

Knowing what's on offer

With its ability to generate substantial tax savings, capital allowances are an important form of tax relief for the construction or purchase of commercial property, Steven Bone advises property investors

For most types of capital allowances, it is not a requirement that the asset should be used, or the premises occupied by the person incurring the expenditure. This means that allowances are available, in appropriate circumstances, to property investors, as well as to owner-occupiers or tenants.

Buildings

Buildings (that is, the structure and fabric, including the substructure, frame, external envelope, upper floors and internal walls, etc.) held by a property investor may qualify for capital allowances in the following circumstances:

Industrial buildings allowances (IBAs)

The use of a building is vital for IBA purposes. When considering a potential tenant or submitting a capital allowances claim for the acquisition or construction of property, a landlord should determine whether the tenant's trade will enable an IBA claim.

The definition of 'industrial' use for tax purposes does not always match the everyday meaning of the term. It includes buildings used for normal industrial activities such as manufacturing, processing and some storage, etc.; and various other niche operations, including utilities and transport undertakings, etc. However, hotels would not generally be considered to be 'industrial', yet they qualify for IBAs, provided certain conditions are met. Similarly, all commercial buildings in designated enterprise zones qualify for IBAs (although this relief is not now available to new expenditure).

Traditionally, tax relief for the construction of new industrial buildings was given at the rate of

4% per annum in equal instalments over 25 years (or in enterprise zones an immediate 100%).

However, following changes announced in the 2007 Budget, if an industrial building is acquired second-hand, the purchaser will effectively step into the shoes of the seller and inherit any tax relief not yet claimed (previously, relief was available on the full original construction cost over the remainder of the building's 25-year tax life). Furthermore, IBAs now have a limited shelf life as they will be abolished from April 2011. This will be achieved by reducing the tax relief by one-quarter each year (i.e. 3% from April 2008, 2% from 2009, 1% from 2010 and thereafter nil).

Therefore, whereas some investors previously took a relaxed approach to claiming plant and machinery allowances (PMAs, see right) on the basis that they should be able to claim IBAs with less perceived effort, it will now become essential to maximise PMAs, as this will be the *only* way that any tax relief will be available for most expenditure in connection with industrial buildings.

Business premises renovation allowances (BPRAs)

From 11 April 2007, a new capital allowance has been introduced for expenditure by investors or occupiers on the conversion, renovation or repairs of buildings to be used for business purposes, with the intention of bringing those premises back into business use.

Broadly, to qualify the building must be situated in one of circa-2,000 designated disadvantaged areas across the UK, been vacant for a year or

more and have last been used as offices or for business purposes.

Tax relief is given at 100% of the expenditure incurred. So, every £100,000 of expenditure will immediately save a property investor £30,000 of tax (if taxable at the 30% full corporation tax rate).

Plant and machinery

Expenditure on plant and machinery (P&M) includes machinery and business apparatus, including many standard fixtures in buildings, and will qualify for capital allowances if it is incurred for the purposes of a property investment business (that is, by a landlord).

Typical examples of the P&M fixtures that may qualify include: sanitary appliances and fittings; parts of cold water systems; hot water installations; heating, ventilating and air-conditioning installations; parts of electrical systems; lifts; fire fighting and warning installations; and many more assets.

The main rule to claim PMAs is that it is necessary to incur capital expenditure on P&M and own those assets as a consequence of incurring that expenditure. Therefore, because

under real estate law assets belong to the freeholder as soon as they are fixed (irrespective of who incurred the expenditure or installed them), complicated rules exist to determine the ownership of fixtures for capital allowances purposes and ensure that only one taxpayer may claim relief on an asset at any one time.

Although 'first year allowances' (FYAs) are generally available to give tax relief to small- and medium-sized businesses in the year, the money is spent at the rates of 50% and 40% respectively, these do *not* benefit property investors as, wrongly, commonly thought. This is because FYAs are not available for expenditure on assets to be leased (with the limited exception of 'enhanced capital allowances' (ECAs) for energy-saving and water-conserving plant). Instead, tax relief is given to property investors at the conventional rate of 25% per annum, reducing balance.

However, from April 2008, government is proposing reducing this rate by one-fifth to 20% and introducing a new 10% rate for 'certain integral fixtures within buildings'. It intends that these integral fixtures will



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comprise many major plant assets in 'normal' modern buildings, including: central heating and air-conditioning systems; lifts, escalators and moving walkways (and possibly electrical lighting and power, hot and cold water installations and environmental features like brise soleils).

Despite government's repeated pronouncements that the changes are 'modernisation' in the interests of commerciality and fairness, the alternative consensus among commentators is that commercial property is an easy target to tax. This is because it cannot move overseas and the Treasury expects to raise an eye-watering amount of tax

(more than cancelling out the cost of the headline grabbing reduction in the large companies' corporation tax rate from 30% to 28%), without losing many votes. In effect, businesses that invest in tangible assets, particularly property landlords, are subsidising the tax rate cut for large businesses that do not.

One minor area of good news (for small investors at least) is that it is proposed to replace FYAs with a new annual investment allowance (AIA) in April 2008 giving 100% tax relief to all businesses (including property investors), on the first £50,000 of expenditure on plant in each year (including 'integral fixtures'). Nevertheless, £50,000

will not go very far for most property acquisitions or major construction projects, and for smaller businesses will be partly cancelled out by the forthcoming phased increase in their tax rate from 19% to 22%. For larger businesses, it will also be insignificant and they will be hit far worse by the other capital allowances withdrawals and reductions outlined above.

In response, the key action needed now is to ensure that all capital allowances claims are up-to-date (especially for unclaimed prior years' expenditure) before the Budget changes bite, to ensure that tax relief is available at the higher rate and not 10%. The proposed

changes were the subject of consultation, and affected businesses and their consultants had the opportunity to make their views known to HM Revenue by October 2007. Now the next step will be for HM Revenue to publish a technical note with draft legislation during November and December 2007.

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