

Revenue Commissioners

Tax Briefing No 03

2010

This content is more than 5 years old.
Where still relevant it has been incorporated
into a Tax and Duty Manual
or other website text.

The VAT Capital Goods Scheme - Direct Taxes Implications

1. The Capital Goods Scheme – a brief summary

The Capital Goods Scheme (CGS) is a mechanism for regulating deductibility over the 'VAT-life' of a developed property. The CGS applies to property that is developed or acquired **on or after 1 July 2008**. The scheme operates by ensuring that the deductibility for a property reflects the use to which the property is put over the VAT-life of the property. The VAT-life of a property is made up of twenty intervals. In the case of a refurbishment the VAT-life is ten intervals. Apart from the second CGS interval which may vary in length, a CGS interval is twelve months.

The scheme requires an annual review, over the VAT-life of the property by the owner of the property, of the use to which the property is put in terms of taxable or exempt use. Where there is a change in the proportion of use for taxable purposes for any year in comparison with the use in the initial twelve months, an adjustment of a proportion of the VAT deductibility will be required. If too much VAT has been deducted, the taxpayer must pay back the excess. If too little has been deducted, the taxpayer is entitled to claim the deficiency as an input credit. Ultimately, the proportion of VAT deducted following all annual adjustments will reflect the actual use of the property over the VAT-life of the property.

The main focus of this article is on the implications of CGS adjustments for some of the direct taxes. For this reason the examples used take a rather simplistic view of how VAT operates. There is a comprehensive treatment of the CGS from a VAT perspective in the Revenue publication "VAT on Property Guide" (chapters 6 to 8).

2. Direct tax implications

These CGS reviews will have no consequences for most property transactions as a person will generally be engaged in either fully taxable or fully exempt activities. Where there are CGS adjustments the 'knock-on' effects on the direct taxes must be considered. This is because VAT may be treated as part of the cost of a property in certain situations. The area most likely to be affected by a CGS adjustment is that of capital allowances. The potential impact on capital gains tax and on stamp duty is also addressed in this article.

The payment of compensation to a person who has incurred an additional tax liability as a result of adopting a particular course of action is not an exclusively CGS issue. However, the CGS has increased the likelihood of certain types of compensation payment being made. For this reason, Revenue has also outlined its approach to this issue in this article.

3. Capital Allowances

The CGS may have an impact on the treatment of those buildings that are regarded as 'industrial buildings' (includes 'commercial' buildings under the various area-based tax incentive schemes) for capital allowances purposes, where those buildings are completed or acquired on or after 1 July 2008. It may also have an impact on certain types of plant and machinery that are treated, for VAT purposes, as part of a building.

When a property is sold during the VAT life of the property there may be one final CGS adjustment required on the vendor. This occurs in two scenarios-

- Where the sale of the property is subject to VAT where the vendor did not have an entitlement to deduct all of the VAT on the acquisition or development of the property, and
- Where the sale of the property is exempt from VAT and the vendor had an entitlement to deduct some or all of the VAT on the acquisition or development of the property.

In the first scenario there is an additional input credit given. In the second scenario a claw-back of VAT occurs. This will be relevant for lessors of 'tax incentive' buildings who sell their relevant interest when the (capital allowances) tax-life of the particular building has expired. Owner-operators who retain their relevant interest in a building will continue to be subject to CGS adjustments that arise during the VAT-life of the building.

3.1 Industrial buildings

3.1.1 Adjustment of qualifying expenditure

Before the introduction of the CGS, the 'test' for whether VAT was a net cost to a person was only applied when the expenditure on development or acquisition was incurred. Since the introduction of the CGS, this test must now be applied throughout the (capital allowances) tax-life of a building. For each chargeable period following the initial payment or recovery of VAT on the development or acquisition of a building, the CGS may result in the payment or recovery of additional VAT. This means that the amount of qualifying expenditure for capital allowances purposes may also be subject to ongoing adjustment. This is because section 319 TCA 1997 does not allow any VAT paid by a person on the provision or acquisition of buildings (or plant and machinery) to be included in the qualifying expenditure for capital allowances purposes where that cost is recoverable in the form of a VAT credit.

