Industrial Buildings Allowances

Industrial buildings allowances (IBAs) allow taxpayers to write off for tax purposes expenditure on industrial buildings. They have been with us for over sixty years and are the second most commonly claimed type of capital allowance, after plant and machinery allowances. Despite this, the basic rules of IBAs are often misunderstood by taxpayers and practitioners alike, particularly where a property is acquired second-hand.

General understanding is that the fundamental requirements for a claim are that capital expenditure is incurred on a building and the building is used for a qualifying purpose. However, the devil is in the detail (for example, some non-capital expenditure incurred by property traders may also qualify for IBAs). All statutory references below refer to the Capital Allowances Act 2001.

Qualifying expenditure

Section 271 confirms that the expenditure which qualifies for allowances is specifically the expenditure on construction of a building. However, an exception is that if an unused building is bought from the developer, allowances are due on the purchase price, not on the cost to the developer (s 296). Where later additions are made they too may qualify for allowances but must, for reasons which will become clear, be separately identified in tax computations.

In contrast to a commonly held misconception, where a building is acquired second-hand, IBAs are not due on the purchase price paid (unless it has been bought unused from a developer) but rather on the original construction cost. However, if the price paid is lower than original cost, allowances are only due on the amount paid.

Whether the property is new or second-hand, no IBAs are due for the cost of land (s 272).

Rate of allowances

Ignoring enterprise zone property and obsolete rates of allowances, IBAs are given at 4% per annum (straight-line) on cost (s 310). So a new industrial building will have a tax life of 25 years, at the end of which the cost will be fully written off. Each tranche of expenditure on a building has its own separate tax life, so a property built in 1990 and added to five years later will have tax lives ending in 2015 for the initial expenditure and 2020 for the additions.

This tax life runs from the time the building is first used for any purpose (s 314), or, for later expenditure, when the building is already in use, from the date of that expenditure. However, the tax life of an IBA-qualifying building may effectively be extended if the writing-down allowances are disclaimed in one or more accounting periods (s 309).

The tax life does not start again when the property is sold. When a property is acquired second-hand, the new owner will be able to write off the original cost (not the present purchase price) over what remains of the original 25-year life. If that 25-year life has already expired, no allowances are due. The purchaser may obtain allowances, depending on the property’s remaining IBA life, of between nil (if its tax life has expired) and 100% (if only one year remains). The other side of the coin is that for the seller, a clawback is generally unavoidable (see Example 1).

Example 1: Effect of sale

X built a factory in 1986 and claimed IBAs on the cost of £1 million. In 2006 he sold the property to Y for £2.5 million. The impact of the sale on IBAs is as follows.

After 20 years X has had allowances of £800,000, so the factory’s tax written-down value (residue of expenditure) is £200,000. X faces a clawback of the amount by which the sales proceeds exceed this written-down value. However, the clawback cannot exceed the IBAs given – that is, £800,000. This increases profits by that amount in the year of sale.

Y can claim IBAs on original cost of £1 million (not the amount he paid). Relief is given over the remaining tax life of the factory (five years), so Y will claim an allowance of £200,000 per annum – an effective rate of 20%.
allowances only if the building is in use for the purposes of a qualifying trade, namely:
• manufacturing;
• processing;
• storage;
• agricultural contracting;
• working foreign plantations;
• fishing; and
• mineral extraction.

IBAs are also extended to various other ‘niche’ activities, such as electricity, water, transport and highway undertakings. However, the majority of claims are made under the headings of manufacturing and processing.

The courts have very seldom been asked to decide whether or not manufacturing was taking place – it has generally been obvious from the facts that a new product was being produced from component parts. The existence of ‘processing’ is generally less obvious and several cases have gone to court. The precise requirement of the statute is that the building is used for a trade which constitutes of subjecting goods or materials to a process. So the first question is whether you are dealing with goods or materials, the second is whether they undergo a process.

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In order to be a qualifying process, the activity in question must be carried out with a degree of uniformity and repetition. Table 1 summarises some decisions of the courts.

