Capital Allowances
The Basics

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CAPITAL ALLOWANCES

Capital Allowances are the only means by which taxpayers receive tax relief on their long term capital investment in property.

Significant capital expenditure is incurred when a company or private individual buys, constructs or improves commercial property. Whilst the costs of running a business can be off-set against tax, this capital expenditure is not an allowable expense. Instead, capital allowances are given on certain qualifying elements of that capital expenditure, with the most common type of qualifying expenditure being plant and machinery.

What is plant and machinery?

The Capital Allowances Act 2001 (CAA 2001) gives no statutory definition of what qualifies as plant and machinery. Instead, CAA 2001 s21 and s22 give tables A and B which list assets treated as buildings, structures and other assets, which are excluded from being plant and machinery.

CAA 2001 s23 Table C then lists over 30 headings of assets that despite being part of a building or structure, could still qualify for plant and machinery allowances.

These headings include, but are not limited to:

- Electrical, cold water, gas and sewerage systems specifically to meet the requirements of trade.
- Air conditioning, heating and ventilation installations.
- Hot water installations.
- Lifts and escalators.
- Data and telephone installations.
- Fire and burglar alarm installations.
- Sanitary fittings.
- Furniture, fittings, carpets and equipment.

The Finance Act 2008 then introduced two different plant and machinery asset classes, the main pool and the special rate pool for integral features. The majority of plant and machinery, specifically those assets integral to the building, would now fall under the special rate pool. As part of this change however, the following additional assets now qualified as plant and machinery, albeit integral features.

- All cold water systems.
- Small power and general lighting systems.
- External solar shading.
- Thermal insulation added to an existing building.

What allowances are given on plant and machinery?

Qualifying expenditure on plant and machinery will either attract a first year allowance (FYA) and/or an annual writing down allowance (WDA).

An FYA of 100% is given for expenditure on energy saving and water efficient plant and machinery which falls under the Enhanced Capital Allowance (ECA) scheme. The details of the ECA scheme are covered by a separate technical guide.

Although not a FYA as such, the Annual Investment Allowance (AIA) also gives 100% allowances in the year of expenditure. Although initially aimed at small businesses, every business has, since April 2008, been given an AIA. From 1st January 2019 this AIA attracts a 100% allowance on the first £1,000,000 spent on qualifying plant and machinery.

When expenditure does not attract FYA's, then the expenditure must be allocated to one of two pools – the main pool or the special rate pool.

Main pool expenditure attracts an 18% annual WDA, whereas special rate expenditure attracts an 8% annual WDA, further reduced to 6% from April 2019. They are both given on a reducing balance basis.

So, whilst the total tax relief available from main rate and special rate pool allowances is the same, the rate at which the tax relief is received differs. This difference reflects the longer life span, or depreciation, of those items integral to a building, such as heating, air-conditioning, lifts etc.

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How do capital allowances result in tax savings?

When completing a yearly tax return, a company or individual will deduct from profit the WDA and/or FYA for that year. The profit for tax purposes is then reduced, with less tax to pay as a result. As capital allowances are a tax relief, their value is ultimately related to the claimant's rate of tax - the higher their rate of tax the higher the value of any allowances to them.

Capital allowances therefore, are only of a benefit if the company or individual are tax payers (i.e. not a charity) and that there is profit for which they must pay tax (i.e. not loss making). A loss making company may claim certain tax credits in relation to ECA's however.

When can you claim capital allowances?

All types of commercial properties will attract capital allowances. Expenditure on offices, retail shops, industrial units, care homes, hotels, leisure facilities and furnished holiday lettings will all result in significant tax savings. Except for communal areas to blocks of flats, expenditure on dwelling houses will not attract allowances.

Capital allowances are available on all types of capital expenditure, including:

- Purchase of a new or second hand building.
- Construction of a new building.
- Refurbishment of a second hand building.
- Fit out of a new or second hand building.

A claimant never loses the right to claim capital allowances, therefore allowances can still be claimed on expenditure incurred many years ago.

Revenue expenditure does not attract capital allowances as it is an allowable expense in the year of expenditure. Developers who hold property as trading stock and refurbishment expenditure on like for like replacements are all examples of revenue expenditure.

Purchase of a new or second hand building

The valuation of capital allowances following the purchase of a building is based upon a "just apportionment" of the purchase price between land, building and qualifying plant and machinery in accordance with CAA 2001 s562. The method of apportionment is not prescribed by statute and is a matter of negotiation between the claimant and HMRC.

The Valuation Office Agency (VOA) has however expressed a preference for the following formula, which is almost always used in practice

$$Q = P \times \frac{A}{B + C}$$

Where
Q = Qualifying expenditure
A = Replacement cost of the qualifying asset
B = Replacement cost of the building (incl A)
C = Bare site land value
P = Purchase price

Therefore in order to value capital allowances in respect of purchase expenditure, valuation and surveying skills are required.

The legislation surrounding capital allowances and the purchase of a building is complicated as there are many ways in which a claim can be restricted, especially following the introduction of mandatory pooling. Specialist advice should be obtained including a full capital allowances due diligence exercise as all available allowances may be lost if not.

Due to the complexities of this subject, the issues relating to the purchase of a property are covered by a separate technical guide.

For further information on the basics of capital allowances or any other matter please contact HCCA.

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