

VAT Information Sheet 14/07

November 2007

HMRC Guidance -Assets used partly for non-business purposes – implementation of 'Lennartz Accounting' Regulations

1. Introduction

What is this Information Sheet about?

This Information Sheet provides comprehensive guidance on the 'Lennartz Accounting' regulations, which came in to force on 1 November 2007.

2. Guidance

2.1 'Lennartz' VAT accounting introduction

At the time a taxable person receives a supply he may be doing so either in the capacity of a private person or in the course of his business. The capacity in which he is acting will determine whether he can deduct the VAT incurred on that supply as input tax.

If the supply is used solely for making supplies in the course of his business, all of the VAT is input tax and he is entitled to deduct the input tax incurred to the extent it is used for making taxable supplies (or other supplies carrying a right to input tax deduction under Value Added Tax Act S26: references to taxable supplies in this section should be read accordingly).

Where he incurs tax on goods that are intended for both business and private/nonbusiness purposes, he has a choice as to how to treat them for VAT purposes:

- he may treat them as a wholly non-business or private asset, in which case the VAT incurred is not deductible
- he may treat them as a part business, part non-business asset, in which case the VAT incurred is only deductible to the extent that it relates to the taxable business activities [Value Added Tax Act S.24(5)] or

- he may treat them as a wholly business asset, the 'Lennartz' approach, in which case the VAT incurred is treated as input tax and is deductible in full, subject to any partial exemption ('PE') restriction (see section 2.11 below); however, VAT must then be accounted for if the goods are used for private/non-business purposes

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In the first case no VAT is payable if he later sells the asset. In the second and third cases, VAT is due if he later sells the asset. VAT is only due on disposal of a business asset, so in the second case where a 'portion' of the asset is treated as business VAT is only due on that element.

Where a taxable person incurs VAT on goods or services with no intention of making any business use of them, he simply has no entitlement to deduct the input VAT incurred.

A taxable person may adopt the 'Lennartz' mechanism (at the time the input tax is incurred – see 2.3 below) provided he intends to use them for taxable business purposes in some degree. Even if the use the goods will be put to is overwhelmingly private use, he can use the 'Lennartz' mechanism, providing there is some genuine business use intended that gives a right to deduct input tax. If, however, there is no business use or intended business use there can be no claim for input tax deduction, since the person is acting as a private consumer, not as a taxable person. A taxable person cannot argue that solely by virtue of paying output tax on private or nonbusiness use, this in itself gives a right to deduct input tax.

A taxable person cannot use the 'Lennartz' mechanism where the only

business use
of the asset is exempt. It is the view of HMRC that EC law requires that there must
be some deduction of tax before a deemed supply can arise in respect of the nonbusiness
or private use of the asset. If the only use of an asset will be to make exempt supplies and for non-business or private use, no right to deduct arises and
consequently the basic conditions for the deemed supply to arise in respect of private
or non-business use have not been met (VATA Sch 4 Para 5(5)).

2.2 What is the 'Lennartz' VAT accounting mechanism?

In 1991 the ECJ ruled in the case of Lennartz (Case C-97/90) that Mr Lennartz, who
had a genuine intention to use a car partly for business and partly for private
purposes, had a right to a full and immediate input tax deduction in respect of VAT
incurred on the purchase of his car. Where this was done, he, as a taxable person,
was then obliged to account for output tax in respect of any private or non-business
use of the car.

This decision relied on Article 6(2)(a) of the VAT Sixth Directive (now Article 26(1)(a)
of Council Directive 2006/112), which provides that the following shall be treated as
supplies for consideration –

'the use of goods forming part of the assets of a business for the private use of the
taxable person or of his staff or more generally for purposes other than those of his
business where the value added tax on such goods is wholly or partly deductible'

The European Court of Justice held that this meant Mr Lennartz made full taxable
use of his car – actual use in business motoring and also deemed taxable use in
connection with his private motoring. As all use was charged with tax it followed there
was an immediate right to full deduction of VAT incurred as input tax.

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(Note: Unlike the UK, Germany did not have a specific restriction preventing deduction of VAT in respect of cars purchased for business use. The UK restriction prevents use of Lennartz VAT accounting in respect of cars intended to be used for business and private or non-business purposes— see section 2.5.)

2.3 When may the 'Lennartz' VAT accounting mechanism be adopted?

Where a taxable person incurs tax on goods and certain services giving rise to goods

(see 2.4 – 2.8) that he intends to use for both business and non-business purposes,

he must make an immediate choice as to how the goods will be treated for VAT

purposes. The 3 options are set out in paragraph 2.1 above. The decision of the ECJ

in the case of Lennartz (Case C-97/90) confirmed that a taxable person can recover

VAT 'solely by reference to the capacity in which they were acting at the time the tax

became chargeable'. It is therefore imperative that a taxable person decides whether

the goods in question are to be included in the 'Lennartz' mechanism in sufficient

time for the tax to be deducted in the VAT return period when that tax was charged.

Depending on the option chosen, the taxable person may then recover none, some

or all of the VAT incurred on the cost of the goods; again this recovery must be

subject to any partial exemption restriction.

Once this decision has been made, the input tax claim may not be re-visited at some

future date even if business use of the goods subsequently increases. This is

because, as stated above, it is the capacity in which the person is acting at the time the tax became chargeable that determines the deductibility of the VAT. The Lennartz decision is unambiguous on this point.

There may be certain unusual circumstances where a taxable person chooses to treat the goods as wholly a business asset but does not immediately recover any of the VAT incurred as input tax. In such circumstances HM Revenue & Customs (HMRC) will need to be satisfied that the decision was made at the material time and will require evidence to support the VAT treatment of the goods. Subsequent claims for input tax must be made within the three year capping period.

