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Capital allowances is the set of tax rules which determines the tax deduction you get when you incur expenditure on capital assets used in a business. The rules affecting 'plant and machinery' are the most important area for the majority of businesses as many businesses do not benefit from capital allowances on their business premises.

Significant proposed changes to these rules were announced back in March 2007 but have only now become final in this year's Finance Act 2008.

The purpose of this briefing is to explain how these rules will now operate. The main emphasis will be on the impact on plant and machinery expenditure but a summary of where we are with tax relief for premises expenditure is included. For companies the changes will apply from 1 April 2008 and for the self employed from 6 April 2008.

Capital Allowances The New Rules

What now qualifies as 'plant and machinery' expenditure?

Relevant assets have always included machines, equipment, furniture, computers, cars and other motor vehicles. However, a key change under the new rules is the introduction of a new category of plant and machinery to be known as 'integral features'.

Integral features will include lifts, electrical and lighting systems, air conditioning and heating systems. It will not include kitchen and toilet fixtures which will continue to be treated as normal plant and machinery. All expenditure belonging to the new group will be allocated to a separate special rate pool for capital allowances. If your business incurs expenditure on plant which was previously treated as long life plant, this will also now be allocated to the same special rate pool.

Comment

Some integral features previously qualified as ordinary plant but some were classified as building expenditure and often did not qualify for any tax relief so this aspect of the change is beneficial.

However the introduction of this new category does increase the analysis required when buildings are purchased, as capital costs will need to be allocated between building, plant and integral features to ensure tax relief is maximised, so do please contact us if this affects you.

Changes to allowances

- The 50% first year allowance (FYA) for small businesses and 40% FYA for medium sized businesses cease to be available for expenditure incurred on plant and machinery from 6 April 2008 for the self employed or 1 April 2008 for companies.
- A new Annual Investment Allowance (AIA) will be introduced.
- A 100% enhanced capital allowance (ECA) continues to be available for expenditure on energy saving plant and machinery which includes certain 'green' cars.
- The annual allowance on the normal plant and machinery pool is reduced from 25% to 20%.
- The annual allowance on the new special rate pool will be 10%.

What is the AIA?

The AIA will apply to expenditure incurred on plant and machinery on or after 6 April 2008 for the self employed or 1 April 2008 for companies. It will not be available for expenditure on cars but will be available for most types of plant and machinery, including integral features.

The annual allowance will be £50,000 per 12 month accounting period and all qualifying expenditure up to that level will qualify for a 100% allowance. Anything over that will fall into the normal capital allowance pools at either 20% or 10%.

An apportionment of the £50,000 limit will be required if the accounting period straddles April 2008. For example, a company with a 31 December 2008 year end will only be entitled to an AIA of £37,500 ($9/12 \times £50,000$).

Am I a winner or a loser?

This depends on how much you spend and what you spend it on. For example, if you spend £10,000 per annum on plant, then you will be a winner. Previously, a small business would have obtained a 50% FYA (£5,000) but then would have had to write the reducing balance off at 25% per annum in future years. With the AIA, all of the £10,000 will be fully written off in year one so many small businesses will now get 100% up front relief on plant expenditure.

However, if you spend £200,000 on air conditioning, you will be a loser. Previously, a medium sized business would have received a 40% FYA (£80,000) and then a 25% reducing balance allowance per annum in future years.

Under the new rules, the AIA will only amount to £50,000. The balance of £150,000 expenditure will be allocated to the special rate pool and will obtain a 10% allowance in the same period. This would give total capital allowances for the year of expenditure of £65,000, being £50,000 AIA plus £15,000 annual allowance. In future periods only the 10% annual allowance will be available.

Comment

The timing of capital expenditure has always been an important consideration because of the effect on taxable business profits. These changes could mean that there is a significant impact. For the small business big swings in taxable profits could occur from one year to the next depending on the level of capital expenditure. You may wish to discuss your expenditure plans so that together we can maximise the benefits available and also advise you of the cash flow implications for tax payments.

Is AIA available to all businesses?

AIA is available to all sizes of business whether you operate as a company, sole trader or partnership. However, a mixed partnership, being a partnership not comprising only of individuals, is excluded.

- A company is entitled to a single AIA for all its qualifying activities.
- A sole trader or a partnership has the potential to have a separate AIA for each qualifying activity that is carried on. This applies even if an individual has several businesses or is involved in several partnerships.

So for example if N and D are in partnership and run a catering business with premises in Coventry and N also operates a childcare nursery in Leicester, each business would be entitled to the AIA. But if both qualifying activities were undertaken by a single company, they would have to share one AIA allowance.

