances at the same rate in accordance with CAA 2001, Section 25. The provision of the cladding system would invariably be considered 'incidental' to the provision of the thermal insulation, provided that it could be proved that the motivating factor for the replacement of the cladding was the provision of thermal insulation. This may not be as difficult as it first appears because of the pressure that is mounting on property owners to improve the energy efficiency of their buildings. It may well be the requirement to add thermal insulation that drives the replacement of the cladding system, rather than the need to update the look of the building. It is, therefore, quite possible that the whole cost of the replacement cladding system could qualify for Capital Allowances.

Whilst Capital Allowances provide tax relief over a much longer period than revenue expenditure, capital expenditure will also provide relief against capital gains tax (CGT) when the building is sold, assuming that the property value increases by at least the cost of the installation. In the case of revenue expenditure, no addition is made to the capital cost base and therefore, the gain on the sale of the building will not be reduced by the cost of the cladding. It should also be noted that in accordance with CAA 2001, Section 63(5), there is no claw-back of Capital Allowances on the thermal insulation when the property is sold. The effect of Section 63(5) would also extend to the remainder of the cladding system, which under Section 25 would be treated as part of the thermal insulation. These factors give rise to some surprising results when the adjusted tax cost of both capital and revenue expenditure are considered, as illustrated by the table below.

These figures represent the net present values of the tax adjusted cost of £1,000,000 incurred on a thermally insulated cladding system to an existing building by an investor or owner occupier paying the highest rate of corporation tax or income tax. As it can be seen from the figures, it is significantly more tax efficient for a company to capitalise the cost of the cladding. The position, however, for an income tax payer is far less conclusive because of the effect of the lower tax rate of 18% applicable to capital gains, as compared to the 40% tax rate for income.

Conclusion

There are likely to be an increasing number of properties that are upgraded in order to conform to new energy efficiency regulations. Whereas the property owner would generally look to maximise revenue expenditure when carrying out any work to an existing building, improvements and alterations are more likely to be capital in nature, rather than revenue. This can act as a disincentive for the property owner to incur expenditure.

In the case of expenditure on thermal insulation by a company, however, it could well be more tax efficient to capitalise the expenditure.

The above conclusion rests on the provision that all the capital expenditure incurred attracts Capital Allowances. This involves complicated considerations which have only been touched upon in this paper. The advice of a Capital Allowances specialist is, therefore, recommended before submitting the relevant tax return.

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TAX ADJUSTED COST:	Company		Individual	
	Capital	Revenue	Capital	Revenue
For holding period of 3 years	£814,509	£969,199	£735,013	£760,199
For holding period of 5 years	£814,509	£941,786	£735,013	£742,577
For holding period of 7 years	£814,509	£917,389	£735,013	£726,893
For holding period of 10 years	£814,509	£885,732	£735,013	£706,542