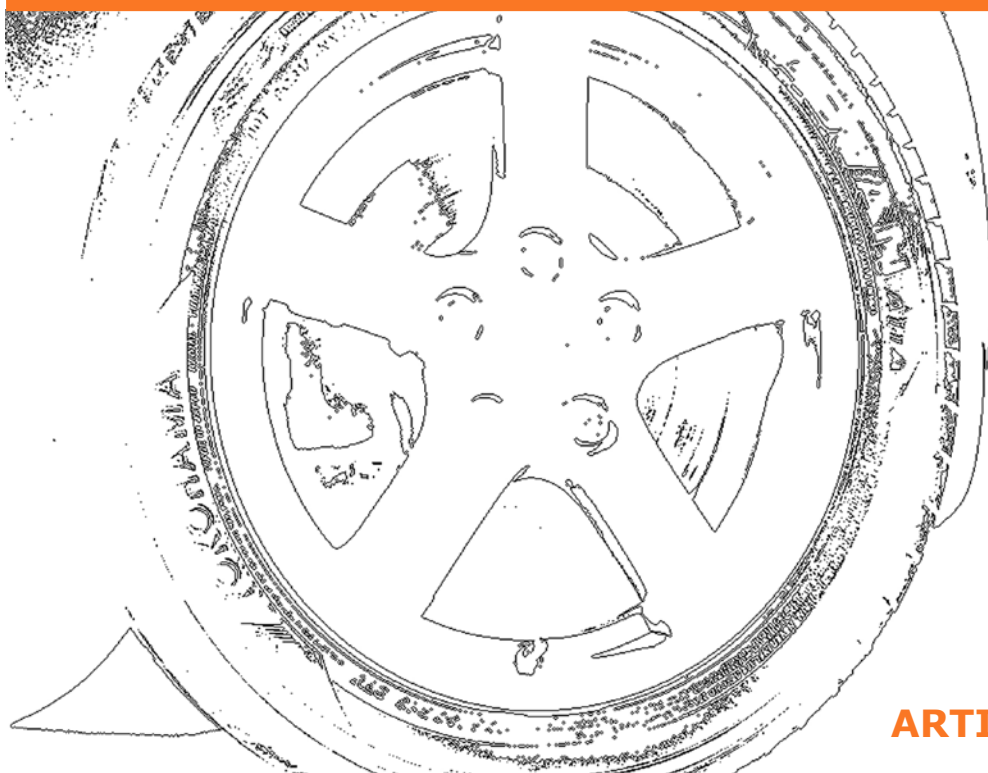


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**ARTICLE 16**

Corporation Tax and Writing Down Allowances

## Corporation Tax and Writing Down Allowances

### Corporation Tax and Writing Down Allowances

In managing your vehicle fleet you will need to understand how taxation affects employers and employees. It is a fact that every decision you make about your fleet –the cars you choose, the method of finance you use and the way you pay for fuel and services – will have a tax impact. There are several taxes at work here; VAT, income tax, corporation tax and National Insurance contributions.

This chapter looks first at the employer's tax position. Historically, that has been the first priority for the fleet manager.

We will then go on to look at the employee's position. As company car tax rates have changed and particularly since the CO2-based company car tax regime was introduced, the fleet manager has needed to understand the employee's tax position as well, in order to make fleet policy decisions that will be acceptable to employees.

### The employer's tax position

#### Motor expenses

Your company can obtain corporation tax relief on motoring expenses as it incurs them. This includes motor insurance, road tax, servicing, maintenance and repair costs.

For income tax purposes a car is a

'Mechanically propelled road vehicle that is not a motorcycle, invalid carriage and not built primarily for the purpose of conveyance of goods'.

There have been many court cases that have sought to determine where exactly the dividing line exists between a car and a van, because these are taxed differently. Double-cab pick-ups were the latest vehicles to challenge this dividing line.

Tax relief for motoring expenses is given on the normal accounting basis: The expenditure has to be allocated to the period to which it relates and it is dealt with on a 'payable' rather than a 'paid' basis.