Storage
Another qualifying activity is storage but only in limited circumstances, provided that it constitutes a trade consisting of storing goods or materials:
• which are to be used in the manufacture of other goods or materials (that is, raw materials, components and consumables);
• which are to be subjected to a process; or
• which, having been manufactured or subjected to a process, are yet to be delivered to a purchaser (that is, finished goods).

A fourth qualifying category, the storage of goods on their arrival in the UK, is aimed primarily at storage facilities at ports and airports and is not as wide-ranging as it seems at first glance.

Key point is that in order to qualify the storage (as with any other qualifying activity) must constitute a trade in its own right – this has recently been confirmed in

Table 1: Qualifying activities

<table>
<thead>
<tr>
<th>Qualifying for IBAs</th>
<th>Not qualifying for IBAs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Packing coal into bags</td>
<td>Processing bank transaction documents</td>
</tr>
<tr>
<td>Shrink wrapping</td>
<td>Repacking and labelling by a wholesaler</td>
</tr>
<tr>
<td>Cutting carpets to customers’ requirements</td>
<td>Operation of a crematorium</td>
</tr>
<tr>
<td>Sorting of rags, scrap metal, etc.</td>
<td>Examining and grading tyres</td>
</tr>
<tr>
<td>Cleaning, sorting and packing fruit</td>
<td>Repairing and maintaining assets used in a taxpayer’s trade</td>
</tr>
</tbody>
</table>
the case of HMRC v Maco Door and Window Hardware (UK) Ltd [2006] EWHC 1832 (Ch). A building used for storage by a taxpayer whose main trade would not otherwise qualify for IBAs will not itself qualify for IBAs. For example, a bank may have entire buildings given over to storage of stationery or transaction records; however, these will not attract IBAs.

Conversely, a manufacturer using a building to store raw materials or finished products will be able to claim IBAs on that building, even though the storage itself is not a trade. In fact, the true basis of such a claim is that the building is in use for the purposes of a manufacturing trade – it is not really a claim under the ‘storage’ heading at all.

**Example 2: Deminimis calculation**

<table>
<thead>
<tr>
<th></th>
<th>Building A</th>
<th>Building B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of factory areas</td>
<td>£250,000</td>
<td>£251,000</td>
</tr>
<tr>
<td>Cost of office areas</td>
<td>£750,000</td>
<td>£749,000</td>
</tr>
<tr>
<td>Total cost</td>
<td>£1,000,000</td>
<td>£1,000,000</td>
</tr>
<tr>
<td>Office cost percentage</td>
<td>25.0%</td>
<td>25.1%</td>
</tr>
<tr>
<td>Amount qualifying for IBAs</td>
<td>£1,000,000</td>
<td>£749,000</td>
</tr>
</tbody>
</table>

**Excluded buildings**

IBAs are not available for buildings used as, or for purposes ancillary to, the following:
- a dwelling house;
- an office (although a drawing or sorting office may qualify);
- a retail shop; or
- a showroom (s 277).

If part of an otherwise qualifying building is in use for one of these purposes, the whole building will still qualify for IBAs, provided that the cost of the non-qualifying part (after deducting expenditure which qualifies for other kinds of allowances, such as plant) does not exceed 25% of the total cost – the so-called ‘de minimis rule’ (s 283). Failing this, the total cost must be apportioned between qualifying and non-qualifying elements (see Example 2). Note that it is cost that is relevant not, for example, area, as is sometimes thought. It might be possible for a small but hi-tech and well-fitted-out office to be less than 25% of the total area, but more than 25% of the total cost.

On a large site with several buildings, each separate building must individually satisfy this test to qualify for IBAs. Each time any building additions are made, a new de minimis calculation should be prepared based on the actual construction expenditure incurred for the new and earlier buildings.

IBAs are a routine tax compliance area, but one where experience has shown that common misconceptions exist. With the self-assessment obligation on taxpayers to submit an accurate return, it is important that they and their advisers get it right to maximise valuable tax relief and avoid exposing themselves to interest and penalties.

For more information please contact the website at: www.cap-allow.com.