EXPLANATORY MEMORANDUM TO

THE VALUE ADDED TAX (AMENDMENT) (No. 6) REGULATIONS 2007

SI 2007 No. 2922

1. 1.1 This explanatory memorandum has been prepared by Her Majesty's Revenue and Customs and is laid before the House of Commons by Command of Her Majesty.

1.2 This memorandum contains information for the Select Committee on Statutory Instruments.

2. Description

2.1 These Regulations, which come in to force on 1st November 2007, amend the Value Added Tax Regulations 1995 ("the 1995 Regulations") (S.I. 1995/2518) by inserting Part 15A of the Regulations (regulations 116A to 116N).

2.2 Part 15A provides a method of calculating the value of all supplies in respect of the non-business use of business assets which arise by virtue of paragraph 5(4) of Schedule 4 to VATA where the use giving rise to the supply occurs during the economic life of the goods as determined in that part of the 1995 Regulations.

3. Matters of special interest to the Select Committee on Statutory Instruments

None

4. Legislative Background

4.1 The Value Added Tax Act 1994 ("VATA") and the subordinate legislation made under it implement the United Kingdom's obligation under EC law (principally by virtue of Council Directive 2006/112/EC ("the VAT Directive") (formerly Directive 77/388/EEC "the Sixth Directive")) to charge a turnover tax on supplies by businesses of their goods and services. Businesses may deduct the VAT they pay on goods and services supplied to them from the VAT they are required to account for provided the goods and services are used for making supplies in the course of their business that are taxable supplies.

4.2 Article 26(1)(a) of the Directive (formerly Article 6(2)(a) of the Sixth Directive) requires that where goods in relation to which a business has deducted VAT incurred on them are used for non-business purposes, the business must be treated as if it had made a supply of services in relation to that use. It must account for VAT accordingly by virtue of Article 75 of the

VAT Directive (formerly Article 11A1(c) of the Sixth Directive) on the "full cost" of providing those services. The directive does not provide guidance as to the method of calculating the "full cost" of providing the services. Case law of the European Court of Justice has established that "full cost" of the services must be based on the taxable costs of acquiring the asset, spread over a suitable economic life. The cost of the services for a particular VAT return period is computed by taking the part of the asset cost attributed to that period, and multiplying by the percentage of non-business use in that period. The longer the economic life, the smaller the part of the asset cost attributed to any particular VAT return period within that life.

4.3 The United Kingdom implemented the requirements of Article 75 of the VAT Directive by paragraph 5(4) of Schedule 4 and paragraph 7(b) of Schedule 6 to VATA. These provided that the value of such supplies should be the "full cost" to the taxable person of providing the services, but do not prescribe how this calculation should be done.

4.4 Businesses that purchase goods for use for business and non-business purposes enjoy a cash-flow advantage: they recover input VAT on purchasing the asset even though it is in part attributable to the intended non-business use, and instead pay output VAT on the actual non-business use over the life of the asset. This advantage as well as the existence of potential avoidance schemes and artificial arrangements (see Policy Background) prompted the UK to introduce legislation amendments which prevented businesses claiming VAT deduction to the extent that the land or building upon which VAT had been paid would be used for non-business purposes, whilst ensuring that VAT would still be due if a business changed the use of land or buildings from wholly business use to part non-business use after the initial input tax claim. The relevant legislation is section 22 of the Finance Act 2003 (c. 14) (which inserted sub-paragraph (4A) into paragraph 5 of Schedule 4 to VATA) and the Value Added Tax (Supply of Services) (Amendment) Order 2003 (S.I. 2003/1055)("the 2003 Order") (which inserted articles 3A and 3B into Value Added Tax (Supply of Services) Order 1993 (S.I. 1993/1507) ("the 1993 Order")).

