These notes refer to the Capital Allowances Act 2001 (c.2) which received Royal Assent on 22nd March 2001

CAPITAL ALLOWANCES ACT 2001

EXPLANATORY NOTES

BACKGROUND

The Tax Law Rewrite Project

5. In December 1995 the Inland Revenue presented a report to Parliament on the scope for simplifying the UK tax system (*The Path to Tax Simplification*). The main recommendation was that UK direct tax legislation should be rewritten in clearer, simpler language.

6. This recommendation was warmly welcomed, both in Parliament and in the tax community. After further work on important practical issues and a period of

   preliminary consultation, the then Chancellor of the Exchequer (the Rt Hon Kenneth Clarke MP, QC) announced in his November 1996 Budget statement that the Inland Revenue would propose detailed arrangements for a major project to rewrite direct tax legislation in plainer language.

7. The project team was given the task of rewriting almost all of the United Kingdom's existing primary direct tax legislation, totalling over 6,000 pages. The aim is that the rewritten legislation should use simpler language and structure than previous tax legislation. The members of the project are from different backgrounds, including Inland Revenue employees, private sector tax professionals and parliamentary counsel including (as head of the drafting team) a senior member of the Parliamentary Counsel Office.

Steering Committee

8. The work of the project is overseen by a Steering Committee, chaired by Lord Howe of Aberavon CH, QC. The membership of the Steering Committee as at December 2000 is in full:

   The Rt Hon The Lord Howe of Aberavon CH, QC

   Ian Barlow

   Adam Broke

   Ian Hay Davison

   David Hartnett

   The Rt Hon Michael Jack MP

   Dr John Avery Jones CBE

   Professor Frank Kidd

   Ms Sheila McKechnie OBE

   Dr John Marek MP

The Rt Hon Lord Mustill of Pateley Bridge

David Swaine

Consultative Committee

9. The work is also reviewed by a Consultative Committee, representing the accountancy and legal professions and the interests of taxpayers. Its members as at December 2000 were:

Neil Munro	Tax Law Rewrite Project Director (Chair)
Graham Aaronson QC	Revenue Bar Association
Richard Baron	Institute of Directors
Adam Broke	Special Committee of Tax Law Consultative Bodies
Colin Campbell	Confederation of British Industry
Russell Chaplin	London Chamber of Commerce
Keith Daniels	Chartered Institute of Taxation
Colin Davis	Chartered Institute of Taxation
Malcolm Gammie	Law Society of England and Wales
Terry Hopes	Institute of Chartered Accountants in England and Wales
Matt McGrath	Association of British Insurers
Simon McKie	Institute of Chartered Accountants in England and Wales
Simon Mackintosh	Law Society of Scotland
H C D Rankin	Institute of Chartered Accountants of Scotland
Mavis Sargent	Association of Chartered Certified Accountants
Simon Sweetman	Federation of Small Businesses
Jane Vass	Consumers' Association
Professor David Williams	
Mervyn Woods	Confederation of British Industry

Consultation

10. The work produced by the project has also been subject to public consultation. This has allowed all interested parties an opportunity to comment on draft sections. This consultation is undertaken first through a series of Exposure Drafts which publish sections in draft. The relevant ones for this Act are numbers 3, 5, 7 and 9. They were published in October 1998, April 1999, July 1999 and February 2000 respectively. A draft Act was published for a further consultation in August 2000. Those who responded to one or more of these documents include:

Alliance & Leicester plc

Association of British Insurers

Canary Wharf Ltd

Brian Chapman

Chartered Institute of Taxation

City of London Law Society

Confederation of British Industry

Construction Industry Joint Taxation Committee

Consumers' Association

Ernst & Young

Federation of Small Businesses

Daron H Gunson

Holborn Law Society

Institute of Chartered Accountants in England and Wales

Institute of Chartered Accountants of Scotland

Institute of Directors

Institute of Payroll and Pensions Management

Investment and Tax Publishing Services

John Jeffrey-Cook

KPMG

Law Society of England and Wales

London Society of Chartered Accountants

National Farmers Union

Oil Taxation Action Committee

Special Committee of Tax Law Consultative Bodies

United Kingdom Oil Industry Tax Committee

Yorkshire Water plc

Note: this table excludes those who asked that their responses be treated in confidence.

