CHAPTER 26
CAPITAL GOODS SCHEME

This chapter looks at how the capital goods scheme restricts the input tax recovery on certain asset purchases to reflect the use of the asset over a period of time.

26.1 Introduction

The capital goods scheme (CGS) deals with input tax recovery on certain capital assets.

The assets concerned are:

1. land and buildings costing £250,000 or more; and
2. computers, ships and aircraft costing £50,000 or more.

The categories of expenditure that must be compared to the £250,000 and £50,000 limits include acquisition, construction, refurbishment, fitting out, lease premiums, alteration and extensions. SI 1995/2518, Reg. 112-116

When looking at computers, be aware that this is solely hardware and the limit set is per piece of hardware, so the scheme essentially covers large main-frame computers.

The item must be treated as capital in the accounts for the capital goods scheme to apply. For example, a business selling main-frame computers with computers in stock, would not be subject to the capital goods scheme. SI 1995/2518, Reg. 112(2)

With effect from 1 January 2011, the Capital Goods Scheme also takes into account fluctuations in business and non-business use.

VAT Notice 706/2 provides useful detail.

26.2 The operation of the scheme

When a capital item is purchased, the initial recovery of input tax follows the normal partial exemption rules.

In the quarter of acquisition, an initial recovery is claimed. This is then adjusted at the end of the partial exemption year by way of the annual adjustment. This is the normal method for partial exemption input tax recovery, but it is not appropriate to leave it at that for capital goods scheme assets.

Goods within the CGS are assets which will last for a long period of time and HMRC request that traders monitor the use of these assets over a number of years. Years for the capital goods scheme are VAT years. The accounting date of the business is not relevant.
26.3 Later Years

The recovery period for land and buildings is **10 years** and for computers, ships and aircraft, **5 years**. These are commonly referred to as the "adjustment period".

If at the time of first use of the item, the number of intervals/years exceeds the number of complete years that the owner's interest in the capital item has to run by more than one, the number of intervals/years is reduced to one more than the owner's interest but not to less than three. For example, a lease of 7 years would have 8 capital goods scheme intervals rather than the normal 10. 

SI 1995/2518, Reg. 114(3)

**Illustration 1**

CB Ltd makes taxable and exempt supplies. It acquires a mainframe computer for £200,000 plus VAT. The input tax suffered is therefore £200,000 × 20% = £40,000.

**Explain how the Capital Goods Scheme applies to CB Ltd.**

With a computer we use a 5-year life for the capital goods scheme.

In year 1, the trader calculates the taxable usage of the computer will be 50%. In year 1, following the partial exemption calculation method, £20,000 of input tax will be recovered.

In year 2 the taxable use is again 50%, so no further adjustment is required.

In year 3 the taxable use of the computer falls to 40%. As the company has not used the asset for the initial 50% recovery, a VAT adjustment is required.

The total VAT per year is £8,000, i.e. the initial £40,000 on the purchase divided by 5. For each of the years in the adjustment period, the company had a provisional recovery of 50%, being £4,000 per year. But in year 3 the taxable use is only 40%, which equates to an input VAT recovery of £3,200 (ie, £8,000 × 40%).

CB Ltd had an upfront input tax credit which effectively gave them £4,000 for each year. However in year 3, they should not have recovered £4,000 – instead they should have recovered only £3,200. There is a therefore capital goods scheme adjustment of £800 as too much VAT has been recovered.

The trader must therefore pay £800 back to HMRC.

26.4 Capital Goods Scheme Adjustments

The initial recovery is based on the year 1 usage, which in illustration 1 was 50%. Over the next 4 years the trader must adjust for actual usage. 

SI 1995/2518, Reg. 115(1)

The formula for calculating the capital goods scheme adjustment is as follows.

Total VAT on purchase/Number of years (5 or 10) × (Initial % – Actual %)= CGS adjustment
Applying this formula to Illustration 1:

<table>
<thead>
<tr>
<th>Year</th>
<th>Formula</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>£40,000 × 50%</td>
<td>£20,000</td>
</tr>
<tr>
<td>Year 2</td>
<td>No adjustment</td>
<td>No adjustment</td>
</tr>
<tr>
<td>Year 3</td>
<td>£40,000/5 × (50 – 40)%</td>
<td>£800</td>
</tr>
</tbody>
</table>

The adjustment is made in the second VAT return following the end of the VAT year. [SI 1995/2518, Reg. 115(6)]

This is an input tax adjustment in box 4 of the VAT return.

