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Deduction of VAT on mixed use
immovable property
-Fiscal neutrality and Art 168a

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Summary

The thesis starts with a description of the background to the change of the rules on deduction of VAT on mixed use immovable property through the insertion of Article 168a in the RVD.

The reason according to the Amendment is to promote equity and to prevent unjustified cash-flow advantages granted to taxable persons who use acquire immovable property, deduct full input VAT and then pay it back over the duration of the adjustment period in the form of assessment for private use.

The three scenarios are described i.e. allocation entirely to a taxable persons private assets, entirely to their business assets or allocated partly to private assets and partly to business assets.

The rules on the sale of immovable property are then discussed, including the fact that it is exempt and how depreciation write-offs work.

The purpose of the thesis is to compare the old system for deductions with the new system in order to ascertain whether the new system is more equitable and better prevents the unjustified cash-flow advantages that were possible in the old system.

The asset labeling doctrine is investigated through an examination of the case law and it is found that Lennartz principle is developed and nuanced through a number of cases with the conclusion that under the asset labeling doctrine a taxable person may choose to allocate entirely to his business assets, his private assets or a mix of the two with different consequences for tax purposes.

In terms of equity, the problems with this system are that it enables a taxable person to allocate an asset entirely to his business assets and then deduct input VAT in full with a staggered imposition of the payments. Furthermore there is a risk of the 10-year interest free loan and untaxed end use.

The pro rata deduction system is then introduced by way of the Wollny and Puffer cases which show the intention that the full costs for private use can correspond to the amount deducted for the period of adjustment in order to best avoid untaxed end use.

Other elements of the pro rata system are then treated for example the concepts of the temporary exemption equalisation, how the initial deduction is to be calculated etc.

An evaluation of the unjustified cash-flow advantages and untaxed end use possibilities is then performed, and it is found that 168a RVD militates these schemes, apart from in the case of deferred private use as the adjustment period still does not correspond to the economic lifetime of an immovable property.

Finally, it is concluded that the insertion of Article 168a RVD and its consequences, means the initial deduction of input VAT with regards to immovable property is more equitable and better equipped to prevent unjustified cash-flow advantages than the asset labelling doctrine.

Preface

This thesis constitutes the final assignment for my Master's of European and International Tax Law (LL.M.).

I would like to thank all those who have assisted me during this endeavour; it has at times been rather trying and exhausting, but has always been rewarding. I feel that it has given me a fantastic basis upon which to commence my career working with international tax issues.

I leave Lund and my *alma mater* Lund University now, after a total of 5½ years being instructed in its prestigious institution with memories, friends, values and knowledge, which I shall carry with me for a lifetime.

I would finally like to thank my tutor Ben Terra for his guidance.

May 2011, Lund, Sweden.

Abbreviations

AG	Advocate General
ECJ, the Court	European Court of Justice
EU	European Union
RVD	The Recast VAT Directives
TFEU	Treaty on the Functioning of the European Union
VAT	Value Added Tax

1 Introduction

1.1 Background

From January 1st 2011 there have been changes in the rules for the deduction of input VAT for immovable property forming part of the business assets of a taxable person and used for both the taxable person's business and for his private use or that of his staff, or more generally, for purposes other than those of his business.¹ These changes are effected by the insertion of a new article² into the rules under the heading of "Origin and scope of right of deduction"³. According to scholars, this amendment is not just of a "primarily technical nature", but involves a fundamental change in the current VAT system.⁴

The former deduction system was based on the so-called "asset labelling doctrine" (henceforth the Doctrine) which involved the immovable property being allocated within a taxpayer's taxable assets, private assets or a combination of the two; referred to as mixed use assets. The labelling determined the rules for deduction of input VAT as essentially the taxpayer was making a statement of for what purposes the asset would be used, and thus if the asset was within the scope of the Directive.

The reason for this change according to the amending directive (henceforth referred to as the Amendment) is that this rule should be clarified and strengthened with respect to the supply of immovable property and expenditure relating thereto in order to ensure that taxable persons are dealt with in an identical manner whenever immovable goods that they use for their business activity are not used exclusively for purposes related to that activity.⁵

The Amendment continues to note that immovable property and related expenditure account for the most significant cases where a clarification and strengthening of the rule is appropriate, given the value and economic lifetime of such property and the fact that mixed use of this type of property is a common practice, the issue also arises, though in a less significant and less uniform manner, with respect to movable goods with a durable nature. In accordance with the principle of subsidiarity, Member States should therefore be given the means to take the same measures with respect to such movable goods that form part of the business assets where appropriate.⁶