If a taxable person incurs tax on goods that will partly be used in their business but does not make any choice at that time he must take the apportionment route if and when he seeks to deduct any of that tax. Apportionment is the default option whereas exclusion from the business or 'Lennartz' treatment requires a positive decision by the business. The taxable person should retain contemporaneous evidence of a decision to treat the goods as wholly a business asset, to support the resulting input tax claim.

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2.4 What types of goods can the 'Lennartz' mechanism be applied to?

The 'Lennartz' mechanism is available for the VAT incurred on the purchase of any goods, including computers, motor caravans, yachts, aircraft etc. It is also available for taxable land and buildings allocated wholly to business purposes,

whatever the nature of the taxable person's interest in the land and buildings (short lease, long lease or freehold) (see VATA 1994 Sch 4 Para 9). It is also available for VAT incurred on importing goods or acquiring them from other EU Member States. Assets to which Lennartz VAT accounting is applied are referred to as 'Lennartz' assets below.

2.5 What types of goods can the 'Lennartz' mechanism not be applied to?

The 'Lennartz' mechanism is not available for goods which are subject to input tax restriction or 'block', such as cars and items used for business entertainment, or goods on which no VAT is charged or on which VAT is charged under a margin scheme (eg second-hand goods), or directors' accommodation.

2.6 What types of services can the 'Lennartz' mechanism be applied to?

The ECJ in the case of Seeling (Case C-269/00) considered that where a taxable person received supplies of construction services, which resulted in the creation of a new business asset, then the resulting asset could be brought within the 'Lennartz' mechanism. As such, where a taxable person incurs VAT on services that are used to create new goods, the 'Lennartz' mechanism is available. For example;

- (a) the construction of new movable goods (eg a yacht);
 - (b) the construction of new building or civil engineering work*;
 - (c) the construction of an extension** or annex to an existing building;
- and
- (d) the reconstruction*** of an existing building.

*Although under UK land law a new building is not a separate asset from the land on which it is constructed, for the purposes of Lennartz accounting it can be treated as a new asset. The ECJ ruled that land and buildings could be treated as separate assets in de Jong (Case C-20/91) and therefore treated the new

building as a separate asset in the case of Seeling.

** An extension must be built on new land adjoining the existing building and it must increase the footprint of the existing building by 10 per cent.

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*** A reconstruction is works so fundamental that they effectively create 'new' goods (eg a new 'asset') from that which existed before eg a university acquires an old derelict warehouse and guts it so as to reduce it to no more than a shell. It then completely reconstructs it internally to create a 'new' teaching facility complete with classrooms, offices, reception etc.

a) The test for whether building works qualify as a reconstruction is not determined by either a change of use of the building or how much money is spent. Consider the following examples.

a) A taxable person buys an old Victorian block which used to be a trade union Headquarters. He plans to open a gallery and carry out works to convert the space. The works involve redecoration, removal and widening of some doorways, inclusion of two light wells in a flat roof and new flooring. What he has on completion is a fully functioning gallery but in essence the existing building remains, albeit refurbished and the works will not qualify as a reconstruction.

b) A taxable person acquires a large functioning office building and carries out works costing £100m. On completion he still has an office building but it is

fully refurbished with modern features; in these circumstances the project will not qualify for 'Lennartz' treatment despite the fact he spent a considerable sum of money.

If the taxable person has obtained zero rated relief on the construction of part of a building, but has incurred VAT on the construction of the remaining part he can still bring the asset within the 'Lennartz' mechanism. In this case the only part of the building affected by the 'Lennartz' output VAT charge will be that part of the building on which VAT was incurred.

2.7 Why is the 'Lennartz' mechanism not available for all services?

The 'Lennartz' mechanism is only available for services that create new goods (or a new land-related asset). This issue has been looked at on a number of occasions by the European Court of Justice, in particular Fischer (Cases C-322/99 and 323/99), Enkler (Case C-230/94), and Mohsche (Case C-193/91). In HMRC's view, these cases show that the 'Lennartz' mechanism is interpreted strictly and only applies to inputs that give rise to VAT 'on' the goods. Services 'related' to the goods are not within the scope of the charge or the related input tax recovery.

So services of repairing, maintaining, refurbishing or renovating existing goods/assets cannot create a new 'Lennartz' asset and cannot be brought within the 'Lennartz' mechanism eg redecoration of a building, refitting and rewiring of an office block, the fitting of a new façade to an existing building etc. Consequently the VAT incurred must be apportioned to reflect actual business use. The mechanism is also not available for services which are normally consumed in relation to day-to-day activity, such as repair and maintenance. This applies whether or not the asset being repaired, refurbished etc is itself a 'Lennartz' asset.

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The fact that refurbishments can create capital items for the purposes of the capital goods scheme (CGS) does not mean that they must also qualify for the 'Lennartz' mechanism. The Principal VAT Directive gives member states the power to include certain supplies that do not create any new goods in the CGS and the UK has used this to bring refurbishments into the CGS.

The 'Lennartz' mechanism does not apply to intangible assets such as software licences, intellectual property and the like, and so VAT on supplies used to produce such assets must be apportioned between business and non-business use.

2.8 If a taxable person is constructing a new building, civil engineering work, annex, extension or carrying out a reconstruction what costs can be included as part of the 'construction' costs for 'Lennartz' purposes?
Any cost that is incurred in the course of the actual 'construction' can be included in the 'Lennartz' mechanism. However, the costs must relate directly to the 'construction' of the new goods and must be incurred after such time as the taxable person knows for certain that the 'construction' will take place.

