6. Capital Allowances

6.1 Introduction

Any expenditure of a capital nature or any loss of capital or cost of any improvements effected charged in the Profit and Loss account are not allowed as a deduction in arriving at the profit for tax purposes.

. *Sec26(1)(h), 26(1)(i)*

Instead, depreciation allowances are given as set out in the Act

6.2 Depreciation Allowance

A. **Plant, machinery & fixtures, motor vehicles and IT equipment**

Depreciation allowance is claimable by a person on any plant, machinery or fixtures if he is the **owner** of the asset and **uses** it a trade, business, profession or vocation carried on by him. Acquisition may be by purchase, gift, inheritance, exchange or any other like manner.

The allowance is granted annually on the cost of acquisition of the asset commencing from the year of assessment in which the asset was put into use, and thereafter each year until the tax written down value is nil. No allowance is given in the year of disposal.

The cost of acquisition is

(i) in the case of purchase the purchase price increased by the expenditure incurred in dismantling the old ones and replacing them with new ones. It will not include cost of overseas trips incurred for inspection.

The cost of acquisition will also not include the VAT input credit in relation to the construction or acquisition

Sec 25(7)((f)(iv)

(ii) in the case of gift, inheritance etc, the market value at the date of acquisition

(iii) original cost of acquisition less depreciation allowances (i.e. tax w.d.v.) in the case of a company formed by conversion of a sole proprietorship or partnership *Sec 25(7)(f)(iii)*

Special cases

a) *Assets purchased on hire purchase terms*

The allowance is granted to a purchaser of plant, machinery or fixtures on hire purchase as the purchaser is the de-facto owner.

b) *Capital allowance is not due* in the following cases -

i. on any asset given to employee to be used in his residence

ii on machinery let on hire to-

(a) an undertaking the whole or part of the profits are exempt from tax.

(b) for use in an undertaking carried on by the person from whom such purchase was made.

iii. on vehicles used for travelling except in respect of-

(a) Motor cycles or bicycles used by non executive officers.

(b) Motor coaches used for the transportation of employees to and from their place of work.

c) *Assets hired for a short period*

Where the owner hires plant, machinery for a short period and subsequently uses it again in its business, allowance is due only for the period of use by the owner.

d) *Renewal of capital assets.*

Renewal of capital assets which do not qualify for depreciation allowance **is allowable as a deduction** against profits. Examples of assets that fall into this category are implements, tools, utensils, furniture and fittings linen, buildings etc which do not qualify for capital allowances. *Sec 25(1)(c)*

*Cost of Renewal **cannot be deducted*** in the following cases -

i. on any asset given to employee to be used in his residence *Sec 26(2)(b)*

ii assets let on hire for use in an undertaking carried on by

- the person from whom such asset was acquired
- any family member of that person or any family member in partnership with another. *Sec 25(5)*

(e) *Fixtures*

Only fixtures that are permanently attached to a building qualify for capital allowances.

(f) *Office furniture*

Allowance is due in respect of office furniture whether metal or wooden

B. **Buildings**

Depreciation allowance is due on

- the cost of construction of any qualified building.
- the cost of acquisition of any condominium property which has been approved by the UDA and constructed to be used as a commercial unit
- the cost of acquisition of any hotel building (including hotel building complex) or any industrial building (including industrial building complex), **acquired from a person who has used such building** in any trade or business.

"Qualified building means a building constructed to be used for the purposes of a trade, business profession or vocation, other than to be used as a dwelling house by an executive officer employed in that trade, business, profession or vocation"

Capital allowance is granted annually and commences from the year of assessment in which the building is first used.

Capital allowance is due on the cost of construction of a building constructed as a replacement of an existing building.

The cost of construction of a building for capital allowances includes the cost of additions and extensions

Capital allowance is not due on -

(i) improvement of a building which does not result in increased floor space.

(ii) a dwelling house used by an executive officer.

(iii) on the value of land.

(iv) building acquired for carrying on the business of letting premises. A building acquired in a business of letting premises for commercial purposes cannot be considered as 'plant'. Only a 'qualified building' is eligible for capital allowances.

'Construction costs' do not include the cost of acquiring the land or planning fees that may be involved. Construction costs will include preparing, cutting, tunnelling or levelling the land and any architects, quantity surveyors and engineers' fees, provided the building is actually constructed.

6.3. Ascertaining What is 'Plant'

The Act does not define 'plant' or 'machinery'. We have to deduce the definition from case laws.
Speaking generally, 'machinery' includes everything which by its action produces or assists in production and plant might be regarded as that without which production could not go on.

'Plant' in its ordinary sense includes whatever apparatus is used by a businessman for carrying on of his business not his stock in trade which he buys or makes for sale, but all goods and chattels fixed and movable, live or dead, which he keeps for permanent employment in his business.

