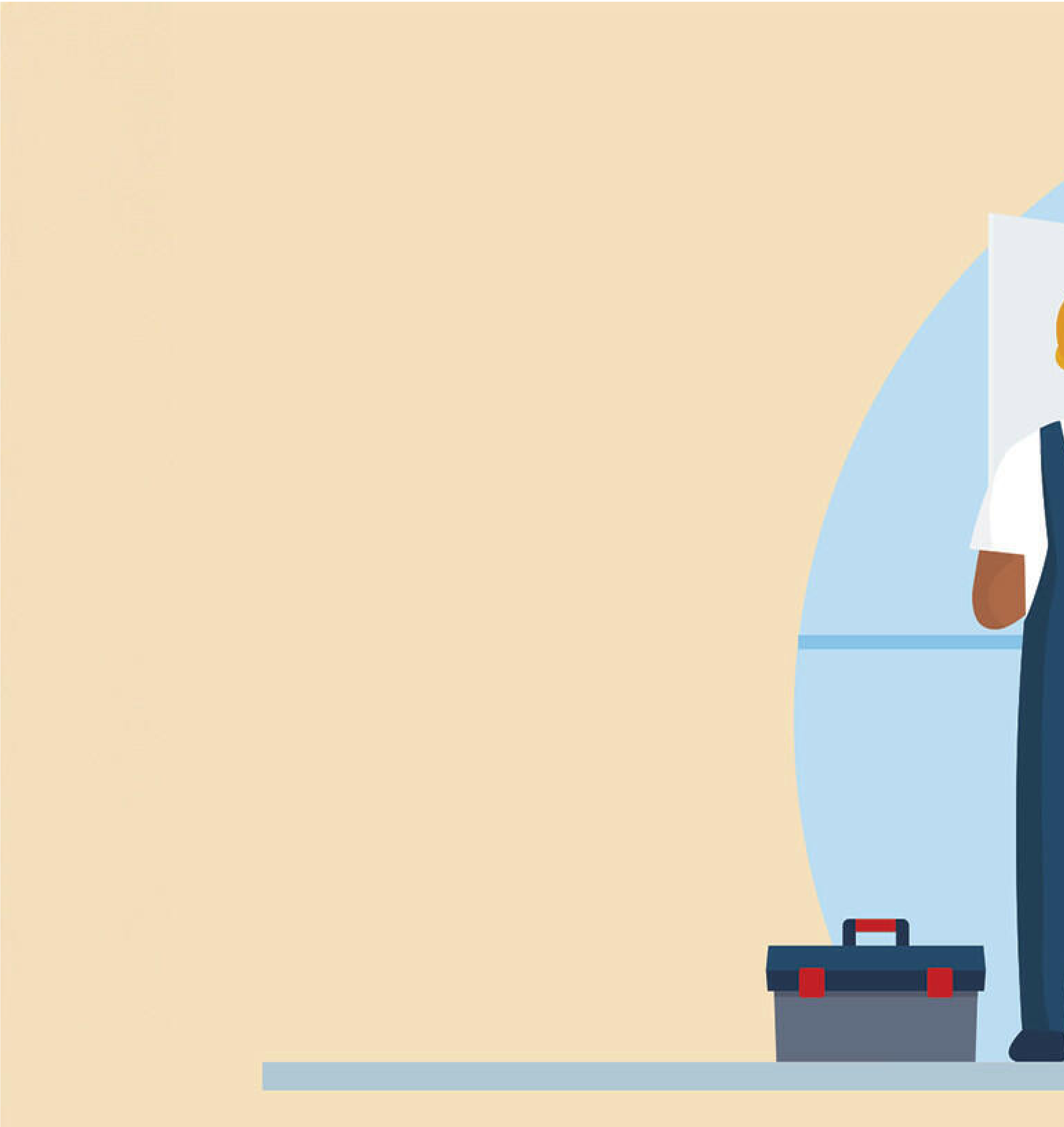
# Capital goods scheme: the practical challenges

Indirect Tax Property Tax



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If an entity either buys a property or improves, extends or alters it, the capital goods scheme will be relevant if the cost is £250,000 or more excluding VAT. We consider the practical challenges.

## Key Points

**What is the issue?**
The capital goods scheme reflects the use of a building over a ten-year period; i.e. input tax is adjusted on an annual basis to reflect any change in the mixture of taxable, exempt and non-business use. The adjustments are declared to HMRC on the second return after the end of the tax year.

