

CAPITAL ALLOWANCE

General

Capital allowance rules in tax law set out the extent to which deductions from profits are allowed in relation to capital expenditure. The basis is different to the way capital expenditure is allowed in financial accounts, which use depreciation charges to spread the capital expenditure out fairly over time. The tax treatment of capital allowances is broadly similar in the United Kingdom and Ireland. The system of capital allowances is being reformed radically in the period 2007 to 2011. This planned reform has been further affected by the economic crisis.

The general principle is that depreciation is not allowed as a deduction and is accordingly added back to the profit figure, in computing taxable income. Capital expenditure is deductible only if it qualifies in accordance with the Capital allowance rules. Even when it is deductible, the deduction is allowed at a stage in the computation after tax adjusted profits have been ascertained. Some capital expenditure is never allowed as a deduction. Other capital expenditure is allowed but on more restrictive terms than would apply in depreciation under financial accounts.

Capital allowances and tax allowances have been used in Ireland so as to stimulate investment in property and other assets in a way that has not been replicated to the same extent in the United Kingdom. There are more limited instances of incentive capital allowances.

Capital Allowances for Plant and Machinery

There are capital allowances for plant and machinery, industrial buildings and various types of research and development expenditure.

Machinery is usually easy to identify and will include cars, computers and office equipment. Plant is a more general concept that is not specifically defined by tax legislation. Plant means apparatus with which the business is carried out. It does not

include a "setting" so therefore would not include a building. Expenditure and computer software are deemed to be plant.

Land and buildings are not "plant". Special systems within a building which provide for the particular requirements of the trade, as opposed to the purpose of the building generally, may qualify as plant. Manufacturing and processing equipment, storage equipment, cookers, washing machines, basins, furniture and fittings, partition walls, sprinklers, and decorative assets in hotel may qualify as "plant" in their particular context.

Capital allowances are not calculated on individual assets. They are in put in a general pool and when an addition is made, the pool increases and when an asset is disposed of, it decreases. The allowance on certain assets is restricted, irrespective of their actual cost. For example, the cost of motor cars over £12,000.00 cannot be included.

Computation of Capital Allowances for Plant and Machinery

An annual writing down allowance of 25% is given on a reducing balance basis. The 25% rate was reduced to 20% in 2008. A special 40% one of allowance is available for the year commencing April 2009.

The allowance is given by reference to expenditure in the period on the "tax written down value" brought forward at the beginning of the period. The "tax written down value" includes all prior expenditure less allowances previously claimed and used. Allowances are given for a period of account. The above percentage is based on an accounting period of 12 months. Where the period is shorter, this is pro-rated.

The writing down allowance applies to all assets in the pool on the last day of the period of accounts. Therefore where business accounts are made up to the 31st March, the writing down allowance is given for assets in the pool on that day, irrespective of whether the asset is purchased at the beginning or last day of the period.

Where an asset in the pool is sold, it is removed from the total tax written down value brought forward in the pool. The writing down allowance for the period is calculated

on the remaining figures. The amount deducted from the pool is the lower of the sale proceeds or the original cost.

If on the disposal of an asset in the pool, the proceeds exceed the brought forward value in the pool the excess allowance previously given or recovered is charged to tax by means of a balancing charge. A balancing charge is taxed as an addition to trading profits.

Balancing allowances arise when the sale proceeds are less than the written down amount for the asset in the pool. Where a business is permanently discontinued and there is still an unrelieved expenditure, the business can claim relief for the unrelieved balance.

Special More Favourable Allowances

First time allowances are available in respect of certain types of plant and machinery. There are only available to small and medium size business. This gives a greater upfront write off against tax liability in the year of purchase against the cost.

The relief gives 50% or 40% first year allowance instead of the 25% writing down allowance. The rate of 50% is available to small business and 40% to medium size business. The balance of expenditure remaining is then added in to the written down allowance pools. It cannot be claimed against motor car unless they are low emission. It is does not have to claimed, if it is not desired.

The definition of small and medium size companies is extracted from the Companies Acts. To qualify two of the following conditions must be met:

- Small business; turnover must not exceed £5.5 million; balance sheet total not exceed £2.8 million; and number of employees not exceed 50.
- Medium size business; turnover must not exceed £22.8 million; balance sheet size must not exceed £11.4 million; and number of employees must not exceed 250.

Special Rules

There are restrictions on the extent of which motor cars exceeding £12,000.00 in cost are included in the pool. If a car costs more than £12,000.00 the capital allowance on each such car must be claimed separately. The annual writing down allowance is restricted to a maximum of £3,000.00. Expenditure on low emission cars by business is eligible for 100% first year allowance.

