An Introduction to Tax Allowances for Capital Expenditure

Business Information Factsheet
BIF243 · March 2017

Introduction

Capital expenditure on assets such as computers and other equipment is a major cost to most businesses, but is not directly allowable as a tax-deductible expense. However, tax relief on this type of expenditure is available through capital allowances.

By understanding how capital allowances are calculated and when they are available to a business, it is possible to achieve tax savings, thereby offsetting the high cost of buying assets for the business.

This factsheet provides an introduction to the tax relief available when buying assets, and how it is calculated.

Tax legislation is a complex area and this information is intended only as a starting point for understanding the issues involved. Professional advice should always be sought before making business decisions regarding tax.

What are capital allowances?

Capital allowances provide a tax deduction against a business's taxable profits and therefore reduce the amount of corporation tax that is payable. The value of the allowance is based on the cost incurred when assets are bought and used in a business. The most common examples of capital expenditure are physical assets, such as computers, office equipment, manufacturing plant and machinery, and motor vehicles.

To ensure compliance with tax legislation, it is necessary to be clear whether a purchase made by a business qualifies as capital or revenue expenditure. Revenue expenditure covers the purchase of items needed for the day-to-day running of the business. These do not qualify for capital allowances, but are wholly tax deductible. Capital expenditure covers the purchase of assets that:

- Are not consumed or resold by the business.
- Have a useful life of more than one year.
- Are expected to have value after one year.

The main legislation covering capital allowances is the Capital Allowances Act 2001, but it is an area of law that often changes and it is therefore necessary to review the rules regularly. This is particularly important when making purchases which are only affordable if they qualify for tax relief from capital allowances.

Accountants or HM Revenue & Customs (HMRC) can advise which purchases qualify. Further information on this is available at www.gov.uk/topic/business-tax/capital-allowances.

What capital allowances are available?

Assets that are eligible for capital allowances are typically grouped according to which rate of capital allowance they qualify for into different 'pools'. The value of a pool consists of the amount paid for new purchases and is reduced by the annual capital allowance, known as the 'writing down allowance'. The value of a pool also reduces when assets are sold. The writing down allowance is a percentage of the value of the pool.

Allowances include:

- Annual Investment Allowance (AIA) pool. The first £200,000 of expenditure on plant and machinery (excluding cars) is subject to 100% allowance against profits.
- Main Rate pool. All expenditure on plant and machinery above £200,000 in a year is pooled and is eligible for an 18% writing down allowance for expenditure in the 12 months from 1 April 2016 and then a writing down allowance of 18% of the carried-forward balance in each subsequent year.
- Special Rate pool. Long-life assets (that is, assets with an anticipated life of more than 25 years), motor cars with high CO2 emissions (over 130g/km) and integrated features of a building, such as a lift, are pooled in a Special Rate pool and are eligible for an 8% writing down allowance. AIA can also be claimed against the Special Rate pool (excluding expenditure on cars).
- Single Asset pool. Short-life assets that have an expected life of less than eight years can be put into a Single Asset pool with an accelerated balancing allowance when disposed of (although if the assets are owned beyond eight years, they must be transferred to the Main Rate pool).
- Enhanced Capital Allowances (ECA) pool. This provides allowances of 100% in the first year, in addition to the AIA, for energy-saving equipment.

What are the rules for business cars?

Cars used for business are subject to special treatment. Cars bought on or after 1 April 2009 are eligible for writing down allowances based on the CO2 emissions of the vehicle. The annual writing down allowances are:

- For cars with emissions of no more than 130g/km: 18% of the cost of the vehicle.
- For cars with emissions greater than 130g/km: 8% of the cost of the vehicle.

There are special allowances for low-emission (up to 95g/km) and electric vehicles, which are eligible for 100% first-year allowances under the ECA.

How do capital allowances differ from depreciation?

Depreciation is an accounting term that provides for wear and tear to fixed assets, and is shown as a cost in a business's profit and loss account. The purpose of taking account of depreciation is to make it possible to calculate a fair charge for the use of the assets, to ensure products and services are costed accurately and to provide a realistic profit figure in each trading year. For further information, see BIF 41, Understanding and Calculating Depreciation.

However, depreciation is not an allowable expense for tax purposes. Each business can employ different depreciation policies to reflect their particular circumstances, providing they conform to general accounting standards. Capital allowances therefore replace the amount charged in the accounts as depreciation, thus allowing the cost of assets to be written off against taxable profits.

Businesses record the depreciated value of their assets in the balance sheet. Ideally, this is recorded by maintaining a fixed asset register. This records the purchase date and price of the asset, the rate of depreciation that applies to that asset, the cumulative depreciation to date and, therefore, the net book value of the assets.

The value of assets that have been subject to capital allowances are not shown in business accounts, but must be recorded in a separate register for fixed assets for capital allowance purposes. If an accountant is employed to help produce annual accounts, they will carry out this task.

When a business's taxable profit is calculated, it is necessary to add the cost of depreciation for that year back into the profit figure in the accounts. Then the capital allowances claimed for that tax year are deducted to calculate adjusted taxable profit. The calculation is shown in the example below:

Profits in the accounts	£10,000
Add - depreciation charge	£5,000
Deduct - capital allowances	(£3,000)
Adjusted taxable profit	£12,000

Note that the final taxable profit determining a business's tax liability may then have other expense adjustments made, depending on the circumstances of each business.