This recognition of the longevity of immovable property's enduring value is provided for in the option made available to Member States to extend the adjustment period for immovable property to 20 years.⁷

¹ Council Directive 2009/162/EU

² Article 168a, RVD

³ Title X, RVD

⁴ Terra, Ben, Kajus, Julie, "A Guide To The European VAT Directives – Introduction to European VAT 2010", Volume 1, IBFD p. 979

⁵ Council Directive 2009/162/EU (10)

⁶ Ibid (11)

⁷ This extension in the adjustment period has been available since May, 1995. See Council Directive 95/7/EC

Therefore with a view to ensuring an equitable deduction system for taxable persons in the context of the new rules, an adjustment system in accordance with the other rules on adjustment of deductions should be provided for which takes into account changes in the business and non-business use of the property concerned common practice.⁸

As such, in the spirit of equality, when the proportion in which the immovable property is used for business versus private use changes, the idea is that this change will be recognised, with the corresponding change in the amount of VAT which is deductible. The intention then it would seem is to bring the change-mechanism in line with the existing mechanism already in place for other capital goods.

This is particularly necessary in the case of immovable property, given that acquisition costs are often very high, that simultaneous business and non-business use is possible and widespread and that the economic lifetime of immovable property is, in theory, much longer than that of other goods used for business purposes. It therefore seems expedient to adapt the deduction of VAT relating to immovable property in such a way as to ensure that the initial exercise of the right to deduct input VAT more closely reflects the basic principle described above and to prevent certain constructions designed to create an unjustified cash-flow advantage.⁹

The opinion of the legislators therefore seems to be that the system for deduction would be improved by being more teleologically appropriate; that is, that the principle that, largely speaking, businesses may deduct input VAT, whereas natural persons may not, would be more opportunely fulfilled if the initial deductions corresponded more accurately to the actual function of the asset.

The aim of the new legislation is therefore to change the asset labelling doctrine-based system currently in place, and replace it with a new system which is fairer in terms of initial deductions and prevents unjustified advantages arising from unrepresentative deductions.

In order to achieve this it is proposed to restrict the initial exercise of the deduction to the proportion of effective business use when mixed-use immovable property is included in the company's assets and liabilities. At the same time, a correction mechanism is proposed in order to reflect the variations between the business and private (or non-business) use of such immovable property.¹⁰

1.2 The problem

The problem is that this new system would seem to change established principles of the VAT system in that the Doctrine has been established through the Court's own case law in a series of cases¹¹ (see below). It was based, as the name suggests, on the labelling of assets.

⁸ Council Directive 2009/162/EU (12)

⁹ COM(2007)677 p. 3

¹⁰ Ibid p. 4

¹¹ 50/88 Kühne, C-97/90 Lennartz, C-193/91 Mohsche, C-291/92 Armbrecht, C-415/98 Bakcsi, Joined Cases C-322/99 Fischer and C-323/99 Brandenstein, C-269/00 Seeling, C-434/03 Charles and Charles-Tijmens, C-72/05 Wollny, C-460/07 Puffer

1.2.1 The three scenarios

These changes are not only related to acquisitions of immovable property but also to services such as construction, renovation or substantial transformations that, in economic terms, can be placed on the same level as the acquisition or construction of immovable property. Simple repairs or improvements are, however excluded from the scope of the Amendment.¹² When a taxpayer performs such an activity, there are three ways in which it may be labelled and which therefore determine whether and/or to what extent they are within the scope of the RVD. These are as follows;

1.2.1.1 Allocated to private assets

The first of these is when immovable property is allocated entirely to a taxable person's private assets. This is essentially the same as a natural person acquiring an asset, and therefore no deduction is possible. This is known as being outside the Scope for VAT.¹³

1.2.1.2 Allocated to business assets

The second is when the immovable property is allocated entirely to a taxable person's business assets. In this scenario, in principle the input VAT can be deducted entirely immediately¹⁴

The intention is that for a taxable person the VAT is not a cost. Nor indeed, by extension thereof, should it at any point even be a temporary burden through reducing liquidity.¹⁵ This is because according to the Directive the right of deduction shall arise at the time the deductible tax becomes chargeable¹⁶ i.e. when the buyer is must pay the input VAT.

Subsequent private use of the asset should be assessed for VAT, or accounted for in some other way in order to prevent the taxable person from enjoying an advantage over the non-taxable person, or the taxable person who uses the asset entirely for business uses.

1.2.1.3 Allocated partly to private assets and partly to business assets

The third scenario is when an asset is allocated partly to a taxable person's business assets, and partly to their private assets due to the intention to employ the asset for uses in both of those spheres.