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Hence if a motor insurance premium relates to the year commencing 1 December and the company has a 31 December year-end and the bill has not been paid by that date, one twelfth of the premium will be allowable for corporation tax (or income tax if it is a partnership or sole trader) regardless of the fact that the premium has yet to be paid.

## Capital allowances

### Background

Companies pay corporation tax on their profits. However, before applying this year's corporation tax rate to this year's profits to determine the corporation tax liability, some adjustments need to be made. The one that concerns us here is the adjustment for depreciation.

Which takes us to the question; what is depreciation?

Depreciation can be defined as the amount of the value of an asset (in this case a vehicle) that has been used up in a particular period. An example may help.

You buy a car on the first day of the company's financial year for £15,000 and plan to keep it for three years.

You expect that at the end of the third year, you will sell it for £6,000.

If you put the car in your books at £15,000 and simply do nothing for three years you will show a loss in your books ('depreciation') of £9,000 on sale.

This does not feel comfortable or right. This is mainly because, in the interim, you will have shown two years of profits that have not reflected the fact the vehicle was in use and that you 'used up' part of the vehicle's value in creating that profit.

So clearly you need to show that you used up some of the vehicle's value in year one and two (or, in accounting parlance, you need to "provide for depreciation" in these years).

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#### The question is, how much?

One approach would be to say that you expect to 'lose' £9,000 of value over three years so you should set aside £3,000 each year. Nice and simple.

Another approach would be to say that the vehicle's market value will be £11,000 at the end of year one, £8,500 at the end of year two and £6,000 at the end of year three so you should set aside £4,000, £3,500 and £2,500 respectively.

There are other amounts that could be proposed but we need not go into these here. The key point is that if companies were allowed to deduct depreciation from their profits before the tax liability was calculated, it would mean they would have a hand in determining their own tax liabilities. Tax-raising authorities do not like the idea that every company could adopt different depreciation policies and could therefore arrive at different amounts of tax payable. So they do not allow companies to include any depreciation whatsoever in their tax calculations.

Therefore, if depreciation has been provided in your company's accounts in arriving at the year's profit, it has to be added back to the profits before the corporation tax liability is calculated. Instead, HM Revenue and Customs allows you to provide for depreciation for tax purposes using a standard method of depreciation that is called 'capital allowances'.

So capital allowances are deducted from profits before arriving at taxable profit, rather than depreciation.

Capital Allowances were first introduced in the Income Tax Act 1945. Successive governments have used them to encourage investment in manufacturing industry.

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## First year allowances

Most assets attract two types of capital allowance; first year allowances and writing down allowances. It is the first year allowances that are usually altered by government to encourage investment. Most motor vehicles are specifically excluded from first year allowances, other than buses, taxis and those used primarily for the carriage of goods and those used for short term hire. For this purpose, 'short term hire' means that the hire of the vehicle should be for a period of no more than thirty days in any twelve-month period.

From 1 April 2008 to 31 March 2013, 100% first-year allowances are available for new cars with CO2 emissions up to 110 g/km, and electric cars. The car must have been bought new on or after 1 April 2008.

A 100% first year allowance is also available for equipment purchased for refuelling vehicles with natural gas, hydrogen or biogas.

## Writing down allowances

Writing down allowances on vehicles are available to businesses carrying out a trade and incurring capital expenditure. The vehicle must be used for the purpose of the trade.

Leases normally include a clause that makes it clear that the owner/lessor, rather than the lessee, will claim the capital allowances. At the very least the agreement will say that the vehicle cannot become the property of the lessee.

The writing down allowance rules for cars are changing from April 2009.

The old rules apply to limited companies purchasing vehicles before 1 April 2009, and to sole traders and partnerships before 6 April 2009.

## The old rules:

Most businesses get writing down allowances of 25% per annum on the purchase price of the vehicle, up to a maximum amount of £3,000 of allowances in any year. So cars costing more than £12,000 attract

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only £3,000 writing down allowance per year. This is because they are considered 'expensive'.

Writing down allowances are calculated on a 'reducing balance' basis, meaning that the 25% is applied to the original capital cost of the vehicle, then the 'unrelieved balance' is carried forward to the next year, whereupon the 25% is applied to the balance brought forward and so on. So you get less writing down allowance each year.