As such, any costs incurred on feasibility studies, demolition of pre-existing buildings on site, works which are required as part of the project but which do not form part of the asset, clearance and cleansing of land, financial advice (including costing of the project), obtaining planning permission, and fees charged by consultants such as architects and surveyors that are incurred before the time of a final decision to

embark on the construction project, cannot be included in the 'Lennartz' mechanism and the VAT incurred must be apportioned to reflect taxable business use. Again what is included in the CGS is not determinative for 'Lennartz' purposes.

2.9 How the 'Lennartz' mechanism works – basic principles

2.9.1 How to calculate the value of 'Lennartz' mechanism supplies

The value of the deemed supply under 'Lennartz' mechanism should be based on the 'full cost' to the taxable person of making the goods or asset available for private or non-business use. Articles 6(2)(a) and 11A(1)(c) of the Sixth VAT Directive (now Articles 26(2) and 75 of Council Directive 2006/112 respectively) and paragraphs 5(4) & 9 of Schedule 4 VAT Act 1994 refer.

The 'full cost' should be determined by reference to taxable VAT-bearing costs of the goods/asset, excluding the VAT itself. If any of the costs of purchase, acquisition or construction are either exempt or zero rated they should not be included in the 'full cost' of the goods (see ECJ decisions in Kuhne (Case C-50/88) and Mohsche (Case C-193/91). All VAT-bearing costs of obtaining the asset are included, even if there are elements that do not depreciate (eg the value of bare land). This was confirmed in Wollny (Case C-72/05).

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The cost of obtaining the goods or asset is then spread over a period called the 'economic life'. The cost attributed to a particular VAT return period is then multiplied by the percentage of private or non-business use in that period to give the 'full cost'

of the deemed supplies of making the goods or asset available for private or nonbusiness use in that VAT return period. These supplies are deemed to be made on the last day of the period (VAT Regulation 81(2)) and so output VAT on them is due in the VAT return.

At the end of the economic life, the whole of the asset cost will have been taken into account in calculating deemed supplies. At this point the deemed supplies cease. This ensures that private or non-business use of the asset is not excessively taxed.

2.9.2 What is the period over which 'Lennartz' charges for private or nonbusiness use should be made?

Up to 1 November 2007 there was no statutory period, but HMRC guidance said that the calculation of the 'Lennartz' charges for private/non-business use of land or buildings should be made over 20 years and five years for other type of goods (Business Briefs 23/03 and 15/05). HMRC have challenged attempts to use economic lives of over 20 years.

The ECJ decision in *Wollny* (Case C-72/05) confirmed that the period over which a deemed supply should be made (the economic life), could be determined by reference to the adjustment period used for the Capital Goods Scheme; in the UK this is ten years.

From 1 November 2007 UK legislation has set out the calculation method and reduced the maximum period for land and buildings to ten years; the period for other goods remains the same at five years. The legislation refers to this period as the 'economic life' of the asset. This new legislation is set out in Part XVA of the VAT Regulations (Regulations 116A – 116N), made under VATA 1994 Schedule 6 Paragraph 7(2)-(4). See section 2.10 below for examples.

In addition, from the same date the VAT (Special Provisions) Order (SI 1995/1268)

Article 10A ensures that no output tax charges arise in respect of periods after the economic life expires. (This was previous HMRC practice, in order to comply with EC law, but was not explicit in UK law).

Where 'Lennartz' assets have been used only for business purposes before 1 November 2007, the duration of the part of their economic life or lives falling after that date will be the remainder of the period of 120 or 60 months as appropriate which commenced on the first use of the goods.

Where 'Lennartz' assets have been used for private or non-business purposes before 1 November 2007, the legislation treats the economic life or lives as commencing on that day and lasting for a period determined in accordance with a formula. The formula takes into account the amount of VAT paid under the old system in respect of private or non-business use before 1 November 2007. Section 2.12 below gives worked examples of these transitional arrangements.

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Where a taxable person acquires land and/or buildings and the length of their interest in the land is less than ten years, the economic life is reduced to the length of their interest.

2.9.3 When does the 'economic life' of goods commence and end?
The 'economic life' commences on the day of the first use of the goods, and runs continuously until the period set by the legislation expires (normally five

or ten years).

The first use means any use, for any purpose after the goods have been supplied to, acquired, imported or 'constructed' by, the taxable person. It includes use by another person if the taxable person makes the goods or asset available to them. The economic life then runs continuously for its duration.

Where a taxable person sells 'Lennartz' goods the 'economic life' of the goods is effectively terminated by this disposal and no further deemed supplies arise.

However, output tax may be due on the sale. If the goods are disposed of for no consideration or taken wholly out of the business, a deemed supply may arise on which output tax is payable. (See section 2.14) A new economic life will start afresh upon the first use by the new owner after the acquisition if he also applies the Lennartz mechanism to the goods.

2.9.4 Transfer of a going concern and 'Lennartz'

Where a taxable person has acquired a 'Lennartz' asset as part of a transfer of a going concern (TOGC) the cost of that asset will have been de-supplied for VAT purposes and he will not have been charged VAT. However, in such circumstances the 'full cost' of making that asset available is based on the taxable asset cost incurred by their predecessor ie the person who made the supply to them, and the economic life starts on the predecessor's first use. The taxable person will therefore need to confirm this date with the predecessor if there is a possibility of private or non-business use of the asset.

This treatment ensures that VAT is correctly accounted for on the private or nonbusiness use of the asset over its economic life. This treatment will apply to any other supply which has been subject to HMRC's de-supply provisions. It will also apply

when the VAT number of the asset's owner changes due to it joining or leaving a VAT group. If there is chain of transfers of a going concern, the taxable cost to the first predecessor must be used.

