Analysis

The first-year allowance (or full expensing)

Speed read

The introduction of ‘full expensing’ in the form of a temporary 100% first-year allowance (FYA) is in many respects a continuation of the super-deduction. The change in the corporation tax rate means the post-tax saving is unchanged. The same exclusions, exceptions and specific rules apply. However, given that the new FYA sits within the existing legislative framework, it is also necessary to review FYA rules that impact on entitlement to and timing of claims. The interactions with loss utilisation and tax accounting are other matters to consider.

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Full circle

The latest changes to the capital allowances regime were part of the Tax Plan published at Spring Statement 2022. The Tax Plan acknowledged that ‘business investment has been a long-standing weakness in the UK’ and noted that the overall tax treatment provided for capital investment in the UK was less generous than the OECD average. In consequence, the government would be considering reforms to best support future business investment, following the end of the super-deduction in April 2023.

First-year allowances (FYAs) and full expensing were given as two different options in the Tax Plan published in 2022. Example rates of 40% and 13% for main and special rate items were given for the former, whilst the latter was described as allowing ‘all qualifying expenditure to be written off in the year … incurred and … uncapped’.

The latest corporation tax reforms are a reversal of government policy in place since the 1980s. A corporation tax rate increase from 19% to 25% and the introduction of a 100% first-year allowance for plant and machinery expenditure in 2023 mean that we have gone full circle, and back to a time before corporation tax rates were only reduced and FYA were replaced by writing-down allowances.

The Budget report suggests that this change ‘will mean that the UK (now) has the joint most generous capital allowance regime in the OECD’. The net estimated cost to the Treasury is £27bn from 2022/23 to 2027/28, or £9bn per year for each of the three years the FYA are to currently be available.

What is in a name?

Branding 100% FYA as new and headline grabbing ‘full expensing’ was too good an opportunity to miss. It did prompt one or two questions as to whether the capital revenue divide no longer mattered, or if a company could now expense qualifying expenditure as a deduction from trading profits, in the same way a company can make an election to treat capital expenditure on land remediation as a revenue expense.

In fact, the new 100% FYA and 50% FYA (semi expensing?) are very much a continuation of and replacement for the super-deduction, without the 30% uplift, and the special rate (SR) allowance introduced for two years in 2021. The government always factored the planned increase in the corporation tax rate into the super-deduction regime, and this is reflected in the difference in the post-tax saving which is minimal at plus 0.3% (25% x 100% v 19% x 130%).

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FYAs

The new 100% FYA and 50% FYA are within the existing framework in CAA 2001. The 100% FYA will be available for main pool plant and machinery. The 50% FYA will be available for special rate pool plant and machinery, including long-life assets. Assets falling into the latter category include plant, such as a lift, treated as an integral feature of a building, and assets where it is reasonable to expect a useful economic life when new of at least 25 years.

The Finance Bill adds a new type of first-year qualifying expenditure to the list in CAA 2001 s 39: ‘section 45S expenditure on plant and machinery in other cases’.

The qualifying conditions are listed in s 45S, namely expenditure:

- incurred on or after 1 April 2023 and before 1 April 2026;
- incurred by a company within the charge to corporation tax;
- on plant and machinery which is unused and not second-hand; and
- not excluded by s 45T (expenditure under disqualifying arrangements) or s 46 (general exclusions).

Date incurred

One notable difference to the super-deduction and SR allowance regime is that there is no contract date rule. The absence means expenditure under a long term contract dated before 3 March 2021 and excluded from that regime will nevertheless qualify for the new 100% FYA and 50% FYA.

Instead, it is only necessary to focus on the time expenditure incurred rules in CAA 2001 s 5, which is broadly the time when the obligation to pay becomes unconditional. A person must pay for goods on delivery unless there is an agreement as to other terms of payment. In this case, the obligation to pay becomes unconditional on delivery. In practice, a company may use invoice or other date as a proxy.

The answer to this question may sometimes be more nuanced, and HMRC's *Capital Allowances Manual* includes guidance at CA11700 and CA11800. It may be necessary to review the agreement or contract in order the establish the date the expenditure was incurred.

