CAPITAL ALLOWANCES

Subject: Formation 2 Taxation
Author: Nuala Aughey, current examiner.

Capital allowances arise for both the self-employed person and for a company, in respect of assets used for the purposes of the trade. They also arise for a person or company with a Case V source of income (rental).

The calculation of capital allowances is quite straightforward and yet students, as a rule, score badly in this area. Although the reasons are several and varied, the **MAIN** reason is that students calculate capital allowances for each tax year with reference to the date the asset was purchased rather than looking to the **basis period in which the asset was purchased**!

For the purpose of this article, I am going address this particular reason, focusing on Plant & Machinery, Fixtures & Fittings & Motor Vehicles. I will outline a step by step approach to a correct capital allowances computation. (I will not be including designated areas allowances).

INTRODUCTION:

To qualify for capital allowances, an asset must be ***in use at the end of the basis period.*** Once an asset is in use at the end of the basis period – **even if only for 1 day**, a full year capital allowance is calculated and granted **without** restriction.

Normally, a motor vehicle will be in use at the end of a basis period. However, beware of the asset delivered before a company's year end, but not put into use until the day after the company's year end.

RATE / METHOD USED IN CALCULATION:
There are **2 rates and 1 method** to be used for all assets **purchased AFTER 2nd December 2002:** (FA 2002).

Rate	Method	Asset
4%	Straight Line on cost	Industrial Building
12 ½ %	Straight Line on cost	Plant, Machinery, Fixtures & Fittings, Cars & Vans

For assets purchased prior to that date, the rate for plant, machinery and fixtures & fittings was different (15% pre 1/1/01 & 20% 2001, 2002). The method of calculation for motor vehicles also differed (reducing balance) and to complicate matters further, there was an irrevocable choice to write down all assets held at 1st January 2001, at 20% straight line, based on the asset tax written down value at that date.

The rates that are to be used in your exam are given in the Tax Tables accompanying the exam paper. There should be no reason for a student using the incorrect rate when answering a question.

CALCULATION:

Believe it or not, the calculation of correct capital allowances is not as difficult as students perceive.

The Golden Rule in calculating capital allowances for an asset, is that it is **IMPERATIVE** to identify the basis period in which the asset was purchased/disposed.

THERE ARE 3 UNCOMPLICATED, STRAIGHTFORWARD STEPS:

STEP 1:
Ask yourself two questions to identify the basis periods in use.
Q1 - Commencement, Cessation or Ongoing – what rules apply?
Q2 – According to the rules; <u>what accounts period end follows each asset transaction</u>?

STEP 2:
Match each basis period end to the tax year it ends in, according to the rules.

STEP 3:
Calculate capital allowances.

EXAMPLE 1-(A)

A trader makes up accounts to 31st August annually. During 2003, he purchased the following and put them into immediate use: 1st February - Shelving €10,000.
31st May - New car €25,000.
1st September - Machine €16,000.

STEP 1: Two questions to identify the basis periods in use
Q1 - Ongoing - Use 12 months accounts.
Q2 – Shelving 1/2/03……..Accounts year end following is 31/8/03
New car 31/5/03…… Accounts year end following is 31/8/03
Machine 1/9/03……..Accounts year end following is 31/8/04

STEP 2: Match each basis period end to the tax year it ends in, according to the rules
Accounts year end 31/8/03 falls into 2003
Accounts year end 31/8/04 falls into 2004

STEP 3: Calculate capital allowances

	Plant & Machinery 12.5%	Fixtures & Fittings 12.5%	Motor 12.5%	Total Allowances
	€	€	€	€
2003:				
Additions		10,000	22,000*	
W & T		(1,250)	(2,750)	4,000
TWDV		8,750	19,250	
2004:				
Additions	16,000			
	16,000	8,750	19,250	
W & T	(2,000)	(1,250)	(2,750)	6,000
TWDV	14,000	7,500	16,500	

*Cars restricted to €22,000 maximum for purchase dates after 1/1/2002. (This is the **ONLY** time that a **purchase date** is looked to in this table).

So you see, although the assets were all bought during the **calendar year** of 2003, this is not what determines the **tax year** in which capital allowances are first calculated. It is determined by the **basis period** of the tax year.

