

Factfile - Issue 5

CAPITAL ALLOWANCES - PART 1

The scheme for relief from tax for capital expenditure is being revised radically as from April 2008 explains Robin Wilson, Wilson Sandford (Hove) Ltd, and member of the Property & Construction Group.

1. The Current Position

At present, the relief is for one half of the amount spent on "Plant and Machinery", with the remainder being written off in later years at the rate of one quarter of the balance per year. If, for example, a business were to spend £2,000 on a piece of equipment for long term use, it would receive a tax allowance of £1,000 in the first year, leaving a balance of £1,000. The allowance would then be £250 (1,000 x 25%) in the second year, leaving a balance of £750, £187 (750 x 25%) in the third year, leaving a balance of £563 and so on, indefinitely. This means that 85% of the cost has been written off after five years.

In practice, there is a Pool of all relevant expenditure. New items are added in after the 50% "First Year" allowance has been deducted, and the proceeds of any sales are deducted, with the 25% allowance being due on the resulting total.

Cars are specifically excluded from these rules, to prevent businesses from eliminating their tax liabilities by buying luxurious limousines! There is a maximum allowance of £3,000 in any year regardless of the cost, and cars are kept separate rather than being added to the pool.

Different rules apply to "Long Life Assets", namely ones which can be expected to remain useful for twenty five years, and to "Short Life Assets", namely ones which are expected to be worn out within four years, but that is a summary of the current position.

2. The New Arrangements

As from April 2008, all businesses will have an Annual Investment Allowance of £50,000, so expenditure up to that figure will be allowed in full, with only the balance being added to the pool. This will mean in practice that most small businesses will be able to write their capital expenditure off at 100% in the year in which it is incurred, and the calculations will therefore be simplified considerably. The allowance on the remaining pool will be reduced to 20% (10% for Long life assets), but most small businesses will cease to have such a pool over the next few years, so this should not be a major problem for them. A helpful new rule will allow a pool to be claimed in full and therefore eliminated once it has fallen below £1,000.

Needless to say, cars are again excluded, so a business with a profit of £50,000 will not be able to make itself tax free by buying a Mercedes or a Bentley!

Groups of companies and companies under common ownership will have to share an allowance of £50,000, so it will not be possible to increase it by dividing a business into a number of companies.

3. Value of Allowances

It is worth mentioning that these allowances are reductions in taxable income rather than deductions from tax. A person entitled to an allowance of £1,000 and liable to tax at 20% will therefore find that his tax bill falls by £200 and not, as he may have been hoping, £1,000!

4. Construction Industry

The above comments apply to all trading businesses and there are no provisions specifically aimed at the construction industry, where the long standing distinction between ordinary and capital expenditure will continue to apply. A house builder will be able to charge consumable items such as bricks against profits, while cement-mixers, cranes, vans and such longer lasting items will be treated as "Capital". The £50,000 limit means that such a business would be well advised to keep spending on such items in any year within that figure in so far as that is possible, and to make its plans so as to use the allowance each year, although it is never sensible to make unnecessary purchases purely with the intention of keeping to a tax plan.

5. Larger Businesses

It follows from the nature of the changes that substantial companies will be affected adversely by these changes, as the £50,000 allowance will rarely, if ever, cover the whole of their capital expenditure in a twelve month period. They will thus add to their pools and will suffer from the reduction in the annual allowance from 25% to 20%. It will, however, be possible to claim a separate 20% allowance for the excess of a year's expenditure over £50,000, before it is added to the pool, so the effect would be reduced.

If, for example, a company had spent £80,000, it would claim the £50,000 and 20% of the remaining £30,000, so only £24,000 would have to be added to the pool for relief in future years. This is 30% of the original cost, but the impact on larger businesses can see if one performs the same calculation for expenditure of £800,000; in that case the equivalent percentage is 70.31%.

As this is tax legislation, there are numerous detailed sub provisions and exclusions, but the above is a reasonable summary of the position. The more detailed changes will be covered in later articles in this series.

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