In some cases, where the contract terms require the purchaser to make advance payments, and the ownership condition will not be met until a later date, it may be possible to rely on CAA 2001 s 67 to obtain FYA if the contract provides that the purchaser will 'become the owner of the plant or machinery on the performance of the contract'.

Companies only

The new FYA are not available to unincorporated businesses, but they will benefit from the amount of annual investment allowance (AIA) becoming permanently fixed at £1m from 1 April 2023.

For some companies, the AIA will provide a more valuable alternative to the 50% FYA for the first £1m of special rate expenditure. For others, who may anticipate selling qualifying plant and machinery assets for value at a later date, claiming AIA will avoid the balancing charges provisions discussed below.

In other cases, where there are many companies within a group or under common control, the new 100% FYA and 50% FYA avoid the grouping provisions applicable to AIA and will be particularly helpful to, for example, private equity portfolio companies.

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Unused and not second-hand

HMRC guidance suggests that plant or machinery will be regarded as 'unused and not second-hand even if it has undergone some limited use for the purposes of testing, delivery or demonstration'.

In the absence of any guidance, it may be necessary to consider the supply chain or corporate structure to ensure the second part of that test is met; using the ordinary meaning of 'second-hand', has there been a previous owner?

Exclusions

The exclusions to which all FYA are subject will apply. Expenditure on cars does not qualify, although 100% FYA is available for electric cars and electric vehicle charging points until 31 March 2025 under other provisions.

The exclusion of plant and machinery for leasing also applies in the same way as it did previously. There is again an exception for leases of 'background plant and machinery for a building': which are fixtures and other items that are necessary for the functioning of a building and included in a property lease. The Capital Allowances (Leases of Background Plant or Machinery for a Building) Order, SI 2007/303, includes lists of examples, assets deemed to be, and deemed not to be, background plant and machinery.

For some groups of companies, which are structured such that major assets are owned by one subsidiary and leased to other operating subsidiaries, the 100% and 50% FYA will not be available, although AIA will be available up to £1m. Restructuring business operations for a tax deduction that may only be available for three years is probably not a viable option.

Balancing charges

Balancing charges potentially apply to disposals of assets by a company on which they have claimed 100% FYA or 50% FYA, in a comparable way to which they potentially apply to disposals of assets on which they have claimed super-deduction or SR allowance.

The rules are included in new CAA 2001 ss 59A and 59B.

Where a company is required to bring a disposal value into account by reference to assets on which the company has claimed 100% FYA, they will be liable to a balancing charge. The amount of charge is calculated as a proportion of the disposal value found by dividing the amount on which 100% FYA was claimed by the total amount upon which 100% FYA could have been claimed. For 50% FYA, the rule is the same, except that the amount on which 50% FYA was claimed is divided by two when calculating the proportion.

In each case, the disposal receipts for the pool to which the expenditure that was the subject of the 100% FYA or 50% FYA was allocated, are reduced by the amount of the balancing charge.

For example, a company incurs qualifying expenditure of £1m on main pool plant and machinery and claimed 100% FYA on £750k and adds the balance of £250k to the main pool. At a later date it sells the same asset for £100k. The balancing charge will be £75k ((£750k/£1m) x £100k) and the disposal receipts for the pool will be £25k.

These provisions will only be of concern to those companies who may dispose of assets on which 100% FYA or 50% FYA has been claimed for more than a negligible value in the future. In all such cases, it will be necessary to have processes and systems in place to track the expenditure on these assets, the tax deduction obtained, and the sale proceeds.

Where the assets in question are fixtures, and subject to consideration of the tax avoidance arrangement rules discussed later, it should be possible to mitigate the balancing charge for the seller by requiring the parties, to what is usually a property transaction, to make an election under CAA 2001, s.198 fixing the disposal value attributable to each pool at £1.

Other FYA rules

The new 100% FYA and 50% FYA sit within the existing CAA 2001 FYA framework and, except for the specific provisions discussed above, are subject to the same rules as any other FYA. The additional complexities may not be familiar to businesses that have only ever pooled expenditure and claimed writing-down allowances.

