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Capital allowances – introduction

Overview

Most day to day business expenses can be deducted from business income when calculating your taxable profits. However the rules are different for 'capital' expenditure.

'Capital allowances' is the term used to describe the allowances which allow businesses to secure tax relief for certain capital expenditure. Most 'capital' items, such as computer equipment, vehicles, machinery etc last for more than a year or so. So the tax rules do not allow you to automatically deduct the full cost of such items in one go. And different rules apply to different types of capital expenditure. In some cases no tax relief is available at all even though you may have spent the money solely for business purposes.

This guide provides an overview of the main types of capital allowances that can be claimed and is aimed at businesses with relatively straight forward tax affairs.

Capital allowances are available in respect of:

- Most 'plant and machinery' used for business purposes;
- Certain building works - for example converting space above commercial premises to flats for renting;
- Certain research and development expenditure.

Your entitlement to claim capital allowances is usually unaffected by how you pay for the items in question. For example, if you buy an item on hire purchase you can claim capital allowances based on the full normal cost of the item. The interest you pay and other charges are not part of the capital cost of the item but can usually be counted as deductible business expenses.

If you simply rent capital equipment, and do not secure ownership of the items, no capital allowances can be claimed. Instead the payments due, under what is usually called an 'operating lease', are simply deductible as a normal business expense.

Plant & Machinery

The official term 'plant and machinery' (P&M) includes items such as cars, vans, machines, equipment, computers, furniture and other similar items used by a business.

Some of the rules related to P&M depend on the nature of the expenditure and how much money has been spent on P&M during the accounting period. There are also special rules to provide tax relief for items of P&M you used privately before using them in your business and items that you only partly use for business purposes.

Annual Investment Allowance

The annual investment allowance (AIA) is available to all businesses regardless of size. This AIA allows businesses to write off 100% of the cost of qualifying plant and machinery, up to the allowed maximum, against taxable profits.

Most businesses had an AIA of £50,000 for plant and machinery purchased during the 2008-09 and 2009-10 tax years.

The AIA limit was increased to £100,000 for plant and machinery bought from 1 April 2010 for the purposes of corporation tax and from 6 April 2010 for the purposes of income tax. Transitional rules have been put in place for businesses whose accounting periods span the operative date of the increase.

The AIA is to be reduced to £25,000 from April 2012.

Writing down allowances

For plant and machinery expenditure that exceeds the AIA and which does not qualify for a first year allowance (see below), a standard 20% writing down allowance (WDA) is available. This is based on the cost of the items in the year they are acquired. Deducting the WDA leaves 80% of the cost as the tax written down value. The following year a further writing down allowance of 20% of this 80% is available. And so on in future years.

The rate of writing down allowance is reducing from 20% to 18% as from April 2012.

First-Year Allowances

Where AIA is not available businesses can claim first-year allowances (FYA) of 100% in the year they purchase certain plant or machinery. As with the AIA this allows businesses to deduct the whole purchase cost of qualifying assets from their taxable profits.

Examples of plant and machinery that typically qualify for the 100% FYA include:

- Low carbon dioxide emission cars.
- Energy-saving plant and machinery.
- Environmentally beneficial plant and machinery.
- Equipment for refuelling vehicles with natural gas, biogas or hydrogen fuel.
- North Sea oil ring-fence plant and machinery and mineral extraction.

Special cases

Most plant and machinery is treated in a standard way for capital allowances, however there are special rules for expenditure on:

- Cars.
- Long-life assets.
- Short-life assets.

- Integral features of buildings and thermal insulation.
- Assets bought by businesses and then leased out.

Cars

A special 100% FYA is available for certain vehicles with low or no carbon dioxide (CO2) emissions.

Qualifying expenditure on cars must be allocated to one of two general plant and machinery pools of expenditure. Which pool is appropriate depends on the car's CO2 emissions:

- Expenditure on cars with CO2 emissions over 160 grams per kilometre (g/km) driven will be dealt with in the special-rate pool and will attract a writing-down allowance (WDA) of 10% per annum.
- Expenditure on cars with CO2 emissions of 160g/km driven or less will be dealt with in the main pool and will attract WDA of 20% per annum.

Cars that have an element of non-business use, by the self-employed, must be allocated to a single asset pool to enable the private use adjustment to be made.

