Fair recovery

Edd Thompson explains the purpose and workings of the value added tax capital goods scheme.

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The capital goods scheme (CGS) crops up regularly in Association of Taxation Technicians paper 6, which relates to VAT. From a question-setting point of view, it is an important and versatile topic to test. For example, the CGS could feature as part of a wider long question about land and property or partial exemption. It could also be tested in the context of a question about a transfer of a going concern. Equally, it might be the principal focus of a question in its own right.

This article aims to give ATT – and chartered tax adviser (CTA) awareness – students an overview of the CGS to complement their studies. A reminder of the fundamentals of the scheme will also benefit many beyond the exam world, where its potential pitfalls are often neglected until it is too late. This is not least the case when dealing with fully taxable businesses – those habitually entitled to recover (more or less) all the VAT they incur on purchases. Such businesses sometimes fail to realise that the right to VAT recovery is not always a foregone conclusion, in particular when one-off property transactions are concerned (as we shall see below).

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Purpose of the scheme

The overarching aim of the CGS is to ensure businesses recover a fair amount of VAT when they purchase expensive assets that they will typically use over a long period of time (known as ‘capital items’). It would not be fair just to recover VAT on the basis of how these long-life assets are being used at a snapshot in time. So, instead, the CGS says the business must monitor its ‘use’ of them over (in most cases) either a five or ten-year period. If the use fluctuates over that period, the business must adjust the amount of VAT initially recovered in the interests of fairness. This can be done by paying money back to HMRC or reclaiming it from the department.

Key points

- The capital goods scheme seeks to ensure businesses recover a fair amount of VAT on expensive assets used over a long time.
- Adjustments may be required if the ‘use’ of a capital item varies over time.
- A sales adjustment may be necessary when a capital item is sold during its capital goods scheme adjustment period.

Meaning of ‘use’

‘Use’ in this context is linked closely to the partial exemption rules which also represent a key element of the ATT paper 6 exam. However, broadly, a fundamental principle of VAT is that a taxpayer can recover the VAT on their purchases only when these are used to make taxable sales (or ‘supplies’).

Taxable supplies are subject to VAT at the standard, reduced or zero rates. To the extent that costs are used for other purposes, such as to make exempt supplies, VAT on those costs cannot be reclaimed from HMRC. Often, a big asset will be used for a combination of taxable and exempt purposes and therefore an apportionment of the VAT on costs will be required.

In practical terms, if I buy and start using a capital item 50% for taxable purposes and 50% for exempt purposes, I will be able to reclaim only half of the VAT. However if, down the line, I start using it for 60% taxable purposes, a CGS adjustment will be required. Because I am using the asset more for taxable purposes than I initially obtained credit for, fairness dictates that I can claim back more of that VAT from HMRC.

Nature of assets

These expensive long-life assets – the capital items – are specifically defined in VAT law so, if they do not fall within the legal definition, the CGS will not apply. Broadly, we are talking about:

- land and buildings costing £250,000 or more (excluding VAT) – these normally have a ten-year adjustment period; and
- computers, ships and aircraft costing £50,000 or more (excluding VAT) – these normally have a five-year adjustment period.

Computer

A business buys a new mainframe computer on 1 January 2018 for £60,000 plus VAT of £12,000 and immediately starts using it in the business. Because the computer costs more than £50,000 (excluding VAT) it is a capital item and it has a five-year adjustment period.

The first interval for CGS purposes runs to the end of the VAT year which, in this case, is 31 March 2018 (the business submits VAT returns on a calendar quarter basis). The first interval requires a normal partial exemption calculation. The computer is used to make both taxable and exempt supplies and the partial exemption calculation indicates that 50% of the VAT is recoverable. Therefore, the business recovers £6,000 of VAT and its initial or 'baseline' recovery percentage is 50%.

In the VAT year ended 31 March 2019 (the second interval) taxable use of the computer increases to 60%. Because this is more than the baseline percentage it is entitled to make an adjustment to recover a little more VAT. There is a CGS adjustment formula for this:

$$\frac{\textit{VAT on initial purchase}}{\textit{Number of intervals}} \times \textit{(Initial recovery \% – Actual recovery \%)}$$

Therefore, the adjustment in the year ended 31 March 2019 is £240, calculated as follows:

$$\frac{£12{,}000}{5} \times (50\% - 60\%) = (£240)$$

This means that a £240 adjustment can be reclaimed from HMRC. It may be helpful to think of a negative adjustment figure like recovering extra input tax, while if the formula gives a positive figure, think of it as output tax – it needs to be paid back to HMRC.

HMRC usually accepts the figures that a business has capitalised in its accounts when establishing the cost of a particular asset.

