Armstrong & Co Chartered Accountants, Auditors & Business Advisors

4A Printing House Yard, London E2 7PR T: 0207 613 2586 E: mail@armco.co.uk

Capital Allowances Are Changing: Make sure you're prepared

The current system of capital allowances will see significant changes from April 2012, including a reduction in the amount of expenditure on plant and machinery which qualifies for a 100% year one write-off (via the annual investment allowance) from £100,000 to just £25,000. The changes will inevitably have an impact on many businesses, especially those facing a need to invest substantial amounts in plant and machinery. This factsheet provides an overview – please contact us for help and advice.

Capital allowances permit businesses to write off the cost of capital assets, such as plant and machinery, against their taxable income. They take the place of commercial depreciation, which is not allowed for tax.

Annual investment allowance (AIA)

This 100% allowance enables most businesses, regardless of size, to reduce their taxable profits by the full amount of their annual capital expenditure on most plant or machinery (apart from cars) up to a maximum amount, which is currently £100,000 a year.

It will nearly always be beneficial for a business to claim the maximum AIA available. However there are certain circumstances where a partial claim may be preferable.

Ta x effect of the AIA

Apart from reducing the amount of tax payable (by up to 50% for additional rate taxpayers), an AIA claim can protect the personal allowance of a business owner earning over £100,000 in that initial year of purchase.

The lowering of profits could have a dramatic effect on an individual's entitlement to claim Tax Credits.

Enhanced capital allowance (ECA) schemes

There are three ECA schemes, which provide 100% first year allowance (FYA) for spending on new equipment which has environmental benefits:

- Energy-saving equipment. The equipment must be certified as meeting energy efficiency criteria, within specified categories such as heat and power systems, lighting, refrigeration etc.
- Water-efficient equipment which saves energy, reduces water use or improves water quality
- Electric and low CO_2 emission (up to 110 g/km) cars.

Where a company (only) incurs a loss attributable to ECAs, that loss may be surrendered in exchange for a cash payment instead of being carried forward to set against future profits.

4A Printing House Yard, London E2 7PR T: 0207 613 2586 E: mail@armco.co.uk

Writing-down allowances (WDA)

Where capital expenditure is greater than the AIA and any ECA, the excess normally enters the *main rate pool*. However, there is a *special rate pool* for expenditure on long life assets, the addition of thermal insulation to existing commercial buildings, cars with CO_2 emissions of 160 g/km or more and *integral features* of buildings, specifically:

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

The rate of WDA, on the reducing balance basis, is currently 20% per annum for the main rate pool, and 10% per annum for the special rate pool.

Businesses are able to allocate their AIA in any way they wish; so it is quite acceptable for them to use their allowance to obtain a 100% write off for expenditure which would otherwise qualify for a lower rate of allowances (such as long-life assets or integral features).

Single asset pools

Single asset pools are required for: short life assets (see below); any asset with part private use by a sole trader or partner; and expenditure before April 2009 on cars costing over £12,000.

Short-life assets

Some assets are projected to wear out quickly over a short period of time and pooling them would result in their value not being fully relieved when they are disposed of. So it is possible to make an election to have capital allowances on any such assets calculated in separate single asset pools. This leads to a balancing allowance or charge arising if the asset is disposed of within four years from the end of the accounting period in which it is acquired. If the asset is still held at the end of that period, the tax written down value is transferred into the main pool.

Write off of small pool values

Where a pool balance (main or special) is less than £1,000, it is possible to claim all or part of it as a WDA. This removes the need to carry forward small balances with ever-decreasing WDA claims. This measure does not apply to single asset pools.

Impending changes

The maximum amount of the AIA will be reduced to £25,000 a year with effect from April 2012. Where the accounting period spans April 2012, the maximum amount of AIA entitlement is calculated on a pro-rata basis (see example below).

