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History of Capital Allowances

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The Early Years

Until 1878 there were no capital allowances though there were deductions for expenditure incurred in renewing or replacing existing machinery or plant. In 1878 a "wear and tear" deduction was introduced. Wear and tear allowance represented the diminished value of plant and machinery used for trade purposes by reason of wear and tear during the year. The amount allowed was whatever was considered "just and reasonable". A similar deduction based on annual value was available for expenditure on mills and factories. It was called mills and factories allowance. These deductions gave tax relief for an amount broadly equal to the actual economic depreciation suffered.

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The Post War System

The Income Tax Act 1945 put in place a system of capital allowances designed to encourage and assist the reconstruction of British industry after the war.

From 1946 the previous system of wear and tear allowances for plant and machinery was replaced by a new system of initial allowances, writing-down allowances, balancing allowances and balancing charges:

An initial allowance (i.e. first year allowance) of 20% for plant and machinery for the first year was introduced to encourage investment in new machinery.

The annual rate of writing-down allowances for plant and machinery was set at 25%, which was above the rate of depreciation generally considered to be just and reasonable.

A balancing adjustment (which could be an allowance or a charge) was made when the asset was sold or ceased to exist to ensure that the overall relief given equalled the actual reduction in value over the period of ownership.

The Board of Inland Revenue could fix rates of writing-down allowance for different classes of plant and machinery. The rates were based on the anticipated normal working life of plant and machinery in each class. They were published and could be amended, as required.

Industrial buildings allowances replaced the mills and factories allowance.
The main features were:

An initial allowance of 10% for new buildings for the first year was introduced to encourage investment in new buildings.
The annual rate of writing-down allowance was set at 2%.

A balancing adjustment (which could be an allowance or a charge) was made when the asset was sold or ceased to exist to ensure that the overall relief given equalled the actual reduction in value over the period of ownership.

Industrial buildings and structures that qualified for the new allowances were defined in the legislation. Shops, offices, hotels and dwelling houses were specifically excluded as the purpose of the relief was to "help the productive or creative industry that gives industrial employment and is the foundation of national prosperity: from the point of view of national prosperity it is the production of things and the export of things and not the retail distribution at home of things that matters."

Agricultural buildings allowance replaced the special relief given to agricultural landowners under the old Schedule A rules. The rate of allowance was set at 10% (rather than the 2% for industrial buildings) following strong opposition from farmers and landowners to any reduction in the generous relief that they had enjoyed previously.

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Investment Allowances

An "investment allowance" was introduced in 1954 to encourage investment in new plant and machinery, mining works, industrial and agricultural buildings, and buildings and plant used for scientific research. Investment allowances were given in addition to initial and annual allowances. This meant that businesses could receive allowances over the period of ownership of more than the asset had actually cost.

The investment allowance was set at a rate of 10% for agricultural and industrial buildings and 20% for other qualifying assets. Investment allowances continued on and off at various rates until 1966. Then they were replaced by direct grants administered by the Board of Trade.

The method of making claims for plant and machinery by reference to a wide range of different rates of writing-down allowance set out in published lists continued until 1962. In a move to reduce the burden on business and simplify the process of claiming capital allowances, the number of rates was then reduced to three (15%, 20% and 25%) and taxpayers were allowed to pool expenditure within each category for the purposes of calculating writing-down allowances. This was a considerable simplification, but difficulties still remained where assets were sold or scrapped, as the pool had to be unscrambled to calculate the balancing allowance or charge.

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The 1971 System

There was a further major simplification in 1971. The number of rates of writing-down allowance for plant and machinery were reduced to just one at 25%. The rules for pooling were extended so as largely to eliminate the need for balancing allowances and charges. This was a considerable simplification and greatly reduced the record - keeping requirements and the number of computations needed for tax purposes.

