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YACHTING VAT NOTE



THE LENNARTZ HAVE IT

The cases that flesh up the EU VAT law often begin innocently enough. So it was with the Lennartz case in 1985 in Germany. Hansgeorg Lennartz worked partly as an employed person and partly as a self-employed tax consultant. He registered for VAT and submitted annual VAT returns in respect of his self-employed activity. He purchased a car using it mainly for private purposes and to a limited extent for his business. When subsequently opening his own tax consultancy office, he decided to contribute the car to the business. He believed that this entitled him under the law to reclaim a proportionate amount of the VAT which he had paid on the car, being the VAT relating to his business use of the car. So, in his next VAT return, Mr Lennartz claimed that small percentage retroactively.

But the German tax authorities refused to grant Mr Lennartz that retrospective reclaim on the basis that he had initially acquired the car solely for private purposes. The fact that Mr Lennartz subsequently used the car for business purposes was irrelevant. Moreover, the use in question could not qualify for VAT deduction anyway, because of the erstwhile German administrative practice whereby no account was taken of the business use of goods where such use accounted for less than 10% of total use. Mr Lennartz's use of the car for his business amounted to about 8%.

That position of the German authorities seemed logical and unassailable. That is, until the redoubtable Mr Lennartz decided to pursue his case in the national court. The court considered the matter in the light of both the German national VAT law and the overriding EU source law, the Sixth Directive. It was then that the doubts surfaced: was the interpretation and practice of the law by the German authorities indeed correct in premising VAT deduction on the initial use of capital assets and the amount of such use? The German court decided to refer the case to the European Court of Justice (ECJ) for clarification and a ruling.

It's all about rights and obligations

The 1991 ECJ ruling did not so much settle the particular Lennartz case, rather, it gave firm guidance and set down the key principles that must apply in this and other cases where capital goods are acquired for mixed use – i.e. for both business and private or non-business purposes.

The focus was on the nature and the exercise of the right to deduct VAT incurred on the purchase of capital goods, and the consequences of such deduction. Firstly, the right to deduct VAT arises from the capacity of the person involved at the time of the acquisition of the goods. If acting in his capacity as a business it must be presumed that the person would use the goods for the purposes of the business and he is thereby entitled to immediately deduct the tax due or paid.

Conversely, if he is a private person then it should be presumed that he would use the goods for their private consumption and no right to deduct can arise. Secondly, the right to deduct the VAT arises at the time of the purchase of the goods, when the deductible tax becomes chargeable, not when the goods are subsequently allocated to a particular business use. Thirdly, the use to which the goods are put, or are intended to be put, merely determines the extent of the initial deduction to which the business is entitled and the extent of any subsequent adjustments in the course of the following periods. Fourthly, the right of a business to deduct VAT immediately on purchase of goods applies however small the proportion of business use. And, lastly, the ECJ underlined the requirement for EU member states to protect these rights of a business – they must obtain specific derogation under the Sixth Directive before restricting these rights in any way.

So much then for the rights of the taxpayer, but the ECJ also specified the following corresponding obligations too. For one, in order to meet the administrative and accounting requirements governing the exercise of the deduction rights within the VAT system, the Court affirmed the role of the authorities to determine in any particular case whether a person has indeed acquired goods for the purposes of his business. That determination is done in the light of all the circumstances of the case and must include an assessment of the nature of the goods concerned and the period between the acquisition of the goods and their use. For the other, and perhaps most critically, once the taxpayer has treated mixed use goods as business goods and partly or wholly deducted the tax on their acquisition of those goods, the exploitation of those goods for the private use of his business, or his staff, or for purposes other than those of his business, must be treated as a supply of services for consideration and taxed on the basis of the cost of providing the services. In other words, where a person chooses to treat a yacht as forming part of the assets of his business and subsequently uses that yacht partly for private purposes, on the one hand, he is entitled to deduct the VAT paid on all construction costs relating to the yacht, on the other, he is subject to the corresponding obligation to pay VAT on the amount of expenditure incurred to effect such use.

That, in essence, is the "Lennartz principle". It is the approach which allows full VAT recovery up front, with a subsequent adjustment to output tax to reflect any private or non business use. It is the non-aggressive approach to tax savings favoured by most cautious VAT advisors, because of its in-built deferment mechanism. And it is the only optional treatment in cases of mixed use that is sanctioned by the EU's highest Court. The UK has taken the telltale step of putting this approach in statute by way of the *Lennartz Accounting Regulations 2007*, which it has explained by citing the yachting sector as one of several targets. In the increasingly choppy waters of EU VAT, those who choose to play safely within the VAT system and reap the benefits of VAT recovery will do well to remember Lennartz.

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