How are capital allowances given?

Capital allowances for a particular year are worked out by adding assets of similar types together into their qualifying pools of expenditure and calculating the capital allowance due.

If an asset is used solely for the business, the whole allowance is available for tax relief. Where sole traders or individuals in a partnership have made any private use of an asset, a proportion is disallowed. The amount of allowance available is reduced by a private-use percentage. Typically, this applies to vehicles used partly for the business and partly privately. Accurate records of business and private use for each asset must be kept for each year because this is an area that HMRC examines closely when reviewing business and tax records.

Capital allowances can be calculated in different ways. Examples of a reducing-balance calculation and private-use calculation are shown below.

Reducing-balance calculation

The following example is a simple calculation for a reducing balance, assuming that it qualifies for the Main Rate pool and an 18% allowance:

Business asset purchased for	£10,000
Year 1 writing down allowance at 18%	£1,800
Written down value carried forward	£8,200
Year 2 writing down allowance at 18%	£1,476
Written down value carried forward	£6,724

In this example, the writing down allowance is the value used to determine the capital allowance for that year.

Private-use calculation

If the asset has been used partly for private purposes, a second calculation is necessary to deduct the proportion of allowances relating to that private use:

Writing down allowance	£1,800
Less private use at 25%	£450
Capital allowance	£1,350

The written down value carried forward remains the same and the private proportions are reviewed according to the use made of the asset each year.

When can capital allowances be claimed?

Self-employed individuals claim capital allowances in their self-assessment tax return. Businesses that are run as limited companies claim them via a corporation tax return. The amount of capital allowance claimed depends on what assets were bought and those that were already owned in the last accounting period.

While most businesses buy assets as and when they are needed, it should be taken into account that the timing of an asset purchase can have a significant impact on the tax bill for a particular trading year.

Any purchase made up to the last day of an accounting year is eligible to a full year's capital allowance at the rate in force on that date. Therefore it makes sense to buy assets before the year end if there is a sound commercial reason to do so. If an item is bought on hire-purchase terms, it must be in actual use by the last day of the accounting period.

It is important to be aware that a business accounting year may not coincide with the Government's financial tax year and to consider the rates in force when a purchase is made. In some cases, rates can come into force on dates other than the start of the financial year, such as the date of a Government Budget. The corporation tax accounting period ends on 31 March. The tax year for self-employed people ends on 5 April.

What if profits are low in the first year?

A business does not have to take all the allowance in any year that profits are low, or if it has made a loss for tax purposes after deduction of capital allowances. For sole traders and partners, this could mean wasting the tax-free personal allowance in the tax year. It is acceptable to claim just enough capital allowances to reduce profit to the level of personal allowances in the year.

For limited companies, each company needs to review its corporation tax calculation to see whether it would benefit by carrying the capital value forward or claiming an increased loss if there is other income against which to set this. The remaining capital value after deducting anything claimed in the current year will be carried forward to the next year.

What happens when assets are sold or disposed of?

When an asset is sold or transferred, the written down value in the books must be compared with the actual value at the time of disposal. The difference will be shown in the profit and loss account as a profit or loss and will be included in the adjustments when arriving at taxable profits.

The sale proceeds are deducted from the tax written down value in the capital allowance fixed asset register. Proceeds are limited to cost. For Single Asset pools only, this may give rise to a balancing allowance (tax deduction) or balancing charge (tax profit). This allowance is then deducted from or added to profit for tax purposes.

If an item is not sold for money but, for example, given to an employee or disposed of, it is still necessary to use an estimate of the market value as the amount shown for the proceeds of the sale. This does not apply where assets are gifted to an employee and the employee incurs a taxable benefit in kind on the gift. Under these circumstances, the disposal proceeds will be nil.

As the balance left in the tax asset register is reduced by deducting capital allowances each year, the remaining value is only an estimate of its worth. On selling, a final adjustment to capital allowances must be made to reflect the actual proceeds received.

Example of loss on a sale

Written down value brought forward	£2,500
Sold for	(£2,000)
Balancing allowance deducted from taxable profit	£500

Example of profit on a sale

Written down value brought forward	£2,500
Sold for	(£3,000)
Balancing charge added to taxable profit	£500

The accounts for the year in which the disposal takes place will include the adjustment.

Hints and tips

- Assets bought on hire-purchase or leased with an option to purchase can be included in a calculation of capital allowances, although there are special rules for leased cars.
- If an accounting period is shorter or longer than 12 months, the capital allowances are reduced or increased proportionately.

Further information

BIF 41 Understanding and Calculating Depreciation
BIF 232 Leasing Business Equipment
BIF 244 An Introduction to Tax Allowable Business Expenditure
BIF 252 An Introduction to Corporation Tax
BIF 264 An Introduction to Tax Self-Assessment
BIF 517 Completing a Self-Assessment Tax Return

Useful publications

'Capital Allowances Manual'
HM Revenue & Customs (HMRC)
Website: www.gov.uk/hmrc-internal-manuals/capital-allowances-manual

Useful contacts

HM Revenue & Customs (HMRC) is the Government department responsible for the collection of tax. It provides information and advice to individuals and businesses.
Tel: 0300 200 3310
Website: www.gov.uk/government/organisations/hm-revenue-customs

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