New rules on capital allowances

There have been some significant recent changes on capital allowances that could influence your decisions on buying business assets in the immediate future.

For tax purposes, a business cannot claim depreciation as a business expense. Instead, the business may be able to claim a capital allowance.

IS IT CAPITAL OR REVENUE?

The first question to ask is whether the expenditure is capital or revenue.

Revenue expenditure is the normal cost and expenditure of a business, such as stock sold, wages, electricity and insurance. Capital is expenditure is normally on things that last for more than a year, such as buildings, furniture, vehicles and machinery.

For tax purposes, most revenue expenditure is wholly allowable for tax in the year it is spent, by reducing your taxable profit. For capital expenditure, only some of the expenditure is usually allowable in the first year. The rest of the expenditure is usually spread out over several years.

In most cases, it is obvious whether spending is capital or revenue. In marginal cases, we can advise you.

DOES IT QUALIFY FOR A CAPITAL ALLOWANCE?

Not all capital expenditure qualifies for an allowance. If expenditure does not qualify, you may find that you get no tax relief at all. This is particularly so for industrial buildings where the allowance is withdrawn after April 2011.

The most important capital allowance is for plant and machinery. The word 'plant' is not defined in tax law. Incredibly, the definition is taken from an injury compensation case of 1887 when a worker was kicked in the leg by an unruly cart horse.

Since then, there have been hundreds of cases heard by the courts. This is complemented by three lists in Capital Allowances Act 2001, and much guidance by the courts.

Even after more than 120 years, the matter is still argued. In 2010 alone, there was a case on whether plant includes an eco-friendly holiday bungalow (no) and a gazebo for smokers in a pub garden (yes). HMRC also produced guidance on what comprises plant in the pig industry.

The distinction as to what constitutes plant is not always obvious, as this table shows:

Plant	Not plant
Special lighting to create an atmosphere in a club or restaurant	Ordinary lighting in a club or restaurant
Flexible partitions to allow premises to meet changing demands of a building	Ordinary partitioning in a building
A stand-alone mezzanine floor that covered most of the ground floor area	A mezzanine floor that is permanently built into the structure
Ordinary canopy at a petrol station	Petrol station canopy with an advertisement
Murals and decorative brickwork in a pub	Shopfronts, tiles, water tanks, staircases and raised floors in a pub

WHAT IS THE ALLOWANCE?

For small businesses, there is an annual investment allowance where all plant and machinery qualifies for 100% allowance.

The amount of the allowance is currently £100,000, but this reduces to £25,000 from April 2012. If your expenditure is within this limit, all your capital expenditure could be written off in the first year, unless it includes cars for which there are separate rules.

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Next year's reduction in this allowance could mean that you will benefit by bringing forward capital expenditure.

There are some assets that separately qualify for a 100% first year allowance. These include low emission cars bought before April 2013 and certain environmentally friendly products. There are also special provisions for patents, and research and development.

There are special agreements for aircraft, greenhouses and printing equipment.

For other plant and machinery, a writing down allowance is given at a rate of 20% or 10%. The 10% rate applies to:

- long-life assets (an expected life of 25 years or more)
- thermal insulation
- features integral to a building
- cars with an exhaust emission of more than 160 g/km carbon dioxide.

Anything else attracts a writing down allowance of 20%. We can advise you what rate applies to your spending.

It should be noted that these are the rates that currently apply. Different rates have applied in previous years. In particular, there were several significant changes in 2008.

The 20% and 10% rates are reducing to 18% and 8% respectively from 1 April 2012, so it may be worthwhile bringing forward expenditure to qualify for the higher allowance. We can help you determine whether that is appropriate in your circumstances.

WHAT ABOUT CARS?

The current position for new cars depends on the exhaust emission:

Exhaust emission	First year allowance	Writing down allowance
Below 110 g/km	100%	20%
Between 110 and 160 g/km	none	20%
160 g/km or more	none	10%

If you lease a car, you may only claim capital allowances for 85% of the cost of a high-emission car.

In addition to considering capital allowances, lower emission cars attract a lower rate of vehicle excise duty. If provided as a company car, the lower the car emission, the less income tax is paid by the employee. We can advise you on the various tax implications of buying new cars.

HOW IS CAPITAL ALLOWANCE CALCULATED?

If some plant and machinery qualifies for a 100% first year allowance, the whole cost is allowed against your taxable profits in the first year. None of the cost is allowed in the second or any subsequent year.

Even if an asset qualifies for a 100% allowance, you do not have to use it. You can take some or none of this allowance, and leave the balance to be written down in future years. This can advantageous if you are a company or an individual and want to claim sideways loss relief. It can also be advantageous if you are an individual to stop you losing your personal allowance. We can advise you on whether these situations apply to you.

The writing down allowance is calculated on the reducing balance method. This means that each year you claim an allowance on the written down value. Suppose you spend £10,000 on an asset that attracts a 20% writing down allowance. The allowances are:

Year	WDA	Written down value
0	-	£10,000
1	£2,000	£8,000
2	£1,600	£6,400
3	£1,280	£5,120
...and so on.		

All the time you still have the asset, its written down value will never reach zero. However you can claim the whole of any balance when you dispose of the asset or when it is in a pool of assets whose value falls below £1,000.

Where an asset attracts this capital allowance, the whole cost will be allowed against taxable profits, eventually. Capital allowances determine in what years the allowance is given. In our example, the business will claim the whole £10,000 against taxable profits for the years in which it possesses the asset.

If the rate of corporation tax (or income tax) did not change from year to year, the reduced rates of writing down allowance would only have a cashflow implication. You would receive less tax relief each year until you disposed of the asset.

However the rates of corporation tax are now reducing each year. The reduction in the rate reduces the value of the capital allowance. The £2,000 writing down allowance at 21% (small profits rate) is worth £420 in tax saved. After 6 April 2011, the rate reduces to 20%, so the allowance is only worth £400.

Suppose the rate reduces to 19% in 2012 (which we don't yet know), the lower 18% writing down allowance is worth only £342. This is not just a cashflow disadvantage.

This could mean that it may be worthwhile bringing forward capital expenditure. We can advise on this.

SOME OTHER MATTERS

There are many other aspects of capital allowances that may need to be considered.

You have the right to elect that any particular asset has its capital allowances calculated separately and not put in a pool with other assets. This can be advantageous for assets with a short life.

If money is borrowed to pay for an asset, the loan relationship tax rules may need to be considered. There are also special provisions when an asset is acquired on a lease.

Although the most common capital allowance is for plant and machinery, it is still possible in 2011 to claim some allowances for industrial buildings, agricultural buildings and enterprise zones. There are some old allowances that still apply for past tax years.

There are separate capital allowances for renovation of business premises before 11 April 2012, research and development, mineral extraction, patents, know-how, dredging, cemeteries and crematoria.

On all these other matters, we can advise you.