In an ideal world, in the name of equity, the tax authorities and the taxpayer would be prescient and therefore the correct and appropriate deduction would be made upon acquisition. This however is seldom the case as the asset may be more useful than predicted for business use, or the space needed to conduct or perform such taxable transactions may increase, or decrease. This will have the consequence that the amount of input VAT that should be deducted will change.

There is also the further problem of dishonesty and exploitation of the mechanism through artificial constructions (as mentioned above and discussed in further detail below) by which a taxpayer may seek to obscure his true intentions of use of the immovable property. Being able

¹² COM(2007)677 p. 8

¹³ Swinkels, "Asset..." p. 12

¹⁴ Article 167 RVD

¹⁵ Opreel p. 262

¹⁶ Article 167 RVD

to deduct input VAT, even if it is later repaid, undoubtedly constitutes a cash-flow advantage, as the taxpayer does not need to pay all the VAT at the time of purchase despite its intended use for private purposes. Add to that the fact that no interest is charged on the repayments.

Arguably, such an interest charge would not even be possible, but either way, there is certainly an advantage to be gained as a direct result of input tax deduction, for the very reason that that mechanism exists; so that it does not burden the taxpayer.

1.2.2 The sale of immovable property

It should be noted that Member States may regard as a taxable person anyone who carries out, on an occasional basis, the supply, before first occupation, of a building or parts of a building and the land on which the building stands or the supply of building land.¹⁷

Furthermore, Member States shall exempt the supply of a building or parts thereof, and of the land on which it stands, other than the supply before first occupation.¹⁸ The same applies to the leasing and letting of immovable property.¹⁹

The result of this is that regardless of how the immovable property is allocated, after the adjustment period, its supply is exempt.

The rules for sale of the immovable property during the adjustment period however, are slightly different. It is regulated in the Directive, where it states that if supplied during the adjustment period, capital goods shall be treated as if they had been applied to an economic activity of the taxable person up until the expiry of the adjustment period. The economic activity shall be presumed to be fully taxed in cases where the supply of capital goods is taxed and fully exempt where the supply of capital goods is exempt. Furthermore the adjustment shall only be made once in respect of all the time covered by the adjustment period that remains to run.²⁰

1.2.2.1 Option for taxation

Despite the sale of immovable property being exempt from VAT, Member States may allow taxable persons a right of option for taxation in respect of the supply of a building or of parts thereof, and of the land on which the building stands²¹ and the leasing or letting of immovable property.²² This means that the taxable person may charge output tax on the transaction.

1.2.2.2 Reversal of depreciation write-offs

During the lifetime of an immovable business asset, the depreciation can be taken into account. This is done by an annual percentage of the cost of the immovable asset being deducted. The economic lifetime of an immovable asset is determined by national legislation, but for example if for example the economic lifetime of an asset is set at 50 years then the cost of acquiring the asset can therefore be deducted over a period of 50 years, therefore at a rate of 2% per year (50 x 2% = 100%).

¹⁷ Article 12 RVD

¹⁸ Article 135 (1)(j) RVD

¹⁹ Article 135 (1)(l) RVD

²⁰ Article 187 RVD

²¹ Article 137 (b) RVD

²² Article 137 (d) RVD

It is also relevant to note that the land on which the immovable property stands will not normally depreciate in value, and as such no depreciation write-offs are possible.

When the property is sold, however, the capital gain made on it must be calculated in order to ascertain the amount which is liable to income tax. The profit is the amount paid by the purchaser minus the cost of the land and the cost of the building. The deductions of the original cost made at 2% per year, however, must be accounted for. Therefore if deductions have been made at that rate for 20 years then 40% (20 years x 2% per year = 40%) of the value of the property will have been deducted. This is done by adding the amount deducted over the years to the amount paid for the property. If this was not done the taxpayer could escape taxation by making large deductions for the cost of the property then be able to reduce the taxable amount on the sale of the property by the entire original cost of the property.

1.3 Aim of the study

The aim of the study is to determine whether the new system better achieves its stated aims of becoming more equitable and is better equipped to preclude the unjustified cash-flow advantages inherent in the former system.

Therefore, it aims to investigate the relative merits of the two systems in these two areas.

1.3.1 Questions of the essay

The questions that need to be answered in order to properly treat this problem are therefore as follows;

1. How did the asset-labelling doctrine work and how equitable was it with regards to deduction of input VAT?
2. What unjustified cash-flow advantages arose from it?
3. What is the form and function of the new system and how equitable is it with regards to deduction of input VAT?
4. To what extent have the unjustified cash-flow advantages been prevented?