Where a person incurs a VAT liability or obtains a VAT credit under the CGS, the capital allowances are revised for the chargeable period in which the VAT adjustment arises and for subsequent periods. No adjustment is made to the capital allowances for earlier periods. Beyond the initial period, or immediately succeeding periods where the VAT position is unchanged, it is not possible to give the allowances at the initial fixed percentage rate per year (e.g. 4% for 25 years) as the amount of the qualifying capital expenditure will have changed.

Any additional VAT liability is treated as qualifying expenditure and the residue (i.e. the remaining unrelieved capital expenditure) is increased by the amount of the additional VAT liability at the time that liability is incurred. Correspondingly, any additional VAT credit reduces the amount of the residue. The revised amount of qualifying expenditure (adjusted residue) is apportioned evenly over the remainder of the writing-down period for the building. If the amount of the VAT credit exceeds the residue, the additional liability is treated in the same way as a balancing charge.

The capital allowances are given at the end of a chargeable period, the quantum of those allowances to be made will depend on any adjustments made for the CGS interval falling within that chargeable period.

The capital allowances computations arising from CGS adjustments can be complicated. To minimise the compliance burden for taxpayers, revised computations will not be required where the difference in the amount of qualifying expenditure arising from a CGS adjustment is not material. This will also apply in relation to capital allowances for plant and machinery.

Example 1

A person who had inherited some land engaged a builder to construct a nursing home on that land. The nursing home is completed in August 2008 (capital allowances over 7 years at 15% per annum and 10% in year 7) at an allowable cost for capital allowances purposes of €2m plus VAT of €270,000. She retains and operates the nursing home and as she is engaged in an exempt activity is not entitled to a VAT credit or repayment. The qualifying expenditure for capital allowances purposes is therefore €2,270,000. For the chargeable period ending 31 December 2008 the capital allowances position is as follows:

	€
Qualifying expenditure (VAT incl)	2,270,000
Writing down allowances at 15%	<u>(340,500)</u>
Residue of qualifying expenditure 31/12/08	1,929,500

If there is no change in the level of exempt VAT supplies throughout the remainder of the VAT-life of the nursing home no CGS adjustments will arise and the capital allowances will continue to be given as shown above.

Assume, however, that having owned and operated the nursing home for 10 years and claimed the full amount of the capital allowances that the person starts to use the property partly for taxable activities. A CGS adjustment results in a VAT credit or repayment of €10,000, which, in turn, results in a balancing charge for the same amount.

Example 2

A person purchases a building for use as a factory (capital allowances over 25 years at 4%) on 1 December 2008. The qualifying expenditure for capital allowances purposes given by the 'net price paid' formula (section 279 TCA 1997) is €900,000 plus VAT of €121,500. The purchaser expects that 60% of his supplies will be taxable and, on that basis, gets a VAT credit of €72,900. The balance of €8,600 is a net cost to the purchaser and is added to the qualifying capital expenditure. For the chargeable period ending 31 December 2008 (also the person's accounting year end) the capital allowances position is as follows:

	€
VAT exclusive cost	900,000
VAT (40% x €121,500)	<u>48,600</u>
Qualifying expenditure	<u>948,600</u>
Writing down allowances at 4%	<u>(37,944)</u>
Residue of qualifying expenditure 31/12/08	910,656

The initial interval for the CGS ends on 30 November 2009. A review of the VAT position for this interval shows that taxable supplies accounted for 60% of total supplies so that no

CGS adjustment is required. This 60% recoverable amount will be used as the benchmark % for the CGS annual reviews. The second CGS interval is brought into line with the accounting year-end of 31 December 2009 and a review shows that recoverable VAT has increased to 70%. This requires a CGS adjustment – $\text{€}21,500 \times (70\% - 60\%) \times 1/20 = \text{€}608$, an additional VAT credit. The effect on the capital allowances position is as follows:

	€
Residue brought forward 1/1/09	910,656
VAT credit	<u>(608)</u>
Qualifying expenditure	910,048
Writing down allowances $\text{€}910,048/24 \text{ yrs}$	<u>(37,919)</u>
Residue of qualifying expenditure 31/12/09	872,129

In 2010 recoverable VAT decreases to 40%. The CGS adjustment is $\text{€}21,500 \times (60\% - 40\%) \times 1/20 = \text{€}1,215$, an additional VAT liability. The effect on the capital allowances position is as follows:

	€
Residue brought forward 1/1/10	872,129
Additional VAT payable	<u>1,215</u>
Qualifying expenditure	873,344
Writing down allowances $\text{€}873,344/23 \text{ yrs}$	<u>(37,971)</u>
Residue of qualifying expenditure 31/12/10	835,373

In 2011 the irrecoverable VAT reverts to 60%. The capital allowances position is as follows:

	€
Residue brought forward 1/1/11	835,373
Writing down allowances	<u>(37,971)</u>
Residue of qualifying expenditure 31/12/11	797,402

The building is sold in 2012. When a property is sold there is no further obligation for the vendor under the CGS, once the final adjustment on the sale, if any, is made. As it is no longer a new building for VAT purposes the sale is exempt. The following is the effect of an **exempt sale**.

1. Clawback of VAT on exempt sale

The part of the VAT that was recovered in the initial interval that is referable to the remainder of the CGS period is clawed back. The claw-back is:

$$72,900 \times 16/20 \text{ [1]} = 58,320.$$

This is treated as the payment of additional VAT.

2. Capital allowances – balancing event

	€
Residue brought forward 1/1/12	797,402
Additional VAT payable	<u>58,320</u>
Revised residue	855,722
Sale proceeds	<u>(950,000)</u>
Balancing charge	(94,278)

Alternatively, assume both the vendor and purchaser elect to make the sale taxable for VAT purposes. The following is the effect of a **taxable sale**.

1. Credit for VAT on taxable sale

The part of the VAT that was not deductible in the initial interval that is referable to the remainder of the CGS period is given as a credit. The credit is:

$$48,600 \times 16/20 [2] = 38,880$$

This is treated as an additional VAT credit.

2. Capital allowances – balancing event

	€
Residue brought forward 1/1/12	797,402
Additional VAT credit [3]	<u>(38,880)</u>
Revised residue	758,522
Sale proceeds	<u>(950,000)</u>
Balancing charge	(191,478)

However, the balancing charge is restricted to €151,805, the amount of capital allowances actually given.

3.1.2 Availability of accelerated capital allowances

Spreading the revised residue over the remainder of the writing-down period for a building will be straightforward where the capital allowances are spread evenly over that period. However, certain buildings can avail of accelerated allowances so that the normal writing-down period is shortened [4]. The usual case is for the capital allowances to be claimed over the shortest period possible. For this reason, the standard approach will be for a revised residue arising from a CGS adjustment to be spread over the remainder of the shortest possible writing-down period for a building. However, a taxpayer will have the option to spread the revised residue over a longer period so long as it does not extend beyond the maximum writing-down period for the building. This treatment will have to be agreed with the relevant inspector. A CGS adjustment arising after the capital allowances have been claimed in full will result in an immediate balancing allowance or charge.

Example 3

Only the annual writing down allowances are claimed so that the writing-down period is not shortened

A person purchases a crèche and leases it to a third party operator. Operating a crèche is an exempt activity for VAT purposes so he facilitates the lessee by not opting to tax the letting. As he is not entitled to a VAT credit the qualifying expenditure for capital allowances purposes is VAT inclusive and should be written off over 7 years at the rate of 15% for the first 6 years and 10% in year 7.

During year 4 the lessee decides to start using part of the crèche for a taxable activity and agrees with the owner that he can opt to start taxing the lettings. This results in a CGS adjustment in the form of a VAT credit which is deducted from the residue at the end of year 3. The revised residue is spread evenly over the remaining 4 years of the 7-year writing-down period [\[5\]](#).