When the vehicle is sold the proceeds are deducted from the balance that is yet to be relieved. If the result is a negative amount this results in a 'balancing charge', which can be thought of as a negative writing down allowance because it will increase the business's tax liability. If the result is a positive amount this results in a 'balancing allowance'. In both cases the net effect is that the business will have received tax relief for the full difference between the purchase price and the sale proceeds of the car.

#### The new rules:

Writing down allowances for vehicles will be calculated by reference to their CO2 emissions.

Until 31 March 2013, cars emitting not more than 110 g/km CO2 will qualify for a 100% writing down allowance.

Cars emitting between 111 g/km and 160 g/km will attract a 20% writing down allowance on reducing balance basis. The maximum amount of the allowance will be £3,000. These vehicles will go into a separate pool, rather than being accounted for as individual assets.

Cars emitting over 160 g/km will attract a 10% writing down allowance on a reducing balance basis, and will go into a separate pool. The maximum amount of the allowance will be £3,000.

Importantly, the new rules do not include the concept of a balancing allowance or balancing charge. If the sale proceeds are less than the unrelieved balance, the car will continue to be depreciated on a reducing balance basis and it will take many years for the business to receive full tax relief on the depreciation.

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### Small and medium size enterprises (SMEs)

Until April 2008 SMEs could claim 40% first year allowances on bikes, vans and trucks. In subsequent years they got the normal 25% writing down allowance.

This system has now been changed for the 2008/09 tax year and covers all sole traders, partnerships and companies.

In addition, all businesses can claim an Annual Investment Allowance on the first £50,000 of expenditure on plant, machinery, bikes, vans and trucks. For expenditure exceeding £50,000, a 20% writing down allowance is now available on all plant and machinery (this expression includes bikes, vans and trucks), on a reducing balance basis.

The Annual Investment Allowance affects most plant and machinery but not cars. However, it is available for expenditure on assets bought by leasing companies for leasing.

### Periods less than or greater than one year

If trade starts or stops part way through the accounting year, writing down allowances are reduced pro-rata to the period of trade.

If the accounting period for a company is more than twelve months it will be divided into two accounting periods for writing down allowance purposes, each of a maximum of twelve months. However, if the business is a partnership or a sole trader, the accounting period can exceed twelve months for capital allowance purposes and the writing down allowance will be increased pro rata.

### Pooling

#### The old rules

These rules apply for cars acquired by companies before 1 April 2009 (6 April 2009 for sole traders and partnerships)

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Cars costing under £12,000 are lumped together with other general plant and equipment for capital allowance purposes. In the parlance of the taxation legislation, this is called 'pooling'.

When a new car is acquired, its value is added to the pool and when a car is sold its disposal value is deducted from the pool. At the end of the accounting year, 25% of the balance in the pool is taken as a writing down allowance.

This makes the calculations easier, particularly if there are a large number of cars costing under £12,000 in the fleet.

However, it also means the values in the pool get mixed up and the balance of the pool ends up reflecting a mixture of purchase prices, writing down allowances and disposal values that cannot be traced back to the original vehicles. The allowances obtained for a particular pooled car are unlikely to be the same as if each vehicle in the pool attracted a 25% writing down allowance.

#### A simple example:

Let us assume the business has a December 31 accounting year, has been in existence for several years, but has never bought a car.

It buys Cars A and B on January 1 costing £8,000 each.

At the end of year one it obtains 25% writing down allowances on the pool, that is,  $£16,000 \times 25\% = £4,000$ . It carries £12,000 forward into year two. During year two it decides to sell the cars, as it wishes to lease all cars in future. Sale proceeds are £6,000 in total.

At the end of the year it obtains 25% writing down allowances on the £6,000 balance in the pool even though it has no cars left. It continues to take 25% per annum writing down allowances for many years, until the £6,000 has reduced to a very low figure, at which time it can be cleared off.