1.4 Material and method

The method employed by this thesis shall be the traditional legal dogmatic method. Therefore, an analysis based on the Recast VAT Directive, the Sixth Directive, relevant case law and the work of legal scholars shall be used.

Therefore, what is necessary is an investigation into whether the new system is more equitable and is better equipped to prevent unjustified cash-flow advantages. That being so; there will first be a comprehensive investigation of the former deduction system including legal analysis of the rules and their implementation by discussing the Court's view of the equity of the asset labelling doctrine where mixed use property is concerned. There will then be a look at what unjustified advantages were possible through that system.

Secondly, the new system will be thoroughly investigated through analysis of its rules, concepts and their potential effects in order to ascertain whether the new system successfully overcomes the shortcomings of the asset labelling doctrine with regard to equity and

unjustified cash-flow advantages, which it may make possible, or not have amended from the asset labelling doctrine.

Finally, there will be an analysis of the changes made, and their consequences as a whole and then a statement on whether the new rules better fulfil the aims of the Amendment, and the VAT system in general, than the old rules.

1.5 Limitation

This is relatively unbroken ground as the new rules have only been in force, and therefore implemented, for a few months at the time of writing. However, some of the areas which this essay shall cover, such as the old deduction system, have already been covered extensively by case law and scholars. For this reason, when investigating those areas these sources will be heavily relied upon. The primary sources for this area will be the articles of the Directives and case law, but in terms of scholars for this area, and for others the main source will be the work of Ben Terra and Julie Kajus²³. For this reason, their work will be the principle point of reference and explanation of the principles and effects at hand in the former deduction system. This will be complemented by the work of other scholars on the subject as necessity dictates in due course.

As regards the section on the new deduction system, the sources will primarily be the Directive and the Amendment.

This essay shall thus limit itself to focusing on the legal form of the new deduction system, and not necessarily its actual consequences when implemented in the Member States, as this is an analysis of EU VAT law.

Furthermore, this essay shall not discuss how to break the system and thereby circumvent the rules, but instead its purpose is to find faults within the system.

Finally, only input tax deductibility with regard to immovable property shall be discussed despite the new rules. The legislators have provided the option for the Member States, through the principle of subsidiarity, to apply this system in relation to expenditure related to other goods forming part of the business assets as they specify as well²⁴.

The reasoning of the author for this limitation is that, as recognised in the Amendment; immovable property is generally more expensive and has a longer economic lifetime than other goods.²⁵ Therefore, in addition to the new rules only potential, and not actual application to other goods forming part of the business assets,²⁶ it was felt that the principle at the heart of this thesis, namely that of fiscal neutrality, was more significantly impacted with regards to immovable property deductions than the deductions of other goods for reasons as shall be explained in due course.

In light of the above, this thesis shall therefore commence with an investigation into the origin and form of the Doctrine.

²³ Primarily in Terra, Ben, Kajus, Julie, "A Guide To The European VAT Directives – Introduction to European VAT 2010", Volume 1, IBFD

²⁴ Article 168a (2) RVD

²⁵ COM(2007)677 p. 3

²⁶ Article 168a (2) RVD

2 The asset labelling doctrine

Prior to 1st January 2011 the rules for deduction on immovable property differed from the current legislation. They relied on a doctrine developed by the ECJ, which was known as the asset labelling doctrine. It was developed through case law. Therefore, there will now follow an analysis of that case law in chronological order so that the Doctrine's development can be better understood.

2.1 Self-supply

The rules on self-supply²⁷ are central to these concepts and apply when a taxable person uses business assets for private purposes. In those cases, the supply must be treated as if it were made for consideration. VAT therefore must be paid. The three conditions are;²⁸

1. The person supplying must be a taxable person.
2. The goods must be part of the assets of the business and VAT on the goods in question should have been wholly or partially deductible.
3. The supply must be taxed i.e. not exempt.

The purpose of the legislation is to prevent a taxable person from deducting input VAT on his business goods and then using them in part, or in whole, for private purposes without paying the tax that a non-taxable person would have to pay on those goods.

This is a manifestation of the principle of equality which dictates that a taxable person who acquires goods through his business and so is entitled to deduct input VAT and then uses them for private use shall not be in a more advantageous position than a natural person who acquires similar goods and therefore must pay input VAT without the right to deduct.

The taxable amount shall be the purchase price of the goods or of similar goods or, in the absence of a purchase price, the cost price, determined at the time when the application, disposal or retention takes place.²⁹ This taxable amount is then used to determine how much VAT shall be paid.