EXAMPLE 1-(B)

Using the figures in example 1(A) above but assuming that the accounts were made up to 31st December annually, the following answers would arise for 2003 & 2004:

STEP 1: Two questions to identify the basis periods in use

Q1 - Ongoing - Use 12 months accounts.
Q2 – Shelving 1/2/03……..Accounts year end following is 31/12/03
New car 31/5/03…… Accounts year end following is 31/12/03
Machine 1/9/03……..Accounts year end following is 31/12/03

STEP 2: Match each basis period end to the tax year it ends in, according to the rules

Accounts year end 31/12/03 falls into 2003

STEP 3: Calculate capital allowances

	Plant & Machinery 12.5% €	Fixtures & Fittings 12.5% €	Motor 12.5% €	Total Allowances €
2003:				
Additions	16,000	10,000	22,000*	
W & T	(2,000)	(1,250)	(2,750)	6,000
TWDV	14,000	8,750	19,250	
2004:				
Additions	nil	nil	nil	
Disposals	nil	nil	nil	
W & T	(2,000)	(1,250)	(2,750)	6,000
TWDV	12,000	7,500	16,500	

*Remember, cars restricted to €22,000 maximum for purchase dates after **1/1/2002**. (The **ONLY** time that a **purchase date** is looked to in this table).

RESTRICTION ON CAPITAL ALLOWANCE

Remember, once an asset is in use at the end of the basis period – **even if only for 1 day**, a full year capital allowance is calculated and granted **without** restriction.

There are <u>2 occasions ONLY</u> where a restriction arises:

(a) where there is private use…………restrict the amount **granted**.
(b) where the basis period is < 12 months……restrict the amount **calculated**

(a) RESTRICT FOR PRIVATE USE

If there is private use, **carry out the calculation as normal** and restrict the amount **granted** to the taxpayer as follows:

EXAMPLE 1-(C)

Again, the figures in Example 1(A), but this time private use has been agreed at 20%

STEP 1: Two questions to identify the basis periods in use

Q1 - Ongoing - Use 12 months accounts.
Q2 – Shelving 1/2/03……..Accounts year end following is 31/8/03
New car 31/5/03…… Accounts year end following is 31/8/03
Machine 1/9/03……..Accounts year end following is 31/8/04

STEP 2: Match each basis period end to the tax year it ends in, according to the rules

Accounts year end 31/8/03 falls into 2003
Accounts year end 31/8/04 falls into 2004

STEP 3: Calculate capital allowances

	Plant & Machinery 12.5% €	**Fixtures & Fittings 12.5% €**	**Motor-- 12.5% €**	**Private 20%**	**Total Allowances €**
2003:					
Additions		10,000	22,000*		
W & T		(1,250)	(2,750)	550	3,450
TWDV		8,750	19,250		
2004:					
Additions	16,000				
	16,000	8,750	19,250		
W & T	(2,000)	(1,250)	(2,750)	550	5,450
TWDV	14,000	7,500	16,500		

*Cars restricted to €22,000 maximum for purchase dates after **1/1/2002.** (This is the **ONLY** time that a **purchase date** is looked to in this table).

(b) RESTRICT ACCOUNT PERIODS LESS THAN 12 MONTHS:

This can arise in (a) Commencement
(b) Cessation

In these situations, the capital allowances that are calculated are restricted to the number of months in the accounting period.

(a) COMMENCEMENT:

In commencement, Year 1 is commonly a short year with an overlapping period with Year 2.
In such situations, asset purchases/disposals of the "overlap" belong to the earlier period - Year 1.

EXAMPLE 2-(Taxpayers option on Commencement not exercised)

A trader commenced 1st July 2003 and decides to make up accounts to 30th June each year. The following assets were purchased and put into immediate use:

1/7/03……….New car €20,000 – Private use agreed at 10%
31/7/03………Office Desk €1,000
31/12/03……..Filing cabinet €800
31/3/04………Shelving €2,400
1/7/04………Printer €4,000

STEP 1: Two questions to identify the basis periods in use

Q1 - Rules on commencement. Year 1: 1/7/03 – 31/12/03 – Note only 6 months
Year 2: 1/7/03 – 30/6/04 – Note overlap 1/7 – 31/12
Year 3: 1/7/04 – 30/6/05

Q2 –Accounts period end that follows asset transaction:

- New car 1/7/03 – 6 months period end following is 31/12/03 – **Rule***
- Office desk 31/7/03 – 6 months end period end following is 31/12/03 – **Rule***
- Filing cabinet 31/12/03 – 6 months period end following is 31/12/03 – **Rule ***
- Shelving 31/3/04 – Accounts year end following is 30/6/04
- Printer – 1/7/04 – Accounts year end that follows 30/6/05

> * ***Rule:*** *Asset dealings of the "overlapped period" in Commencement fall into the earlier period .*

STEP 2: Match each basis period end to the tax year it ends in, according to the rules

6 months accounts ending 31/12/03 falls into 2003
12 months accounts ending 30/6/04 falls into 2004 - ***Rule****
12 months accounts ending 30/6/05 falls into 2005