Yes, this is an extreme example but it correctly reflects the main problem with pooling cars costing less than £12,000. If the sale proceeds are less than the unrelieved value of the vehicle in the

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pool, it will take many years before you get full tax allowances on the depreciation you have suffered on a vehicle.

'Higher value' cars costing more than £12,000 are not pooled. Technically, each such vehicle is said to be in its own pool. When the vehicle is sold the balance of its pool is cleared out. If the sale proceeds are insufficient to clear the balance, the remainder is given as an additional writing down allowance known as a 'balancing allowance'. Alternatively, if the sale proceeds exceed the unrelieved balance, the total amount of allowances that the company is obtaining is reduced. Otherwise too much allowance will have been given on the depreciation of the vehicle. This reduction is called a 'balancing charge' and it is an additional taxable amount.

#### The new rules

These rules apply for cars acquired by companies on or after 1 April 2009 (6 April 2009 for sole traders and partnerships)

As explained above ('Writing Down Allowances') the new system is based on the CO<sub>2</sub> emissions of the car rather than the purchase price. Cars emitting not more than 110 g/km CO<sub>2</sub> will qualify for a 100% writing down allowance so pooling is not a consideration; they will be written off for tax purposes in the year of acquisition.

Cars emitting between 111 g/km and 160 g/km will attract a 20% writing down allowance on reducing balance basis. The maximum amount of the allowance will be £3,000. These vehicles will go into a separate pool, rather than being accounted for as individual assets.

Cars emitting over 160 g/km will attract a 10% writing down allowance on reducing balance basis, and will go into a separate pool. The maximum amount of the allowance will be £3,000.

The new rules do not include the concept of a balancing allowance or balancing charge so if the sale proceeds are less than the unrelieved balance the car will be depreciated on a reducing balance basis for many years.

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## Very expensive cars

As we have seen, capital allowances are a method whereby your business can obtain tax relief for incurring capital expenditure on items to be used in the business.

If you buy an expensive car that blatantly exceeds the type of vehicle needed by the business, HM Revenue and Customs will seek to reduce the level of capital allowances. They will argue the choice of car has more to do with the personal choice of the driver (usually the owner of the business) than the needs of the business itself. They have case law to support this approach.

In determining whether to allow the business full capital allowances on such a vehicle, the Revenue will consider

- The size and type of car
- The nature of the business
- The extent the car is used for business purposes
- The relationship between the cost of the car and the turnover of the business.

A very expensive car that is bought 'on the business' but rarely used for the purposes of the business is likely to be denied full capital allowances. On the other hand, if the same vehicle is used for a substantial level of business mileage you are likely to be granted full capital allowances without restriction.

## If the employer leases a vehicle

### **The Old Tax Relief Rules: The half-the-excess rule**

Significant corporation tax changes come into effect for limited companies from 1 April 2009 (or 6 April 2009 for sole traders or partnerships).

The following rules apply for vehicles entered into before these dates and will apply until those leases have terminated.

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If the employer leases a vehicle under a contract hire, operating lease, daily hire or finance lease arrangement, the rental paid is fully tax deductible for cars costing under £12,000.

Above this, the allowable amount is determined by the 'half-the-excess rule' and is calculated using this formula:

$$\text{Allowable} = \frac{\text{£12,000} + \frac{1}{2} (\text{retail price} - \text{£12,000})}{\text{Retail price when new}} \times \text{Rental (net of VAT)}$$

Example: Rental payable £480 per month (net of VAT)  
Retail price of car £24,000

$$\text{Allowable} = \frac{\text{£12,000} + (\frac{1}{2} \times (\text{£24,000} - \text{£12,000}))}{\text{£24,000}} \times 480$$

$$\begin{aligned} &= 18 \div 24 \times \text{£480} \\ &= \text{£360}. \end{aligned}$$

So in this case only three-quarters of the rental would be tax deductible.

The retail price here excludes any fleet discounts or volume related bonuses.

The disallowance applies only to the finance element of the lease rental, not any maintenance amount. This is why contract hire companies show these amounts separately in quotes and on invoices.

