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Capital allowances and property

The aim of this Briefing is to outline the tax relief position of capital expenditure in buildings. Unlike repairs which are generally 100% deductible against business profits, only capital expenditure eligible as plant and machinery (P&M) qualifies for tax relief and often, this is then spread over several years. Awareness of what qualifies for P&M capital allowances is therefore essential for maximising opportunities for tax savings.

The starting point

Expenditure on tangible assets is divided into categories, the most important of which are 'plant and machinery (P&M)' and 'buildings and structures'.

In many instances there are no allowances on buildings and structures so identifying and maximising P&M allowances is the main objective. In buildings, P&M may either be tangible moveable assets (machinery and equipment) or assets which are attached to or an integral part of the building (air conditioning system). The latter type is usually referred to as 'fixtures' and it is this category in particular where it is estimated that millions of pounds of capital allowances go unclaimed each year. So what is the starting point?

In order to qualify for P&M allowances there must be two key ingredients:

- a qualifying activity and
- qualifying expenditure.

Qualifying activities

Qualifying activities for the purposes of P&M allowances include:

- a trade, profession or vocation
- a property business
- a furnished holiday lettings business (UK or European Economic Area)
- an overseas property business or
- managing investments of a company with investment business.

Where the qualifying activity is a property business, expenditure incurred on the provision of plant or machinery for use in a dwelling house does not generally qualify for P&M allowances. However, a key exception exists for plant and machinery used in dwellings which qualify as a furnished holiday lettings business.

Qualifying expenditure

A distinction is made between expenditure which qualifies for 'main pool' and 'special rate pool' (SR pool). The correct identification of P&M between the two pools is crucial because of the level of annual writing down allowance (WDA) available in each case as follows:

- an 18% WDA applies for main pool items
- an 8% WDA applies for the SR pool.

These rates came into force with effect from 1 April 2012 for companies and 6 April 2012 for the unincorporated business. Increased rates of 20% and 10% applied to accounting periods preceding these dates and special rules apply to accounting periods which straddle the date of change. The WDA applies to the balance of expenditure not otherwise relieved by one of the other allowances considered later in the Briefing.

Table 1 provides a list of some of the key items of P&M expenditure found in buildings that would usually qualify as main pool items.

Table 1

- Machinery
- Manufacturing and processing equipment
- Storage and display equipment counters and checkouts
- White goods (cookers, refrigerators, dishwashers, etc)
- Sinks, baths, showers and sanitary ware
- Furniture & furnishings
- Computer, telecommunication and surveillance systems
- Refrigeration or cooling equipment
- Fire alarms, sprinklers, and other fire fighting equipment
- Intruder alarm systems
- Moveable partitioning (if intended to be moved in the course of the trade)
- Decorative assets provided for the enjoyment of the public (in hotels, restaurants, and other similar establishments)

Integral features

One of the main categories of expenditure designated as SR pool expenditure is 'integral features'. The integral features rules were brought in from April 2008 and consist of a list of specific expenditure as detailed in table 2 opposite. Prior to its introduction some of these items would have



received no capital allowances at all, for example, general lighting systems. However, other costs, such as air conditioning would previously have qualified for main pool allowances.

Table 2

- Electrical systems (including lighting systems)
- Cold water systems
- Space or water heating systems, powered systems of ventilation, air cooling or air purification, and any floor or ceiling comprised in such systems
- Lifts, escalators and moving walkways
- External solar shading

Any asset whose principal purpose is to insulate or enclose the interior of a building or to provide interior walls, floors or ceilings which are intended to remain permanently in place are classed as part of the fabric of the building and are not allowed as integral features so no allowances are usually due.

Replacements of integral features

A particular point to be aware of is a special rule for 'replacements' which applies to certain repairs on integral features. Repairs to P&M generally result in an immediate unlimited 100% tax deduction against business profits. This treatment is often more beneficial than the capital allowances that would be available if the

expenditure was classed as capital. Expenditure on P&M would only generally be classed as capital if the whole asset was replaced. However, where the expenditure incurred on an integral feature is more than 50% of the cost of replacing the whole integral feature, this is treated as though it were expenditure on a new asset and only 8% relief may be available per year.

Example

Jake needs to replace the electrics on the ground floor of his workshop following flood damage. The quote to replace the wiring and sockets on the ground floor is £30,000. He is advised that a quote to rewire the whole building would cost £55,000. As the replacement cost represents more than 50% of the total replacement cost, the integral features replacement rule will apply. This means that tax relief for the expenditure may only be 8% and not 100%!

Other SR pool expenditure

P&M allowances are also available on certain other types of SR pool expenditure. The key types are summarised below.

- The addition of 'thermal insulation' to existing buildings used for any qualifying activity other than residential property businesses for expenditure incurred from April 2008. The ordinary meaning of the expression is defined as 'insulation against loss of heat'. This could include capital expenditure on things like roof lining, double glazing, draught exclusion and cavity wall filling.
- Expenditure on plant and machinery classified as 'long life asset' expenditure. This generally means P&M which when new could reasonably be expected to have a useful economic life of at least 25 years. However, expenditure of this type is only treated as SR pool expenditure and not main pool expenditure if it exceeds an annual expenditure limit (diluted if associated companies) of £100,000.
- Solar panning expenditure incurred on or after 1 April 2012 for companies and 6 April 2012 for unincorporated businesses.

