

# Integral Fixtures

**J**uly saw the latest stage of the debate about the future of capital allowances and whether they are suited to the modern commercial environment, when the Government published its consultation document 'Business tax reform: capital allowances changes'. *Inter alia*, this document sets out proposals to 'modernise' the rates of tax relief available for plant and machinery.

## WHAT IS PROPOSED

- A reduction of the standard rate of writing-down allowance from 25% a year to 20%, which the Government believes is the true economic rate of depreciation for plant and machinery and will give relief over approximately 13 years. According to Treasury forecasts this is expected to raise an additional £2.27 billion of revenue by April 2010.

- A new reduced rate of writing-down allowances of 10% for certain fixtures integral within a building. This will give relief over approximately 30 years and again reflects the Government's professed concern that capital allowances should reflect true economic depreciation. It is claimed to be based on how long these assets will actually last. The Treasury expects this measure to raise a further £200 million of revenue by 2010.

Integral fixtures will include:

- lifts, escalators and moving walkways
  - central heating systems and
  - air-conditioning systems
- and may also include:
- electrical lighting and power systems and
  - hot and cold water systems.

These assets comprise a substantial proportion of the cost of modern commercial buildings.

The Government has sensibly ruled out using the definition of 'background plant and machinery for a building' implemented during the Finance Act 2006 leasing reforms (SI 2007 No 303). This is because its current intention is specifically to *exclude* integral fixtures from a 'more generous' rate of

**Steven Bone and Martin Wilson** of *The Capital Allowances Partnership LLP* comment on the latest proposals for changes to capital allowances on fixtures

allowance and a comprehensive definition is not suited to that purpose. Furthermore, that definition includes many short-lived assets like blinds, curtains and data installations that clearly should not suffer tax relief over 30 years.

The capital allowances changes have been discussed generally in previous articles by Andrew Green (*The Tax Journal*, Issue 899, 20 August 2007) and Martin Wilson (*Taxation*, 23 August 2007) and this article will concentrate on one of the most significant areas of change: the proposed regime in respect of fixtures.

undermined growth (that is, remedying underinvestment in areas deemed worthy) and

- the system for relieving capital expenditure could be 'more coherent, consistent and comprehensive'.

As a result the Government floated two main ideas:

- replacing capital allowances with commercial depreciation and
- introducing a commercial buildings allowance (giving allowances for *all* expenditure on buildings, including integral plant).

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## WHAT IS THE CASE FOR CHANGE?

In recent years the capital allowances system has been criticised by some because of its perceived anachronistic nature and complexity. In 2002 the Government began a consultation process on the reform of corporation tax, which included proposals in relation to capital allowances.

The Government's view was that:

- the capital allowances system departed from the principle of economic depreciation and there was a need to remove tax distortions, to ensure that decision-making was driven by commercial reasons rather than tax ones
- there was a need to promote productivity by tackling 'market-failures' that

In March 2004 the Government announced that it had decided to retain the capital allowances system (abandoning the idea of using commercial depreciation) but released a further consultation paper in December of that year confirming it was still considering modernisation and in particular introducing a commercial buildings allowance.

Then came the U-turn. In March of this year the Government instead made its shock announcement that it would abolish industrial and agricultural buildings allowances (see 'Trouble at Mill' by Keith Gordon in *Taxation*, 10 May 2007) and at the same time publicised its proposals to *reduce* the rates of relief for plant and machinery to 20% and 10%.



**Steven Bone**

The proposed plant regime is similar to that proposed by the Chartered Institute of Taxation (CIOT) in its response to HMRC's December 2004 consultation. The CIOT suggested that there might be only two capital allowances pools, referred to for convenience as the '25% pool' and the '10% pool'. However, despite the CIOT cautioning against the temptation to cherry-pick items, HMRC's proposals differ in three significant ways:

- the CIOT recommended that the '10% pool' should include long-life assets, clearly defined categories of fixtures *and buildings* but unlike many of the UK's main competitor nations, the current proposals do not include any relief for expenditure on the 'bricks and mortar' of buildings
- the CIOT's rationale for the '10% pool' was that if it contained a significant element of plant and machinery, the rate would need to be higher than the existing 4% straight-line and 6% reducing-balance rates for industrial buildings and long-life assets but the latest proposals are for a pool *exclusively* comprising plant and machinery and *no* buildings), yet the proposed rate is only slightly higher than the existing rates for buildings and long-life assets and
- the CIOT's general pool gave tax relief at 25%, not 20% as in the current Government proposals.