Example 4

The full amount of the accelerated allowances are claimed at the earliest possible time so that the writing-down period is shortened to its fullest extent

An owner-operator of a coffee shop in a Town Renewal area has qualifying expenditure for capital allowances purposes of €800,000. This excludes VAT paid on the purchase of the building for which the person claimed a VAT credit as he is engaged in a fully taxable activity. An initial allowance of €400,000 (50%) is claimed for the first chargeable period. Annual writing-down allowances of €32,000 (4%) are claimed for the following two chargeable periods. During the following chargeable period (year 4) there is a change in the level of taxable supplies. Assume that a CGS adjustment results in additional VAT payable of €50,000. This amount is added to the residue of the capital expenditure at the end of the third chargeable period, i.e. €36,000 (€800,000 less €464,000). The revised residue of €386,000 is spread evenly over the following 11 years (based on shortest possible writing-down period of 14 years) rather than the 22 years remaining in the writing-down period for the building. The taxpayer does not opt for a longer writing-down period to apply.

Example 5

The full amount of the accelerated allowances are not claimed at the earliest possible time so that the writing-down period falls somewhere between the shortest period possible and the tax-life of the building.

A person spends €908,000 on the construction of a crèche. This amount includes €108,000 VAT that cannot be recovered as the building is to be used for exempt activities. Qualifying expenditure for capital allowances purposes is therefore €908,000. An owner-operator can claim an initial allowance of 100% or free depreciation of up to 100%. Thus, the write-off period can vary from 1 year (100% allowances claimed up front) to 7 years (only annual allowances claimed).

The annual allowances are increased to 40% for both of the first two chargeable periods so that the residue at the end of the second chargeable period is €181,600 (i.e. €908,000 less €726,400). Assume a CGS adjustment in the form of a VAT credit arises during the third chargeable period and is deducted from the residue of €181,600. The revised residue can be

written off at the end of that chargeable period as the person still has the opportunity to increase the annual allowances to 20% and is in a position to write off the full amount of the qualifying expenditure at that stage. The person could instead opt to spread the revised residue over a longer period.

3.2 Plant and Machinery

Unlike the capital allowances regime, the CGS does not distinguish between a building and its component parts. Certain component parts of a building may qualify for plant and machinery wear and tear allowances rather than for industrial building allowances. A CGS adjustment may therefore affect the capital allowances position in a different way than that outlined in section 3.1.

There is a Revenue practice (contained in Tax Instruction 9.2.3) that allows taxpayers to elect to treat expenditure on specified items of plant and machinery that are an integral part of an industrial building as part of the construction cost of the building instead of as expenditure on plant and machinery. The effect of such an election is that the expenditure on plant and machinery qualifies for industrial buildings allowances rather than for wear and tear allowances. Where such an election has been made a CGS adjustment has the same effect on the capital allowances arising as a result of the election as it does in the case of a 'stand-alone' building.

Without such an election, capital expenditure on a building that contains plant and machinery has to be apportioned between the building and the plant and machinery. Where expenditure is incurred on (or received for) a building and plant and machinery as part of a single transaction, section 311 TCA 1997 provides for that expenditure to be apportioned on a reasonable basis for the purposes of determining capital allowances and balancing charges/allowances. The fraction that is used to apportion expenditure between a building and plant and machinery for capital allowances purposes should also be used to apportion any CGS adjustment amount between these two components.

Example 6

A person who has inherited some land engages a builder to construct a hotel on that land. The hotel is completed in August 2008 (capital allowances over 7 years at 15% per annum and 10% in year 7) [6] at an allowable cost for capital allowances purposes of €2m plus VAT of €270,000. The allowable cost includes the installation of a lift and heating and air conditioning systems. An election is made to treat the cost of these items of plant and machinery as part of the construction cost of the hotel. As the hotelier will be engaged fully in a taxable activity he recovers the €270,000 VAT that was paid to the builder so that the qualifying expenditure is €2m.

