

# Budget/FB: Capital Allowances

## Clutching at straws

One of the surprises in the recent Budget was the reintroduction, for one year, of first-year allowances (FYAs) for capital expenditure on plant and machinery. Whilst, as a capital allowances specialist, I can only welcome the decision, it does rather emphasise how much has changed in the last year or two.

Little more than one year ago, that is to say with effect from April 2008, the Government brought in major changes to the system of capital allowances, including the abolition of 40% FYAs for small and medium-sized enterprises, and a reduction in the main rate of writing-down allowance (WDA) from 25% (which rate had been in place for 40 years) to 20%.

It was said at the time that this rate reduction reflected more accurately the true economic rate of depreciation for plant (see *The Tax Journal*, 9 April 2007, page 11), though most commentators thought the real reason was the huge acceleration of tax payable, which in effect funded entirely the corporation tax rate reduction from 30% to 28%. The HM Treasury/HMRC document 'Business Tax Reform: capital allowances changes' (July 2007) claimed that the rate reduction was aimed at 'reducing the distortive impact of capital allowances'.

One year on the Chancellor has reintroduced 40% FYAs, not only for small and medium-sized enterprises but for all businesses. 'Distortion' is clearly back in favour! The rationale emerging from the Treasury is that the reintroduction is part of 'a package of measures that will support the adjustment towards renewed economic growth and improve the UK's competitiveness'. One might see in this a tacit admission that the Government's previous policy had had the effect of preventing economic growth and reducing the UK's competitiveness!

The stated policy objective behind reintroducing FYAs is to encourage investment, by supporting businesses that invest in 2009/10 and to provide an incentive for businesses to bring forward

*Martin Wilson of The Capital Allowances Partnership Ltd discusses the Budget announcements on capital allowances*

investment. The availability of a FYA is of course merely a matter of timing – claiming more allowances now will simply mean less allowances to be claimed in future; indeed the Treasury and HMRC themselves acknowledge that the net present value benefit is nil ('Budget 2009 Impact Assessment', available on the HM Treasury website at <http://www.lexisurl.com/ffJB3>).

### Something – but not a lot

The same document discusses what other policy options were considered, or rather what option, in the singular, was considered. This other option was (... wait for it ...) 'do nothing'. Whilst we should perhaps be grateful that the Government has done something, rather than nothing, clearly more could have been considered. A radical move (and accepting that the Government has now abandoned its previous concern with 'distortion') would have been to legislate for a 100% FYA, or even more radical, to reintroduce investment allowances.

### Investment allowances – what was once, and might have been again

The following paragraph draws on historical precedent to demonstrate what would have been a genuinely radical measure – I mention this only in case the reader is perusing this article in a hurry, alights on this paragraph and mistakenly believes that the Government has introduced a relief which would truly benefit the investor.

Most readers will not be familiar with investment allowances, the key feature of which was that the allowance was not deducted in arriving at the residue of

expenditure, which could then be written off in the normal way. The result, of course, was that the total allowances available could exceed the actual expenditure. The same principle has in effect been applied in recent years for expenditure on the remediation of contaminated land, which attracts relief at 150%, and on research and development (up to 175%), so the concept is not unknown to the present legislators.

Incidentally, the reason given for the creation of investment allowances in 1954 was that the economic and fiscal position was discouraging investment – ring any bells?

### Back to the present

Returning to the approach actually unveiled by Alistair Darling in his Budget, how effective is it likely to be?

It should not be forgotten that the reintroduced FYA is merely a matter of timing and that any immediate benefit begins to be recouped by the Treasury from year two onwards. Without the FYA, 89% of expenditure will be written off in ten years; with the allowance, that rises to 92%. It is therefore doubtful whether the temporary allowance will have the required effect of encouraging investment. The Treasury estimates that the cost of the allowance in 2009/10, in terms of tax lost, will be in the order of £1.64 billion, but that is of course not a gift, but merely a loan, to be repaid by higher taxes in future years.

### Details of the allowance

The following paragraphs are based on HMRC's Budget Note 04, released on Budget Day.

Legislation in Finance Bill 2009 will introduce a new temporary 40% FYA

for expenditure on 'normal' plant and machinery, that is to say, expenditure on plant and machinery that would normally be allocated to the main capital allowance pool.

The temporary FYA will be available to:

- any individual carrying on a qualifying activity (this includes trades, professions, vocations, ordinary property businesses and employed individuals)
- any partnership and
- any company.

It is worth highlighting the fact that the allowance is not restricted to small and medium-sized enterprises. There are, however, some exclusions, as set out below.

The temporary FYA will apply to qualifying expenditure incurred in the 12-month period beginning on 1 April 2009 for the purpose of corporation tax, and on 6 April 2009 for the purpose of income tax.

