

### PURPOSE AND INTENDED EFFECTS OF THE MEASURE

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#### Objective

**2.1** 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

**2.2** 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.

**2.3** 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.

**2.4** 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).

- 2.5** 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

- 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.

- 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.
- 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

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**2.6** 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

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### 1. Implement all three measures

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

### 2. Implement only measure 1

**2.8** 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.

### 3. Do Nothing

**2.9** 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.

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## COSTS AND BENEFITS

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### Sectors and groups affected

**2.10** 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

**2.11** 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.

**2.12** 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.

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

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## SUMMARY OF COSTS AND BENEFITS

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

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## SMALL FIRMS IMPACT TEST

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**2.15** 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'.

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## COMPETITION ASSESSMENT

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**2.16** 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.

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## ENFORCEMENT, SANCTIONS AND MONITORING

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**2.17** 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**

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**2.18** 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**

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

## **SUMMARY AND RECOMMENDATIONS**

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**2.20** 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.

## **Contact Point**

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## REGULATORY IMPACT ASSESSMENT

### Vat: Implementation Of European Court Of Justice Decisions Charles & Charles Tijmens And Wollny

#### Statement of Ministerial Approval

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

Signed by the responsible Minister

DAWN PRIMAROLO  
PAYMASTER GENERAL

Dated: 1 March 2007