4.5 In 2005, a similar strategy adopted by the Netherlands was held to be unlawful by the European Court of Justice in its judgment in ***P Charles and T S Charles-Tijmens v Staatssecretaris van Financiën (Case C-434/03) ("Tijmens")***. As a result the UK reversed the 2003 changes described above; Section 99(2) of the Finance Act 2007 (c. 11) repealed paragraph 5(4A) of Schedule 4 to VATA with effect from1st September 2007. Articles 3A and 3B of the 1993 Order were removed by the Value Added Tax (Supply of Services) (Amendment) Order 2007 (S.I. 2007/2173).

4.6 In 2006 the European Court of Justice held in ***Hausgemeinschaft Jörg und Stefanie Wollny v Finanzamt Landshunt (Case C-72/05)*** ("Wollny") that Member States could determine how taxpayers should calculate the value of deemed supplies arising from the non-business use of buildings forming part of the assets of a business. In particular, they could limit the economic life to the period of time over which input tax adjustments are made under

Article 187 of the VAT Directive (formerly Article 20(2) of the Sixth Directive) the "capital goods scheme".

4.7 Adjustments under Article 187 relate to VAT paid on "capital goods" and deducted from tax payable on sales as described at paragraph 4.1 above. The business use of capital goods by a business can change during the capital goods scheme adjustment period so that the initial deduction no longer reflects the use in making taxed supplies. For example, if the use in making exempt supplies increases then the business must repay some of the input tax they initially deducted. The same happens if the asset is sold as an exempt supply.

4.8 Article 187(1) of the VAT Directive allows Member States to choose an adjustment period of up to 20 years in the case of immoveable property such as land and buildings and prescribes a period of 5 years in respect of other capital goods. The UK has a nominal adjustment period of ten years for most interests in land and buildings, although because it is linked to the "VAT years" of the taxable person for partial exemption purposes, the actual period is between nine and ten years in practice.

4.9 In the light of the Wollny judgment, paragraph 7 of Schedule 6 to VATA was amended by section 99(5) and (6) of the Finance Act 2007 so as to afford the Commissioners for Her Majesty's Revenue and Customs power to make regulations for determining how the full cost to a business of the supplies arising by virtue of paragraph 5(4) of Schedule 4 to VATA should be calculated.

4.10 By virtue of these Regulations 2007, Part 15A has been inserted into the 1995 Regulations to provide a method of calculating the value of all supplies arising under paragraph 5(4) of Schedule 4 to VATA by reference to the economic life (of 5 or 10 years) attributed by those regulations to the goods described therein. In particular, the new regulations provide that, in relation to land and buildings (which are brought within the meaning of "goods" for purposes of paragraph 5(4) of Schedule 4 to VATA by virtue of paragraph 9 of that Schedule), the calculation of the value of the supplies is made by reference to an economic life approximately equal to the capital goods scheme adjustment period.

4.11 In consequence of limiting the economic life of goods as described, the Treasury has, by the Value Added Tax (Special Provisions) (Amendment) Order 2007 (S.I. 2007/2923), exercised the power afforded by section 5(3) of VATA to amend the Value Added Tax (Special Provisions) Order 1995 (S.I. 1995/1268) by inserting article 10A to that Order which provides that no supply under paragraph 5(4) VATA arises in respect of the use of goods which, for the purposes of Part 15A of the 1995 Regulations, have no economic life at that time.

5. Extent

This instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

As the instrument is subject to negative resolution procedure and does not amend primary legislation, no statement is required.

7. Policy background

7.1 Businesses that purchase goods for use for business and non-business purposes enjoy a cash-flow advantage: they recover input VAT on purchasing the asset even though the VAT is partly attributable to the intended non-business use, and instead pay output VAT on the actual non-business use over the life of the asset.. If the proportion of non-business use does not change, the overall effect is simply to spread the VAT cost over the life of the asset. By contrast, VAT paid assets purchased by businesses and consumers which are not intended to be used for any business purpose cannot be reclaimed so that the whole of the VAT cost is borne immediately at the time of purchase.

