CHAPTER 26

CAPITAL GOODS SCHEME

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 costing £50,000 or more. 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)

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 **5 years**. These are commonly referred to as the "adjustment period".

With land and buildings on short leases less than 10 years long, the adjustment period is taken to be 5 years. 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 x $17\frac{1}{2}$% = £35,000.

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, £17,500 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 £7,000, i.e. the initial £35,000 on the purchase divided by 5. For each of the years in the adjustment period, the company had a provisional recovery of 50%, being £3,500 per year. But in year 3 the taxable use is only 40%, which equates to an input VAT recovery of £2,800 (ie, £7,000 x 40%).

CB Ltd had an upfront input tax credit which effectively gave them £3,500 for each year. However in year 3, they should not have recovered £3,500 - instead they should have recovered only £2,800. There is a therefore capital goods scheme adjustment of £700 as too much VAT has been recovered.

The trader must therefore pay £700 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.

$$\frac{\text{Total VAT on purchase}}{\text{Number of years (5 or 10)}} \times (\text{Initial \% - Actual \%}) = \text{CGS adjustment}$$

Applying this formula to Illustration 1:

Year 1	£35,000 x 50%	£17,500 recovered
Year 2	No adjustment	
Year 3	$\frac{£35,000}{5}$ x (50 – 40)%	£700 repaid to HMRC

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 2008 for £300,000 plus VAT. The taxable use to date is as follows:

VAT year:

30.4.09	45%
30.4.10	40%
30.4.11	58%

You are required to calculate the input tax recovery for the years to 30.4.09, 30.4.10 and 30.4.11.

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 2011 for £60,000 plus VAT. (Assume that the standard rate of VAT continues to be 17.5%) The taxable use from 1 May 2011 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 2012. The normal adjustment is

Normal adjustment:
$\frac{52,500}{5}$ x (45% - 54%) = (£945 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:
$\frac{52,500}{5}$ x (45% - 100%) x 1 = (£5,775) recovery

Thus the total adjustment required for the sale year to 30 April 2012 is £6,720 (£945 + £5,775). This will be a repayment due for the quarter to 31 October 2012.

26.6 Restrictions

The capital goods scheme adjustments may be restricted in 2 situations.

The first restriction concerns **just** the sale adjustment. Where the **sale adjustment exceeds the VAT charged on the sale** of the capital item, the **sale adjustment is restricted to the VAT charged on the sale.** SI 1995/2518 Reg. 115(3)

In Illustration 2 there was a sale adjustment of £5,775. VAT charged on the sale of the computer of £10,500, (i.e. £60,000 sale price x 17.5%). In this case no restriction is needed. However, if the VAT charged on the sale was (say), £5,000, the sale adjustment would be restricted to that £5,000.

The second restriction is 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 2008 for £600,000 + VAT.

The taxable use of the property is as follows:

VAT year:	
31.5.09	50%
31.5.10	63%
31.5.11	41%
31.5.12	40%

The building is to be sold on 10 December 2012 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 31.5.09 31.5.10, 31.5.11, 31.5.12 and 31.5.13.

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. (Again assume that the VAT rate continues to be 17.5% for the purposes of this example)

Calculate the input tax recovery in the year of sale.

26.7 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?

If the original asset purchased is within the capital allowances computation, it would have been included at **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 changes. Therefore this will have an effect on the capital allowance computations. CAA 2001, Chapter 18

A payment to HMRC is treated as an asset addition, and a repayment from HMRC is treated as an asset disposal.

Illustration 3

Large Ltd purchased a main-frame computer on the 11th August 2008 for £300,000 plus VAT. The Company's accounting year is 31 July and its VAT year is 31 March. The recovery percentages in respect of the computer were:

Year ended 31 March	
2009	50%
2010	65%
2011	40%

Consider the VAT position first.

In the year of acquisition (y/e 31 March 2009), recovery of VAT would have been obtained under partial exemption. 50% of the input tax would have been recovered; ie

£300,000 x 17½% = £52,500 x 50% = £26,250

CGS adjustments will be made as taxable use changes. The adjustments are as follows;

Y/e 31.3.10	$\frac{£52,500}{5}$ x (50 – 65)%	(£1,575) recovered from HMRC Recovery in VAT q/e 30.9.10
Y/e 31.3.11	$\frac{£52,500}{5}$ x (50 – 40)%	£1,050 paid to HMRC Due in VAT q/e 30.9.11

Now consider the capital allowances position.

