Budget 2007 – Capital Allowances

Martin Wilson of The Capital Allowances Partnership LLP examines and comments upon the main provisions relating to capital allowances in the Budget and Finance Bill

For the first time in many years this Budget included significant provisions relating to capital allowances and the reaction of both tax specialists and business leaders has been almost unreservedly negative.

Industrial buildings allowances

The big surprise was the impending abolition of industrial buildings allowances (IBAs) and agricultural buildings allowances (ABAs), widely seen as an unwarranted attack on the British manufacturing, hotel and transportation industries, not to mention farming. The withdrawal of the relief will cost these sectors dear and scarcely encourages investment. Adverse effects on business, including business closures, cannot be ruled out.

The recent consultation on potential capital allowances reform highlighted the lack of tax relief for most taxpayers' expenditure on business premises under the current system. This is said to put the UK at a competitive disadvantage to its main competitors, most of which recognise the strong economic case to allow tax depreciation on the physical structure of buildings as well as providing accelerated rates for faster depreciating assets. However, instead of levelling the playing field between different economic sectors by extending buildings capital allowances to sectors outside those that currently qualify for IBAs, ABAs or R&D allowances, the Chancellor chose to withdraw the relief entirely. This has left those industries that currently benefit from the relief much worse off, as well as failing to remedy the lack of relief experienced by other sectors of the economy.

Although the system of IBAs was discussed in consultation, it was not previously suggested it would be abolished. Despite this, it is to be phased out over the next four years, a change which, as will be seen below, essentially has retrospective effect.

The rationale given for the phasing out was that IBAs were 'poorly-targeted' and their abolition would help fund a reduction in the large companies' corporation tax rate (although of course smaller companies losing IBAs will not benefit from this reduction but will see their tax rate increase to 22%, whilst individual investors will continue to pay tax at 40%).

The phasing-out will be achieved by reducing the rate by one-quarter each year over four years (on a straight-line basis). So a business currently claiming 4% a year will see this reduce to 3% from April 2008, 2% from April 2009, 1% from April 2010 and 0% from April 2011. If the property was acquired second-hand with, say, ten years of its 25-year IBA life left to run, such that the current claim is 10% a year, this will reduce to 7.5%, then 5%, then 2.5%, then nil.

All this means that after April 2011, any unrelieved balance of expenditure will simply be written off and will not attract tax relief, resulting in substantially increased future tax bills for affected businesses (Example 1).

Example 1: IBA abolition

> Gordon and his brother spent £5 million on constructing a factory in 2006, expecting that the whole of this expenditure would attract tax relief via IBAs over the next 25 years. At their marginal tax rate of 40%, this would be worth £2 million over time. Instead, they will begin claiming allowances at the expected 4% a year but will then see this gradually reduced to 1% for 2010/11, before allowances cease altogether.
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> In April 2011 the residue of expenditure (that is, the unrelieved part of the original cost) will be £4.3 million, which will then be written off without relief. So in future years the brothers will pay total additional tax of £1.72 million.

The full legislation is yet to be published but with immediate effect from 21 March 2007, a taxpayer's IBA claim for the purchase of a second-hand building will be based on the vendor's tax written-down value (and the sale of an existing industrial building will not, as at present, give rise to a balancing charge or allowance) (Finance Bill 2007, Clause 35).

One effect of the abolition of IBAs is that it will be more important than ever to maximise plant and machinery allowances, as for most taxpayers this will be the only way of obtaining any tax relief for expenditure on property.

Plant and machinery – rates of allowance

The current system and rates of allowances for plant and machinery remain in place for the next year. However, from 2008/09 there will be two major changes, the scope and details of which will be the subject of consultation.

Firstly, the standard rate of writing-down allowance will fall from 25% a year to 20%, which the Chancellor believes is the economic rate of depreciation for plant and machinery. So the tax relief will come through slightly more slowly, although the impact is less severe than might be thought. Currently, 90% of the relief accrues in the first ten years – using the new rate, 90% of the relief will accrue in the first twelve years. However, whereas the standard rate currently applies by default to all plant, this new rate is expected to apply only to movable plant and non-integral fixtures.

Secondly, the rate of writing-down allowance on certain other types of plant will be 10%, which would mean that it would take more than 20 years for 90% of the relief to accrue. Again, this reflects Mr Brown's concern that allowances should 'better reflect true economic depreciation, ensuring that business investment decisions better reflect commercial rather than tax considerations'. The Chancellor's speech explicitly stated that the rates are 'based on how long an asset will actually last'.