Any CGS adjustments are treated in the same way as those for the factory in example 2. The sale of the hotel in 2015 will not give rise to a balancing event as the sale will take place outside of the tax-life of the building. Nor will there be a balancing event in the case of the lift and the heating and air conditioning systems as the hotelier had elected to treat these items as part of the building for capital allowances purposes.

Example 7

Assume the same facts as in the previous example except that the hotelier does not elect to treat the expenditure on the lift and heating and air conditioning systems as part of the construction costs of the hotel. Instead, he claims wear and tear allowances on the cost of their provision having estimated this cost to be €100,000 or 5% of the qualifying expenditure. Thus, annual wear and tear allowances are €12,500 (12½%). In 2010 the hotelier starts to use one of the hotel's meeting rooms for an exempt activity so that the percentage of taxable use is less than the benchmark VAT deductibility figure of 100% and a CGS adjustment is required. Assuming 5% of exempt use would result in additional VAT payable of €675, i.e. €270,000 x (100% - 95%) x 1/20.

For the chargeable period ending 31 December 2008 (also the hotelier's accounting year end) the capital allowances position is as follows:

	Building	P&M
	€	€
Qualifying expenditure	1,900,000	100,000
(VAT exclusive cost)		
Writing down allowances at 15%/12½%	<u>(285,000)</u>	<u>(12,500)</u>
Residue of qualifying expenditure 31/12/08	1,615,000	87,500

For the chargeable period ending 31 December 2009 the capital allowances position is as follows:

	Building	P&M
	€	€
Residue brought forward 1/1/09	1,615,000	87,500
Writing down allowances at 15%/12½%	<u>(285,000)</u>	<u>(12,500)</u>
Residue of qualifying expenditure 31/12/09	1,330,000	75,000

	Building	P&M
	€	€
Residue brought forward 1/1/10	1,330,000	75,000
Additional VAT payable €675 [7]	<u>641</u>	<u>34</u>
Revised residue	1,329,359	74,966
Writing down allowances 1,329,359/5 yrs [8]	<u>(265,872)</u>	
Wear and tear allowances 74,966/6 yrs [9]		<u>(12,494)</u>
Residue of qualifying expenditure 31/12/09	1,063,487	62,472

4. Capital gains tax

Expenditure incurred on the acquisition or enhancement, or the incidental costs of acquisition or disposal, of a property may include VAT. These costs should be reduced by the amount of any VAT that has been paid and that is recoverable in the form of a VAT credit as no net cost

is incurred. Any VAT that is not recoverable is included in these costs. [\[10\]](#) The same principle applies to the payment of a premium.

Example 8

A person buys a property that he uses as a shop. The cost of the property is €908,000, which includes VAT of €108,000. The incidental costs of acquisition are €12,100, which includes VAT of €2,100. The property is used for a fully taxable activity and the person gets a VAT credit for €10,100. The shop is used in the sixth CGS interval for partly exempt activities which gives rise to a VAT liability of €500 as a result of a CGS adjustment. The shop is sold in the chargeable period (seventh CGS interval) following this CGS adjustment. As the sale takes place more than 5 years since the acquisition of the property, the property is no longer regarded as new for VAT purposes and is therefore exempt from VAT. This results in a CGS adjustment, which claws back VAT of €75,600 [\[11\]](#). The CGT computation on disposal is as follows:

	€
Sale proceeds	950,000
Base cost of property	(876,100)
(€800,000 + €500 + €75,600)	
Incidental costs of acquisition	<u>(10,000)</u>
Chargeable gain	63,900

5. Stamp duty

The CGS does not have any direct implications for stamp duty (but see section 6). For stamp duty purposes any consideration/rent/premium paid in respect of a property is the VAT exclusive amount. The consideration chargeable under the head of charge "CONVEYANCE or TRANSFER" on the sale of property is exclusive of VAT (section 48 SDCA). The rent and premium (if any) that comprise the stampable consideration chargeable under the head of charge "LEASE" are the VAT exclusive amounts (section 56 SDCA). Unless told otherwise, Revenue assumes that the consideration recited in a conveyance or a lease is a VAT exclusive consideration.