The taxpayer has the option of claiming the whole, part or none of the FYA. The balance of the expenditure is added to the relevant pool. When there is a disposal of an asset on which FYA has been claimed, the balance of the expenditure is added to a pool, even if the balance is nil. The mechanism is designed to make sure any sale proceeds are brought into account in the pool and means, for example, that the pooling requirement applicable to the sale of fixtures would be met.

In the case of expenditure on which 100% FYA or 50% FYA has been claimed the disposal will, as explained above, give rise to a balancing charge.

In year only

Another FYA rule, sometimes overlooked, is the necessity for the company to claim FYA for the year in which it incurred the expenditure. It is not possible to carry-forward the expenditure and make the claim in a later year, although the company could of course still claim writing-down allowances on that expenditure in the later period.

There are a number of scenarios where we know this rule can cause practical difficulties, both in terms of the identification and quantification of qualifying expenditure. Some clients have found it necessary to enhance data extraction and reporting processes to support claims for super-deduction and SR allowance and similar challenges apply to the new FYA.

For some businesses, the detailed analysis of capital expenditure is only completed when assets are transferred from AUC (assets under construction) and capitalised on the fixed asset register (rather than analysing the additions in the period). Two potential issues arise, both of which carry a compliance risk.

Firstly, if the expenditure is incurred in year 1 but is only capitalised in year 2, there is a possibility that FYA will be lost as they must be claimed in year 1 or, alternatively, they may be incorrectly claimed in year 2. Secondly, if provisional numbers are used for AUC in year 1 and reversed in year 2 (which in the absence of FYA would be by addition to and subtraction from the relevant pool), the amount of FYA claimed may be incorrect and there will be practical difficulties in tracking the assets on which the FYA claim has been made.

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A further layer of complexity arises when the plant and machinery is part of a major project and the qualifying expenditure includes related design fees, for example. In many cases, the expenditure on those fees may, at least in part, be incurred in an earlier period to that on the assets to which they are directly attributable. Entitlement to FYA only arises, *inter alia*, if a person owns the plant and machinery in the period, but the FYA must be claimed in the period in which the expenditure is incurred. Where the facts are as outlined, the expenditure is incurred in the earlier period, but the asset is not owned until the later period; it is not possible to claim FYA in respect to the fees as the expenditure was incurred in the earlier period. Instead, that expenditure must be allocated to the relevant pool in the later period.

Straddling periods

For companies with an accounting period ending on 31 March 2023, the transition from super-deduction and SR allowance to 100% FYA and 50% FYA will be clear cut.

For companies with periods ending on, say, 31 December 2023, less so, at least as far as super-deduction and 100% FYA are concerned. Qualifying expenditure in the three months to 31 March 2023 would qualify for super-deduction, albeit the 130% FYA is restricted on a pro-rata basis to reflect the change in the corporation tax rate, whilst that in the remainder of period would qualify for 100% FYA. The former is also subject to the 3 March 2021 contract date rule and potentially a different balancing charge calculation if the business sold the asset by the end of the period.

Interaction with AIA

The AIA is now permanently set at £1m. Companies have a choice as to whether to claim AIA or 100% FYA, or 50% FYA as appropriate, on that expenditure, but they are prevented by CAA 2001 s 52A from claiming both AIA and FYA on the same expenditure.

For example, a company with £1.5m of qualifying special rate expenditure could choose to claim AIA on the first £1m and 50% FYA on the remaining £500k, or vice versa. What it cannot do is claim 50% FYA on £1.5m and AIA on the other 50%, i.e. £750k, which the company should add to the special rate pool. Otherwise, the company would be claiming AIA and FYA on the same expenditure.

Anti-avoidance

Both the FYA and balancing charges are subject to specific and widely drawn anti-avoidance rules.

New CAA 2001 s 45T excludes expenditure from being qualifying expenditure if incurred directly or indirectly in consequence of, or otherwise in connection with, 'disqualifying arrangements', broadly defined as arrangements to secure a tax advantage related to qualifying expenditure. The new rules overlay existing anti-avoidance rules such as the denial of FYA where the transaction is between connected persons by s 214 and s 218, and the exception for manufacturers and suppliers in s 230.