2.2 Case law

The Doctrine has been developed incrementally by case law, and therefore in order to understand it, there must be a systematic review of each case in order to better comprehend the origin of the concepts that became the fundamentals of the old regime.

2.2.1 50/88 Kühne

The Kühne case was the genesis of the asset labelling doctrine. In the case, Kühne, who as a lawyer was a taxable person for VAT purposes, bought from a private person, who was therefore a non-taxable person, a second-hand business car that he then used for private and business purposes. The German tax authorities charged VAT on the car in respect of its

²⁷ Article 26 RVD

²⁸ Terra p. 416

²⁹ Article 74 RVD

depreciation in proportion to the private use made of it by Dr. Kühne, who challenged that decision. He claimed that since he had been unable to deduct the VAT on the car, if tax were charged on the depreciation of the car by reason of his private use, turnover tax would be levied twice, which would be contrary to the VAT system. Furthermore, he claimed that for purposes of private use account should be taken of the actual running costs of the car, and not depreciation.³⁰

The tax authorities asked the Court for clarification on the meaning of the phrase “where the value-added tax on such goods is wholly or partly deductible”³¹.

The Court concluded that the purpose of the provision was to prevent the non-taxation of business goods used for private purposes and therefore requires the taxation of the private use for such goods only where the tax paid on their acquisition was deductible.³²

The Court continued to note that since a taxable person is not permitted to deduct the residual tax on business goods purchased second-hand from a non-taxable person, the VAT on such goods must be considered not to be deductible and no tax may therefore be levied under that provision on the depreciation of the goods in respect of their private use.³³

Such taxation of business goods on which the residual tax was not deductible would lead to double taxation contrary to the principle of fiscal neutrality, which is inherent in the common system of value-added tax.³⁴

As regards the right to partial deduction, The Court continued that the answer must be the same where although the taxable person was not able to deduct the VAT in respect of the supply of the goods to him, he was none the less able to deduct the VAT on the supplies of goods and services which he sought and obtained from other taxable persons for the maintenance or use of the goods.³⁵

Therefore, if the taxable person was not able to deduct the residual input VAT, then he couldn't be charged output VAT on private use as that would have amounted to double taxation.

2.2.2 C-97/90 Lennartz

H. Lennartz was a German tax consultant from Munich.³⁶ In 1985 and 1986, Mr Lennartz worked partly as an employed person and partly as a self-employed tax consultant. He submitted annual VAT declarations for that period in respect of his self-employed activity. In 1985, Mr Lennartz purchased a car for DM 20 206.15, plus VAT of DM 2 826.86. In 1985, he used his car mainly for private purposes and only to a limited extent - about 8% - for business purposes. On 1 July 1986, he opened his own tax consultancy office and contributed the motor car to the business. In his VAT declaration for 1986, he claimed retroactively, on the

³⁰ Case 50/88 Kühne paragraph 4

³¹ Ibid paragraph 5

³² Ibid paragraph 8

³³ Ibid paragraph 9

³⁴ Ibid paragraph 10

³⁵ Ibid paragraph 15

³⁶ Case C-97/90 Lennartz paragraph 2

basis of German law, a deduction of DM 282.98 for the purchase of a car, being 6/60ths of the total VAT which he had paid on the car.³⁷

The Finanzgericht decided that Mr Lennartz should be regarded as having initially acquired the car solely for private purposes and that he was not therefore entitled to any adjustments if the car was subsequently used for business purposes. The Finanzamt based its view that the car was used initially only for private purposes on an administrative practice followed by the German tax authorities whereby in general no account is taken of the business use of goods where such use accounts for less than 10% of total use. Consequently, the Finanzamt refused to grant Mr Lennartz a retrospective adjustment of the VAT declaration filed by him for 1985.³⁸

The Court concluded that only the capacity in which a person is acting at the time of the purchase can determine the existence of the right to deduct. Therefore, in so far as a taxable person, acting as such, uses the goods for the purposes of his taxable transactions, he is entitled to deduct the tax due or paid in respect of those goods.³⁹ Therefore, no deduction can arise in relation to the part allocated to his private assets.