Capital allowances

11. In general taxpayers cannot deduct capital expenditure in arriving at their income or profits. Depreciation in commercial accounts is not allowed as a deduction for tax purposes. Capital allowances, broadly speaking, take the place of depreciation charged in the commercial accounts.

12. Capital allowances give taxpayers relief for certain kinds of expenditure. The Act deals with who gets relief for what expenditure, when and how.

13. Allowances are available mainly for expenditure on:

- plant and machinery;

- industrial buildings;
- agricultural buildings;
- mineral extraction;
- research and development;
- know-how;
- patents;
- dredging; and
- dwelling-houses let on assured tenancies.

14. Capital expenditure does not necessarily qualify for any of these allowances. For example, expenditure on commercial buildings normally gives no entitlement to allowances.

15. Some allowances are given only for expenditure incurred in a specific period.

History of capital allowances

16. The Customs and Inland Revenue Act 1878 introduced deductions in respect of capital expenditure. It required “the Commissioners to allow such deduction as they may think just and reasonable as representing the diminished value by reason of wear and tear during the year of any machinery or plant used for the purposes of the concern”.

17. Allowances for mills, factories and the like were introduced in 1918.

18. The modern era of capital allowances started with the Income Tax Act 1945. This abolished most previous deductions and allowances. (The main exception was scientific research which had been covered by the Finance Act 1944.) It introduced in their place a new system of initial and annual allowances. These covered industrial buildings, plant and machinery, mines, oil wells and other mineral deposits, agricultural buildings and works and patent rights. There were also balancing allowances and charges which, very broadly, gave an extra allowance when an asset was sold or imposed a charge so that the net allowances in total matched the actual depreciation.

19. The basic approach taken in 1945 remains today. Allowances for capital expenditure reduce a person’s income or profits for tax purposes. Balancing charges (which may arise when, for example, people sell things) increase their income or profits. But many changes have been made to the legislation since 1945.

20. Investment allowances were given at various times in the 1950s and 1960s. They were followed by cash investment grants.

21. Plant and machinery allowances are by far the most common type of capital allowances. In 1971, a new system of allowances for plant and machinery came in. This gave a special allowance called a first-year allowance in the year expenditure was incurred. The balance of expenditure left over after deducting the first-year allowances was then put into a “pool” of expenditure. Writing-down allowances were given on the balance remaining each year. See paragraph 28 below.

22. First-year allowances were phased out in 1984 but reintroduced in the early 1990s.

23. The rates of allowances for plant and machinery have also changed substantially over the 50-odd years since 1945. The various rates of allowances for writing-down expenditure were reduced in 1962 to just three (15%, 20% and 25%). They were further reduced in 1971 to the single rate of 25%. At the same time, there was a change in the way plant and machinery allowances were calculated to give writing-down allowances on the “pool” of expenditure rather than on each item individually.

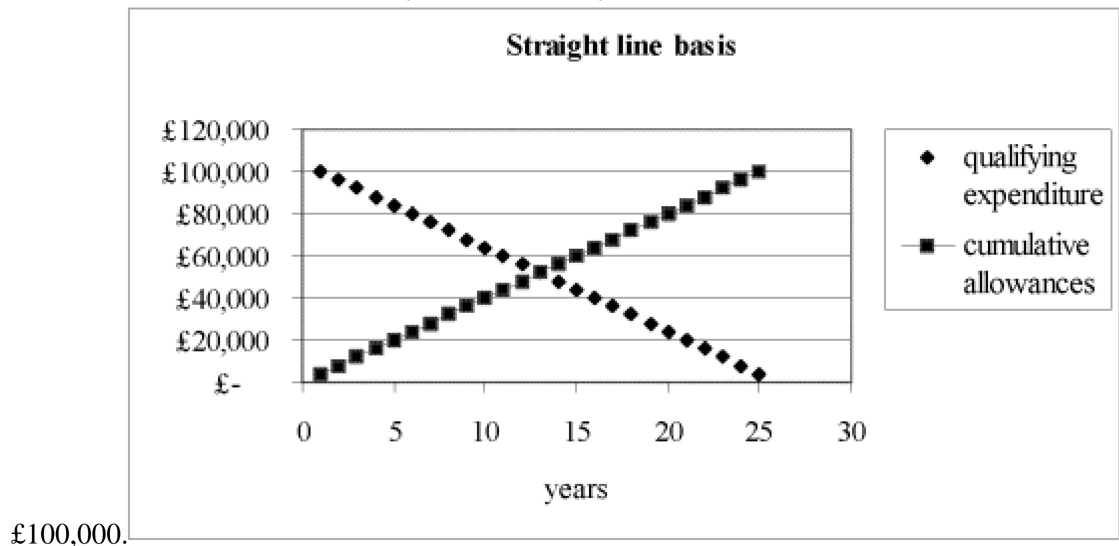
24. A 10% rate of writing-down allowances for plant and machinery for overseas leasing was introduced in 1982. A 6% rate for long-life assets was introduced in 1997.