Where assets are used partly for business and partly for non business purposes the capital allowances must be pro-rated in proportion to the respective uses

It is possible to elect to treat assets as "short life" assets where the intention is to sell them or scrap them within 4 years. In this case each short life asset is subject to separate capital allowance computation. If disposed of within the four years, a balancing allowance or a balancing charge arises relative to the written down amount. If no disposal is made within four years, the unrelieved balance is transferred back into the pool.

"Long life" assets mean plant and machinery with a working life in excess of 25 years. "Long life" assets have a writing down allowance of 6% rather than 25%. First year allowances are not available.

Capital Allowances for Industrial Buildings

This allowance is progressively reduced from 1 April 2008 for companies, and from 6 April 2008 for income tax cases. Both of these allowances will be withdrawn from April 2011.

Capital allowances for buildings are only available to buildings used for a "qualifying trade". A qualifying trade is one carried on in a mill factor or similar premises or for the manufacture of goods or materials by subjecting them to process or for the storage of goods of materials used for manufacturing which are to be subject to processed finished goods which have been manufactured

The effect of the above is that capital allowances are only available for what would broadly be described as factories or hotels. They are not available to retail premises, offices and other commercial properties. In effect, the capital expenditure on such

buildings is not allowed as a tax deduction. The interest on the acquisition finance may be allowed as a deduction.

There is case law very similar to that applied in Ireland in relation to the drawing of the line between an "industrial" building and other buildings. Dwellinghouses, retail premises and offices are specifically excluded. Hotels are subject to certain conditions including that they must be open at least four months in the 1st April to 31st October season, have at least 10 bedrooms and provide certain minimal services.

The cost of an industrial building allowed for tax deduction includes only the expenditure incurred on construction. The cost of land does not qualify. Where part of a building is used for a non qualifying purpose, it is ignored if less than 25% and pro-rated if more than 25%. Where buildings are acquired after construction but before use, there are special rules for computing the eligible expenditure.

Writing down allowances allowed on a "straight line" basis (same amount each year) at 4% per year. This is reduced if the period of account is less than 12 months proportionally. Temporary non-use does not affect the allowance. Industrial buildings have capital allowance life of 25 years. No allowance or charge will arise in the sale after 25 years.

Where a building is disposed of within the 25 year tax allowance period and the proceeds are less than the "written down" value, a balancing allowance is given. This is a further allowance to reflect the fact that the actual cost is less than the allowance which is made. Where the disposal proceeds exceed the tax written down amount, a balancing charge will arise. This effectively reclaims the excess allowances previously given to the extent that the allowances given, exceeded the difference between cost and sale price.

Where buildings are being used for a non industrial purpose at the end of the reference accounting period no writing down allowance, is given. There is notional writing down but it is not allowed by way of deduction from the trading profits.

A purchaser of a second hand industrial building is entitled to industrial building allowance where it is within its original 25 years tax life. Provided the subsequent

purchaser uses it in a qualifying trade he is entitled to writing down allowance on the lower of the purchase price or the capital allowance amount.

The annual writing down allowance is computed by spreading the allowance over the remaining tax life. The allowance is the written down value of the building prior to the sale plus balancing charge. This sum is then written off over the remaining part of the 25 year tax life.

2008 Changes

A number of changes were made in 2008. The main ones were:

- The introduction of a new Annual Investment Allowance which is effectively a 100 per cent allowance for business expenditure on plant and machinery (apart from cars) of up to £50,000 a year. This applies to businesses regardless of size, and replaced the previous 40 per cent or 50 per cent first-year allowances for small and medium-sized businesses.
- Changes to the rates of capital allowances on plant and machinery from 25 per cent to 20 per cent for the main pool, and from 6 per cent to 10 per cent for long-life assets in the new special rate pool. The 20% rate is 40% for the year from April 2009/
- The phased withdrawal of industrial and agricultural buildings allowances by 2011.
- New payable tax credits for businesses that make losses attributable to investment in environmentally beneficial plant and machinery.

This Guide is intended as an overview and broad outline of the matters covered in it. Its purpose is to inform and raise awareness. We are happy to offer specific legal advice on particular circumstances.

This Guide should not be relied on as a substitute for comprehensive legal advice with reference to the particular circumstances.

While we have taken due care in the preparation of this publication, we do not accept legal liability as a result of any reliance placed on anything in this Guide. The reader should rely only on specific legal or taxation advice.