Cars purchased before 1 April 2009 (Corporation Tax) and 6 April 2009 (Income Tax) continue to be treated under the old rules for a transitional period of five years. This means that cars with no non-business use costing:

- Less than £12,000 continue to be handled in the main rate pool regardless of their emissions. The tax relief for such cars is set at 20% of the tax written down value each year.
- £12,000 or more continue to be treated individually. The tax relief for such cars is set at 20% of the tax written down value each year, subject to a maximum of £3,000 allowance per year.

Short-life assets

There are special rules where a business purchases equipment that it expects to keep for a short time or that is expected to wear out quickly.

If the life of the asset is ‘short’, businesses can choose to calculate the capital allowances outside the main pool. This will generally mean more tax relief but only when the assets are written off, scrapped or sold.

In the March 2011 Budget, the Chancellor announced that legislation is to be introduced to increase the period from 4 to 8 years over which expenditure on plant or machinery can be treated as short-life assets.

The measure will have effect for expenditure incurred

- on or after 1 April 2011 for businesses within the charge to corporation tax (CT); and
- on or after 6 April 2011 for businesses within the charge to income tax.

The change extends the potential benefits of the current short-life assets regime.

Long-life assets

This term refers to assets with an expected useful life of more than 25 years.

The tax allowance here is set at 10% of the written down value each year with all expenditure on long life assets being added to a special 10% rate pool.

Integral features of buildings and thermal insulation

The same relief as for other long life assets is also available for the cost of new or replacement 'integral features' of a building.

Such features are:

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

Businesses can also claim the 10% allowance each year for expenditure on installing thermal insulation in all existing buildings used for any qualifying business purpose - other than if it's a residential property business.

Research and development

Businesses can claim a capital allowance of 100% on the capital costs incurred on qualifying elements of capital expenditure incurred on ‘Research and Development’. The rules as to what qualifies in this regard are complex. In general however a project qualifies as R&D if:

- It seeks to achieve an advance in science or technology.
- The research is relevant to the business.
- The business is of a trading nature as distinct from someone working in a profession or vocation.

Assets leased out

In certain circumstances businesses can claim capital allowances for assets they own and lease to other businesses.

Private use

This section is only relevant if you operate your business as a sole trader or partnership. So this issue is not relevant if your business is a limited company.

Where a business asset is used partly for private purposes the entitlement to capital allowances are restricted. The asset is not included in any pool but is the subject of a separate calculation.

The allowances are computed in the normal way so can in theory attract the 100% AIA or the relevant writing down allowance.

However only the business use proportion is allowed for tax purposes. Private use of assets by employees does not require any restriction of the capital allowances.

Buildings

Businesses can claim capital allowances on the cost of:

1. Renovating existing flats - or converting space above qualifying shops and other commercial premises to provide flats for rent.

   Businesses can usually claim an initial allowance of 100%, or a writing-down allowance (WDA) of 25% a year on a straight-line basis, of the cost of:

   - converting underused or vacant space above commercial premises into qualifying flats;

   - renovating an existing flat above commercial premises into a qualifying flat.

2. Converting or renovating unused qualifying business premises in a disadvantaged area

   Until April 2012, businesses can claim an initial allowance of 100%, or a WDA of 25% a year on a straight-line basis, of the cost of:

   - converting a qualifying building into business premises;

   - renovating a qualifying building that is, or will be, qualifying business premises;

   - repairs to a qualifying business premises ;

   The building must:

   - be in a disadvantaged area;

   - have been used formerly for business purposes;

   - have been unused for one year or more.

3. Constructing (or buying unused) certain commercial, industrial or agricultural buildings - these particular allowances have been abolished with effect from April 2011.

   The original allowance for such expenditure was just 4% per annum on a straight-line basis. However, in 2010-11 the allowance was restricted to just 1%.

Buildings-related expenditure that doesn't qualify for capital allowances

Businesses cannot claim capital allowances on the cost of:

- Developing adjacent land.
- Furnishing qualifying flats.
- Houses, showrooms, offices and shops.
- Extensions, unless they provide access to qualifying flats.
- The land itself, such as buying the freehold of a property or acquiring a lease.

Claiming capital allowances

All claims for capital allowances are made through the business's annual tax returns.

You do not need to claim the full amount of the available allowance. You might choose to limit your claims to capital allowances to avoid other allowances or reliefs being wasted.

How we can help

We would welcome the opportunity to assist you in maximising your claims to capital allowances. We can also help you arrange your business expenditure generally so as to maximise your entitlement to secure tax relief.

For further information please call [name] on [number] or email [email address]