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Understanding the Capital Goods Scheme: Navigating Complexities

Introduction

The Capital Goods Scheme (CGS) was introduced as part of the new Irish VAT-on-property regime that took effect on 1 July 2008. Despite the fact that the CGS has been a fundamental component of the VAT-on-property rules for the past 16 years, it continues to cause confusion among practitioners and property owners. The CGS applies where a taxable person has been charged VAT on the acquisition or development of a property. It also applies to owners of transitional properties. A person to whom the CGS applies is referred to as a "capital good owner" in CGS terminology.

Why Is the CGS Needed?

Central to the operation of our VAT system is the principle that an accountable person may deduct VAT paid on goods and services that are purchased in the course or furtherance of a taxable business. This principle of "deductibility" in the context of VAT paid on property is governed by the CGS. Given that a property is likely to have a long life, changes often occur in the taxable use to which it is put during that useful life.

The CGS is made up of detailed rules that are provided for in ss63 and 64 of the Value-Added

Tax Consolidation Act 2010 (VATCA 2010). These rules regulate the deductibility of VAT paid on property over this useful life, referred to as its "VAT life" or the "adjustment period". The scheme provides that any capital good in respect of which VAT is incurred has a VAT life of either 20 years (for newly developed property) or 10 years (for refurbished property). Under the CGS, annual adjustments may be made throughout the property's VAT life to reflect correctly the actual use of the property for VAT purposes compared with the intended use at the time the VAT was paid. This requirement to continually review how the property is being used can make it challenging for property owners to apply the scheme correctly.

How Does the CGS Operate?

When VAT is paid on the acquisition or development of a property, the normal rules for reclaiming VAT on the acquisition or development of a property are followed. This is based on the principle of "deductibility", referred to above. Therefore, where a business pays VAT on the purchase or development of a property, it can reclaim all of the VAT paid if the property is to be used for the purpose of making fully taxable supplies. However, where a property is intended to be used partly for taxable purposes, the owner is entitled to reclaim the portion of VAT paid that corresponds to the intended proportion of taxable use of the property. Thereafter the capital good owner reviews annually the actual use to which the property is put from a VAT perspective.

The CGS divides the adjustment period of a property into "intervals", which are specific periods of time during which adjustments to deductible VAT may be required in respect of the property. There are 20 intervals for a new property and 10 intervals in the case of property refurbishments. At the end of each CGS interval the capital good owner is obliged to review and, if necessary, adjust the amount of VAT reclaimed based on the actual use of the property compared to its intended use at the time of acquisition or completion.

The CGS intervals may be categorised as follows:

- initial interval,
- second interval and
- subsequent intervals.

It is important that capital good owners understand the meaning of these key terms.

Initial interval

Under the CGS the "initial interval" refers to the first 12 months after the acquisition or completion of a property. This period is crucial to determining the initial use of the property and setting the baseline for future VAT adjustments under the CGS.

At the end of the initial interval the property owner is obliged to undertake a review of the amount of VAT reclaimed. This is to ensure that the VAT reclaimed reflects the actual use of the property for VAT purposes. If there is a difference, the owner must make a VAT adjustment. This is best explained by way of example.

Example 1

On 1 June 2020 XYZ Limited purchased a property and reclaimed all of the VAT paid. This was on the basis that it intended to use all of the property for the purposes of its taxable manufacturing trade. The acquisition cost of the property was €5m plus VAT of €675K (at 13.5%). The company's annual accounting year-end is 31 December. In this case the "initial interval" of the property purchased is the period from 1 June 2020 to 31 May 2021. During this period XYZ Limited used the property solely for the purposes of its manufacturing trade. Therefore, no VAT adjustment was required under the CGS at the end of the initial interval.

Second interval

Under the CGS the "second interval" begins on the day after the initial interval ends and concludes at the end of the property owner's

accounting year in which the initial interval ends. The purpose of the second interval is to align any adjustments that may be required under the CGS with the property owner's accounting year-end. This is intended to facilitate easier integration of the CGS adjustments into regular financial reporting and VAT return processes.