**What does it mean for me?**
The capital goods scheme also applies to improvements, extensions and alterations to a property if the cost of the works is £250,000 or more excluding VAT. However, a phased improvement project is excluded unless any of the phases exceed the £250,000 threshold, in which case it will apply to those phases only.

**What can I take away?**
Calculation errors are sometimes made when a property is sold before the end of the ten-year adjustment period, when all of the outstanding adjustments are declared in the tax year of the sale, and the input tax adjusted will depend on whether the property sale is taxable or exempt.

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The capital goods scheme is all about fair play as far as input tax on major building projects is concerned. It applies to all VAT registered entities and has often proved a particular challenge for charities and not-for-profit organisations. I am a big fan of its intentions and methodology, although the £250,000 threshold has not increased for decades and is more out-of-date than the school library book I forgot to return when I was twelve years old. That was a long time ago!

In this article, I will consider common challenges with the scheme and pitfalls to avoid. As the pundits say on the hit TV programme, *Dragons Den…* it's all about the numbers.

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## What are the basic principles?

The outcome of the capital goods scheme is that input tax claimed on property related expenditure costing £250,000 or more excluding VAT is adjusted over a ten-year period to reflect the use of the asset in that period of time; i.e. changes between taxable and non-taxable use. It applies to the purchase of a building where VAT has been charged, as well as improvements, alterations and extensions. Associated costs connected with a property purchase are excluded, such as legal or estate agency fees.

An entity must make annual input tax adjustments over a ten-year period to reflect changes in their use of the building between taxable, non-business and exempt activities. See ***Hamwell Lawyers: Buying a new office.***

Note: the capital goods scheme also applies to civil engineering works, such as the construction of roads and bridges, as well as the spending of £50,000 or more excluding VAT on computers, aircrafts, ships, boats and vessels.

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## Hamwell Lawyers: Buying a new office

Hamwell Lawyers purchased a new office building for £1 million plus VAT on 1 January 2021 and fully claimed input tax of £200,000 because its activities of supplying legal services are taxable.

If they continue to use the building for the same activity until 2030 – or any other taxable activity, such as tax advice work – the annual capital goods scheme adjustments will be nil; i.e. the initial input tax claim does not require correction.

However, if the partnership generates exempt income from the building, perhaps by sub-letting a part of the property without making an option to tax election, the adjustments will produce an input tax repayment each year.

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## What happens if no input tax is claimed on a property purchase?

What would happen if the property purchased by Hamwell Lawyers had been wholly used for an exempt activity, so the initial input tax claim was zero?

The annual adjustments will still apply and this will lead to an input tax windfall in the following ten years if the use changes to either a partly or fully taxable activity. For example, if Hamwell Lawyers purchased the building to supply insurance services which are exempt from VAT, and did not claim input tax, there would be future windfalls if they used the property for legal services during the following ten-year period. The business will claim a tenth of the total input tax for each year where the building is wholly used for taxable activities.

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## What about a building used for taxable and exempt activities?

If a building is used for both taxable and exempt purposes, the input tax must be adjusted according to the usual partial exemption method of the business. The calculation will usually be based on the standard method, carried out according to the split of taxable and exempt turnover for the partial exemption tax year in question.

A partial exemption tax year ends on 31 March, 30 April or 31 May, depending on the return periods of the business; it ends on 31 March for a business that submits monthly returns.

For example, if a not-for-profit members golf club uses a capital goods scheme building for both catering (taxable) and golfing (exempt) activities, the percentage of input tax will almost certainly change each tax year because the percentage of taxable income will fluctuate. An alternative strategy is for the club to apply to HMRC for a special method, perhaps based on the square footage splits of the building between taxable and exempt use.

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## Are £250,000 deals included?

I saw a capital goods scheme scenario go wrong many years ago, when a business purchased a property for £250,000 plus VAT and claimed input tax. The directors did not carry out capital goods scheme adjustments over the next ten years because they were advised that the scheme only applies to deals that exceeded £250,000. That’s wrong!

The legislation at The Value Added Tax Regulations 1995 (SI 1995/2518) Reg 112 refers to spending which is ‘not less than £250,000’. This story did not have a happy ending because there was a change in use two years later that required a capital goods scheme input tax repayment.

However, there is a potential planning opportunity. If your clients negotiate a deal to purchase a property for £249,995 plus VAT, the capital goods scheme will not apply. In this case, input tax is only reviewed in the VAT quarter when they buy the property, followed by the usual annual partial exemption adjustment.