### Interaction with the Annual Investment Allowance

Since 1 April 2008 (corporation tax) or 6 April 2008 (income tax) most businesses, regardless of size, have been able to claim the new Annual Investment Allowance (AIA) on the first £50,000 spent on plant or machinery (subject to certain exclusions). Businesses have been able to claim the AIA in respect of special-rate expenditure such as on long-life assets, and integral features, as well as on general plant and machinery. Where businesses spend more than £50,000 in any chargeable period, any additional expenditure will be dealt with in the normal capital allowances regime, entering either the main pool or 'special rate' pool, where it will attract WDAs at the appropriate rate.

Businesses incurring expenditure in excess of the AIA cap that would normally be allocated to the main pool and qualify for a 20 per cent WDA in the 12-month period beginning on 1 April 2009 (or 6 April 2009) will now be able to claim a 40 per cent FYA instead.

### Exclusions

As with previous and existing FYAs, there are exceptions where expenditure will not qualify for the temporary FYA. The main exceptions include:

- 'special rate' expenditure (including long-life assets and integral features)
- expenditure on cars and
- assets used for leasing.

Long-life assets are those with an expected useful life, when new, in excess of 25 years, while 'integral features' (a concept introduced for the first time only last year) include:

- electrical systems
- cold water systems

- space or water heating systems
- ventilation, air cooling or air purification systems
- lifts and escalators
- external solar shading.

### Other measures – energy-efficient plant

So-called 'green reliefs' continue to feature at the forefront of the Government's thinking. FYAs at the rate of 100% (so-called 'enhanced capital allowances' or ECAs) have for some years been available for expenditure on energy-saving plant and environmentally friendly (which means water-conserving) plant and machinery.

Plant qualifies for ECAs if it appears on the Energy Technology Criteria List and Water Technology Criteria List, which are reviewed annually by the Department of Energy and Climate Change and the Department for Environment, Food and Rural Affairs, respectively.

Following this year's review the Energy Technology Criteria List will be revised to include one new technology (uninterruptible power supplies) and two new sub-technologies (air to water heat pumps and close control air conditioning systems). Three existing sub-technologies (air source: single duct and packaged double duct heat pumps, ground source: brine to air heat pumps and water source: packaged heat pumps) will be removed.

This will be of little relevance to most businesses.

### Plant leasing

Various changes are proposed to counter perceived opportunities for tax avoidance in connection with the leasing of plant. Again, most taxpayers will be unaffected and the subject of plant leasing deserves separate treatment in a future article.

However, by way of overview, legislation, which was announced and published in draft on 13 November 2008, will be introduced in Finance Bill 2009 to ensure that:

- a business entering into a sale and leaseback or lease and leaseback does not gain more relief than it would have done had it obtained loan finance
- tax is not avoided when a lessor grants a long funding lease and
- when a long funding lease ends the lessee has obtained an appropriate amount of relief.

Long funding leases are those where, following FA 2006, the right to capital allowances rests with the lessee rather than the lessor. Excluded from these rules are short leases, leases of 'background plant' (that is, plant leased with a building to which it is fixed that might reasonably be

expected to be installed in a building and adds to the functionality of the building) and plant leased with land.

In addition, amendments will be made to ensure initial payments under a lease do not escape taxation and to ensure consistency with the taxation of chargeable gains.

Furthermore, it is thought that the definitions of sale and leaseback in Capital Allowances Act 2001, ss 216 and 221 do not cover all the ways in which sale and leaseback arrangements can be structured, allowing some opportunities for tax avoidance involving the refinancing of existing assets. This measure will amend the definitions in those sections to provide certainty and remove these avoidance opportunities. Amendments will be made to ensure the definitions will cover a sale and leaseback to a person connected to the seller where that person continues to use the asset in his or her qualifying activity after the date of the sale. This change will have effect for sales on or after 22 April 2009.

Again, most taxpayers will be unaffected by these changes.

### Conclusion

Most taxpayers will be unlikely to come across the proposals relating to leasing. Similarly, most will be unaffected by the changes to the allowances on energy-efficient plant. What about the main change announced by the Chancellor – that is, the reintroduction of FYAs? At first sight, it will affect all businesses. However, last year, when announcing the creation of the AIA, the Government was keen to point out that 95% of businesses incurred annual capital expenditure of under £50,000. Those businesses will be untouched by the new allowance. Furthermore, as the allowance is a tax relief, loss-making businesses will be unable to benefit.

Any profitable business spending more than £50,000 on main pool plant and machinery (which is not an integral feature, long-life asset, etc) will benefit from the FYA. It should never be forgotten, though, that it is merely an acceleration of tax relief, not an extra relief. A 100% allowance, or an investment allowance as described above, might have genuinely encouraged investment. The measures actually announced will have more limited effect.

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