If we continue our example above, the second interval in respect of the property that XYZ Limited purchased on 1 June 2020 refers to the period from 1 June 2021 until 31 December 2021. Where the company continues to use the property solely for the purposes of its taxable manufacturing trade, no adjustment is required in respect of the purchase VAT reclaimed in June 2020.

Subsequent intervals

After the first and second intervals the CGS requires an annual review of the use to which the capital good is put over its remaining VAT life. As previously noted, this is to ensure that the amount of VAT reclaimed reflects the actual use of the property throughout the adjustment period.

If there is a change in the proportion of the property that its used for taxable purposes in any year compared to the use during the initial interval, an adjustment of a proportion of the VAT reclaimed will be required. This means that if the property is used more or less for taxable activities than initially expected, the amount of VAT that can be reclaimed needs to be adjusted as either a payment of overclaimed VAT or a refund of underclaimed VAT.

Where the adjustment period is 20 years, each annual review should consider 1/20th of the VAT initially recovered. In our example above, 1/20th of the VAT recovered is €33,750 (i.e. €675,000 x 1/20th).

Example 2

In January 2024 XYZ Limited entered into a lease to rent out 30% of the floor area of the property that it purchased in June 2020 under a VAT-exempt lease. XYZ Limited is therefore obliged to repay VAT of €10,125 to Revenue each year throughout the term of the exempt letting, calculated as follows:

Total purchase VAT reclaimed (being 100% of VAT paid)	€675,000
Amount of VAT subject to annual review (1/20th)	€33,750
% of property applied to exempt use	30%
Amount of VAT repayable to Revenue for the interval	€10,125 (€33,750 x 30%)

Similarly, where the adjustment period is 10 years, in the case of a refurbishment of an existing property, the annual review will consider 1/10th of the VAT initially reclaimed.

Big-swing adjustment

Special rules apply where the VAT-deductible use for an interval differs by more than 50 percentage points from the VAT-deductible use for the initial interval. Because of the major "swing" in taxable use, a full adjustment is required, and the adjustment is not based on 1/20th of the VAT paid (or 1/10th of the VAT paid, in the case of refurbishments) (ss63(2) and 64(2) VATCA 2010). The adjustment is based on the full VAT incurred at the initial interval reduced by the number of intervals that have already expired in the adjustment period.

After a big-swing adjustment there is a rebalancing of the benchmark figure, and this revised benchmark figure is then used for all remaining intervals in the property's VAT life after the interval in which the big swing occurs. Consistent with the CGS overall, the purpose of the big-swing adjustment is to ensure that the VAT recovery on a capital good accurately reflects its use over time, particularly when there is a significant change in how the property is used in terms of taxable versus exempt activities. The big-swing adjustment may be illustrated by way of examples.

Example 3

ABC Limited bought a building in 2020, in respect of which it paid VAT of €500,000. During the first year after the property purchase, the property was put to fully taxable use by the company, which, accordingly, recovered all €500,000 of the VAT paid in its VAT return for the period in which the purchase took place. Therefore, in each of the following 19 intervals, the potential annual VAT adjustment is €25,000 (being €500,000 ÷ 20). This is referred to as the reference deduction amount.

At the beginning of interval 5 the company rented out 65% of the property under a VAT-exempt lease, meaning that only 35% of the property was being used for taxable purposes. Therefore, there has been a "big swing" in use of more than 50 percentage points in interval 5 compared with the initial interval. In this scenario the adjustment required is with respect to the entire remainder of the VAT life of the property, calculated as follows.

Initial details	
Reference deduction amount (C) (i.e. VAT amount initially deducted when the property was used for fully taxable purpose)	€25,000
Interval deduction amount (D) (i.e. VAT amount deductible in the current interval after the change in use, which is now 35% owing to the exempt lease on 65% of the property)	€8,750
Number of full intervals remaining (N) (this includes the current interval as the change in use occurred at the beginning of interval 5)	16

The formula to calculate the big-swing adjustment is:

$$C - D \times N,$$

i.e. (€25,000 – €8,750) x 16 = €260,000

In this scenario ABC Limited must repay €260,000 to Revenue in interval 5, so that in every future interval the base amount against which recovery is calculated is a recovery of 35%, i.e. €8,750.

