

Goods and services used by taxable persons for both business and non-business use

HM Revenue & Customs (HMRC) have announced changes in their policy on the recovery of VAT incurred on certain goods and services supplied to a business and used for both business and non-business purposes.

Background

Under Article 6(2) of the EC Sixth VAT Directive the private use of goods forming part of the assets of a business is treated as a taxable supply of services, and thus as liable to output VAT. In 1991 the European Court of Justice (ECJ) decided that taxable persons making both business and private use of goods had a right to full and immediate deduction of input tax on purchases, and could then account for the private use of the goods (as a supply of services) as this took place. It was not necessary for input tax to be apportioned initially between business and private use, with a deduction being denied for the latter. (The so called "Lennartz principle").

In FA 2003 changes were made to UK law in response to two developments. First, Customs formed the view that the Lennartz principle was being exploited unfairly. Secondly, the ECJ found that the principle could be applied to construction services, opening its use up to taxable persons incurring VAT on constructing a building in addition to those purchasing a major interest in a building.

The FA 2003 changes provided that where land and buildings or civil engineering works used in the business were put to non-business use this did not constitute a supply of services for a consideration. In Customs' view this meant that where such items were purchased for mixed business and non-business use the taxpayer had no right to recover the VAT incurred to the extent that it was attributable to the non-business use. In making these changes the UK relied on the proviso to Article 6(2) that 'Member states may derogate from the provisions of this paragraph provided that such derogation does not lead to distortion of competition'.

Recent developments

In the case of *Charles & Chartes-Tijmens v Staatssecretaris van Financien*. The appellants had purchased a holiday bungalow in the Netherlands with the intention of using it 87.5 percent for business rental and 12.5 percent for private purposes. The Dutch tax authorities maintained that a deduction was available for only 87.5 percent of the VAT incurred. However, the ECJ found that the derogation in Article 6(2) could not be used to deny taxpayers the right to treat all the VAT incurred as input tax when they purchased capital goods for mixed business and private use and allocated the goods wholly to the business. The result is that the UK's legislation in FA 2003 is ultra vires.

HMRC's new policy

HMRC has therefore revised its policy so that the Lennartz mechanism is now available for VAT incurred on the purchase of land, buildings and civil engineering works with mixed business and non-business use where the goods are allocated wholly to the business. It can also be used for construction services that result in the construction of a new building or civil engineering work, or a major refurbishment or extension of an existing building. This approach relies on the direct effect of the Sixth Directive, overriding the UK legislation. HMRC will require the output tax charge under the Lennartz mechanism to be calculated over a maximum 20-year period based on straight-line depreciation, unless a shorter period is appropriate (for example, where a taxpayer's leasehold interest in the building has under 20 years to run).

The mechanism continues to be available for other types of goods (for example, computers, yachts and motor caravans) with mixed use, where these are allocated wholly to the business. For such assets HMRC will normally require the output tax charge to be calculated over a maximum of five years, based on straight-line depreciation.

This VAT update is published for the general information of 4 Eyes Ltd personnel, clients and contacts. It provides only an overview of the rules and regulations in force at the date of publication, and no action should be taken without consulting the detailed legislation or seeking professional advice. Therefore no responsibility for loss occasioned by any person acting or refraining from action as a result of the material contained in this e-mail will be accepted by the authors or the firm.

The Lennartz mechanism also continues to apply in respect of purchases of services that are incorporated into goods used in the business, significantly increasing their value to the business. It does not apply, however, to VAT on services that are consumed in relation to day-to-day activity such as repair and maintenance; this must continue to be apportioned.

The business is not obliged to use the Lennartz mechanism where it is available; it may choose to treat as input tax only the proportion of the VAT incurred that relates to business use.

There is no change to the way that partial exemption operates. If the asset is to be used for both taxable and exempt purposes (as distinct from business and non-business use) input tax can only be deducted in accordance with the applicable partial exemption method. If the current partial exemption method does not facilitate the use of the Lennartz mechanism, HMRC will consider proposals for a revised method; they will not, however, approve a method that gives a good result for the purposes of the Lennartz mechanism but does not achieve a fair and reasonable result overall.

If the asset continues to be used for non-business purposes at the end of the 20-year or five-year period no further output tax will arise. If the goods are sold or the taxpayer deregistered (other than on a transfer of a going concern) whether before or after the expiry of this period, they are treated as wholly business assets, so that VAT may well be due on the full selling price. This would not arise if apportionment of VAT between business and non-business use had been made at acquisition. Use of the Lennartz mechanism may therefore not always work to the advantage of the taxpayer, particularly where the goods increase in value.

HMRC have stated that they will challenge any attempts to exploit the Lennartz mechanism to obtain an unfair advantage by introducing artificial arrangements.

Claims for repayment of VAT

HMRC have indicated that businesses that wish to make claims for input VAT on the supply of construction services, or on the purchase of land, buildings and civil engineering works, or past claims for other services, may do so by making a voluntary disclosure to their local VAT office, subject to the normal limit that restricts late claims for input tax to three years from the due date of the return for the VAT accounting period in which the input tax was chargeable. Such claims must take into account any output VAT due under the Lennartz mechanism up to that point.

Claims for construction services and land, buildings and civil engineering work purchased prior to 9 April 2003, when the FA 2003 changes took effect, will not be accepted because businesses already had the option of using the Lennartz mechanism before that time. For periods thereafter claims will be accepted provided they are made no later than six months from the issue of HMRC's revised policy on 9 August 2005.