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TEMPORARY FIRST YEAR ALLOWANCE FOR PLANT AND MACHINERY

Introduction

Much has already been written about the temporary 40% first year allowance (FYA) that was reintroduced in the Budget for expenditure on plant and machinery incurred during the tax year ending April 2010. As we mentioned in our earlier Budget announcement, the FYA will be available for most types of businesses, including property investment and there is no cap on the level of FYA. The FYA, however, is not available for certain types of expenditure. These exclusions mean that some businesses will benefit more than others. This article looks in more depth at some of the issues involved with claiming the FYA, as well as how it will affect different types of property and different types of businesses.

The exclusions

There are several exclusions for FYA purposes set out in the Capital Allowances Act 2001 (CAA 2001) at Section 46, including cars, railway assets, ships and any plant and machinery that is acquired as a gift. The main exclusion, however, affecting property investors is in respect to leased plant and machinery. In addition, the Finance Bill 2009, Section 24, also excludes special rate expenditure. It is these last two exclusions that will be applicable to most businesses and they are, therefore, considered in more detail below.

Special rate expenditure

Special rate expenditure is defined by Section 104A of CAA 2001 and consists of the following:

- (i) Thermal insulation.
- (ii) Long life assets (with expected useful life over 25 years).
- (iii) Integral features.

Of the above, it is integral features that will be most commonly encountered by most businesses. Integral features are defined by Section 33A of CAA 2001 and consists of the following:

- (a) An electrical system (including a lighting system).
- (b) A cold water system.
- (c) Heating, hot water, air-conditioning and ventilation systems.
- (d) A lift, escalator or a moving walkway.

The items mentioned overleaf attract an annual allowance of 10% on a reducing balance basis. Whilst these items will form a significant proportion of the plant and machinery in any building, the proportion will vary dependant on the use of the property. As the proportion of special rate expenditure increases, the affect of the FYA will reduce. This is clearly illustrated by the table opposite.

Leased plant and machinery

As stated overleaf, one of the exclusions for FYA is plant and machinery that is leased. This includes plant and machinery that is leased as part of a building, such as sanitary appliances and fire fighting equipment, as well as direct leasing that would be applicable to items such as photocopy machines and similar equipment. This exclusion, however, does not apply if the plant and machinery is 'background plant and machinery' as defined by Section 70R of CAA 2001. Background plant and machinery is basically the items that would be found in any type of property, which includes most of the items that are covered by special rate expenditure, as well as sanitary appliances and fire fighting equipment that are main pool items. Certain items of plant and machinery that are not included in the category of special rate expenditure may also be outside the category of background plant and machinery. A couple of such examples would be dock levellers (that can often be found in warehouses) and chattels that are leased with some buildings, such as the furniture in hotels.

The exclusion for leased plant and machinery may be difficult to apply in practice because the non background plant items will be pooled together with the background plant and machinery within the main pool expenditure, normally attracting a 20% annual allowance on a reducing balance basis. In the case, therefore, of leased plant and machinery, rather than just applying the 40% FYA to main pool expenditure for the year to April 2010, the taxpayer will need to consider whether any of the main pool items are not background plant and machinery in accordance with Section 70R.

The relative benefit of FYA for different property types and businesses

The table opposite sets out the typical percentages of total construction expenditure that will qualify for plant and machinery allowances in the first year of claim, with and without the FYA. All expenditure is assumed to be incurred between April 2009 and April 2010 and both Enhanced Capital Allowances and annual investment allowances have been ignored for the sake of consistent comparisons. The percentages of claimable expenditure, as well as the split between the main pool expenditure and special rate expenditure are based on our in-house data from actual projects. Total

construction expenditure excludes the cost of land and all non construction related expenses.

Property (Business)	Claimable	Main Pool	Special Rate	First Year (No FYA)	First Year (40% FYA)
Air-conditioned Office (Property Investor)	35.47%	6.95%	28.52%	4.24%	5.63%
Nursing Home (Nursing Home Operator)	25.27%	10.74%	14.53%	3.60%	5.75%
Hotel (Hotelier)	42.95%	24.05%	18.90%	6.70%	11.51%
Hotel (Property Investor)	42.95%	24.05%	18.90%	6.70%	8.91%
Doctors' Surgery (Medical practitioners)	17.83%	6.96%	10.87%	2.48%	3.87%
Retail Store (Fit-out) (Retailer)	85.00%	53.55%	31.45%	13.86%	24.57%
Pub (Refurbishment) (Brewer)	45.50%	37.57%	7.93%	8.31%	15.82%
Petrol Filling Station (Oil Company)	30.60%	11.44%	19.16%	4.20%	6.49%

The above table illustrates the fact that the benefit from the temporary 40% FYA is dependant on the type of property and taxpayer's business. In the case of an air-conditioned office, the FYA will increase the Capital Allowances in the first year of claim from £42,400 to £56,300 for every £1 million of construction expenditure. This represents an increase of 33%, which will, of course, also be the increase in the actual tax saving in the first year. If we look, however, at the percentages for a nursing home (excluding the chattels), we can see that the FYA will increase the Capital Allowances in the first year of claim from £36,000 to £57,500 for every £1 million of construction expenditure. This represents an increase of 60%, which is far higher than the benefit of FYA for an office, because of the higher proportion of main pool plant within a nursing home.

The relevance of the taxpayer's business can be seen clearly from the relative percentages for a hotel owned by an hotelier, as compared to the percentages for a hotel owned by a property investor. Due to the fact that the FYA will not apply to leased plant and machinery that is not background plant and machinery, the property investor will not get a FYA for the furniture and some other operating equipment. The FYA results in £89,100 of Capital Allowances in the first year for every £1 million of expenditure on a new hotel (including chattels) incurred by a property investor, but this figure increases to £115,100 if the expenditure is incurred by an hotelier. (We have assumed, for ease of comparison, that the chattels are not caught by Section 34A as plant and machinery leased on a long funding lease).

Summary

As set out above, the fact that FYA is not available on special rate expenditure or certain leased plant and machinery, the benefit of the FYA will depend on the type of property and the business of the taxpayer. As property investors will tend to suffer most from both these exclusions, the increased tax savings from the temporary FYA will not be as high for property investors as for other types of businesses. The biggest winners identified from the table overleaf are retailers incurring expenditure on fitting out their new stores. A high proportion of fitting-out expenditure incurred by retailers will normally qualify as plant and machinery and a major proportion of this will be main pool expenditure that will attract the FYA. The same conclusion could be reached for other businesses that fit-out their premises, such as licensees of public houses, leisure operators and restaurateurs.

In the case of leased plant and machinery, the correct application of the legislation will be far from straight forward because of the pooling system. As the main pool could include items that are not background plant and machinery in accordance with Section 70R, the simple application of the 40% FYA to the main pool could produce incorrect tax computations. This complication might, therefore, result in excessive claims for Capital Allowances, with obvious implications for interest on under-paid tax and possibly penalties. Perhaps this is an argument for property investors to split the main pool into two, one part for background plant and machinery and the other for non background plant and machinery?

For further advice concerning any of the issues raised in this briefing, please contact one of our key individuals detailed overpage, or alternatively call our helpline on 0800 526262. Information on other property tax related topics can also be found on our website at <http://bankingtaxfinance.davislangdon.com>.