4A Printing House Yard, London E2 7PR T: 0207 613 2586 E: mail@armco.co.uk

For chargeable periods ending on or after 1 April 2012 (for businesses within the charge to corporation tax) and on or after 6 April 2012 (for businesses within the charge to income tax), the rates of WDA will be reduced to 18% (main rate pool) and 8% (special rate pool).

Since the rate changes apply from a fixed date, for those businesses where the accounting period spans the change date, hybrid rates will apply for the whole of the transitional chargeable period.

Hybrid rates

There will be two hybrid WDA rates:

- one for any expenditure that qualifies for the current 20% WDA; and
- the other for any expenditure that qualifies for the current 10% WDA.

For example, if Asset Ltd's accounting period begins on 1 January 2012 and ends on 31 December 2012, approximately one quarter of that period would fall before the date of change (1 April 2012) and approximately three quarters would fall after that date.

Fraction of period	**Main Rate**		**Special Rate**	
91/366	20%	4.97%	10%	2.49%
275/366	18%	13.52%	8%	6.01%
Hybrid rate		**18.49%**		**8.50%**

Transitional AIA

Asset Ltd will also be subject to a transitional AIA maximum, calculated as follows:

Dates	**Fraction of period**	**Allowance for full year**	**Transitional allowance**
01/01/12 to 31/03/12	91/366	£100,000	£24,863
01/04/12 to 31/12/12	275/366	£25,000	£18,784
	Transitional AIA maximum		**£43,647**

An unpleasant surprise?

Asset Ltd may have planned to buy machinery worth £80,000 in February 2012 in order to make use of the current £100,000 AIA limit. However, the calculation above shows that the amount of AIA which may be used against expenditure incurred *in the whole of 2012* is limited to £43,647. The effect is that capital allowances on the purchases will arise as follows:

4A Printing House Yard, London E2 7PR T: 0207 613 2586 E: mail@armco.co.uk

			Allowances for year
Year to 31 December 2012 – transitional AIA			43,647
Balance allocated to main pool		36,353	
WDA Year to 31 December 2012 – hybrid rate	18.49%	(6,722)	6,722
			50,369
			=====
WDV b/f		29,631	
WDA Year to 31 December 2013	18%	(5,334)	5,334
			=====
WDV c/f		24,297	
WDA Year to 31 December 2014	18%	(4,373)	4,373
			=====

And so on for many years on a reducing balance basis

Is there an alternative?

It is clear that the result for Asset Ltd is far less favourable than was intended, but what alternatives are there?

The most obvious would be to advance the purchase to December 2011. The purchase would then be in the previous accounting period which does not contain any changes in the AIA maximum. But does it make commercial sense?

Another, more drastic, alternative would be to change the accounting period end from 31 December 2011 to 31 March 2012. The purchase in February 2012 would also be in an accounting period which does not contain any changes in the AIA maximum. There could, however, be repercussions in terms of additional cost and possible advances of tax liability.

Anti-avoidance legislation

The capital allowances anti-avoidance legislation denies AIA and FYA, without exception, where there is a sale or hire purchase of plant or machinery if either:

(i) the buyer and seller of the plant or machinery are connected, or

(ii) the transaction was put in place solely or mainly to get the benefit of capital allowances, or

(iii) the plant or machinery was sold and then leased-back to the seller and the seller continues to use the plant or machinery for the purposes of a qualifying activity.

4A Printing House Yard, London E2 7PR T: 0207 613 2586 E: mail@armco.co.uk

Prior to 12 August 2011 there was an 'exception for manufacturers and suppliers': where the plant or machinery had been bought or hire-purchased from a manufacturer or supplier of such plant or machinery in the normal course of business, then the buyer was not precluded from claiming FYA or AIA. The plant or machinery must never have been used before the sale or the making of the hire-purchase contract.

This change is being brought in before other proposed changes to the anti-avoidance legislation because the Government is aware that schemes are being promoted that seek to exploit the 'manufacturers and suppliers exception'.

If you intend to invest in your business and want to discuss the impact of capital allowances on your plans, please contact us.