STEP 3: Calculate capital allowances

	Plant & Machinery 12.5% €	Fixtures & Fittings 12.5% €	Motor-- 12.5% €	Private 10%	Total Allowances €
2003:					
Additions		desk 1,000	20,000		
		cabinet 800			
		1,800			
W & T **x 6/12**		(113)	(1,250)	125	1,238
TWDV		1,687	18,750		
2004:					
Additions		Shelves 2,400			
		4,087			
W & T		(525) **W.1**	(2,500)	250	2,775
		3,562	16,250		
2005:					
Additions	4,000				
	4,000	3,562	16,250		
W & T	(500)	(525) **W.2**	(2,500)	250	3,275
TWDV	3,500	3,037	13,750		

Working 1: €1,000 + €800 = €2,400 = €4,200 @ 12.5%
Working 2: €4,200 @ 12.5%

(b) CESSATION:

In cessation, there will usually be a short final year and a "gap" between the final year and the Penultimate year. In such situations, asset purchases/disposals of the "gap" belong to the penultimate year.

EXAMPLE 3-(Revenue option on Cessation not exercised)

A sole trader died on 30th June 2004. He had made up accounts to 30th September annually, The year before he died, he had purchased a van for €24,000 on 31st October 2003, for use in the business. The TWDV of all other assets held was Nil.

STEP 1: Two questions to identify the basis periods in use

Q1 - Rules on cessation: Final year 1/1/04 – 30/6/04 – **note 6 months**
Penultimate year: 1/10/02 – 30/9/03 – **Note "gap"**

> ** * **Rule:** Asset dealings of the "gap period" arising in cessation, fall into the Penultimate year.*
> *(Penultimate year effectively "stretches out" to absorb the gap)*

Q2 –Accounting period end that follows each asset transaction:
Van 31/10/03 in "Gap" period 1/10 to 31/12/03 Goes back into Penultimate year

STEP 2: Match each basis period end to the tax year it ends in, according to the rules
6 month set of accounts (final) ending 30/6/04 falls into 2004
12 month set of accounts (penultimate) ending 30/9/03 falls into 2003 – ***Rule* * above***

STEP 3: Calculate capital allowances

	Van	
	12.5%	
	€	
2003:		
Additions	24,000	– no restriction on vans
W & T	<u>(3,000)</u>	
TWDV	21,000	
2004:		
Wear & Tear **x 6/12**	<u>(1,500)</u>	
TWDV	19,500	

<u>FINALLY……</u>

I cannot leave the area of Capital Allowance computations without mentioning <u>one last small computation</u>. Up to here everything has been based on asset ADDITIONS. What happens when an asset is DISPOSED of ?

<u>Two actions:</u>

(a) Remove the asset from the capital allowance computation table at the TWDV
(b) Carry out a balancing allowance/charge computation

(1) REMOVE ASSET **at TWDV:**

USING EXAMPLE 2, but the car was sold on the 15th August 2004 for €16,000.

STEP 1: Q1 Ongoing – Use 12 months accounts
Q2 Accounts year end following disposal is 30/6/05

STEP 2: Account year end 30/6/05 falls into tax year 2005

STEP 3: Calculate capital allowances

	Plant & Machinery 12.5% €	**Fixtures & Fittings 12.5% €**	**Motor-- 12.5% €**	**Private 10%**	**Total Allowances €**
2003:					
Additions		desk 1,000	20,000		
		cabinet 800			
		1,800			
W & T **x 6/12**		(113)	(1,250)	125	1,238
TWDV		1,687	18,750		
2004:					
Additions		Shelves 2,400			
		4,087			
W & T		(525) **W.1**	(2,500)	250	2,775
		3,562	16,250		
2005:					
Additions	4,000				
Disposal			**(16,250)**		
	4,000	3,562	nil		
W & T	(500)	(525) **W.2**			1,025
TWDV	3,500	7,500			

As you can see, NO WEAR & TEAR is calculated for the car in the year of disposal

(2) CARRY OUT **BALANCING CHARGE / ALLOWANCE** COMPUTATION:

In this computation, the sale price is compared to the TWDV removed from the above table.

	€
Sale Proceeds	16,000
TWDV	(16,250)
Balancing Allowance	(250)
Less 10% private	25
	225

	€
2005 Capital Allowances as calculated above……..	1,025
Balancing Allowance…………………………	225
Total due for year……………………………	1,250

Note: If the sale proceeds exceeded the TWDV, a Balancing Charge would arise.
Subject to (i) The sale proceeds must exceed €2,000.
(ii) The charge calculated is restricted to the total allowances granted.

SUMMARY:

In this article, I have focused on students preparing for exams and some of the problems they regularly encounter when trying to decide what year capital allowances are initially given.

You will see from the 6 examples in the article that the **3 Steps and 2 Questions** will always place you in the correct tax year. Try the **"Steps & Questions"** out on other Capital Allowance questions you have done and also those you did incorrectly! Students should always strive to handle capital allowance computations correctly. They are important, appearing frequently both in exam situations and also in practice.