Where the predecessor used the 'Lennartz' mechanism before 1 November 2007, the length of time over which the current owner has to account for private/nonbusiness use of the asset should be adjusted by reference to the transitional arrangements referred to above in section 2.9.2.

2.9.5 How does the 'Lennartz' mechanism apply when a new building, extension or annex is constructed on existing land?

Where a taxable person already has an existing asset (land or a building), which has commenced or completed its 'economic life', the first use of the new building on the land, or an extension or annex to the existing building (ie the new 'Lennartz' asset for EC law purposes) is regarded as the commencement of a new 'economic life'.

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Under UK law, there is only one asset (the land), so the UK legislation treats that asset as having two economic lives (which may overlap), each with its own related costs (eg the cost of the land and the cost of the building where a building is constructed on previously used land). The deemed supply value calculation for a VAT return period is done separately for each economic life that is running in the period and the results added together.

In such circumstances the 'full cost' of making the new 'Lennartz' asset available for private/non-business use shall be determined by reference to the full

cost of constructing the new building, extension or annex. If the original asset has not completed its 'economic life' its 'Lennartz' mechanism (if applicable) continues unaffected and the two 'economic lives' run concurrently, each with their own related asset costs.

This does not apply where the taxable person has not already put the land to use before constructing the building. In that case he can treat the land and the building as separate assets, and decide separately whether to apply the Lennartz mechanism to each. If he treats them both as wholly business assets under the Lennartz mechanism, then the calculation should be done as if there was a single 'Lennartz' asset.

2.9.6 How is the repair and maintenance or refurbishment of business assets treated within the 'Lennartz' mechanism?
This expenditure is not itself eligible for 'Lennartz' treatment – see 2.8 above.

2.10 How to calculate the value of the deemed supply
2.10.1 The value of the deemed supply for the private/non-business use of a business asset treated as goods (see sections 2.4 and 2.6) should be established using the formula below. This is subject to the transitional provisions, see 2.9.2 and 2.12, and provisions for periods of no use, see 2.10.2. The formula will give the value of the supply for a VAT return period; normally one, three or 12 months.
$$A \times (C \times U \text{ per cent})$$
$$B$$

Where-

A is the number of months in the VAT return period during which the relevant supply occurs and which fall within the economic life of the goods concerned.

B is the number of months of the economic life of the goods concerned. This will normally be 120 months in case of land and buildings and 60 months for all other goods. However, the period may be shorter; see the final paragraph of 2.9.2.

If A or B is not a whole number of (calendar) months, it should be expressed to two decimal places. So a period from 8 February 2008 to 31 March 2008 is one month (March) and 22/29 of another month (February) – 1.76 months to two decimal places.

C is the full cost of the goods; see 2.9.1

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U per cent is the extent, expressed as a percentage, to which the goods are put to any private use or used, or made available for use, for non-business purposes as compared with the total use made of the goods during the VAT return period. See

2.10.2 below if there is no use of the goods in the VAT return period. HMRC have not set a prescribed method for determining the non-business use percentage of the goods. However, the method used must arrive at a fair and reasonable figure and it must demonstrably reflect the actual use of the goods, which may change and must be monitored from period to period. For example, in respect of a piece of machinery the appropriate measure may be by reference to hours of usage of the machinery while in respect of a building the appropriate measure may be by reference to the floor area occupied for private/non-business activities.

U per cent is based on use of the goods so where, say, a yacht is used ten days for private purposes and ten days for business purposes in a 90 day VAT return period, U per cent will be 50 per cent.

Example 1 – The basic position

A taxable person buys a yacht for £1,000,000 plus £175,000 VAT at the start of his three month VAT return period ending 31 January 2008. He intends to use the yacht for both business and private purposes, and has a business plan indicating around 60 per cent business use. He decides in the same period to make the yacht wholly a business asset and recovers all of the VAT incurred as input tax. As a result of doing so, he must account for tax on the deemed supply created by his private use in the periods in which that use occurs.

The yacht is actually used for private purposes 50 per cent of the time in period 01/08. The expected private use percentage of 40 per cent is irrelevant to this calculation. What matters is the actual private use percentage in that particular VAT return period.

The 'economic life' of a yacht is set at 60 months (see 2.9.2)

The 'full cost' of the asset is £1,000,000 (see 2.9.1)

The taxable person submits VAT returns quarterly.

By applying the formula

$$\frac{A \times (C \times U \text{ per cent})}{B}$$

$$\frac{3}{60} \times (£1,000,000 \times 50 \text{ per cent})$$

The net value of the deemed supply is £25,000

The output tax due on the VAT return for 01/08 is therefore £ 4,375

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Thus, assuming that the private use percentage does not change, and that the VAT rate does not change, the output tax due over the yacht's economic life will be £4,375 x 20 VAT return periods = £87,500 or 50 per cent of the total VAT incurred on buying it. However, if either the private use percentage changes or the VAT rate changes, it may be more or less than this.

2.10.2 An economic life of an asset has commenced but the asset is not used for either business or non-business/private purposes in certain VAT return periods
A deemed supply only arises where there is actual non-business or private use of an asset within a VAT return period. So where an asset is used exclusively for businesses purposes within a VAT return period no deemed supply in respect of that asset arises.

It therefore follows that, where there is no use at all of an asset within a VAT return period (for either business or non-business/private purposes), no deemed supply will arise. This situation is particularly common with yachts, which are removed from the water during winter, and buildings which may close for refurbishment. However, such periods still count as part of the economic life.

