

Going down

MARTIN WILSON reviews

HMRC's recent consultation document on proposed changes to the system of capital allowances.

PROPOSALS FOR CHANGES to the way in which relief will be given for expenditure on plant and machinery have recently been published by HMRC and HM Treasury (see *Business tax reform: capital allowances changes, July 2007* at www.hm-treasury.gov.uk). These will affect almost all taxpayers to a greater or lesser extent, with investors in property (whether as an investment or for own use) being particularly badly hit. By the Treasury's own admission, the most widespread change, a reduction in the rate of allowances generally available, will raise an additional £2.27 billion of tax by April 2010.

The package of proposals is a confused one, although that may well reflect its political origins, rather than poor drafting. Some parts have the stated aim of encouraging investment; others pointedly discourage it. The document speaks of the Government's concern that investment should be driven by commercial, rather than tax, considerations; elsewhere it advocates allowances as a tax incentive to investment.

The proposed measures are described variously as a modernisation, or as making the system fairer. Ultimately, as most businesses will come to realise, it is another instance of raising taxes by the back door. In particular, changes in the rates of allowances will negate the whole of the effect of reducing the main rate of corporation tax to 28%. In effect, businesses that invest will subsidise those that don't.

Annual investment allowance

The Treasury has made a great deal of its proposed 'annual investment allowance' (AIA), to be introduced in April 2008 for the first £50,000 of expenditure on plant and machinery (other than cars). This will replace existing first year allowances for small and medium-sized enterprises and – it is claimed – will encourage investment. However, even moderate investors, such as purchasers of single shops, offices or pubs, may find they are worse off after April. The problem is that the AIA is aimed only at the smallest businesses, which spend no more than £50,000 on plant

KEY POINTS

- The new annual investment allowance.
- Which businesses will win and which will lose?
- The new rates of allowances.
- Fixtures integral to a building.
- The end of IBAs and ABAs.

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in a single year. Many small businesses spend substantially below this figure, so will barely benefit and anyone undertaking a major capital purchase, for example buying a property, is likely to find that the part of the cost attributable to 'plant' is well over this £50,000 limit, and the excess will (as shown below) qualify only for reduced rates of allowance. There is no provision to carry forward unused AIA to later years.

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For example, a publican spending £500,000 to acquire a pub may typically find that £150,000 relates to 'plant'. Currently, the whole of this would attract tax relief at the rate of 50% in the first year (assuming it is a small business) then at 25% per annum. From next April, the first £50,000 will be relieved immediately by the AIA (provided profits are sufficient). However, the balance will be relieved at a mixture of 20% and 10% (see below). This is not the place to go into detailed calculations, but within three or four years of purchase, the whole of the AIA will effectively have been taken back by HMRC by the slowing down of the other capital allowances. Thereafter, the publican will be worse off.

Larger investors will derive negligible benefit from the AIA – for a company paying the standard rate of corporation tax, it will be worth £14,000 – and they will typically be hit far worse by the other reductions and withdrawals of capital allowances. Groups of companies will have to share a single AIA of £50,000.

The AIA will apply to expenditure incurred on or after 1 April 2008 for corporation tax, and 6 April 2008 for income tax. In contrast to the general rate change (see below), there is no time apportionment of expenditure incurred in accounting periods which overlap the implementation dates. Some commentators have advised taxpayers to defer expenditure until after the relevant date, but as discussed above, this very much depends on the amount of expenditure involved. If the amount is much above the £50,000 limit, taxpayers may find that the AIA does not compensate them for the reduction in writing-down allowances generally.

Rate of allowances

Currently, expenditure on plant and machinery may be written off for tax at a rate of 25% each year. Under HMRC's proposals, from next April the rate of relief will be reduced, meaning that while the tax relief will still be given, it will come through more slowly. Allowances will be given at two rates – 20% per annum for the general pool, but only 10% for 'fixtures integral to a building' and for long life assets. In each case, as at present, allowances will be given on a reducing balance basis.



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The reduction from 25% to 20% is said to reflect more accurately the true economic life of plant. Two observations need making. First, the effect is to assume that plant has a life of broadly thirteen years rather than ten – this is fine-tuning indeed! The cynical may suggest that 20% was simply the figure needed to balance the Budget, recouping the tax lost to the Treasury by the reduction in the main corporation tax rate. Secondly, does 'ordinary' plant really last 13 years (remembering, as illustrated below, that long-life plant and building integral fixtures will have a slower rate of allowances, and should not be included in this consideration)?

Many retailers and taxpayers in the leisure and hospitality industries (many of them already hit by the withdrawal of industrial buildings allowances for hotels) will be surprised to hear that their plant is expected to last this long – although still in relatively sound condition, their assets quickly become tired and dated in appearance and are ripped out long before they are life-expired. It is also worth remembering that many of the assets will be 'machinery' (not plant), which by their very definition have moving parts and tend to wear out quickly, so should benefit from accelerated tax depreciation.

As mentioned above, the 20% rate will apply from 1 April 2008 for corporation tax, and 6 April 2008 for income tax. Where a business makes up accounts for a period which overlaps those dates, the rate to be applied is calculated on the basis of time apportionment, rather than by splitting the accounting period into 'pre' and 'post' segments and looking at when the expenditure was actually incurred. See **Example 1** below.

Example 1

GBtaxco Limited makes up its accounts to 30 September each year. For the year to 30 September 2008, the general pool will attract writing-down allowances at the rate of 22.5%, that is, $6/12 \times 25\%$ plus $6/12 \times 20\%$.