7.2 The uncertainty in relation to calculating the "full cost" of the deemed supplies in relation to the non-business use of goods has been exploited by some businesses to gain significant tax advantage. Land and buildings are particularly vulnerable to such exploitation on account of businesses claiming credit for all of the VAT charged in relation to purchase or construction costs but accounting for small amounts of VAT for non-business use by arguing that the costs should be apportioned over an extended economic life of the land or building. Economic lives of 50 years or longer have been claimed, even though this is contrary to guidance issued to taxpayers that a 20-year life should be used. Artificial schemes to exploit this VAT accounting system to recover VAT on buildings used for exempt business purposes have now been devised by tax advisors.

7.3 In addition, some taxpayers avoid the output VAT charges for non-business use long before the economic life of the goods is finished, for example by selling the building exempt from VAT, or entering into lease and leaseback arrangements. This converts a cash-flow advantage into an absolute VAT advantage: non-business use thereafter goes entirely untaxed. In general such avoidance has to be undertaken after the capital goods scheme period for buildings expires otherwise some of the input tax initially deducted would have to be repaid under the capital goods scheme rules.

7.4 In 2003 the UK legislated to prevent this form of VAT accounting being used for land and buildings, so that businesses which are registered for VAT were required to apportion VAT incurred on acquiring land or the construction of a building intended for use for both business and non-business purposes, and not recover the non-business portion. However, the judgment of the European Court of Justice in the *Tijmens* case in 2005 made it clear that EC VAT law does not permit Member States to require businesses to apportion VAT in this way (although they may choose to do so if they wish).

7.5 Following the decision in *Tijmens* businesses could ignore the changes made to UK legislation in 2003 (see paragraph 4.5 above). HMRC issued a Business Brief which set out how business should account for the ongoing non-business use of their asset. In this HMRC set an economic life of 20 years for land and buildings and 5 years for other goods; 20 years being the longest adjustment period envisaged by Article 187 of the VAT Directive (formerly Article 20(2) of the Sixth Directive). The longer period of 20 years being offered in the light of ongoing challenges for much longer economic lives and a degree of uncertainty as to how the EC legislation would be interpreted by the European Court of Justice. Following the judgment of the European Court of Justice in the *Wollny* case, the matter was mostly resolved. The Court held that Member States may match the economic life of a business asset with the adjustment period used by that State for Article 187 adjustments (the capital goods scheme). In the UK VAT paid on the supplies relating to land and buildings described in Part 15 of the 1995 Regulations fall for adjustment under the capital goods scheme rules over a period of 10 years.

7.6 Defining the economic life of a business asset to equal (or approximately equal) the ten year capital goods scheme adjustment period prevents businesses entering into schemes to avoid the tax required for non-business use of the asset after expiry of the capital goods scheme adjustment period in order to obtain an absolute VAT advantage, and puts reasonable limits on the cash-flow benefit. It ensures that, over that life, any VAT which has been recovered in respect of the asset, is adjusted to reflect non-business or private use of that asset. Consequently, at the end of the economic life the business will have had credit for the correct amount of VAT comprising the initial deduction of input tax less the output tax paid in respect of the deemed supplies arising by virtue of paragraph 5(4) of Schedule 4 to VATA.

7.7 The changes made by the Value Added Tax (Special Provisions) (Amendment) Order 2007 ensure that at the end of the economic life of the goods, no further VAT is due in respect of any future deemed supplies. This approach is consistent with the requirements of the VAT Directive.

7.8 The views of the sectors most affected by the changes, the charity and education sectors, have been sought. Some concerns were expressed that the shortening of the economic life would create some cash flow difficulties for some organisations that had planned on spreading the irrecoverable VAT cost of buildings over 20 years or longer. While it is accepted that that this may be the case, it is considered that the immediate full tax recovery is a significant advantage and that the transitional relief contained in these Regulations, assist with the move to a shorter adjustment period. The transitional provisions require the deemed supplies in respect of non-business use from 1st November 2007 to be calculated on one tenth or one fifth of the asset cost each year, as under the new regime. The provisions take account of the previous payments made by the taxable person in respect of non-business use of the asset and use this to calculate a new economic life, which runs for up to 10 years, until the whole cost of the asset has been taken into account in computing non-business use charges.