As a result periods of non-use could distort the overall result of the 'Lennartz' mechanism; eg no deemed supply charge is due even though the

refurbishment,
which causes the non-use for the period, will benefit both the business and the private use of a yacht. To address this, HMRC have introduced VAT Regulation 116F which adjusts 'A' in the basic formula set out in 2.10.1. Under normal circumstances 'A' will be the number of months in the VAT return period; usually three. However, where a VAT return period is preceded by one in which no use occurred, then 'A' must be increased to reflect not only the number of months in the current period but also the number of months in the previous 'no-use' period (or periods).

Example 2 – Periods of no use

This example uses the basic facts of Example 1. A taxable person buys a yacht for £1,000,000 plus £175,000 VAT at the start of his three month VAT return period ending 31 January 2008. The yacht is actually used for private purposes 50 per cent of the time in period 01/08, consequently, as per the above example, the taxable person pays output tax of £ 4,375 in respect of the deemed supply.

For the duration of the next VAT return period, 04/08 the yacht is not used at all and no output tax is accounted for.

In the VAT return period 07/08 the yacht is again used for private purposes 50 per cent of the time. However, this time the formula for calculating the value of the deemed supply is amended as follows;

The 'economic life' of a yacht is set at 60 months (see 2.9.2)

The 'full cost' of the asset is £1,000,000 (see 2.9.1)

'A' is now six months; that being the number of months in the current VAT return period plus the number of months in the previous period.

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By applying the formula

$$\frac{A \times (C \times U \text{ per cent})}{B}$$

$$6/60 \times (£1,000,000 \times 50 \text{ per cent})$$

The net value of the deemed supply is £50,000

The output tax due on the VAT return for 07/08 is therefore £ 8,750.00

Example 3 – ‘Economic life’ of an asset commences part way through a VAT

return period: separate land, construction and demolition costs

A research institute bought a plot of land in 2005 at a cost of £100,000 plus £17,500

VAT with the intention of constructing a research facility on it. The research would

comprise both taxable 'commercial' research and non-business publicly funded

research. It opted for 'Lennartz' treatment and was able to treat the £17,500 VAT

incurred as input tax. The land remained unused until 2007 when the institute

constructed the research building. The cost of the construction was £2,400,000 plus

£420,000 VAT with an additional £10,000 plus £1,750 VAT being incurred on

removing a derelict building, which sat on the site.

The research facility is first used by the research institute on 5 January 2008.

Non-business research comprises 80 per cent of its use.

The institute submits VAT returns quarterly. The first one due after the research

facility is brought into use covers the period 1 November 2007 to 31

January 2008.

Being a building, the economic life of the facility is set at 120 months; however, as the facility is used for only 27/31 of a month in that accounting period, 'A' in the formula for determining the net value of the deemed supply will be 0.87 rather than three.

The 'full cost' of the asset is the cost of the land and the cost of constructing the new building (ie £100,000 + £2,400,000). The cost of demolition is not included and the VAT incurred on this service can only be recovered to the extent that the institute uses it for taxable business purposes ie 20 per cent.

Thus, applying the formula to the three month VAT period to 31 January 2008:

$$\frac{A \times (C \times U \text{ per cent})}{B}$$
$$0.87/120 \times (£2,500,000 \times 80/100)$$

The net value of the deemed supply is £14,500.00

The output tax due on the VAT return for 01/08 is therefore £ 2,537.50

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For VAT return periods covering the remainder of the facility's economic life (bar the last one) 'A' will equal three and therefore, assuming that non-business use remains unchanged, the net value of the deemed supply in each VAT return period is:

$$3/120 \times (£2,500,000 \times 80/100) = £50,000 \text{ deemed supply; therefore, the output tax}$$

due would be £8,750 (unless the VAT rate changes from 17.5 per cent).

For the VAT return period covering the last two months and four days of the facility's economic life, 'A' will equal 2.13, giving a £35,500 deemed supply and output tax of £6,212.50 (unless the VAT rate has changed from 17.5 per cent)

Thus, assuming that non-business use and the VAT rate do not change throughout the facility's economic life, the total output tax due is £350,000 or 80 per cent of the input tax incurred on the land and the construction of the facility.

2.11 Partly exempt businesses wishing to adopt 'Lennartz' treatment

Partly exempt businesses such as universities are entitled to adopt 'Lennartz' treatment for their assets as any other business would. However, it does not make either all of the VAT incurred on the asset, or that part made input tax by the adoption of 'Lennartz' treatment, wholly deductible. Where an asset will be used partly for taxable purposes (including 'Lennartz' deemed supplies) and partly for exempt purposes the input tax on it will be 'residual' for Partial Exemption (PE) purposes. Its deductibility will depend on the terms of the business's partial exemption method.

The new regulations will not affect taxable persons' existing PE methods. If this leads to an unfair deduction of input tax on the 'Lennartz' asset then a new PE method will be needed. HMRC are happy to agree new PE methods in these circumstances so long as they give a fair and reasonable result for the business overall. HMRC will not allow the 'Lennartz' asset to be 'cherry-picked' as a sector for more accurate deduction while the overall result remains unfair. If the existing PE method gives an unfairly large recovery of VAT on the asset, then PE method override provisions may apply or HMRC may direct a new, fairer method.

If the amount of non-business use giving rise to deemed taxable supplies changes over the economic life of the asset, then the Capital Goods Scheme (CGS) can adjust the input tax deduction to mirror any resultant changes to the amount of exempt use. Normally the CGS ascertains taxable use in any year based on the PE method in place. If this does not lead to a fair solution then alternative calculations can be agreed, again subject to them being part of an overall fair result.