A person who acquires goods for the purposes of an economic activity within the meaning of the Directive does so as a taxable person, even if the goods are not used immediately for such economic activities.⁴⁰

Furthermore, it is the acquisition of the goods by a taxable person acting as such that gives rise to the application of the VAT system and therefore of the deduction mechanism. The use to which the goods are put, or intended to be put, merely determines the extent of the initial deduction to which the taxable person is entitled and the extent of any adjustments in the course of the following periods.⁴¹

The Court then explained the self-supply system stating that; the use of capital goods for the private use of a taxable person or for purposes other than those of his business, where the VAT on such goods is wholly or partly deductible, is treated as a supply of services for consideration. Therefore, where a taxable person acquires goods, which he employs partly for private use, he is deemed to effect for consideration a supply of services taxed on the basis of the cost of providing the services. Consequently, a person who uses goods partly for the purposes of taxable business transactions and partly for private use and who, upon acquiring the goods, recovered all or part of the input VAT, is deemed to use the goods entirely for the purposes of his taxable transactions. Consequently, such a person is in principle entitled to a right of total and immediate deduction of the input tax paid on purchasing the goods.⁴² This is generally known as the Lennartz Principle.⁴³

The Court stated also that Member States are not authorised to limit the right of deduction, even where the use of the goods for the purposes of economic activities is very limited, except where they may rely on one of the derogations provided for in the Sixth Directive.⁴⁴

³⁷ Ibid paragraph 3

³⁸ Ibid paragraph 4

³⁹ Ibid paragraph 8

⁴⁰ Ibid paragraph 14

⁴¹ Ibid paragraph 15

⁴² Ibid paragraph 26

⁴³ Terra p. 458

⁴⁴ Case C-97/90 Lennartz paragraph 29

2.2.3 C-193/91 Mohsche

In 1983 Mr Mohsche, a tool manufacturer, used for private purposes a motor car belonging to his business. In assessing the VAT payable for 1983, the Finanzamt included in the taxable amount a sum corresponding to the provision for depreciation of the vehicle and a percentage of certain expenses incurred for the use and maintenance of the vehicle.⁴⁵

The Court has held that it follows from the structure of the Sixth Directive that it is designed to prevent the non-taxation of business goods used for private purposes and therefore requires the taxation of the private use of such goods only where the tax paid on their acquisition was deductible.⁴⁶

The taxation of business goods on which the residual tax was not deductible would lead to double taxation contrary to the principle of fiscal neutrality.⁴⁷

Therefore, the Directive must be interpreted as precluding taxation of the private use of goods forming part of the assets of a business upon whose acquisition the taxable person was able to deduct the VAT in so far as such use also includes services which the taxable person received without deduction of input tax from third parties for the maintenance or use of the goods.⁴⁸

2.2.4 C-291/92 Dieter Armbrecht

Mr Armbrecht, a hotelier, owned a building comprising a guesthouse, a restaurant and premises used as a private dwelling. In 1981, he sold that building for a price of DM 1 150 000 "plus 13% VAT"⁴⁹ and opted for taxation on the business part.⁵⁰

In his declaration for 1981, Mr Armbrecht regarded only the sale of the part of his building which was used for professional purposes as subject to turnover tax; he treated the DM 157 705 received in respect of the private dwelling as exempt from turnover tax and accordingly invoiced the purchaser for turnover tax only on the former part.⁵¹

The Court stated that a taxable person performing a transaction in a private capacity does not act as a taxable person and therefore a transaction performed by a taxable person in a private capacity is not subject to VAT.⁵² Furthermore, there is no provision in the Directive which precludes a taxable person who wishes to retain part of an item of property amongst his private assets from excluding it from the VAT system.⁵³

This interpretation makes it possible for a taxable person to choose whether to integrate into his business, for the purposes of applying the Directive, part of an asset which is given over to his private use. This, the Court maintained concurs with one of the basic principles of the Directive, namely that a taxable person must bear the burden of VAT only when it relates to

⁴⁵ Case C-193/91 Mohsche paragraph 3

⁴⁶ Ibid paragraph 8

⁴⁷ Ibid paragraph 9

⁴⁸ Ibid paragraph 15

⁴⁹ Case C-291/92 Armbrecht paragraph 3

⁵⁰ Ibid paragraph 4

⁵¹ Ibid paragraph 5

⁵² Ibid paragraph 17 and 18

⁵³ Ibid paragraph 19

goods or services which he uses for private consumption and not for his taxable business activities. This does not impede the application of the Lennartz principle, to the effect that capital goods used both for business and private purposes may none the less be treated as business goods the VAT on which is in principle wholly deductible.⁵⁴

Furthermore, apportionment between the part allocated to the taxable person's business activities and the part retained for private use must be based on the proportions of private and business use in the year of acquisition and not on a geographical division. The taxable person must, moreover, throughout his period of ownership of the property in question, demonstrate an intention to retain part of it amongst his private assets.⁵⁵

Finally, where a taxable person sells property part of which he had chosen at the time of acquisition not to assign to his business, only the part of the property assigned to his business is within the Scope.⁵⁶