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8. Impact

8.1 A Regulatory Impact Assessment is attached to this memorandum.

8.2 The impact on the public sector, which will include the NHS and education sectors, is significant in that for land and building costs the new Regulations will reduce the cash flow advantage they currently enjoy as a result of the immediate recovery of what would essentially be irrecoverable VAT. However, where the capital expenditure is publicly funded and the irrecoverable VAT, which the organisation would ultimately suffer, is included in the funds, the impact will simply be to reduce the period over which the organisation enjoys an interest-free loan from the Exchequer.

9. Contact

David Webb at Her Majesty’s Revenue and Customs Tel: 020-7147-0641 or e-mail: david.webb@hmrc.gsi.gov.uk can answer any queries regarding the instrument.

Regulatory Impact Assessment: VAT: Implementation of European Court of Justice decisions Charles & Charles-Tijmens and Wollny

Purpose and intended effect

Objective

To introduce appropriate legislative controls to 'Lennartz accounting' in order to protect VAT revenues and help clarify the process for organisations using 'Lennartz accounting', by implementing certain decisions of the European Court of Justice (ECJ) in the 'Lennartz' strand of case law.

Background

So-called 'Lennartz accounting' derives from decisions of the ECJ. It allows taxpayers to treat a new asset as a wholly business asset, even if there will be some non-business use and even if business use is very small. This means they can recover all the VAT incurred on the asset immediately and then account for VAT on the non-business use over the economic life of the asset ("non-business use charges"). This spreads the cost of irrecoverable VAT over the economic life of an asset. If Lennartz accounting is not used, the VAT is apportioned between business and non-business use at the outset and there is no further adjustment. The choice of whether to use Lennartz accounting is implicit in EU and UK law.

To date, there have been no specific rules dealing with Lennartz accounting in the UK: the ECJ's decisions have been allowed to apply directly. This is possible because the ECJ has consistently said that Lennartz accounting is implicit in EC (and therefore UK) law: the decision to allocate the asset wholly to business purposes is made at the outset and VAT law is then applied accordingly.

In 2003 legislation was introduced which was intended to prevent Lennartz accounting on land and buildings. This legislation was rendered ineffective by the ECJ's decision in *Charles & Charles-Tijmens* (C-434/03). Subsequently, HMRC accepted that Lennartz accounting could apply to land and buildings, and adopted a policy that the economic life of the asset should be 20 years. Subsequently, the ECJ decided in *Wollny* (C-72/05) that an EC member State could introduce legislation to make the Lennartz accounting period the same as the scheme for adjusting input tax on capital items (the UK's capital items scheme provides for a 10 year adjustment period).

In view of the above, the Government has decided to introduce three measures:

1. To implement the European Court of Justice (ECJ) decisions in *Charles & Charles-Tijmens* by repealing ineffective legislation.

2. To implement the European Court of Justice (ECJ) decisions in *Wollny* by limiting the period over which so-called 'Lennartz accounting' occurs.

3. To clarify the legislation to resolve what is arguably a loophole.

Rationale for Government intervention

1. Certain legislation should be repealed because the decision of the ECJ in *Charles & Charles-Tijmens* has rendered it ineffective. If action is not taken, dead wood is left which might confuse tax payers or even be manipulated by those seeking to avoid VAT.

2. The decision of the ECJ in *Wollny* allows the UK to legislate to set out the process of accounting for VAT on non-business use of 'Lennartz assets'. To date there has been no explicit process in the legislation. This change clarifies the process and helps protect VAT revenues and provide certainty for our customers. If action is not taken uncertainties will remain for affected organisations and HMRC, and VAT revenues will suffer.

3. There is a possible loophole which, if exploited successfully, could enable organisations to make an absolute VAT saving of up to 50% of the VAT initially incurred. The position is being clarified to give customers certainty and protect the revenue. If action is not taken at the same time as the above measures, it may prevent an attractive exit route for those seeking to avoid VAT.