It is important to note that this is a permanent tax disallowance, not just a deferral. The 'lost' allowances are not made up when you sell the vehicle, which is what would happen if you bought a car outright and financed it on hire purchase etc.

If you lease a car costing more than £12,000, the disallowed rental is disallowed forever.

This makes it expensive, from a tax perspective, to lease an expensive car.

This disallowance does not just apply to end user lessees. It also applies to lessors. So if, for example, a contract hire company buys a car costing more than £12,000 to lease to you, they suffer the half the excess rule permanent disallowance too.

## Corporation Tax and Writing Down Allowances

This chart shows the allowable proportion of the lease rental for cars with retail prices from £7,500 to £50,000:

Retail Price	Allowable %
£	
7,500	100.0%
8,000	100.0%
8,500	100.0%
9,000	100.0%
9,500	100.0%
10,000	100.0%
10,500	100.0%
11,000	100.0%
11,500	100.0%
12,000	100.0%
12,500	98.0%
13,000	96.2%
13,500	94.4%
14,000	92.9%
14,500	91.4%
15,000	90.0%
15,500	88.7%
16,000	87.5%
16,500	86.4%
17,000	85.3%
17,500	84.3%
18,000	83.3%
18,500	82.4%
19,000	81.6%
19,500	80.8%
20,000	80.0%
20,500	79.3%
21,000	78.6%
21,500	77.9%
22,000	77.3%
22,500	76.7%
23,000	76.1%
23,500	75.5%
24,000	75.0%
24,500	74.5%
25,000	74.0%
25,500	73.5%
26,000	73.1%
26,500	72.6%
27,000	72.2%
27,500	71.8%
28,000	71.4%
28,500	71.1%

Retail Price	Allowable %
£	
29,000	70.7%
29,500	70.3%
30,000	70.0%
30,500	69.7%
31,000	69.4%
31,500	69.0%
32,000	68.8%
32,500	68.5%
33,000	68.2%
33,500	67.9%
34,000	67.6%
34,500	67.4%
35,000	67.1%
35,500	66.9%
36,000	66.7%
36,500	66.4%
37,000	66.2%
37,500	66.0%
38,000	65.8%
38,500	65.6%
39,000	65.4%
39,500	65.2%
40,000	65.0%
40,500	64.8%
41,000	64.6%
41,500	64.5%
42,000	64.3%
42,500	64.1%
43,000	64.0%
43,500	63.8%
44,000	63.6%
44,500	63.5%
45,000	63.3%
45,500	63.2%
46,000	63.0%
46,500	62.9%
47,000	62.8%
47,500	62.6%
48,000	62.5%
48,500	62.4%
49,000	62.2%
49,500	62.1%
50,000	62.0%

### Corporation Tax and Writing Down Allowances

Since 17 April 2002, lease rentals on cars with less than 120g/km of CO2 emissions were fully tax deductible without this disallowance.

As with other motoring expenses, tax relief on contract hire and operating lease rentals is given on the 'accruals basis'.

Many leases require you make a lump sum payment on inception of the contract. This protects the lessor against your default. In such cases, HM Revenue and Customs requires the lease rentals be spread evenly over the period of the lease for tax purposes. This will normally match your accounting treatment.

HM Revenue and Customs published Statement of Practice 3 (SP3/91) in 1991. In determining how tax relief will be given for finance lease rentals, this statutory provision says that uneven rentals must be spread evenly over the period of the lease and then split into interest and capital repayment elements. To calculate the interest element you may use the Rule of 78, the actuarial method or, for small leases, the straight-line method.

If you use the Rule of 78 or the actuarial method, interest costs will be higher in the earlier part of the lease, so you will receive more tax relief on interest in this period.

#### The New Tax Relief Rules: 160g/km threshold

For vehicles leased by companies from 1 April 2009 (or 6 April 2009 for sole traders or partnerships) a new system will apply.

The new system is much simpler. Where a company car's emissions exceed 160 g/km, 15% of the lease rental will be disallowed. Below this threshold the full rental will be tax-deductible.

Taxis, hire cars and cars leased to the disabled were exempt from the disallowances under the old scheme. They will no longer enjoy this exemption under the new scheme.