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The 1984 reforms

In 1984 the then Chancellor of the Exchequer, Nigel Lawson, started a series of reforms to create a more neutral, broader based tax system. Initial allowances and first year allowances were phased out over three years. The 1984 business tax reforms brought capital allowances closer into line with actual rates of commercial depreciation. Allowances were set at 25% for plant and machinery, 4% for industrial and agricultural buildings.

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Developments After 1984

Short-life assets: For assets with lives of less than 4 years, the 25% rate for plant and machinery was recognised as representing less than economic depreciation. To adjust for this, from 1985 taxpayers have been able to elect to keep specific assets out of the general pool. If the asset is then sold or scrapped within 4 years a balancing allowance or charge is made, bringing the allowances given into line with the actual economic depreciation of the asset.

Long-life assets: In 1996 the then Government introduced a new 6% rate of allowance for plant and machinery with an expected life of more than 25 years when new. This was a further step towards greater neutrality of the tax system, bringing allowances more closely into line with rates of economic depreciation. The rules only apply to businesses which spend more than £100,000 a year on long-life assets.
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Return Of Incentive Allowances

First-year allowance for plant and machinery and initial allowances for industrial and agricultural buildings were reintroduced on a temporary basis for expenditure incurred in the year ended 31 October 1993.

First-year allowances (FYAs) were introduced again for expenditure incurred by small and medium sized enterprises from 2 July 1998 to April 2008; the rate varied over this period, but was either 40% or 50%. 100% FYAs were introduced for assets purchased by small and medium-sized businesses in the period 12 May 1998 to 11 May 2002 for use primarily in Northern Ireland. Subsequently, other 100% FYAs targeted to encourage particular types of socially desirable investment were introduced for expenditure on:

ICT by small businesses, between 1 April 2000 and 31 March 2004;
energy-saving plant and machinery, from 1 April 2001;
cars with low carbon dioxide emissions, from 17 April 2002;
plant or machinery for gas refuelling stations, from 17 April 2002;
plant or machinery for use wholly in a ring fence trade, from 17 April 2002;
environmentally beneficial plant and machinery, from 1 April 2003

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Other New Allowances

Two new codes of allowances (not restricted solely to expenditure on plant or machinery) were introduced in the early years of the 21st century: Flat conversion allowances (FCAs) were introduced by FA2001. Business premises renovation allowances (BPRA) were introduced by FA2004, but the scheme did not come into effect until 11 April 2007.
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The FA2008 Reforms

The capital allowances changes introduced in FA2008 represented the biggest reform of the capital allowances system since the 1980s. The changes were part of a wider 'Business Tax Reform' package, which included a 2% cut in the main rate of corporation tax. The reforms had three main objectives: (1) to promote investment and growth; (2) to reduce distortions and complexity and (3) to maintain fairness and refocus the tax system for smaller businesses.

The main capital allowances changes were:

The introduction of a new Annual Investment Allowance (AIA), which is effectively a 100% allowance for business expenditure on plant and machinery (apart from cars) up to £50,000 a year. The AIA applies to businesses regardless of size, and replaced the previous 40% or 50% FYAS for small and medium-sized businesses only.

A new small pools allowance, allowing historic and future pools of plant and machinery expenditure of £1,000 or less to be written-off immediately.

New payable tax credits for businesses that make losses attributable to investment in environmentally beneficial plant and machinery.

The phased withdrawal of industrial and agricultural buildings allowances by 2011.

Changes to the rates of capital allowances on plant & machinery: from 25% to 20% for the main pool, and from 6% to 10% for long-life assets in the new special rate pool.

The introduction of a new classification of "integral features" of a building or structure to apply to new and replacement expenditure and which will attract 10% allowances in the special rate pool.

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Consolidation

The capital allowance legislation was consolidated in 1990 in CAA90 apart from the legislation on patents and know-how, which stayed in ICTA88. The legislation was rewritten in 2000 and all of the capital allowance legislation is now in CAA2001. You can find CAA2001 and the explanatory notes that go with it on the Intranet or on the Internet at www.hmso.gov.uk/acts/acts 2001.

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