It must be emphasised that the 'Lennartz' mechanism which requires output VAT to be charged when the 'Lennartz' asset is put to private/non-business use is totally independent of the PE method and the CGS calculation principles. In particular, the extent of non-business use in a VAT return period (U per cent) must be based on actual use, whatever the PE method of deciding the extent of exempt business use. As a result, mismatches are possible and so partly exempt businesses need to give active consideration to their PE methods at the time that they make their decision over 'Lennartz' treatment.

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HMRC's aim is to ensure that, over the asset's economic life and the CGS adjustment period (ie ten years for buildings), the 'Lennartz' output tax charges properly mirror the non-business use, and a fair amount of input tax is recovered as a result.

Example 4 – A partly exempt organisation

A university constructs a research building which will be used for non-business publicly funded research (80 per cent) and the university's core business activities, which are both taxable and exempt (20 per cent). The cost of construction is £2,500,000 plus £437,500 VAT.

The university's partial exemption method, which gives a recovery of ten per cent for general costs, recognises the extensive planned taxable use via deemed supplies and so the university recovers 82 per cent of the input tax; 80 per cent in respect of the deemed taxable supplies for non-business use and 2 per cent in respect of the taxable business use as part of the university's core business activities (10 per cent of 20 per cent = 2 per cent), giving a total VAT recovery of £358,750.

The university's partial exemption year ends on 31 July and it submits quarterly returns.

Partial Exemption Year to 31 July 2008 (first CGS interval)

The research facility is first used by the university on 1 February 2008.

The first VAT return due after the research facility is brought into use covers the period 1 February 2008 to 30 April 2008. Being a building, the economic life of the facility is set at 120 months.

The 'full cost' of the asset is the cost of constructing the new building ie £2,500,000.

Thus, applying the formula to the three month VAT period to 30 April 2008 (Period 1):

$A \times (C \times U \text{ per cent})$
B

$3/120 \times (£2,500,000 \times 80/100) = a \text{ £}50,000$ deemed supply; therefore, the output

tax due would be £8,750.

Thus, assuming that non-business use and the VAT rate do not change throughout the facility's economic life, the total output tax due is £350,000 or 80 per cent of the input tax incurred on the land and the construction of the facility.

The fact that the university was unable to obtain full recovery of the input tax incurred in constructing the building does not affect the calculation of the 'Lennartz' output tax charge. As the building is a capital item, any changes in the non-business use will be reflected in adjustments under the CGS. Changes in the output tax charge will affect the percentage of taxable supplies made from the building. Over the economic life of the building this will provide a broadly fair result as the economic life is similar to the CGS life.

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If the university's PE method had led to an unfair initial restriction on input tax deduction or to the CGS failing to reflect changes in subsequent use properly then this would have to be addressed via the PE and CGS rules, not via the calculation of the output tax charge.

Period 2 ending 31 July 2008:

$A \times (C \times U \text{ per cent})$
B

$\frac{3}{120} \times (£2,500,000 \times \frac{80}{100}) = \text{a } £50,000 \text{ deemed supply; therefore,}$
the output tax due would be £8,750.

As the input tax recovery properly reflects the actual use in this PE year, no adjustment to the initial deduction of input tax is required in the PE annual adjustment (the CGS does not make adjustments for the first CGS interval).

Partial Exemption Year to 31 July 2009 (second CGS interval)

To illustrate the interplay with CGS referred to above, we will carry on with the above example and include the 'Lennartz' calculations up to the end of the second interval, in respect of which the first CGS adjustment will have to be made. Assuming the university has a tax year end of 31 July that will be 31 July 2009.

For the purpose of the example, assume that the non-business use in the year ending 31 July 2009 drops to 50 per cent and the university's core business activity increases to 50 per cent. With this change of use the overall recovery percentage drops from 82 per cent to 55 per cent; that being 50 per cent in respect of the deemed taxable supplies for non-business use and 5 per cent in respect of the taxable business use as part of the university's core business activities (10 per cent of 50 per cent = 5 per cent). Thus the difference between the two recovery rates is 27 per cent.

Period 3 ending 31 October 2008:

$$\frac{A \times (C \times U \text{ per cent})}{B}$$

$\frac{3}{120} \times (£2,500,000 \times 50/100) =$ a £31,250 deemed supply; therefore, the output tax due would be £5,468.75

Period 4 ending 31 January 2009:

$$A \times (C \times U \text{ per cent})$$

B

$3/120 \times (£2,500,000 \times 50/100) = a \text{ £}31,250$ deemed supply; therefore,
the output
tax due would be £5,468.75

Period 5 ending 30 April 2009:

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A x (C x U per cent)
B

$3/120 \times (£2,500,000 \times 50/100) = a \text{ £}31,250$ deemed supply; therefore,
the output
tax due would be £5,468.75

Period 6 ending 31 July 2009:

A x (C x U per cent)
B

$3/120 \times (£2,500,000 \times 50/100) = a \text{ £}31,250$ deemed supply; therefore,
the output
tax due would be £5,468.75

The total 'Lennartz' output tax over the year to 31 July 2009 is therefore
£21,875 –
one tenth of 50 per cent of the input tax incurred of £437,500.

The CGS adjustment in respect of the building's use in interval two
requires the
university to look at the change of use and adjust the overall recovery
percentage
accordingly. The overall recovery position has dropped from 82 per cent
to 55 per
cent, a difference of 27 per cent. As a result, for the financial year
ending 31 July

2009, the university must pay back 27 per cent of 10 per cent of £437,500 (that being the VAT incurred on the asset) = £11,812.50. Under the CGS rules this adjustment is included in the 01/10 return. The net input tax recovery in respect of CGS interval 2 (the year to 31 July 2009) is thus 1/10 of the £358,750 originally deducted, less the £11,812.50 paid back, equalling £24,062.50.