Yarmouth v France (19 OBD 647

The very important test, in deciding what is plant, asks whether:

(i) the asset in question forms part of the setting in which the trade is carried on?; or

(ii) the asset in question is something which a trader actively uses in his trade i.e. does the asset perform a function in the business?

If the asset has a function, it **will be plant**. If the expenditure has been incurred by the trader as part of the setting within which he runs the business, it **will not be plant**. The distinction is important because if an asset is not plant then capital allowance cannot be claimed as plant.

The test used in deciding what is plant is referred to as '**function v setting'** test. The following are examples of what a plant is and what is not

a. *A garage canopy over a petrol filling station* did not actually help in the supplying of petrol. It was part of the setting and therefore not plant. *Dixon v Fitch's Garage Ltd – (1975*)

b. *Dockside concrete grain silos* were held to be plant as they fulfilled a function in the trade. They held the grain in a position from which it could be discharged to purchasers. This was a function and the silos were therefore plant. *Schofield v R & H Hall Ltd - (1975)*

c. *A swimming pool* used for carrying on its trade by a caravan park with leisure facilities performed a function i.e. the caravan park used the swimming pool for carrying on its trade, and it was a major attraction to the caravan park and therefore is plant. *Cooke v Beach Station Caravans Ltd (1974)*

d. *Moveable partitions in an office* to subdivide floor space performed a function as they were movable and intended to be used in the course of the business. The partitions are therefore plant. *Jarrold v John Good & Sons Ltd*
e. Books purchased by a lawyer are plant. – *Departmental ruling*

f. A train engine cannot be categorised within the meaning of motor vehicles inorder to deduct capital allowances. It is a 'plant and machinery'

6.4. Disposal of Assets

In the event of sale or discard, the sale proceeds in excess of the tax written value is treated as a profit, or if negative as a loss in arriving at the profits and income of that trade or business.

Where the full proceeds of the sale of an asset on which capital allowances have been claimed are used to replace the asset sold, within one year from the sale, the cost of acquisition of the asset so purchased, for purposes of capital allowance, will be the actual cost reduced by the profit on sale of the asset so replaced. *Sec25(7)(f)(i)*

A bus with a seating capacity for 30 was sold and out of the full proceeds a purchase of another with a seating capacity for 47can be treated as a replacement.

A van which is a dual purpose vehicle, intended for both transport of goods and of persons will not be a replacement of a truck which is intended solely for transport of goods.

6.5 Conversion of business carried on by an individual or partnership into a company *Sec 25(7)(f)(iii)*

Where a company formed by the conversion of business carried on by an individual or partnership, the value to be taken for calculation of capital allowances of the company will be the tax w.d.v. at the time of take over. The rates of capital allowance previously applied on the assets will be continued to apply.

6.6. Assets Purchased on Finance Lease Agreements *Sec26(1)(p)*

Lease rental paid in any y/a under any finance agreement **is deductible** in arriving at the profits and income subject to the following limit:

IT equipment (computers, software & accessories)
Up to 1/4th of the total rental payable in agreement – Allowable

Motor vehicle, furniture, plant, machinery & equipment (other than IT)
Up to 1/5th of the total rental payable in agreement – Allowable

The excess over these limits will be disallowed

The following lease rentals paid **do not qualify for deduction** in arriving at the profits and income:

(i) Rental payments in respect of vehicles used for travelling other than a motor cycle bicycle used by a non-executive officer

(ii) Rental payments in respect of any assets provided for use in the place of residence of any officer or employee

(iii) Lease rentals paid prior to the commencement of business

On disposal of a leased asset on which lease rentals have been allowed the profit on sale is the proceeds on sale less any cost of acquisition other than the lease rentals paid. *Sec25(7)(f)(vi)*

On termination of a lease agreement, such asset will be treated as an asset on which full capital allowances has been granted to the extent of the repayment of the capital value of such asset. *Sec25(7)(f)(vii)*

Self Test

Which of the following types of expenditure qualifies as plant?

a. General lighting in a retail store
b. Display lighting in sore windows
c. Decorative tapestries in a hotel
d. Ship used as a floating restaurant
e. Suspended ceiling over a stairwell
f. Suspended ceiling over an eating area.

Answers to Self Test

a. General lighting in a retail store – does not qualify for plant. It is considered to be part of a setting.

b. Display lighting in stores windows can be regarded as plant. The lighting is much more specialized and with that it fulfils a function. i.e. to attract customers into the shop.

c Decorative tapestries in a hotel are regarded as plant. Tapestries and murals fitted to the walls of pubs and hotels created an ambience and atmosphere with which to attract customers. Therefore such expenditure had a function rather than being part of the setting. *CIR v Scottish & Newcastle Breweries Ltd*

d. Ship used as a floating restaurant was not regarded as having a function. It was actually the setting in which the trade was carried on. *Benson v Yard Arm Club Ltd(1979)*

e. A suspended ceiling over a stairwell is not regarded as plant. It does not fulfil a function, but instead is merely part of the setting. *Hampton vFortes Autogrill Ltd (1980)*

f. A suspended ceiling over an eating area could be regarded as plant as it fulfils a function in the trade creating a general atmosphere. Exposed wiring over an eating area is not attractive to customers.