CGS and Property Sales

The CGS is very relevant to property sales, and its exact application depends on:

- the VAT treatment of the sale itself, i.e. whether the property sale is taxable or exempt or transfer-of-business (TOB) relief applies, and
- whether the property is a capital good with intervals remaining in its adjustment period.

Taxable sales during the adjustment period

Where a property sale is taxable, the vendor's VAT position depends on its VAT recovery entitlement at the time of acquisition or development of the property. The CGS adjustment will depend on whether the vendor was fully entitled, partially entitled or not entitled to VAT recovery on the initial acquisition or development costs. Indeed, the vendor may be eligible for further VAT recovery based on the taxable use of the property during the adjustment period up to the date of sale.

Example 4

In 2022 D Limited acquired a commercial property for €1m plus VAT at 13.5% (€135,000). However, the company was entitled to reclaim only 50% of the VAT paid as input credit because the property was used for both taxable and exempt purposes. Therefore, the input VAT credit claimed was €67,500. D Limited has a 31 December year-end.

In February 2024 D Limited sold the property for €1.2m and charged VAT of €162,000 on the sale. D Limited is entitled to get back some of the VAT that it did not recover when it purchased the property, as calculated by the formula:

$$\frac{E \times N}{T}$$

where:

E = non-deductible VAT incurred on property acquisition

N = number of intervals remaining plus 1

T = total number of intervals

Applying this formula to the facts in our example:

Original VAT paid	€135,000
VAT credit claimed initially	€67,500
Remaining VAT credit (E)	€67,500
Adjustment period (T)	20 years
Intervals remaining plus 1 (N)	17 + 1 = 18

$$\frac{€67{,}500 \times 18}{20} = €60{,}750$$

D Limited is entitled to a VAT deduction of €60,750, which may be included as input VAT in its January/February 2024 VAT return.

The property now becomes a capital good for the purchaser, and the new CGS commences. The VAT paid on the purchase of the property becomes the purchaser's total tax incurred, and the adjustment period/VAT life will be 20 intervals starting on the date of purchase.

Exempt sale during the adjustment period

If the property is sold and the sale is exempt from VAT, clawback provisions of the CGS will apply. This means that if the vendor had previously recovered VAT on the acquisition or development of the property, a portion of this VAT will need to be repaid to Revenue where the exempt sale takes place during the adjustment period.

Sales subject to transfer-of-business relief

Where a property is sold under the TOB provisions, the CGS implications must be carefully considered TOB relief refers to the VAT relief that mandatorily applies where there is a transfer of goods (including capital goods) to an accountable person and such transfer constitutes transferring the totality or a part of the assets of an undertaking that is capable of being operated on an independent basis. Where the relief applies, the transfer is deemed not to be a supply for VAT purposes and no VAT is chargeable.

A property sale will come within the TOB provisions if the property being transferred is subject to an existing letting agreement, an agreement to lease or a licence to occupy. This is on the basis that such agreements, together with the property, constitute an undertaking that is capable of being operated on an independent basis.

The CGS implications of a property sale that is within the scope of the TOB provisions depend on whether the sale would be taxable or exempt in the absence of the TOB provisions' applying. Where the sale would have been taxable in the absence of TOB relief, the vendor is treated as having used the property for fully taxable purposes for the remaining intervals of the property's VAT life. In such a scenario the purchaser is deemed to have been charged the VAT that would have been charged on the sale. Therefore, the property becomes a new capital good of the purchaser, and if the purchaser is not entitled to recover this VAT cost, the VAT must be paid by the purchaser to Revenue in the period in which the sale took place.