Example 1

PC Ltd acquired a computer on the 10th May 2013 for £300,000 plus £60,000 VAT. The taxable use to date is as follows:

<table>
<thead>
<tr>
<th>VAT year</th>
<th>Taxable Use</th>
</tr>
</thead>
<tbody>
<tr>
<td>30.4.14</td>
<td>45%</td>
</tr>
<tr>
<td>30.4.15</td>
<td>40%</td>
</tr>
<tr>
<td>30.4.16</td>
<td>58%</td>
</tr>
</tbody>
</table>

You are required to calculate the input tax recovery for the years to 30.4.14, 30.4.15 and 30.4.16.

26.5 Sale Adjustments

Where a capital item is sold within the adjustment period, two adjustments must be made; the normal adjustment and the sale adjustment. Both of these adjustments will apply in the year of sale. [SI 1995/2518, Reg. 115(3)]

The normal adjustment is calculated in the usual way; we take the percentage for taxable use to the date of sale, and assume that the asset is used for the whole year for that taxable use. The date of sale in the year is irrelevant.

The sale adjustment follows the normal capital goods scheme method for the remaining complete years of VAT life for that asset.

If the sale is a taxable sale, we assume that the taxable use for the remaining years is 100%.

If the sale of the asset is exempt, we assume 0% taxable use for each remaining year.

Illustration 2

Looking again at PC Ltd in Example 1, the computer is sold on 6 July 2016 for £60,000 plus VAT. The taxable use from 1 May 2016 to the date of sale was 54%.

For the normal year adjustment, we assume the asset was used for 54% for the whole year. The date of sale is irrelevant.

The year of sale is the year to 30 April 2017.
Calculate the adjustment required in the year of sale.

Normal adjustment:

\[ \frac{60,000}{5} \times (45\% - 54\%) = (£1,080) \text{ recovery} \]

In the year of sale, there is also a sale adjustment. The computer was sold as a taxable supply (i.e. plus VAT), thus we assume 100% taxable use in the remaining years of adjustment.

PC Ltd had the initial year of recovery and then another 3 normal adjustments, so that leaves one year to be accounted for in the sale adjustment.

Sale adjustment:

\[ \frac{60,000}{5} \times (45\% - 100\%) \times 1 = (£6,600) \text{ recovery} \]

Thus the total adjustment required for the sale year to 30 April 2017 is £7,680 (£1,080 + £6,600). This will be a repayment due for the quarter to 31 October 2017.

26.6 Restrictions

The capital goods scheme adjustments may be restricted by way of an anti-avoidance cap. This applies to total input tax recoverable over the whole period of ownership. The cap restricts the overall recovery to the amount of output tax charged on the sale of the asset. SI 1995/2518, Reg. 115(3a)–(3b)

The anti-avoidance cap only applies in exceptional circumstances and Business Brief 30/97 gives examples of when HMRC would not seek to impose the cap. The sale of computer equipment is just one of those instances. Primarily the cap is applied to VAT avoidance schemes which are trying to improve the VAT recovery position. SP 12/97

Example 2

PH Ltd acquired a new commercial property on 21 August 2011 for £600,000 + VAT.

The taxable use of the property is as follows:

\[
\begin{align*}
\text{VAT year:} & \\
31.5.12 & 50\% \\
31.5.13 & 63\% \\
31.5.14 & 41\% \\
31.5.15 & 40\% \\
\end{align*}
\]

The building is to be sold on 10 December 2015 for £780,000. PH Ltd has not opted to tax the property. Taxable use to the date of the sale is 55%.

You are required to calculate the input tax recoveries for the years to 31.5.12, 31.5.13, 31.5.14, 31.5.15 and 31.5.16.

Example 3

Looking at Example 2, now assume that the company has opted to tax the building. Therefore the company will be selling the property for £780,000 plus VAT. All the other information remains the same.
Calculate the input tax recovery in the year of sale.

26.7 Non-business use

With effect from 1 January 2011 the capital goods scheme was widened to include non-business activities. VAT Information Sheet 06/2011

Illustration 3

A business purchases a building for £1 million and incurs £200,000 VAT. The building is to be used for 60% business purposes and 40% non-business purposes. The business has a residual recovery of 70% on its business activities and the property is regarded as a residual asset.

Detail how the CGS would apply in these circumstances.