Although it was popular with businesses during consultation, the Government has ruled out the proposed commercial buildings allowance because 'the Exchequer costs are extremely high and it does not address the wider issue that many commercial buildings appreciate in value'. Whilst there is some truth in this,



**Martin Wilson**

it fails to differentiate between land and buildings. Land does not deteriorate and increases in value over the long term. In contrast, buildings have finite lives and many decline in value until eventually a point is reached where it makes economic sense to demolish the building and start again. Consequently, whilst there is little case for depreciating land (which is why no capital allowances are available for expenditure upon it), there are strong grounds for depreciating buildings and especially equipment within them (which is why tax depreciation is available in the form of capital allowances).

The key part of the Government's comment is the first part, that 'the Exchequer costs are extremely high'. Put another way, whether fair or not, it has decided that granting businesses buildings allowances is not a financial priority.

## COMMENTARY ON THE PROPOSALS Reducing tax relief for plant in the general pool to 20%

It is proposed to reduce the rate of writing-down allowances for plant in the general pool to 20%. This will apply to all:

- chattels (that is, moveable plant and machinery)
- fixtures related to the occupier's trade and process-related fixtures (examples given include production lines, printing presses and milking equipment) and
- all other fixtures not on the integral fixtures list (to avoid the need for a 'purposive' test this includes 'standard fittings in a "normal" modern building', such as toilet and kitchen facilities which may be productive equipment for the purposes of some occupants' trades – for example, restaurateurs or hoteliers).

It is difficult to justify *reducing* the rate of 25% presently applying to the general pool. This currently includes assets with longer lives that will be in the 10% pool in future – the new general pool will only comprise assets with shorter lives, so there can be no justification for *reducing* the rate to 20%. Leaving revenue-raising reasons aside, it would seem a fairer reflection of economic depreciation to consider *increasing* the rate rather than reducing it.

## Machinery

It is often overlooked that 'plant' and 'machinery' are different things – if they were not, the phrase 'plant *and* machinery' would not be used. According to HMRC published guidance, 'machinery' includes machines and the working parts of machines, and a 'machine' usually has moving parts. One immediate observation is that irrespective of whether they are standard fittings in 'normal' buildings, many of the proposed integral fixtures may include elements which are 'machinery', not 'plant' (for example, boilers, air-conditioning units, lift motors, etc). Therefore they suffer rapid wear and tear and in all fairness should benefit from much faster tax depreciation than the 30 years over which the new 10% rate would grant relief. Sophisticated modern machinery normally becomes obsolete much faster than that.

It may be argued in response that the subsequent replacement of, say, a boiler after ten years would be a repair of the central heating system, qualifying for a revenue deduction. However, this has two serious flaws. Firstly, it does not remedy the fact that the original boiler would still continue to attract writing-down allowances of an ever-diminishing amount long after the actual plant had been scrapped, which would not be fair or reflect commercial reality. Secondly, even if the replacement was agreed to be a repair, the cost might often be capitalised (particularly by listed companies anxious not to depress earnings). In HMRC's view a tax deduction is only available for such 'deferred' repairs when they are charged to the profit and loss account. Therefore tax relief would effectively be given on depreciation – an idea which the Government has already rejected!

## Broadening the definition of plant

As discussed in our back-to-basics article on plant and machinery (16 October 2006), there is presently no statutory definition of plant and machinery (although the legislation does attempt to define what

is *not* plant). Instead plant is identified by applying principles drawn from case law. These seek to distinguish between the apparatus *with which* a business is carried on (which is plant) and the premises *in which* it is carried on (which is not plant).

For many taxpayers this results in a number of ‘tax nothings’ which do not qualify for relief. For example, although many mechanical and electrical services in buildings routinely qualify for capital allowances, electrical power, lighting and cold water installations often do not. The Government is considering including all of these assets within the 10% integral fixtures classification, which would be welcomed by some taxpayers.