The AIA will also have to be shared in what are known as 'related' business situations. The detailed rules are not considered here but simple examples of those affected include:

- a group of companies
- businesses with similar activities controlled by the same person
- businesses which operate from shared premises and which are controlled by the same person.

Comment

These rules are aimed at ensuring that businesses are not artificially structured simply to obtain more than one AIA entitlement such as splitting one trade between 2 companies. However there will be a number of genuine businesses and independent companies which are caught by the rules so if you are involved in multiple business activities, you should consider obtaining advice on this issue so that your AIA entitlement can be established.

Expenditure not covered by AIA or ECA

Where expenditure is not 100% covered by AIA or because it attracts a 100% allowance on energy saving or water efficient equipment, it will either attract the 20% annual reducing balance allowance in the main pool or 10% allowance if in the special rate pool. For many businesses there will be an accounting period which straddles the changes and the annual allowance will be adjusted for that period. For a year to 31 December 2008 the principle is that 3 months will be at 25% the old rate and 9 months at 20% resulting in a hybrid rate of 21.25%. There is no hybrid rate for the special rate pool as it did not exist prior to April 2008, but a special hybrid rate will apply to the long life asset pool during the changeover period.

Small plant and machinery pools

Businesses will be able to claim a one off allowance of up to £1,000 in the case of both the plant and the special rate pool, once the unrelieved expenditure in either the main rate pool or the special rate pool is £1,000 or less. This is to get rid of the tedious situation in very small businesses where for example a main pool balance of £600 continues to be written off bit by bit each year by the annual allowance of 20%.

This measure has effect for chargeable periods beginning on or after 1 April 2008 for businesses within the charge to corporation tax and on or after 6 April 2008 for businesses within the charge to income tax. So if a self employed person prepares accounts to 31 May, the first relevant period to which this new facility could be applied will be the year ended 31 May 2009.

Business cars

The Budget 2008 included announcements about proposed changes to the basis of capital allowances for car purchases from 1 April 2009. The current position on car purchases until then is:

- Cars with CO₂ emissions up to 110 grams per kilometre (gm/km) qualify for the 100% ECA irrespective of cost.
- Cars costing up to £12,000 are included in the general plant pool and

get a 20% annual allowance only. The AIA cannot be applied against such purchases whereas it is available on vans.

- Cars costing more than £12,000 (so called expensive cars) have to be allocated to a separate single asset pool which will qualify for the annual allowance of 20% but with a maximum allowance on each car of £3,000. On disposal of each separate asset an extra allowance is available on any overall net cost.
- Any cars used by the self employed are also separately allocated to a single asset pool so that any private use element can be restricted. This does not apply to employee provided cars.

From 1 April 2009 the annual allowances are to be dependent on the CO₂ emissions position of the car rather than the cost. The proposal states that cars between 110-160 gm/km will get an annual allowance of 20% whereas cars in excess of 160 gm/km will only qualify for 10% in the special rate pool.

Comment

The proposals clearly reduce the annual allowances available on many business car purchases. It would also appear that the advantage of obtaining an extra allowance on a disposal to cover overall net cost will be lost in the pool balances carried forward. If this is the case it will particularly impact on companies and other businesses which provide employees with cars.

Since the Budget 2008 no further detail has yet been issued in the form of draft legislation so please get in touch for any updated guidance as to how this may impact on your business.

Summary of the changes to buildings

For many businesses there is no relief for expenditure on the premises from which they operate but the main buildings allowances which have been available were Industrial Buildings Allowances (IBAs) and Agricultural Buildings Allowances (ABAs)

There have been two major changes to both IBAs and ABAs:

- from this tax year 2008/09 the annual allowance on industrial buildings (including hotels) and agricultural buildings will be gradually phased out, with final withdrawal of both regimes by April 2011 and
- to prepare the way for final abolition, on a disposal of such buildings most balancing adjustments are withdrawn from 21 March 2007. A balancing adjustment was a method of either giving the seller an additional allowance or clawing back allowances.

Whilst some businesses may benefit from the second change if they now sell a building where IBA or ABA have been claimed (there will be no claw back of allowances previously given), the first change is bad for all businesses concerned.

As stated above the rate of annual allowance will reduce over the period from April 2008 to April 2011 when the allowances will disappear. In 2007/08 or Financial Year 2007 for companies, the allowance was either 4% of original cost or a specially recalculated amount following a purchase or sale. The entitlement will be reduced as follows:

2008/09	75%	Example Company X had an entitlement of £72,000 IBA in the year to 31 March 2008. This will now be £54,000 (75% of £72,000) for the year to 31 March 2009.
2009/10	50%	
2010/11	25%	
2011/12	0%	

So what do I do now?

These changes are fundamental to many businesses. Please get in touch with us as soon as possible to discuss how we can maximise any allowances for your business.