Of course, many tax computations and returns are now prepared automatically, either by commercially available software or on-line. In those cases, the calculation and time-apportionment of allowances will be automatic. However, expenditure on plant still needs to be identified in the first instance. Whilst it is normally obvious that expenditure has been incurred on plant, there are instances where specialist input is needed, for instance where property has been acquired and the plant content needs to be established. This will remain the case.

Integral fixtures

HMRC propose that certain assets will qualify for relief, not at the new generally available rate of 20% per annum, but at only 10% – the stated logic for this is that they are assets which have a long life, and do not therefore need an accelerated form of tax relief. They are described as 'fixtures integral to a building' and comprise lifts, central heating and air-conditioning. The Government has asked for views as to whether electrical lighting and power, and hot and cold water systems should also be included.

This measure is the latest in a series of attempts to restrict the capital allowances claimed on items of plant included in buildings. This follows the lists of items regarded as buildings and structures (introduced in 1994 and now in CAA 2001, ss 21 to 23) and the 1996 long life asset rules (CAA 2001, ss 90 to 104), neither of which has been particularly successful in practice. One cannot read the consultation document (or indeed the HMRC manuals) without detecting a note of frustration that the courts have repeatedly found in the taxpayer's favour on the question of plant in buildings.

It further seems to be HMRC's belief (or perhaps the Government's) that the availability of allowances (or indeed, any other form of tax relief) can be a distortive influence on decision-making. Most tax advisors are well aware that this is far from the case, and that most business decisions are made with very little regard to capital allowances or other tax implications!

That said, few would deny the logic of reducing the rate of allowances for assets which have a genuinely long life, if the intention is to mirror economic depreciation. The danger will be if the lower rate is extended to assets which in fact have a much shorter life. It was apparently considered whether the definition should be the same as for 'background plant' under the 2006 'long funding lease' rules, which would have had the strange effect of treating items such as sanitary ware, kitchen equipment, curtains and blinds as if they had a life of some 30 years! This has sensibly been rejected, on the basis that the Government's intention is to exclude integral fixtures from a 'more generous' (20%) rate of allowance and the comprehensive definition of 'background plant and machinery' is not suited to that objective.

Short life assets

One odd feature of this particular proposal is that integral fixtures will not be eligible for treatment as 'short-life assets' under CAA 2001, Ch 9. Whilst this at first seems logical, it does in fact misrepresent the true intention of that legislation. The term 'short-life asset' has always been misleading – the assets referred to are distinguished, not by having a short-life, but by being owned by the taxpayer for a short period of time. The original legislation aimed at accelerating tax relief where assets were sold at a loss after (broadly) a maximum of five years. So long as the asset was plant, its exact nature was irrelevant. A business incurring expenditure on fixtures, then scrapping them within the prescribed period would, in all fairness, be entitled to the accelerated allowances, as has been the case for more than twenty years. To exclude integral fixtures from short life asset treatment will mean that many businesses will still be claiming allowances on assets, 30 years or more after they disposed of them! This is not (to use the Government's phrase) a 'fairer system', nor does it reflect 'economic reality'. It does, of course, raise taxes.

Again, the 'integral fixtures' rules will apply to expenditure incurred on or after 1 April 2008 for corporation tax, and 6 April 2008 for income tax. However, unlike plant and machinery, where an accounting period overlaps those dates, expenditure must be split into 'pre' and 'post' elements – it is not permissible to simply time apportion the expenditure for the year. Consequently, expenditure incurred before April on relevant assets will

Example 2

GBtaxco Limited incurred expenditure on the construction of a factory and has been claiming IBAs at 4% per annum. This will be reduced to 3% from April 2008, 2% from April 2009, 1% from April 2010 and 0% from April 2011. It has another warehouse property which it acquired second-hand with ten years of its 25 year IBA life left to run, such that the current claim on that property is 10% per annum. This will reduce to 7.5%, then 5%, 2.5%, then nil.

Where an accounting period overlaps the date of the rate change, the rate of allowance for that year will be time-apportioned. GBtaxco Limited makes up accounts to 31 December each year, and will claim IBAs on its factory at the following rates:

Year ended 31 December	Rate of allowance	Calculation
2007	4%	Current rules apply
2008	3.25%	$3/12 \times 4\%$ plus $9/12 \times 3\%$
2009	2.25%	$3/12 \times 3\%$ plus $9/12 \times 2\%$
2010	1.25%	$3/12 \times 2\%$ plus $9/12 \times 1\%$
2011	0.25%	$3/12 \times 1\%$
2012	nil	Allowances fully abolished

Allowances on the warehouse would be phased from 10% to nil in the same manner.

attract a higher rate of allowances on an ongoing basis, and there may be some advantage therefore in accelerating expenditure to take advantage of this.

Phasing-out of IBAs and ABAs

The proposed abolition of industrial buildings allowances (IBAs) and agricultural buildings allowances (ABAs) was to many businesses and their advisers the greatest shock of the Budget, as it is in effect a retrospective withdrawal of tax relief for transactions entered into up to 25 years ago, and a major blow to beleaguered British manufacturers. Even for those businesses not directly affected, the retrospective and draconian nature of this measure will reduce confidence that the UK tax system can be relied on. IBAs and ABAs will be phased out by reducing the rate by one-quarter each year over four years (on a straight-line basis) as shown by **Example 2**.

Conclusion

Overall, it is difficult to see this package of measures as anything other than detrimental to UK business. In particular, it acts as a positive discouragement to serious investment. HMRC have asked for comments on its proposals (except those dealing with IBAs) by 19 October 2007. Taxpayers and their advisers are recommended to read the proposals and make sure their views are heard. ■

Martin Wilson is a partner with the Capital Allowances Partnership LLP (see www.cap-allow.com).