By contrast, where the sale would have been exempt from VAT in the absence of the TOB provisions' applying, the vendor will not incur a clawback of VAT that was recovered on acquisition or development as the vendor's CGS obligations are transferred to the purchaser. To enable the purchaser to meet this obligation, the vendor is required to provide a CGS record to the purchaser, including the following information:

- Capital Goods Records – the vendor is obliged to provide the purchaser with the CGS records related to the property being

transferred (details of the information required in these records are set out below);

- details of the VAT treatment of the property up to the date of transfer – this includes information on any VAT charged or reclaimed on the property during the vendor's ownership;
- a waiver of exemption (if relevant) – if a waiver of exemption was in place for the vendor, details of this should be provided to the purchaser; and
- any binding contractual arrangements that were in place before the sale that might affect the VAT treatment should be disclosed.

Emergency Accommodation

As noted previously, when a property's use changes from taxable or partly taxable to fully exempt, it necessitates a CGS adjustment. This adjustment is needed to account for the change in the taxable use of the property, calculated on a time-apportioned basis.

This is a matter that is very pertinent in the case of hotels and similar businesses that are providing buildings for the provision of emergency accommodation where the buildings were previously used for taxable purposes. In this context the provision of emergency accommodation refers to accommodation in a hotel or guesthouse when contracted to a State agency to be provided exclusively as emergency accommodation and not available as guest or hotel accommodation to the general public, which is regarded as an exempt supply of emergency accommodation. The supply of accommodation for the purposes of Direct Provision also constitutes a VAT-exempt supply of emergency accommodation.

For completeness, it should be noted that the option to tax rents is not permitted where property is used for emergency residential accommodation.

Also, services such as laundry of bedlinen, security, reception and administration that are included in the cost of emergency accommodation are considered to be ancillary supplies and, hence, are also VAT exempt. However, catering services are not considered ancillary to the supply of emergency accommodation.

Development by a Tenant

Where a property is leased and the tenant carries out development on the property, it is important that both the landlord and the tenant are aware of the potential CGS considerations. Where the tenant is entitled to reclaim some or all of the VAT paid on the refurbishment works, the tenant creates a new capital good arising from the work on the property. This capital good is separate from the underlying property and has an adjustment period of 10 years. Importantly, the tenant is regarded as the owner of this capital good and has the following obligations in respect of the capital good:

- The tenant is obliged to monitor and adjust for any changes to the VAT use of the capital good throughout the 10-year adjustment period.
- The tenant is required to make annual adjustments based on the actual use of the capital good compared with the intended use declared at the outset. This is part of the normal CGS obligations and involves adjusting the VAT recovery if the use of the capital good changes.
- If a tenant assigns or surrenders the lease of a property within the 10-year adjustment period, then the tenant must ensure that the CGS obligations are passed to the landlord or new tenant, as relevant. This means that:
  - The tenant may be required to pay to Revenue a portion of the VAT recovered on the development.
  - If there is full VAT recovery by the tenant on the refurbishment costs, the tenant and the landlord can agree that the landlord takes over the tenant's capital good and related obligations. This agreement must be in writing, and the tenant must provide the Capital Goods Record.

Compliance with these obligations is crucial for tenants to avoid potential clawbacks of VAT reclaimed and to ensure a smooth transition of CGS responsibilities in case of lease assignment or surrender. The following example sets out the operation of the CGS in relation to refurbishment work by a tenant on a leasehold property.

Example 5

On 1 June 2022 LM Limited entered into a lease on a property and undertook development work to prepare the unit for trading. The total cost of this work was €600,000 plus VAT @ 13.5% of €81,000. LM Limited reclaimed 90% of this VAT (being €72,900), on the basis that the property was to be used for 90% taxable activities.

The development work was completed on 23 July 2022, and the initial interval for the capital good commenced on that day. After the end of the initial interval LM Limited realised that the property was in fact being used for 100% taxable activities, contrary to the initial expectation of 90%.

In this situation the CGS adjustment for LM Limited is:

Total VAT incurred: €81,000

Base VAT amount: €8,100 (i.e. €81,000 ÷ 10)

Initial reclaimed VAT: €72,900 (i.e. 90% of €81,000)

Revised reclaimable VAT: €81,000

On the basis that the actual taxable use of the property is higher than initially anticipated, LM Limited is entitled to reclaim the additional VAT that was not initially reclaimed, calculated as follows:

€81,000 – €72,900 = €8,100

LM Limited can apply for a refund of VAT of €8,100 as a result of this CGS adjustment, reflecting the increased proportion of taxable use of the property by LM Limited, the capital good owner.

