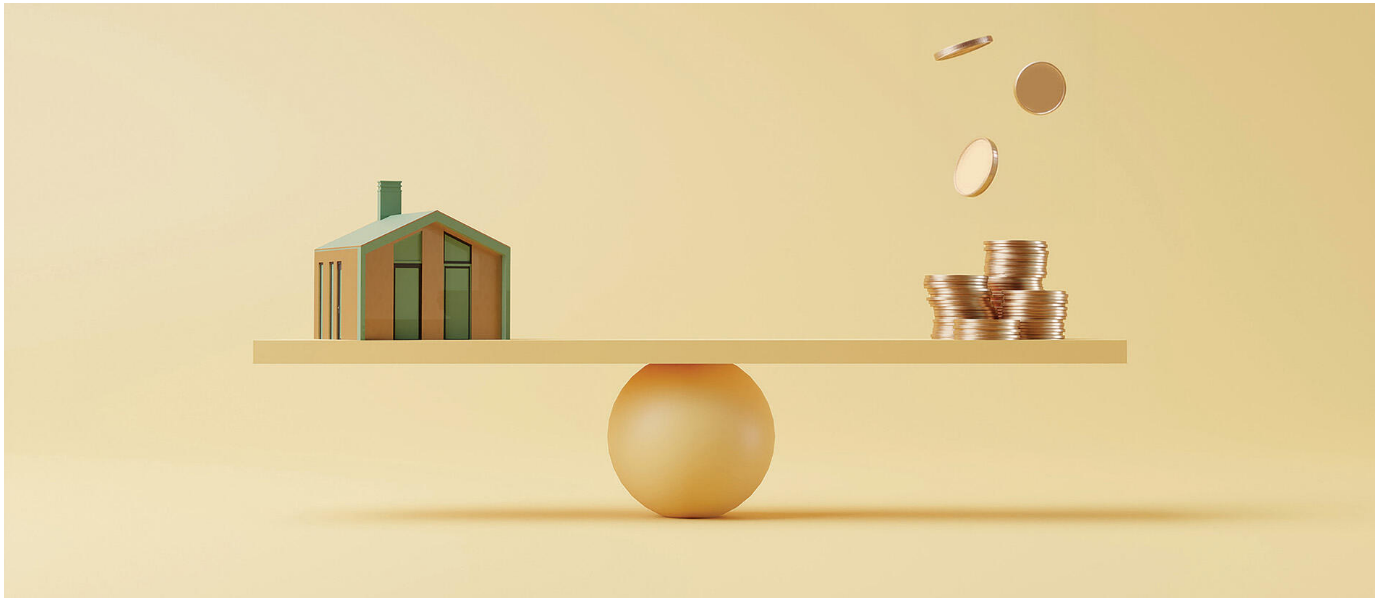
The Capital Goods Scheme: long-term VAT recovery

Indirect Tax | Large Corporate



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The Capital Goods Scheme adjusts VAT recovery over time, creating long-term risks, particularly on property and disposals, requiring careful planning.

Key Points

What is the issue?
The Capital Goods Scheme adjusts VAT recovery on high-value assets over time, meaning changes in use (particularly between taxable and exempt activities) can trigger additional VAT reclaims or significant clawbacks, sometimes years after acquisition.

What does it mean to me?
Even fully taxable businesses can face unexpected VAT liabilities, especially on property transactions or disposals, creating hidden risks or opportunities.

What can I take away?
The Capital Goods Scheme requires long-term planning and careful monitoring of asset use. Key risks can often be managed through use of the option to tax and thorough due diligence on transactions.

In ‘Demystifying partial exemption: getting VAT recovery right’ (March 2026, Tax Adviser), we explored the fundamentals of partial exemption – the process of determining how much VAT a business can recover when it has both taxable and exempt income. This involves an annual calculation to apportion input tax fairly over a year. However, for high-value assets with a long economic life, an annual snapshot is not enough. This is where the Capital Goods Scheme comes into play, introducing a significant, long-term complication to the VAT recovery puzzle.