6. Payments made as compensation for VAT liabilities arising under CGS

Revenue was asked to comment on the following three scenarios involving the compensation of whichever party to a transaction suffers a VAT liability as a result of a CGS adjustment. An example of this is where a clause in a lease enables a tenant to oblige a landlord to cancel his or her option to tax the lettings. When this occurs there is a clawback of some or all of the input VAT taken by the landlord.

The following comments are intended to be of a general nature. A definitive opinion would depend on the actual documentation and agreements used and each case is ultimately to be decided on its particular facts and circumstances.

6.1 Scenario 1 - outright sale of land

A is selling a 10 year old property to B for €10m (VAT exclusive). B cannot recover VAT and it is agreed that an option to tax will not be exercised. A will suffer a CGS adjustment as a consequence. The agreement is subject to B agreeing to pay A an equivalent amount of compensation in addition to the €10m consideration.

Tax treatment (assumes sale of fixed asset)

The consideration will be increased by the compensation amount and the vendor's base cost by the same figure. The CGT on the disposal is thus unchanged.

The stamp duty treatment will depend on the documentation but it is very likely that the compensation will form part of the consideration.

6.2 Scenario 2 - grant of a short lease out of a freehold or long lease

A is granting a 20 year lease of a newly completed property to B. B cannot recover VAT and it is agreed that an option to tax will not be exercised. A will suffer a CGS adjustment as a consequence. The agreement is subject to B agreeing to pay an equivalent amount of compensation in addition to rent.

Tax treatment

The compensation amount will be treated as premium, part of which will be chargeable to income tax and part to CGT in the usual way.

A part of the CGS adjustment sufficient to produce no chargeable gain will be set against the capital receipt. No part of the adjustment amount may however be set against the part of the compensation which is chargeable to income tax.

The stamp duty treatment will depend on the documentation but it is likely that the compensation payment will form part of the consideration for the grant of the lease and is in the nature of a premium for stamp duty purpose. Stamp duty would arise on this sum in addition to the rent reserved.

6.3 Scenario 3 - CGS adjustment during the term of a short lease

A is granting a 20 year lease of a newly completed property to B. B cannot recover VAT and it is agreed that an option to tax will not be exercised. After 5 years A agrees to terminate the option to tax and A suffers a CGS adjustment as a consequence. This is subject to B agreeing to A an equivalent amount of compensation in addition to rent.

Tax Treatment

The chargeable gains and income tax position will be the same as in scenario 6.2.

The stamp duty treatment of the compensation payment will depend on the terms/conditions of the original lease and the nature of any subsequent agreement entered into in connection with the termination of the option to tax.

Footnotes

1. The numerator is the number of complete intervals remaining in the CGS period plus 1.
2. As previous footnote.
3. Treating the additional VAT credit as reducing the residue or as increasing the sale proceeds gives the same answer.
4. Until Finance Act 2010, the only type of industrial building that continued to qualify for accelerated capital allowances was a Childcare Facility (100% initial allowance and free depreciation). In the case of industrial/commercial buildings in the various area-based incentive schemes, initial allowances or free depreciation of 50% can be claimed so that the qualifying expenditure for such buildings can be written off over 14 years instead of over the standard writing-down period of 25 years. The relevant interest in the building can be sold after 13 years without triggering a balancing event.
5. The lessor has not availed of the initial allowance and the writing-down period cannot therefore be shortened and remains at 7 years.
6. Planning conditions met by 31 December 2004 and qualifying expenditure incurred during 2007 and 2008 restricted by 25% and 50% respectively.
7. 95% of €675, i.e. €641, is apportioned to the building and 5%, i.e. €34, is apportioned to the plant and machinery.
8. Remainder of 7-year writing-down period.
9. Remainder of 8-year writing-down period.
10. Tax Instruction 19.2.2 outlines how VAT is treated in a CGT computation.
11. $€108,000 \times 14/20$ (14 = number of full intervals + 1 remaining in CGS adjustment period).

This content is more than 5 years old.
Where still relevant it has been incorporated
into a Tax and Duty Manual
or other website text.