The year of acquisition is to 31 July 2009. Note the accounting year is different to the VAT year, but that is quite normal.

The addition was £326,250, being cost of £300,000 plus the irrecoverable VAT of £26,250.

Now we're going to assume that the company has already claimed the annual investment allowance on other assets and therefore the company will get a writing down allowance of 20% (which is £65,250, giving a written down value of £261,000.

	£
Year ended 31 July 2009:	
Addition (11.8.08)	326,250
WDA @ 20%	(65,250)
TWDV c/f	261,000

In the year to 31 July 2010 the writing down allowance is calculated at 20% on the balance brought forward. There is no Capital Goods Scheme adjustment to account for in this period because the **adjustment is deemed to be made on the last day of the quarter in which the Capital Goods Scheme adjustment is made** (ie on 30 September 2010)

Year ended 31 July 2010:	£
TWDV b/f	261,000
WDA 20%	(52,200)
TWDV c/f	208,800

The first Capital Goods Scheme adjustment is made in the quarter to 30 September 2010. That is in the year to 31 July 2011.

As VAT of £1,575 has been recovered from HMRC, this is treated as a disposal for capital allowances purposes. The capital allowance position for the year ended 31 July 2011 is as below:

Year ended 31 July 2011	£
TWDV b/f	208,800
Disposal (30.9.10)	(1,575)
	207,225
WDA @ 20%	(41,445)
TWDV c/f	165,780

In the year to 31 July 2012, a payment of £1,050 is due to HMRC under the Capital Goods Scheme. This is treated as an addition for capital allowances purposes. The addition is deemed to be made on 30 September 2011 being the last day of the return in which the Capital Goods Scheme adjustment is made.

Year ended 31 July 2012	£
B/fwd	165,780
Addition	1,050
	166,830
WDA @ 20%	(33,366)
TWDV	£133,464

Answer 1

£300,000 x 17½% = £52,500

Year of acquisition (y/e 30.4.09)	
£52,500 x 45% =	(£23,625) recovery
Year to 30.4.10	
$\frac{52,500}{5}$ x (45% - 40%) =	£525 payable to HMRC
Year to 30.4.11	
$\frac{52,500}{5}$ x (45% - 58%) =	(£1,365) recovered from HMRC

In the year of acquisition, the recovery is based on the partial exemption method. £52,500, (the initial VAT paid), times 45% (year 1 usage). The upfront recovery is £23,625.

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 2010, the taxable use is 40%. Applying the formula we see that £525 will be payable to HMRC. This will be shown as a negative input on the quarter to 31 October 2010, the second return after the VAT year-end.

In the year to 30 April 2011 the taxable use has increased to 58%. Applying the formula there is a £1,365 repayment. Again this is shown on the return for the quarter to 31 October 2011, but this time it will be additional input tax in order to secure the repayment from HMRC.

Answer 2

	£
Year to 31.5.09 - £105,000 x 50% =	(52,500) recovery
Year to 31.5.10 - $\frac{105,000}{10}$ x (50% - 63%) =	(1,365) recovery
Year to 31.5.11 - $\frac{105,000}{10}$ x (50% - 41%) =	945 payable
Year to 31.5.12 – $\frac{105,000}{10}$ x (50% - 40%) =	1,050 payable
Year to 31.5.13	
Normal Adjustment:	
$\frac{105,000}{10}$ x (50% - 55%) =	(525) recovery
Sale Adjustment:	
$\frac{105,000}{10}$ x (50% - 0%) x 5 =	26,250 payable
	25,725 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 £525.

The sale adjustment is £105,000 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 £26,250. The net amount due to HMRC is £25,725. This will be payable to HMRC as negative input tax in the quarter to 30 November 2013.

Answer 3

	£
Year to 31.5.13	
Normal Adjustment:	
$\frac{105,000}{10}$ x (50% - 55%) =	(525) recovery
Sale Adjustment:	
$\frac{105,000}{10}$ x (50% - 100%) x 5 =	(26,250) recovery
	(26,775) recovery

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 £26,775.

There is no capping of the sale adjustment since the VAT charged on the sale of the property was £136,500.