2.2.4.1 AG Jacobs Opinion

AG Jacobs agreed with the opinion of Advocate General Van Gerven⁵⁷ that a taxable person may choose to exclude the parts of an immovable property set aside for private occupation from the assets of his business for the purposes of applying the Directive.⁵⁸

Jacobs noted that a fixed geographical division of an immovable property into business and privately occupied parts is inconsistent with the scheme of the directive and liable to lead to double taxation.⁵⁹

This double taxation would be contrary to the principle of fiscal neutrality as it would mean that the taxable person who used assets in this way would otherwise be in a less advantageous position than a natural person or a taxable person who used such an asset for only taxable purposes.

The AG noted that the advantage for the taxable person of opting for this method is that it will take account of any reduction in the proportion of private use in later years. If, on the other hand, the taxable person opts to keep part of the asset out of the business he bears tax definitively on the private element as determined in the year of acquisition. He also noted that an increase in private use would trigger the self-supply rules.⁶⁰

Jacobs concluded that this approach may be favoured by a taxable person who considers that his degree of private use of goods is unlikely to vary significantly and would prefer administrative simplicity or who acquires an asset that does not depreciate over a useful life which can be accurately estimated. It may be noted that the fact of giving a choice to the taxable person will not lead to tax avoidance. On the contrary, it will allow private use to be accounted for in accordance with the principle that the tax burden should resemble as closely as possible that which would have been borne if the goods had remained in the taxable person's private domain.⁶¹

⁵⁴ Ibid paragraph 20

⁵⁵ Ibid paragraph 21

⁵⁶ Ibid paragraph 29

⁵⁷ Opinion of Advocate General Van Gerven, C-291/92

⁵⁸ Opinion of Advocate General Jacobs, C-291/92 paragraph 4

⁵⁹ Ibid paragraph 40

⁶⁰ Ibid paragraph 49

⁶¹ Ibid paragraph 49

2.2.5 C-415/98 Laszlo Bakcsi

During 1990, Mr Bakcsi carried on business as a self-employed haulage contractor. For that purpose he used a Mercedes 300 D motor car, which he had purchased from a private individual without being able to deduct VAT. The vehicle was used to the extent of 70% for business purposes.⁶²

Mr Bakcsi disposed of the motor car on 16 May 1990 for DEM 19 000, without showing the VAT element separately in an invoice.⁶³

The Finanzamt held that the sale of the car was subject to VAT⁶⁴ as did the Finanzgericht who took the view that the sale had to be subject to VAT on the ground that, by claiming deduction of the input tax paid in respect of the costs of repairs to the car, Mr Bakcsi had demonstrated his decision to allocate the car to his business.⁶⁵

The Court reiterated its stance that a capital item held entirely within a taxable persons private assets is outside the scope of VAT, regardless of how it is used. Therefore no deductions are possible.⁶⁶

The Court ruled that is also necessary to point out that the use, for business or private purposes, to which a taxable person actually puts a capital item need be taken into account for the purpose of determining how that item has been assigned only if the taxable person requests the right to deduct, wholly or in part, the input VAT paid in respect of the acquisition. In such a case, it is necessary to determine whether the goods have been acquired by the taxable person acting, at least in part, as such, that is to say, for the purposes of his economic activities.⁶⁷

It follows that, since the taxable person has not been authorised to deduct the residual VAT on capital goods purchased second-hand from a non-taxable person, the VAT on such goods must be considered not to be deductible and no tax may therefore be levied on that withdrawal under that provision⁶⁸

This it was deemed, would therefore be compatible with the objective of equal treatment since the taxable person does not enjoy any advantage to which he is not entitled in comparison with an ordinary customer.⁶⁹

The Court concluded that where a taxable person has chosen to incorporate wholly into his business assets a capital item which he uses for both business and private purposes, the sale of that item is subject in full to VAT, in accordance with the Directive. Where a taxable person assigns to his business assets only the part of the item used for business purposes, only the sale of that part is subject to VAT. The fact that the item was purchased second-hand from a non-taxable person and that the taxable person was therefore not authorised to deduct the

⁶² C-415/98 Bakcsi paragraph 9

⁶³ Ibid paragraph 10

⁶⁴ Ibid paragraph 11

⁶⁵ Ibid paragraph 12

⁶⁶ Ibid paragraph 27

⁶⁷ Ibid paragraph 29

⁶⁸ Ibid paragraph 44

⁶⁹ Ibid paragraph 45

residual VAT on that item is irrelevant in this regard. However, if the taxable person withdraws such an item from his business, the VAT on that item must be considered not to be deductible and no tax may therefore be levied on that withdrawal under that provision. If the taxable person subsequently sells the item, he will be carrying out that transaction in a private capacity and the transaction will therefore be excluded from the system of VAT.⁷⁰