The Capital Goods Scheme extends the principles of partial exemption over several years. It is a mechanism designed by HMRC to adjust the amount of VAT initially recovered on expensive assets to reflect changes in their use over time. Getting this wrong can lead to unexpected and substantial VAT bills, sometimes years after the asset was purchased.

What is the Capital Goods Scheme?

The Capital Goods Scheme provides a way to achieve a fair and reasonable attribution of VAT on major capital expenditures over the long term. It ensures that the amount of VAT recovered accurately reflects the balance between taxable and exempt use throughout the asset’s life in the business.

The scheme requires a business to monitor the use of a ‘capital item’ and make adjustments to the initial VAT recovery. These adjustments can result in either a further reclaim of VAT from HMRC or, more commonly, a clawback of VAT that was previously recovered.

Which assets are covered?

The Capital Goods Scheme does not apply to all purchases; it is reserved for high-value assets defined as ‘capital items’. Under the current rules, the main categories and their thresholds (exclusive of VAT) are:

- Land and property: An interest in land, a building or a civil engineering work where VAT-bearing capital expenditure is £250,000 or more.
- Computers and computer equipment: A single computer or item of computer equipment with a value of £50,000 or more.
- An aircraft, ship or boat where capital expenditure is £50,000 or more.

The scheme does not apply to assets acquired solely for resale or for non-business purposes.

Future changes

As part of the Spring 2025 Tax Update, the government announced significant simplifications to the Capital Goods Scheme, acknowledging that the longstanding £250,000 property threshold was overdue for an increase. The announced changes are:

- The capital expenditure threshold for land, buildings and civil engineering works will be increased from £250,000 to £600,000.
- Computers and computer equipment will be removed from the scheme entirely.

These changes are intended to reduce the administrative burden on businesses by significantly decreasing the number of assets that fall within the scheme. However, the government has only committed to making these changes ‘within this Parliament’, with further details to be published later. This lack of a firm implementation date or transitional rules creates uncertainty, particularly for businesses with property assets valued between £250,000 and £600,000 which are currently part-way through their Capital Goods Scheme adjustment period. I would, however, expect grandfathering rules to be introduced, and there are rumours of an update this Spring.

The mechanics of adjustment

The Capital Goods Scheme works by establishing a ‘baseline’ for VAT recovery in the year that an asset is acquired, and then comparing this to its actual use in subsequent years.

The adjustment period: The use of a capital item is monitored over a set 'adjustment period' – typically ten years for land and property and five years for all other capital items.

Intervals: The adjustment period is divided into 'intervals'. The first interval covers the first use of the asset until the day before the start of the business's next tax year. Subsequent intervals align with the business's tax years.

Initial recovery: In the first interval, a business recovers VAT based on the extent to which it expects to use the asset for making taxable supplies. For a fully taxable business, this is 100%. For a partially exempt business, this is determined by its partial exemption method. This initial recovery percentage becomes the baseline for all future adjustments.

Subsequent adjustments: For each subsequent interval, the business calculates the percentage of taxable use for that year. It then compares this to the baseline recovery percentage. The adjustment is calculated using the following formula:

(Total VAT on the capital item ÷ Number of intervals) × (Taxable use % for the interval − Baseline recovery %)

If the result is positive, the business can reclaim more VAT. If it is negative, the business must repay VAT to HMRC.

Case Study 1: The partially exempt property investor

Let's consider a partially exempt business, DevCo Ltd, which buys a commercial property for £1 million plus £200,000 in VAT.

Initial recovery: In the year of purchase, DevCo's partial exemption recovery rate is 70%. It therefore recovers £140,000 of the VAT (£200,000 x 70%). This 70% is its baseline recovery.

Adjustment period: As this is a property, the adjustment period is 10 years. The VAT subject to annual adjustment is £200,000 ÷ 10 = £20,000.

Interval 3: Two years later, DevCo's business model changes, and its taxable use of the property increases. Its partial exemption recovery rate for that year is 90%. The adjustment amounts to:

£20,000 x (90% − 70%) = **£4,000**

DevCo can reclaim an additional £4,000 from HMRC.