In some cases, though, the scheme might be useful if the percentage of taxable use is expected to increase. If so, pay an extra £5 and buy it for £250,000 plus VAT instead!

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## What about a phased refurbishment?

Consider the case where a business owns a three-storey office block and spends £100,000 plus VAT in each of the next three years, refurbishing one floor each year. The key figure is £100,000 rather than £300,000, so the capital goods scheme does not apply. Each improvement phase is treated separately as far as the £250,000 threshold is concerned.

Another quirk is that the calculations only include expenditure that is ‘plus VAT’ as far as the £250,000 limit is concerned; i.e. exempt and zero-rated expenditure is excluded. So, for example, if standard rated spending on an improvement project is £240,000 plus VAT and there is zero-rated expenditure of £20,000, the capital goods scheme does not apply.

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## When are annual adjustments declared on a return?

The practical reality of the capital goods scheme is that a tenth of the original input tax claim is reviewed for each adjustments period.

The first period ends at the end of the partial exemption tax year that includes the purchase of the asset and the original input tax claim, and then it is reviewed for the following nine years.

For example, a building was purchased for £1 million plus VAT and 80% input tax was initially claimed. An input tax repayment of £2,000 would be made if the taxable use was only 70% at the end of year two (i.e. the total input tax of £200,000 divided by ten years multiplied by the 10% reduced taxable use). The adjustment is included on the second period after the end of the partial exemption tax year; i.e. the September return for a business that submits calendar quarter returns (see VAT Notice 706/2 s 8).

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## What about non-business use?

If, for example, a charity buys a building that will be wholly used for non-business purposes – i.e. its charitable activities – then no input tax will be claimed on the purchase of the building. The non-business outcome effectively means that no subsequent input tax claims can be made with the capital goods scheme if, say, it is partly used in the next ten years as a business building, perhaps a charity shop.

However, if input tax is partly claimed because there is some business and non-business use, the charity can choose to either:

- exclude the non-business element from the capital goods scheme calculations, effectively taking it out of the balance sheet; or
- include the full value of the asset in the capital goods scheme.

For example, a charity purchased a building for £5 million plus VAT and initially claimed 40% of the input tax as relevant to taxable use, disallowing 60% for non-business activities.

In this case, the input tax reviewed each year will be £400,000 – and not £1 million, as it would be if the second option is taken.

It makes sense to include the full value of the asset in the calculations if the taxable use is expected to increase. The option to exclude the non-business part of the asset must be made when the building is purchased and records of the decision-making process should be kept (see VAT Notice 706/2 para 4.2 s 5).

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## What happens if you sell a property?

The final capital goods scheme adjustment in the year of the sale will adjust input tax for all of the remaining years and not just the final one. For example, if a property is sold at the end of year six, and the sale is exempt from VAT, the final capital goods scheme adjustment will treat all input tax for years six to ten as relevant to exempt supplies. A single calculation is made at the end of year six.

In reality, the outcome is fair:

- If your client sells a property and the sale is VATable, the remaining capital goods scheme intervals will all be treated as taxable.
- If your client sells the property and the sale is exempt from VAT, the remaining capital goods scheme intervals will be treated as non-reclaimable; i.e. wholly linked to exempt income.

As explained above, the VAT for all of the outstanding adjustments is paid or reclaimed on the annual adjustment that falls within the tax year of the sale. See ***Florist Flo: Property sale after eight years***.

Note: If a property sale is made at a reduced value that could be considered by HMRC to be an anti-avoidance strategy – perhaps a sale to an associated business that is less than market value – a ‘disposal test’ must be considered, which could result in an extra VAT liability. HMRC’s guidance refers to ‘an unjustified tax advantage’ (see VAT Notice 706/2 s 11).

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## Florist Flo: Property sale after eight years

Flo purchased the freehold of a shop for £1 million plus VAT in June 2015 and fully claimed input tax because she used it for her florist business; i.e. there are no partial exemption issues.

She sold in in September 2022 for £3 million – no VAT was charged on the sale because she had never opted to tax it. Adjustment year eight ends on 31 March 2023, when she used the property for both taxable and exempt purposes, and the final two years to March 2024 and 2025 are wholly linked to exempt supplies; i.e. the final sale.

So, the final annual adjustment made on the VAT return ended 30 September 2023 must adjust the original input tax claim to recognise the disposal.