The non-business element of 40% is not recoverable in year one. The year one recovery under partial exemption principles is therefore 42% (i.e. 60% × 70%) and this will form the baseline recovery percentage for CGS purposes.

If in year two the business use increases to 80% and the residual recovery rate decreases to 60% the percentage used for year two under CGS will be 48% (i.e. 80% × 60%). This is compared to the 42% baseline recovery in the CGS calculation for year two. The CGS adjustment would be £1,200 being £200,000/10 × 6%.

26.8 Interaction with Capital Allowances

A Capital Goods Scheme adjustment will result in either an additional VAT liability where the trader pays money to HMRC or an additional VAT rebate where HMRC repay the money. How are these amounts treated for direct tax? The original asset purchased is probably within the capital allowances computation and would have been included at the net cost plus any irrecoverable VAT in the year of acquisition. As the trader moves through the Capital Goods Scheme periods the amount of irrecoverable VAT is changing. Therefore that must have an effect on the capital allowance computations. The detailed rules are all found within Chapter 18 of the Capital Allowances Act 2001. Generally these provisions say that a payment to HMRC is treated as an asset addition, and a repayment from HMRC is treated as an asset disposal. The date of addition or disposal is the last day of the CGS adjustment period i.e. 30 September 2016 for the CGS year to 31 March 2016. CAA 2001, Chapter 18
ANSWERS

Answer 1

£

Year of acquisition (y/e 30.4.14)  
60,000 × 45% = (27,000) recovery

Year to 30.4.15  
60,000/5 × (45% – 40%) = 600 payable to HMRC

Year to 30.4.16  
60,000/5 × (45% – 58%) = (1,560) recovered from HMRC

In the year of acquisition, the recovery is based on the partial exemption method. £60,000, (the initial VAT paid), times 45% (year 1 usage). The upfront recovery is £27,000.

If the business uses the asset for 45% for the whole of the computer’s adjustment period, there will be no adjustments to the initial recovery. However this is not the case in this example.

In the year to 30 April 2015, the taxable use is 40%. Applying the formula we see that £600 will be payable to HMRC. This will be shown as a negative input on the quarter to 31 October 2015, the second return after the VAT year-end.

In the year to 30 April 2016 the taxable use has increased to 58%. Applying the formula there is a £1,560 repayment. Again this is shown on the return for the quarter to 31 October 2016, but this time it will be additional input tax in order to secure the repayment from HMRC.

Answer 2

£

Year to 31.5.12 – 120,000 × 50% = (60,000) recovery

Year to 31.5.13 – 120,000/10 × (50% – 63%) = (1,560) recovery

Year to 31.5.14 – 120,000/10 × (50% – 41%) = 1,080 payable

Year to 31.5.15 – 120,000/10 × (50% – 40%) = 1,200 payable

Year to 31.5.16
Normal Adjustment:
120,000/10 × (50% – 55%) = (600) recovery

Sale Adjustment:
120,000/10 × (50% – 0%) × 5 = 30,000 payable

29,400 payable

In the year of sale, the normal adjustment is calculated using taxable use to the date of sale of 55%. That gives a repayment of £600.

The sale adjustment is £120,000 divided by 10, times 50% being the initial usage, minus 0% as the sale is exempt, (no option to tax has been made).
This is multiplied by 5, being the remaining intervals, (i.e. the initial year of recovery, year 1, then another 4 normal adjustments which leaves 5 years).

This gives an amount payable to HMRC of £30,000. The net amount due to HMRC is £29,400. This will be payable to HMRC as negative input tax in the quarter to 30 November 2015.

✔ **Answer 3**

<table>
<thead>
<tr>
<th>Year to 31.5.16</th>
<th>£</th>
</tr>
</thead>
<tbody>
<tr>
<td>Normal Adjustment:</td>
<td></td>
</tr>
<tr>
<td>120,000/10 × (50% – 55%) =</td>
<td>(600) recovery</td>
</tr>
<tr>
<td>Sale Adjustment:</td>
<td></td>
</tr>
<tr>
<td>120,000/10 × (50% – 100%) × 5 =</td>
<td>(30,000) recovery</td>
</tr>
<tr>
<td></td>
<td>(30,600) recovery</td>
</tr>
</tbody>
</table>

This time, because the sale was taxable and the sale adjustment was calculated using 100% taxable use, there is a repayment due to the trader of £30,600.

HMRC are unlikely to consider the anti-avoidance cap as there does not appear to be any avoidance motive present.