Workings of the adjustments

The best way to understand how the CGS works in practice is to work it through with numbers as in ***Computer***. It is one those areas at ATT and CTA level for which there is no substitute for question practice to develop the required understanding. However, here are some key points on the mechanics:

- The adjustment period is almost always broken down into five or ten 'intervals'.
- The first interval ends at the end of the VAT year in which a capital item is first used with subsequent intervals normally ending in line with the subsequent VAT years.
- The first interval is different from the others because it involves a normal partial exemption calculation; there will never be a CGS adjustment here.

Refurbishment

A fully taxable business refurbishes its commercial premises for £300,000 plus VAT of £60,000 in the VAT year ended 30 April 2018. It continues to use the building in its fully taxable business until 1 July 2019 at which point it sells it. At this point, the building is more than three years old. There is no option to tax in place.

The cost of the refurbishment means that it falls within the scope of the CGS and has a ten-year adjustment period. Because the building is used entirely in the taxable business for the years ending 30 April 2018 and 2019, VAT is recovered in full initially and no CGS adjustment is required in the second interval.

The building is sold in the VAT year to 30 April 2020 (interval three) and the sale is exempt from VAT. In the year of sale the business must normally make both a normal CGS adjustment for the year of sale and a sale adjustment for the remaining intervals. However, no normal CGS adjustment is required because use in the year of sale continued to be 100% taxable.

The sale adjustment is calculated as follows:

$$\frac{\textit{VAT on initial purchase}}{\textit{Number of intervals}} \times \textit{(Initial recovery \% – Actual recovery \%)} \times \textit{remaining intervals}$$

Therefore, the adjustment in the year ended 30 April 2020 is £42,000, calculated as follows:

$$\frac{£60{,}000}{10} \times (100\% - 0\%) \times 7 = £42{,}000$$

By selling the business on an exempt basis, it has triggered a CGS adjustment of £42,000 which it needs to pay back to HMRC (remember that positive figures mean amounts the business owes the department). If the business had opted to tax before sale it would have been able to avoid this adjustment (albeit it would have needed to charge VAT on the selling price).

- At the end of subsequent intervals, adjustments may be required but only when use in the tax year is different from the amount calculated for the first interval.
- Adjustments are calculated using the CGS adjustment formula – see ***Computer***.

The 'VAT year' for CGS depends on the 'stagger' of when a business submits its VAT returns, so look out for this in the exam questions.

It might seem that the CGS will be relevant only for partly exempt businesses. After all, it is only if the 'use' of an asset changes over time that adjustments become necessary. Readers would be forgiven for thinking it follows that, if a business only makes taxable supplies, it will never need to make an adjustment. However, this is an area that trips up many fully taxable businesses in the real world and, more often than not, sale adjustments are to blame (as we shall see below).

Perils of sale adjustments

A sale adjustment occurs when a business sells a capital item while it is still in its five or ten-year adjustment period. When this happens it adds complexity to the CGS process and, as such, is very examinable. At the end of the VAT year of sale two things must be done:

- a normal CGS adjustment for the year of sale; and
- a special sale adjustment for any remaining intervals still to run.

The special sale adjustment is similar to a normal CGS adjustment but with some key tweaks. In essence, the sale adjustment rolls up all the CGS intervals left to run into one single adjustment. For example, if I sell the capital item on a taxable basis, I assume that I would have used it for 100% taxable purposes for the remainder of that period. However, if I sell the capital item on an exempt basis, I assume that I would have used it for 100% exempt purposes. The best way to understand this is with the aid of numbers, as shown in ***Refurbishment***.

Refurbishment also illustrates the key risk of sale adjustments, in particular to fully taxable businesses, when it comes to selling land and property. The default VAT liability of the sale of commercial property is often exempt – VAT can be charged on this but only before the event. Many fully taxable businesses will sell CGS items within their adjustment periods without charging VAT, unaware that this might trigger an obligation to repay a huge amount of VAT to HMRC. This is a key reason why it is always essential for any business – partly exempt or otherwise – to give careful consideration to VAT before engaging in any property transactions.

Closing thoughts

Students of ATT paper 6 on VAT will need to be familiar with the CGS in terms of both the calculations and their explanations. An understanding of what the scheme seeks to achieve should help the mechanics fall more readily into place. It is important to be comfortable with both normal adjustments and sale adjustments.

The CGS is not just of theoretical interest; anyone dealing with one-off property transactions should pay close attention to the scheme at the earliest opportunity in the process.

Planning points

- Make sure clients keep records of their capital items for the capital goods scheme even if they are fully taxable at the moment because adjustments may be needed in future.
- Always consider the CGS before a client enters into large one-off property transactions.

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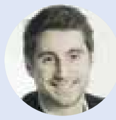

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- Readers' forum – repay input tax: tinyurl.com/y4w8hfvm
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