Alterations to a building

Expenditure on alterations to an existing building incidental to the installation of P&M is treated as expenditure on that item of P&M. An example of this could be strengthening a floor to accommodate heavyweight machinery. What qualifies as incidental is open to interpretation and has been challenged on several occasions in the tax courts in recent years so advice is recommended before undertaking significant project expenditure. The treatment of any qualifying expenditure will follow the treatment of the plant item concerned.

Professional fees

There will be costs in addition to the direct costs of the qualifying P&M in buildings. Most notably, there will be professional fees incurred at the various stages of a design and build project. Very often no relief is sought for these additional

and often fairly significant costs. However, to the extent that there is a direct relationship between the fee and the provision of the P&M, relief will be available.

Allowances available

In addition to the annual WDA detailed above there are other allowances which may be available and as these could provide 100% relief on qualifying P&M expenditure a business would first of all seek to maximise these claims.

Annual Investment Allowance (AIA)

Most businesses are first able to claim the AIA before considering the annual WDA. This provides 100% relief on actual expenditure incurred in the accounting period. The AIA was £100,000 annually but has recently reduced to £25,000 for expenditure incurred on or after 1/6 April 2012. Special rules again apply for periods which span the date of change. Other conditions also affect its availability, so it is recommended that you check any such entitlement for a particular accounting period. The AIA relief applies to P&M expenditure whether it has been allocated to the main pool or the SR pool but it is best used against SR pool acquisitions as any excess in that category only qualifies for the lower annual WDA of 8%.

Enhanced Capital Allowances

In addition to the AIA, 100% relief can be obtained on any P&M expenditure incurred which meets the criteria to qualify as energy saving or environmentally friendly. Full details of what qualifies can be accessed at <http://etl.decc.gov.uk> but it can include lighting, water and heating systems.

Late claims

Sometimes claims may initially be overlooked in respect of qualifying expenditure. This can occur for various reasons such as a lack of good records or a lack of supporting detail provided. Is there any recourse for a missed claim?

It is not possible to backdate claims to earlier periods once the tax return time limit (generally two years from the end of an accounting period) is closed but it is possible to make certain claims in later years (provided that the asset is still owned). This may allow WDA claims for the later periods but it is not possible to claim other types of allowance such as the AIA.

Example

Snail Ltd makes up annual accounts to 31 March. In September 2012 a review reveals that a claim for P&M allowances could have been made on £50,000 of qualifying expenditure in the year to 31 March 2010, the time limit for which was 31 March 2012. All the qualifying assets are still in use in the business and would have qualified for the SR pool.

The company can however amend the submitted 31 March 2011 corporation tax return, as the time limit runs until 31 March 2013. The claim will be for £5,000 in that return, that is 10% (the WDA rate on SR pool up to 31 March 2012) of

the £50,000 expenditure. An additional amount of £4,500 (10% on the balance of £45,000) will then be included as part of the other capital allowances in the year to 31 March 2012. The tax saving effect will depend upon the rate of corporation tax payable for each period. Further allowances on the balance can be claimed in future periods.

Second hand P&M 'fixtures'

A key issue for purchasers (which has over recent years led to missed or late claims) is establishing qualifying expenditure on second hand P&M when premises are sold on by subsequent owners. This is particularly true in relation to P&M which is classified as fixtures (attached to or part of a building). Problems arise because there is often no clear allocation of value in the sale agreement to fixtures nor a clear analysis of what constitutes fixtures and their related capital allowance history.

Certain controls do exist in tax law to ensure that tax relief on P&M generally (including fixtures) does not exceed the original expenditure when first acquired on a subsequent sale or transfer. There are also rules which can direct a reasonable apportionment when various assets are sold together. However, it would appear that the operation of the rules in relation to fixtures has been neither sufficiently robust to avoid duplicate claims nor comprehensive enough to provide certainty to purchasers and vendors about their respective tax position. This has led to certain aspects of the rules for fixtures being changed, some with effect from April 2012.

Recent developments on P&M fixtures

The key effect of the changes is that purchasers of existing fixtures in buildings will only be able to claim P&M allowances if certain requirements have been satisfied. The requirements are technically complex but the general principles are as follows:

- any qualifying P&M fixtures expenditure incurred and owned by a seller must be included within either the main or SR pool prior to an onward sale to a future purchaser (this includes any items on which 100% relief is obtained upfront) and
- the seller and the purchaser must generally by joint election agree a disposal value for those fixtures.

The aims are clear, to ensure that qualifying expenditure on fixtures is clearly identified and to ensure that only one party at a time obtains the appropriate tax allowances.

What we can do to help

As you can see there are a number of qualifying technical factors to consider to secure the maximum capital allowances on fixtures in buildings. Other critical factors include proper planning before expenditure is incurred and clear documentary evidence to identify the type of expenditure incurred. Please do contact us if you have plans to acquire, sell or refurbish premises as we can assist you in these processes as well as dealing with the appropriate tax relief claims.