So in respect of the year 1 August 2008 to 31 July 2009, after all adjustments are brought to account, the university effectively recovers £24,062.50 input tax and pays £21,875 output tax. The difference of £2,187.50 represents the 5 per cent of the use of the building in that year that is for taxable purposes other than the deemed supplies.

2.12 How will an existing 'Lennartz' calculation be affected by the 1 November 2007 changes?

The new legislation which comes in to effect on 1 November 2007 contains specific provisions to assist with the transition from an existing 'Lennartz' calculation to the new, post 1 November, treatment. The change will principally affect existing calculations for land and buildings, where the 'economic life' of an asset has now been set at ten years (or less if the interest in the land or buildings lasts for a shorter period); however, it may apply to other goods where the taxable person has used a different 'economic life' from the five years required by the new legislation. The transitional provisions should have no effect if the asset is not land or buildings and before 1 November 2007 the taxable person were already using a five year basis for calculating 'Lennartz' charges, as required by HMRC guidance.

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The transitional provisions provide for the economic life of the goods to be treated as commencing from 1 November 2007 (not upon the first use of the goods), but adjusted to take account of (and give credit for) any deemed supplies arising from private use up to that date. Thus, the economic life of the goods is reduced to the figure given by the formula below:

$$\frac{D \times E - F}{E}$$

Where-

D is the number of months which would have been the economic life of the goods concerned if no 'Lennartz' accounting had occurred before 1 November 2007; for example 120 for land and property (see 2.9.2)

E is the full cost of the goods (see 2.9.1)

F is the part of the cost of the goods that at 1 November 2007 has already been taken into account in computing deemed supplies arising from private use, and is to be determined using the formula-

$$F = \frac{G \times X}{100}$$

Where-

G is the total value of relevant supplies of the goods made before 1 November 2007 (ie the total value of the supplies already accounted for as private/non-business use to date); and

X per cent is the extent, expressed as a percentage, to which the goods

have been put to any private use or used, or made available for use, for non-business purposes before 1 November 2007 as compared with the total use made of the goods before that date.

As noted in sections 2.4 and 2.6, 'goods' includes interests in land and buildings treated as goods for the purposes of 'Lennartz' VAT accounting.

The net effect of this calculation is to truncate the economic life over which output tax on deemed supplies needs to be paid to take account of charges already made to 31 October 2007. So, if a 20 year (240 month) economic life had been applied, and at 1 November 2007 the goods have been used for two years (24 months), that would give the taxpayer a credit of 1/10th of the full cost equivalent to 1 year (12 months) of a ten year (120 month) economic life. Thus, rather than having to account for output tax on deemed supplies for ten years (120 months) from 1 November 2007, the taxpayer only has to account for output tax on deemed supplies for a further nine years (108 months).

The detailed operation of the transitional provisions is best explained by reference to the following examples.

Example 5 – Transitional provisions with constant private use

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A taxable person on quarterly VAT accounting periods constructed a commercial property at a cost of £1,000,000 plus VAT of £175,000; it was first used on 1

November 2005. The taxable person originally chose an 'economic life' of 20 years, in line with HMRC's stated policy at the time. Private use of the building was constant at 65 per cent.

Step 1

For each quarter up to 31 October 2007 the net value of the deemed supply was calculated by the taxpayer using the same formula as that contained in 2.10.1 but using 240 months (ie 20 years) rather than 120 months (10 years) as the value for 'B'.

Thus the formula:

$$\frac{A \times (C \times U \text{ per cent})}{B}$$

translated into the calculation:

$$\frac{3}{240} \times (£1,000,000 \times 65 \text{ per cent})$$

generating a deemed supply of £8,125 per accounting period.

Total net value of deemed supplies up to 1 November 2007 is therefore £65,000; that

being eight quarters at £8,125 each.

Step 2

Determine the value of F in the transitional provisions formula.

$$F = G \times 100$$

$$X \text{ per cent} \times 100$$

G is total value of deemed supplies made before 1 November 2007 ie £65,000

X per cent is the extent of private use before 1 November 2007, in this case a

constant 65 per cent

The calculation can also be expressed as $(G \times 100 / X \text{ per cent}) / 100$

$$F = 65000 \times 100$$

$$65\% \times 100$$

F = £100,000.

Thus, £100,000 of the full cost of the property has been brought to account through

the 'Lennartz' mechanism from its first use up to 31 October 2007.

Since a 20 year

life was being used and two years had expired by 31 October 2007, it naturally

equates to 2/20 of the original cost.

Step 3

Apply the transitional provisions formula to determine the revised 'economic life'.

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$D \times E - F$
E

D is the new 'economic life' as determined by the new legislation ie 120 months

E is the 'full cost' of the goods ie £1,000,000

F is £100,000

$$\frac{120 \times 1,000,000 - 100,000}{1,000,000} = 108 \text{ months}$$

So, in this example the new 'economic' life of the asset, which commences on 1

November 2007, is 108 months or nine years. That is to say, rather than accounting

for output tax on deemed supplies for a further 18 years using the pre-1 November

2007 calculation, the taxable person need only account for output tax on deemed

supplies for a further nine years, albeit that the value of 'B' in the formula changes

from 240 months to 120 and therefore the deemed supply value for each VAT return period is twice as high as previously.