However, there are many instances where these types of assets do already qualify (at 25%). For example, entire electrical installations may be plant (based on a Commissioners’ decision that this was appropriate for a new-build supermarket) and normal lighting and cold water installations qualified as plant in *Wimpy International Ltd v Warland* [1989] STC 273. HMRC will even accept that office fluorescent lighting often qualifies, provided that certain criteria are met. The inclusion of these types of assets in the 10% pool will leave many taxpayers worse off, particularly hoteliers and the hospitality industry, who have already been hit hard by the abolition of industrial buildings allowances (IBAs).

Although the Government is considering giving capital allowances for ‘green’ design features that deliver energy-saving and other environmental benefits (for example, brise-soleils and active facades), which would be welcomed, it might also have considered broadening the definition of plant to include expenditure required to meet:

- modern trading conditions (such as decorative finishes in industries that are not ‘hotels, restaurants, or similar trades’ (CAA 2001, s 23) – for example, high specification reception and client areas in a solicitors’ office designed to promote the traditional, dependable qualities of the firm) and
- recent legislation, such as expenditure to comply with disability discrimination regulations (for example, access ramps) and the smoking ban (for example, smoking shelters).

### Long-life assets

Long-life assets are plant and machinery expected to have a useful economic life when *new* of at least 25 years. It should be welcomed that the rate of tax relief for

long-life assets is to be increased from 6% to 10%, although the main beneficiaries will be the privatised utilities, which were the original targets of this ‘windfall tax’. Perhaps this will be seen as partial compensation for the loss of IBAs for these businesses.

Furthermore, there is an anomaly affecting certain assets which HMRC previously routinely accepted during long-life asset discussions as having a life of less than 25 years (boilers, pumps, calorifiers, etc). The Government now proposes that they should qualify for tax relief over a period of some 30 years, which can in no way be said to reflect true economic depreciation.

### Short-life assets

The proposals state, without explanation, that integral fixtures will not be eligible for ‘short-life asset’ treatment. The purpose of the so-called ‘short-life asset’ election is to accelerate tax relief where a taxpayer realises a genuine, commercial loss on an item of plant in a short period of time. The system should not arbitrarily differentiate between different types of plant. If the election continued to apply to integral fixtures, the overall effect on the

Furthermore, the Government’s insistence that the proposed rates are the ‘true’ ones for all businesses is at odds with the so called ‘business use test’ case law definition of plant. This considers whether the asset performs a *particular* function as apparatus in the context of the ‘nature of the particular trade being carried on, and the relation of the expenditure to the promotion of the trade’ – that is, whether the asset functions as apparatus in that taxpayer’s *particular* business (recognising that identical assets may be plant in one business and not in another). If changes are to be made, logically it seems inconsistent to consider the taxpayer’s particular business important in determining whether an asset is plant but not in establishing the tax depreciation rate to be used.

### CONCLUSION

The Government likes to refer to its actions as ‘modernisation’, in the interests of fairness and commerciality. Whilst these are laudable objectives, an alternative interpretation is that property is an easy target to tax because it cannot move overseas. The Treasury expects to raise a large amount of tax from these capital

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Treasury would probably be minimal but for the taxpayers affected the relief would be welcome and such a move would be ‘fair’ and would reflect commercial reality. In the light of its stated aims the Government should welcome such a move. If there is a concern that the measure could be abused, the legislation should target the abuse rather than taxpayers generally.

### Economic depreciation

The Government’s proposals have made repeated reference to the true or actual rate of economic depreciation for integral fixtures. However, determining this is a subjective matter that, far from being an exact science, as the Government appears to suggest, will depend on the nature of the business that owns the assets and the use to which they are put. So presumably this is the type of question that is best left to management of a business, rather than the Government and ‘a one size fits all’ approach cannot possibly determine the true rate, despite the former Chancellor’s pronouncements to that effect.

allowances changes (almost exactly cancelling out the effect of reducing the full corporation tax rate) without losing many votes. It is hard to see how the changes will help the UK’s economy and international competitiveness and achieve the new Prime Minister’s stated aim of ‘encouraging growth through investment’.

It has been said that there will be winners and losers. But apart from the Treasury itself, it is essentially a picture of small winners and big losers.

In response, many businesses should consider bringing forward expenditure plans by a year and making sure all capital allowances claims are up-to-date (especially unclaimed prior years’ expenditure) without delay, to ensure that tax relief is available at the higher rate. They should also make their views known by the 19 October consultation deadline.

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