The types of plant to which this 10% rate may apply are described as 'certain fixtures integral to a building' (with no further details or explanation currently available). This is likely to include fixtures such as heating, cooling and hot-water systems, sanitary installations, etc, that typically currently qualify for relief at 25% a year.

From the taxpayer's point of view, the key objective of consultation must be to ensure that the 10% rate only applies to assets which (as the Chancellor stated) do genuinely depreciate over a long period of time. There is some logic in applying the reduced rate of allowance to, say, copper pipes, which may last 20 years, but it would be grossly unfair to apply it to, for example, carpets or blinds that may need replacing in three.

For this reason, it would be wrong, as has been suggested by some commentators, to simply apply the 10% rate to the types of asset proposed as 'background plant' by Statutory Instrument 2007/303, which deals with long funding leases of plant and machinery, a quite different purpose, and which includes relatively short-lived assets such as carpets, kitchen facilities and alarm systems.

The proposed 10% rate, if too extensive, would also discriminate against businesses that refurbish their properties often, especially 'service' businesses such as retailers and those in hospitality trades, whose economic asset lives are much shorter than envisaged by the proposed 10% rate of allowance. In fact, in some sectors (such as the London office market) entire buildings have been demolished in periods shorter than that envisaged by the proposed rate of relief.

Although, as mentioned in our recent article (Back to Basics – Plant & Machinery Allowances Common Misconceptions, *The Tax Journal*, Issue 869, 22 January 2007) it is possible to claim capital allowances in a later period's return as long as those assets

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are still owned in that later period, it is certainly true that any claims for plant allowances should be made as soon as possible, to ensure that qualifying expenditure is added to the general pool before April 2008, and therefore qualifies at the higher rate.

Plant and machinery – long life assets

Subject to some exemptions, plant with a life expectancy in excess of 25 years currently qualifies for allowances at a rate of 6% a year, which will increase to 10% in a year's time. The impact of the 'long life assets' legislation is largely (though not entirely) restricted to those businesses which will suffer most from the abolition of IBAs, so the rate change affords some measure of relief, but it is of course only a timing difference, whereas the abolition of IBAs is a permanent loss of tax relief.

Plant and machinery – first-year allowances/annual investment allowance

The first-year allowance of 50% for small businesses will be extended for another year, while the rate for medium-sized businesses continues at 40% (Finance Bill 2007, Clause 36).

However, from 2008/09 first-year allowances will be replaced by a new Annual Investment Allowance, under which the first £50,000 of expenditure incurred on plant each year will qualify for 100% relief. Readers with long memories will recall that an earlier form of 'investment allowances' were given *in addition to* the standard capital allowances. That is unlikely to be the case under these proposals. Details are to be confirmed but it is expected that the investment allowance will not apply to, for example, cars or the above-mentioned 'fixtures integral to a building'. Whilst any extra relief is to be welcomed, this is of course only an acceleration of relief, £50,000 doesn't go very far, and consequently the maximum benefit that the investment allowance affords is very limited. For larger businesses the amount is likely to be immaterial, while for a small company, it represents a present-value tax saving of around £5,000, which may well all go in paying tax at the now increased small companies' rate.

Business premises renovation allowance

Finance Act 2005 paved the way for a 100% allowance for the cost of converting or renovating property to bring it back into business use. It has now been announced that, following the granting of state aid approval, this allowance will be available from 11 April 2007.

The allowance is available provided that strict criteria are met, chief among which are:

- that the property in question has been vacant for a period of at least twelve months, after having last been used for the purposes of a trade, profession or vocation, or as offices, but not as a dwelling; and
- it is situated in a designated disadvantaged area.

This allowance has little to fault it, except perhaps its restriction to designated areas, but it sits uneasily alongside the negative measures announced in this year's Budget, in particular the fact that a rise in the number of vacant business premises cannot be ruled out in consequence of the abolition of industrial buildings allowances. It will have little impact on the majority of businesses.

Conclusion

More businesses are expected to suffer as a result of Budget changes to the capital allowances system than will benefit. Allowances will be harder to come by and it is even more essential to maximise claims for plant allowances, and to do so without delay, before the Budget changes take full effect.

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