Step 4

Assuming the private use remains constant at 65 per cent the value of the deemed supply for the first full VAT period after 1 November 2007 will be as follows:

Using the same formula as that contained in 2.10.1.

$$3/120 \times (£1,000,000 \times 65 \text{ per cent}) = £16,250$$

Output due at 17.5 per cent is £2,843.75

The denominator in this fraction is the standard economic life for this asset (ie 120 months).

The result (assuming no change of use or VAT rate) is output tax charges on deemed supplies of £65,000 per year for a further nine years after 1 November 2007.

Since the deemed supplies made up to 31 October 2007 totalled £65,000 as well, this means that overall output tax is accounted for on charges of £650,000, representing 65 per cent of the original cost of the asset, in line with the 65 per cent private use throughout.

Example 6 – Transitional provisions with variable private use

A taxable person constructed a commercial property at a cost of £1,000,000 plus VAT of £175,000; it was first used on 1 November 2003. The taxable person originally chose an 'economic life' of 20 years, in line with HMRC's stated policy at the time. Private use of the building varied each year.

Step 1

For each quarter up to 31 October 2007 the net value of the deemed

supply was
calculated using 3/240 of the building costs (as in Example 5 Step 1):.

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Year Private Use Value of Deemed Supply
2004 50 per cent £25,000
2005 75 per cent £37,500
2006 25 per cent £12,500
2007 35 per cent £17,500
Total Value of deemed supplies £92,500

Step 2

Determine the value of F in the transitional provisions formula.

$F = G \times 100$
 $X \text{ per cent} \times 100$

G is the total value of deemed supplies on pre-1 November 2007 use ie
£92,500

X per cent is the extent of private use; in this case (where the previous
periods are
all years), the average of the 48 previous months (ie the four years
above) = 46.25
per cent. In any event, the figure must represent the extent of private
use before 1
November 2007.

$F = 92,500 \times 100$

46.25 per cent x 100
 $F = £200,000$ ie the part of the property cost that has already been
taken into account
in calculating 'Lennartz' charges by 31 October 2007. Since a 20 year
life was being
used and four years had expired by 31 October 2007, it is 4/20 of the
original cost.

Step 3

Apply the transitional provisions formula to determine the revised 'economic life'.

$D \times E - F$

E

D is the new 'economic life' as determined by the new legislation ie 120 months

E is the 'full cost' of the goods ie £1,000,000

F is £200,000

$120 \times 1,000,000 - 200,000 = 96$ months

1,000,000

So, in this example the remaining 'economic' life of the asset, which commences on

1 November 2007, is 96 months or eight years.

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Step 4

Assuming the private use in the next period after 1 November 2007 is 50 per cent the value of the deemed supply for the that first VAT period will be as follows;

Using the same formula as that contained in 2.10.1.

$3/120 \times (£1,000,000 \times 50 \text{ per cent}) = £12,500.00$

Output due at 17.5 per cent is £ 2,187.50

2.13 Withdrawal where the 'Lennartz' mechanism has been adopted for a construction project

As part of the transitional provisions a taxable person who has opted to bring an

asset wholly within his business (ie treat it as a 'Lennartz' asset), and has

consequently treated all the VAT incurred as input tax, may elect to withdraw from

this decision (without any penalties). The result is that the taxable

person foregoes the extra input tax deduction given by 'Lennartz' treatment, but does not have to account for output tax charges on private or non-business use.

The withdrawal is subject to the following conditions:

- 'Lennartz' treatment can only be reversed where there has been no use of the asset by the time of withdrawal;
- The goods in questions are intended or expected to be put to some private/non-business use during their 'economic life';
- The input tax claimed must be adjusted so that either: (a) no input tax is recovered (thereby leaving the asset outside of the business); or (b) the taxable person recovers an amount of tax which properly reflects the expected business use of the asset (thereby making it a partly business asset);
- the input tax claimed was incurred within the period of two years ending on 21 March 2007 (when the changes to Lennartz accounting were announced);
- the withdrawal is made by way of a voluntary disclosure under VAT regulation 35 (whatever the amount of the claim that is withdrawn) before 1 February 2008.

HMRC will not charge interest on VAT repaid as a result of such a withdrawal.

2.14 When do Lennartz output tax charges cease?

- At the end of the asset's economic life or lives.

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- On sale of the asset. A 'Lennartz' asset is by definition an asset of the business and when that asset is sold it must be treated as a business supply for VAT purposes and where appropriate output tax must be declared. No further 'Lennartz' deemed supplies can arise since the asset is no longer an asset of the business, so effectively this brings to an end the 'economic life'.
- On disposal of the asset for no consideration. In this case there may be a deemed supply of the asset under VAT Act 1994 Sch 4 Paragraph 5(1), at its market value at the time (ie what it would cost to purchase a similar asset in similar age and condition – VATA 1994 Sch 6 Paragraph 6).
- On taking the asset into wholly non-business or private use, so it

no longer forms part of the assets of the business. In this case there may be a deemed supply of the asset under VAT Act 1994 Sch 4 Paragraph 5(1), at its market value at the time.

- On deregistration. In this case there may be a deemed supply of the asset under VAT Act 1994 Sch 4 Paragraph 5(1), at its market value at the time.

3. Who can I contact for further information?

If you have a query for which you have been unable to find the answer within this

VAT Information Sheet please contact our National Advice Service (NAS) on 0845

010 9000 (+44 2920 501 261 for International Enquiries).

The National Advice Service is available from Monday to Friday, 8.00am to 8.00pm

(GMT), and will be able to answer both general queries and deal with enquiries

relating to the Special Scheme.

If you have hearing difficulties, please ring the Textphone service on 0845 000 0200.

Alternatively, international enquirers may email us at voes@hmrc.gsi.gov.uk.