25. Major changes to other allowances were:

- the introduction of allowances for dredging in 1956;
- the extension of industrial buildings allowances in 1978 to some hotels;
- the introduction in 1980 of 100% allowances for some buildings in enterprise zones;
- the introduction in 1982 of allowances for dwelling-houses let on assured tenancies by approved bodies on a temporary basis (for expenditure up to April 1992);
- the revision of agricultural buildings allowances in 1986;
- the introduction of allowances for know-how in 1968 which, together with allowances for patents, were brought into line with other capital allowances in 1986; and also then based on "pools" in broadly the same way as plant and machinery allowances; and
- the introduction of the new system of mineral extraction allowances in 1986.

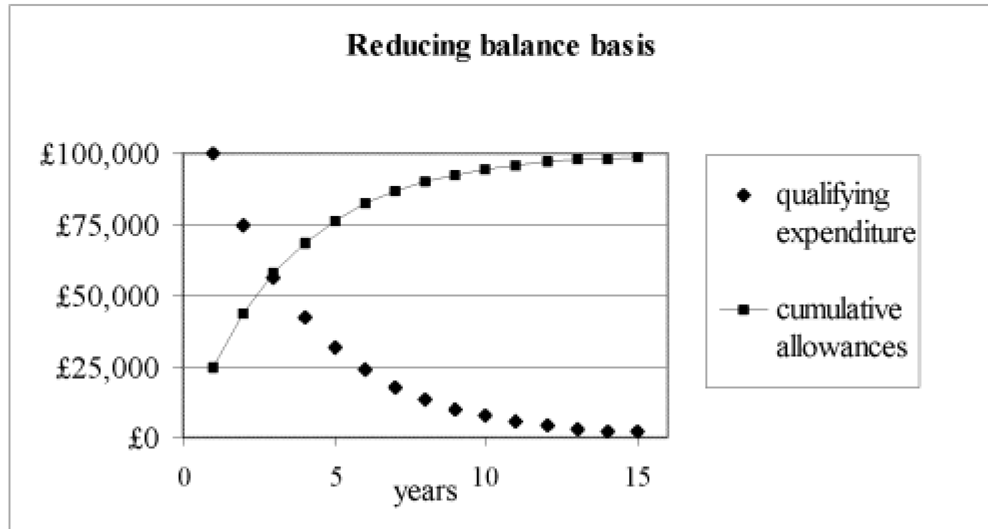
26. This means there are today broadly two ways in which allowances are worked out.

27. Allowances for industrial and agricultural buildings, dredging and assured tenancies are given on what is known as the "straight line basis". This basically means the annual allowance is worked out on the basis of the expenditure which qualifies. Then the same allowances is given year by year until all the expenditure is used up. So the expenditure is "written off" in a straight line over time. E.g. for £100,000 expenditure on a factory there will be allowances at 4% of £4,000 a year. After 25 years the total allowances will be £100,000.



28. Allowances for plant and machinery, mineral extraction, patents and know-how are given on what is known as the "reducing balance basis". This basically means the amount of the allowance is worked out again each year on the balance of expenditure less allowances left over from the previous year. So the amount of the allowance goes down year by year as the balance of expenditure reduces. This gives more allowances in the early years compared with the straight line basis. E.g. for £100,000 expenditure on plant or machinery the allowances

will be £25,000 in year 1, £18,750 in year 2, £14,063 in year 3 and so on.



29. Most of the legislation dealing with capital allowances was consolidated successively as Income Tax Act 1952, Capital Allowances Act 1968 and Capital Allowances Act 1990. The legislation about allowances for patents and know-how was consolidated in the Income and Corporation Taxes Act 1970 and then again in Chapter I of Part XIII of the Income and Corporation Taxes Act 1988.

30. Most subsequent legislation amended or added to the consolidated legislation. But there are exceptions if legislation is in Finance Acts, Income and Corporation Taxes Act 1988 or other Acts.