Interval 5: Four years later, DevCo loses a major tenant and its taxable use drops. Its recovery rate for that year is only 40%. The adjustment amounts to:

£20,000 x (40% − 70%) = (**£6,000)**

DevCo must repay £6,000 to HMRC.

This demonstrates how the Capital Goods Scheme ensures that the total VAT recovered over the 10-year period accurately reflects the asset's journey through taxable and exempt use.

Case Study 2: The fully taxable business

The Capital Goods Scheme is not just a concern for partially exempt businesses. A business that is fully taxable can be a trap for the unwary, as the following example illustrates.

TradeCo Ltd is a fully taxable manufacturing business.

- **Year 1:** TradeCo buys a warehouse for £1 million plus £200,000 in VAT. As it uses the warehouse entirely for its taxable trade, it recovers the £200,000 of VAT in full. The Capital Goods Scheme adjustment period of 10 years begins.
- **Year 5:** Having outgrown the premises, TradeCo buys a new, larger warehouse for £2 million plus £400,000 in VAT, again recovering the VAT in full. It puts the original warehouse up for sale.
- **The sale:** The lawyers handling the sale ask if TradeCo has 'opted to tax' the original warehouse. It has not. The default VAT treatment for a commercial property sale is exempt from VAT. Without careful diligence, the sale proceeds are an exempt supply.

The consequence: The sale of the warehouse is the final use of the asset by TradeCo. Because the sale is an exempt supply, the Capital Goods Scheme treats the use of the asset for the remainder of the 10-year adjustment period as fully exempt.

The clawback: The sale of the warehouse occurred in Year 5, halfway through the 10-year period. This means that the use for the remaining five full intervals (Years 6, 7, 8, 9, and 10) is now deemed to be fully exempt, whereas the initial recovery was 100%.

The VAT per interval is £20,000 (£200,000 ÷ 10). With five remaining full intervals, this results in a total repayment of **£100,000** simply because TradeCo made an exempt supply.

The solution: This outcome could be avoided. If TradeCo takes action before the sale to make the supply taxable, no Capital Goods Scheme clawback would have been triggered. This is achieved through an ‘option to tax’.

Transfer of a going concern

The long-term nature of the Capital Goods Scheme creates a critical due diligence point when a business is bought or sold as a transfer of a going concern (TOGC). A TOGC is not a supply for VAT purposes, but the Capital Goods Scheme obligations attached to any capital items within the transfer pass to the new owner.

Under the regulations, the buyer is treated as having done everything the seller has done in respect of the capital item. The buyer inherits the Capital Goods Scheme history and must continue making adjustments for all remaining intervals in the adjustment period. This can lead to two outcomes for the buyer:

1. **An unexpected liability:** If the buyer uses the asset for more exempt purposes than the seller did, they may be required to repay VAT that the original seller recovered.
2. **A potential windfall:** If the buyer uses the asset for more taxable purposes, they may be entitled to recover additional VAT that the seller was unable to claim.

It is therefore essential for any buyer in a TOGC transaction to confirm whether any assets are subject to the Capital Goods Scheme and to obtain a full history from the seller to understand any future VAT risks or opportunities. This is also a requirement of TOGCs, although I have significant personal experience of dealing with oversights in this area, so it is clear that this is something that requires greater awareness.

Thinking ahead

The Capital Goods Scheme is a critical and complex piece of the VAT landscape. It demonstrates that decisions made today can have financial repercussions for up to a decade. As our second case study shows, a single transaction, such as the sale of a property, can trigger a significant VAT liability if not managed correctly. Furthermore, the transfer of a business can carry hidden Capital Goods Scheme liabilities.

This brings us to a vital strategic tool in the world of property VAT: the option to tax. By exercising an option to tax, a business can turn an exempt supply into a taxable one, protecting its VAT recovery position and navigating the long-term hazards of the Capital Goods Scheme.

We will therefore demystify the option to tax in my next article, explaining what it is, how to exercise it, and how it serves as the key to addressing many of the challenges raised by both partial exemption and the Capital Goods Scheme.

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