New s 59C provides that balancing charges will apply ignoring the effect of tax avoidance arrangements.

Tax accounting implications

The tax accounting effect of the new FYA will generally be to increase a company's deferred tax liability or decrease a deferred tax asset, if recognised.

Fixed asset temporary/timing differences are calculated by comparing the net book value to the tax base of all qualifying fixed assets at the balance sheet date. If either the 100% FYA or 50% FYA is claimed on additions, the tax depreciation is accelerated and therefore the qualifying net book value of additions will have increased more than the tax base by the end of the period. This will result in an increase in the taxable (or reduction in the deductible) temporary/timing difference on which deferred tax is calculated. If a company initially has a deductible temporary/timing difference and the impact of the accelerated tax depreciation is that they end up with a taxable temporary/timing difference, then a deferred tax liability should be recognised. As the corporation tax rate is currently set at 25% with no upcoming legislated changes there will be no effect on a company's ETR as the deduction for the first year allowance will be at 25% and the deferred tax liability will also be measured at 25%.

From a tax accounting perspective, we do not need to consider the balancing charge mechanism on any future disposals as we should assume that the assets will be used throughout their useful economic life and disposed for nil proceeds. If subsequently an asset is disposed of for proceeds resulting in a balancing charge and deferred tax is fully recognised, there will be an equal and opposite movement in deferred tax and current tax in that year. If unrecognised, there will be an ETR impact in the year of disposal and this should be shown as a reconciling item in the statutory accounts for that year.

Example: Company A has an opening deductible temporary difference on fixed assets of £30m being the difference between a qualifying NBV of £120m and TWDV of £150m in the special rate pool. The potential deferred tax asset is £7.5m (25% of £30m) which Company A has not recognised due to a lack of sufficient future taxable profits. Company A originally acquired the assets for £200m and depreciates all its fixed assets on a straight line basis over a ten year period.

In the year ending 31 March 2024, Company A has fixed asset additions qualifying for the special rate pool of £200m. All AIA entitlement has been claimed by another group company. Company A claims the 50% FYA on all the additions and receives a deduction of £100m (50% of £200m) against its trading profits.

At 31 March 2024, the qualifying NBV is £280m (£120m x 5/6 + £200m x 9/10) and TWDV is £235m (£150m + £100m - £15m (6% writing down allowance claimed)). Therefore, it has a closing taxable temporary difference on fixed assets of £45m. Company A should now recognise a deferred tax liability of £11.25m (25% of £45m) and disclose this in its statutory accounts.

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Loss considerations

The 100% and 50% FYA are available from 1 April 2023, the same date the corporation tax rate increased to 25%. There is no potential tax benefit to delaying deductions to a period with a higher tax rate, as in previous years.

However, as loss offset is restricted to 50% on profits above £5m, loss-making companies which expect to be affected by the restriction when utilising losses against future profits will need to decide whether to claim the FYA now and increase the loss carried forward, or not claim the FYA now and claim larger writing down allowances in future periods, noting that it will take 12 years to get 50% relief for a special rate asset. It is important that companies model future taxable profits before making a decision. They may also want to consider whether they can carry back any losses.

Temporary

Looking past the novel branding, the *de facto* continuation of the temporary first-year allowances available to companies from 1 April 2001 is welcome. Forecasts suggest that the positive effect of the FYA will outweigh the negative effect of the increase in the corporate tax rate and may even increase inward investment into the UK.

Nevertheless, the Budget report statement that 'Larger businesses will benefit from full expensing for the next three years, simplifying claims and investment decisions' does not necessarily stand up to scrutiny. Given the idiosyncrasies of the UK's capital allowances legislation, it is difficult to see how the latest changes are 'simplifying claims'.

More importantly, the FYA is temporary and may only be available for the next three years. Whilst this timeframe may have been necessary to allow the government to meet their own fiscal rules, it only serves to create uncertainty for business about the future and for long term planning, and it will diminish the positive impact on investment decisions. ■

For related reading visit taxjournal.com

- Spring Budget 2023: capital allowances after the super-deduction (P Farey, 15.3.23)
- The super-deduction and first year allowances: practical issues (S Alcock, 8.4.21)