Example 1 Capital allowances

Ayz Ltd carrying on a trade incurred the following costs in constructing buildings and acquiring machinery to be used for the purpose of the business:

Year ended	Construction of building Rs.	acquisition of plant & machinery Rs.
31.03.10	3,000,000	3,200,000 – completed installation on15.04.10
31.03.11	6,000,000	----
31.03.12	5,000,000	4,800,000 – used in that year

Calculate the depreciation allowance applicable for the years of assessment..

Answer

a. It is a qualified building and the depreciation allowance rates to be applied on the cost of construction incurred in that y/a.

b. Plant & machinery purchased in the y/e 31.03.10 and used on 15.04.10 will qualify for capital allowances from y/a 2010/11.

c. The rates of capital allowances are -

	Qualified Building	Plant & machinery
prior to 01.04.2011	6 2/3%	12 ½ %
after 01.04.2011	10 %	33 1/3%

	Cost incurred	Rate	Allowance	Tax w.d.v
Year of assessment 2009/10				
Qualified building:				
Incurred in 2009/10	3,000,000	6 2/3%	200,000	2,800,000
Year of assessment 2010/11				
Qualified building:				
Incurred in 2009/10	3,000,000	6 2/3%	200,000	2,600,000
Incurred in 2010/11	6,000,000	6 2/3%	400,000	5,600,000
Plant & machinery	3,200,000	12 ½%	400,000	2,800,000
Year of assessment 2011/12				
Qualified building:				
Incurred in 2009/10	3,000,000	6 2/3%	200,000	2,400,000
Incurred in 2010/11	6,000,000	6 2/3%	400,000	5,200,000
Incurred in 2011/12	5,000,000	10 %	500,000	4,500,000
Plant & machinery				
In 2010/11	3,200,000	12 ½ %	400,000	2,400,000
In 2011/12	4,800,000	33 1/3%	1,600,000	3,200,000
	22,000,000		3,100,000	17,700,000

Example 2 – Capital allowance

AB Ltd purchased a lorry for use in the business on 10th June 2009 for Rs.7,350,000 and sold it on 20th Sept 2011 for Rs.6,750,000.

Show the capital allowance etc in respective of each year of assessment involved in the following cases

a. Based on the information given
b. Purchased another lorry as a replacement on 25th Feb 2012 for Rs.8,150,000

Answer

(a) Year of Assessment

Year of Assessment			Rs.
2009/10	Capital Allowance – 20 % on 7,350,000		1,4700,000
2010/11	Capital allowance		1,4700,000
2011/12	Capital Allowance		Nil
	Profit on Sale – taken as Profit		
	Cost	7,350,000	
	Less Capital Allowance claimed	2,940,000	
	Tax w.d.v.	4.410,000	
	Sale proceeds	6,750,000	
	Profit	2,340,000	2,340,000
		========	

This amount will be treated as profit for tax purposes for y/a 2011/12

(b) The new lorry has been purchased within one year from the date of sale and the full proceeds on sale has been used for the purchase of the new one. The cost of the new lorry, for capital allowance purposes will be taken as Rs.8,150,000 – 2,340,000 = Rs. 5,810,000

Year of assessment 2011/12

Capital allowance 20 % on 5,810,000 = Rs.1,162,000

The profit on sale has been given credit in the cost of the new lorry purchase and therefore will not be taken as profit .

Example 3 - Purchase on a finance lease

BC Ltd purchased a lorry for use in the business on 10th June 2007 on a four year finance lease.

The following payments on the lease have been made-

Year ended	Rs.
31/03/08	2,500,000
31/03/09	2,700,000
31/03/10	2,700,000
31/03/11	500,000
Total payable on the lease	8,400,000

a. Show the claims that would have made for the years of assessments involved.

b. Had the vehicle been sold on 30/09/09 for Rs.4,000,000 after making payments of Rs.1,350,000 on the lease for the period 01/04/06 to 30/09/09 on the basis that the finance lease is taken over the purchaser of the vehicle. Show the treatment for the year of assessment 2009/2010

Answers

a. Year of assessment

			claimed Rs.
2007/08	1/5 th8,400,000	1,680,000	
	Payment made	2,500,000	
	Lesser of the two		1,680,000
2008/09	as above		1,680,000
2009/10	as above		1,680,000
2010/11	Payment made	500,000	
	1/5th 8,400,000	1,680,000	
	Lesser of the two		500,000

b Year of assessment

2007/08	as above		1,680,000
2008/09	as above		1,680,000
2009/10	Payment made	1,350,000	
	1/5th thereof	1,680,000	
	Lesser of the two		1,350,000
	Sale Price	4,000,000	
	Profit on sale		(4,000,000)