Transitional Properties

In the context of the VAT-on-property rules a transitional property refers to properties that were in existence on 1 July 2008 and includes properties that were held on that date but were not completed. A transitional property may be a freehold interest or under a lease of 10 years or more that was subject to VAT when it was created (a so-called legacy lease under the pre-July 2008 VAT-on-property rules).

There are specific CGS rules in relation to transitional properties, which recognise their status at the time of the change in the VAT-on-property rules on 1 July 2008. The following are key points regarding the operation of the CGS in relation to transitional properties:

- The normal CGS requirement to make annual adjustments based on the proportion of taxable use versus exempt use does not apply to transitional properties.
- The big-swing adjustment rule applies only where the property is used for the first time or there is a change in taxable use of more than 50 percentage points on or after 23 February 2010.
- The normal adjustment on the exercise and termination of the landlord's option to tax a letting of a transitional property does not apply. However, where the owner makes an exempt letting of such a property, a deductibility adjustment independent of the CGS is required.
- If a transitional property is sold during the adjustment period and the sale is VAT exempt, the CGS clawback provisions in relation to exempt supplies apply.
- If a transitional property is sold during the adjustment period and the sale is taxable, the additional CGS input credit provisions in relation to taxable supplies apply.

Capital Goods Record

A capital good owner is obliged to maintain a Capital Goods Record (CGR) of a property capital good that the owner has acquired or developed from 1 July 2008. To ensure

accurate tax reporting and compliance, the CGR should contain:

- the amount of the total tax incurred on its acquisition or development,
- the amount of the total tax incurred that is deductible,
- the date on which the adjustment period begins,
- the number of intervals in the adjustment period,
- the initial interval proportion of deductible use,
- the total reviewed deductible amount,
- the proportion of deductible use for each interval,
- details of any adjustment required to be made in accordance with s64 VATCA 2010 (big-swing rules) and
- details of any sale or transfer of the capital good or details of any assignment or surrender of a lease where responsibility for the tenant's refurbishment is assumed by the assignee or landlord.

The purpose of the CGR is to track the adjustment period of the capital good, which is essential to determining the VAT adjustments required based on the use of the property. It is used to calculate the required adjustments during the adjustment period, including changes to the use of the property that might impact the proportion of deductible VAT.

Also, as noted above, where a property is transferred under TOB rules, the vendor must provide the purchaser with the CGR. This is to ensure that the purchaser has the information needed to continue complying with the CGS in respect of its newly acquired property.

Practical Issues

Unsurprisingly, practical issues often arise, which reflect the complexity and detailed nature of the CGS:

- Correctly identifying the initial interval and subsequent intervals for CGS adjustments, and understanding the obligations at the end of each interval, can be intricate.
- Maintaining detailed records, by way of the CGR, over the lengthy adjustment period of a property can be challenging.
- The requirement to make a big-swing adjustment when the taxable use of a property changes by more than 50 percentage points can be complex. Identifying such swings and understanding when and how to apply the adjustment can be problematic.
- Understanding how the CGS applies to transitional properties can be challenging.
- Difficulties can arise for property purchasers where TOB relief applies to the transfer. Obtaining sufficient CGRs can be challenging, particularly in the case of sales by a receiver or liquidator.

Conclusion

This article discusses the key challenges and obligations of capital good owners in respect of the CGS. The scheme is a complex set of rules that regulate the deductibility of VAT paid on property over its VAT life and it can be challenging to apply correctly. By way of guidance for capital good owners, the following steps are recommended:

- Understand the key terms and their obligations under the CGS, including adjustment period, intervals and the big-swing adjustment rule;
- Maintain detailed records by way of the CGR over the lengthy adjustment period of the property;
- Continually review the use of the property and make necessary adjustments to reflect the actual use of the property for VAT purposes;
- Seek professional advice when necessary to ensure compliance with the complex set of rules that regulate the deductibility of VAT paid on property over its VAT life.