Consultation

There has been an ongoing dialogue between HMRC and businesses for a number of years concerning the correct interpretation of number of decisions of the ECJ in this area. The first two measures above implements two clear ECJ decisions in the context of that dialogue. Draft legislation for the main change, measure 2 above, should be published in time for consultation before the intended implementation date of 1 September.

Options

Option 1 – Implement all three measures

This option repeals ineffective legislation, protects the revenue and clarifies the process for accounting for VAT on non-business use charges.

Option 2 – Implement only measure 1

This option only repeals the ineffective legislation, with a view to making the minimum change necessary to keep UK legislation in line with the ECJ case law. This option carries the risk of deterioration in terms of increased revenue loss and ongoing confusion for our customers in terms of the absence of any regulations governing the 'Lennartz accounting' process. This option might

also encourage non-compliant organisations to try to exploit the absence of ‘Lennartz accounting’ regulations.

Option 3 – Do nothing

This option carries the risk of deterioration in terms of increased revenue loss and ongoing confusion for our customers in terms of the absence of any regulations governing the ‘Lennartz accounting’ process. This option might also encourage non-compliant organisations to try to exploit the absence of ‘Lennartz accounting’ regulations.

Costs and benefits

Sectors and groups affected

These measures affect any organisation with both business and non-business activities, or any business which has regular non-business use of business assets. Primarily, organisations in the education, health and charity sectors are using ‘Lennartz accounting’, although in principle any business sector might be eligible, depending on the way their assets are used. In addition, some businesses are looking at ways to exploit ‘Lennartz accounting’ artificially.

Analysis of costs and benefits

Option 1. This option results in negligible additional compliance burden on businesses and other organisations in terms of familiarisation with the new rules. It also results in a negligible reduction in administrative burden in that (in simple terms) Measure 2 halves the period over which non-business use must be monitored and non-business use charges must be calculated and paid. Option 1 also produces the benefits of clearing ‘dead wood’ in the legislation, clarifying the process of accounting for non-business use charges and protecting VAT revenue.

Option 2. This option results in negligible additional compliance burden on businesses and other organisations in terms of familiarisation with the new rules. Option 2 has the benefit of clearing ‘dead wood’ in the legislation.

Option 3. This option has no immediate effect on costs and benefits.

Summary of costs and benefits

Option 1 involves negligible, and offsetting, compliance cost additions and reductions. It provides certainty for customers and helps to protect VAT revenues.

Small Firms Impact Test

Small firms that use ‘Lennartz accounting’ will be affected by these changes. The effect will be to regulate the cash flow advantage that has been enjoyed by those that have used ‘Lennartz accounting’.

Competition Assessment

The competition filter test has been applied and the changes passed. The changes will not impact directly on any particular markets as 'Lennartz accounting' can in principle be used across all sectors by any size of business. Sectors where assets are commonly purchased for both 'business' and 'non-business' use include, Health, Education and Charities. The introduction of legislative controls to Lennartz accounting are not expected to have any significant effects on competition in any sector although they will make it easier for those businesses that purchase assets for both 'business' and 'non-business' use.

Enforcement, sanctions and monitoring

This will be enforced through the normal operation of the VAT system, including HMRC's assurance programme. VAT repayment claims relying on 'Lennartz accounting' will continue to be separately monitored to detect trends to inform policy-making and identify artificial avoidance activity.

Implementation and delivery

These Measures involve very minor change to the VAT system, so will be implemented and delivered through the Finance Bill, secondary legislation and the normal VAT assurance programme. Measures 1 & 2 will be effective from 1 September 2007 and measure 3 will be effective from Budget Day. Guidance to customers will be provided as early as possible to ensure that the measures can be implemented as easily as possible.

Compliance Cost Review

A compliance cost review should be carried out two or three years after introduction of the legislation.

Summary and recommendations

We recommend Option 1 because it delivers real benefits to both external organisations and HMRC with no overall additional administrative burden, as well as protecting VAT revenue in a significant area.

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Declaration

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

DAWN PRIMAROLO
PAYMASTER GENERAL

Date 1st March 2007