2.2.6 Joined Cases C-322/99 Hans-Georg Fischer and C-323/99 Klaus Brandenstein

The questions were raised in proceedings between the Finanzamt Burgdorf and Mr Fischer and, the Finanzamt Düsseldorf-Mettmann and Mr Brandenstein concerning liability for VAT on the allocation by taxable persons for their private use of motor vehicles which they had purchased from private individuals without VAT being deductible but where VAT on supplies of various services and goods for those vehicles had been deductible.⁷¹

In 1989, Mr Fischer, who traded as a second-hand car dealer, bought a Bentley motor car from a private individual. He was therefore unable to deduct VAT from the purchase price, which was DEM 28 000. The vehicle was acquired for the purposes of Mr Fischer's taxable activities, namely to be re-sold in the course of his business.⁷²

In 1990, Mr Fischer restored the Bentley, having extensive bodywork repairs and respraying done. The invoice for that work, dated 14 May 1990, came to DEM 10 800, plus VAT of DEM 1 512. In the same year, Mr Fischer deducted the VAT on that invoice as input VAT.⁷³

On 31 December 1992, Mr Fischer ceased trading and took the unsold vehicles, including the Bentley, into his private assets.⁷⁴

Mr Brandenstein was a self-employed tax adviser and auditor. In 1985, he purchased a vehicle for business use from a private individual for DEM 33 600 and was unable to deduct VAT. It is not disputed that from the time of purchase Mr Brandenstein used the vehicle in question solely for business purposes.⁷⁵

In 1991, he allocated the vehicle to his private assets. Up to that time Mr Brandenstein had spent a total of DEM 16 028.54 on, inter alia, servicing, minor repairs, replacement tyres, the fitting of a catalytic converter in 1987 and of a new windscreen in 1991. He had deducted the input VAT on each occasion.⁷⁶

The Court ruled that the components already present when the goods are initially acquired and the components incorporated after acquisition cannot be treated differently. In both cases, if a taxable person has deducted the VAT on the component parts of the goods, he must, when he allocates the goods for his private use, be prevented from enjoying an advantage to which he is not entitled by comparison with an ordinary consumer.⁷⁷

⁷⁰ Ibid paragraph 47

⁷¹ Joined Cases C-322/99 Hans-Georg Fischer and C-323/99 Klaus Brandenstein paragraph 2

⁷² Ibid paragraph 14

⁷³ Ibid paragraph 15

⁷⁴ Ibid paragraph 16

⁷⁵ Ibid paragraph 22

⁷⁶ Ibid paragraph 23

⁷⁷ Ibid paragraph 57

On the other hand, it is consistent with the objective pursued by Article 5(6) of the Sixth Directive for that type of allocation to be subject to VAT where the post-acquisition supplies of goods have led to a lasting increase in the value of the goods, which has not been wholly consumed at the time of the allocation.⁷⁸

Where a taxable person allocates for purposes other than those of the business, goods in respect of which no VAT was deductible and which, after acquisition, had VAT-deductible work done on them, VAT is payable under Article 5(6) of the Sixth Directive if the work resulted in the incorporation of component parts within the meaning of that provision. Where a motor vehicle is allocated, the component parts are goods supplied which have definitively lost their physical and economic distinctiveness as a result of being incorporated in the vehicle and which have given rise to a lasting increase in the value of the goods which has not been entirely consumed at the time of the allocation.⁷⁹

Taxation of the goods in such a situation, where the input tax was not deductible on purchase, would lead to double taxation contrary to the principle of fiscal neutrality. Taxation of the component parts ensures, moreover, that the taxable person does not enjoy any advantage to which he is not entitled by comparison with an ordinary consumer.⁸⁰

Thus, the VAT payable is solely that to the component parts of the goods in respect of which there was entitlement to deduct, namely the components which definitively lost their physical and economic distinctiveness when they were incorporated in the vehicle, after its purchase, following transactions involving supplies of goods which led to a lasting increase in the value of the vehicle which has not been entirely consumed at the time of the allocation.⁸¹

The Court concluded therefore that where work which is carried out on goods after their purchase and on which the input VAT was deducted does not give rise to liability for VAT when the vehicle is allocated, the VAT deducted in respect of that work must be adjusted in accordance with the Directive if the value of the work in question has not been entirely consumed in the context of the business activity of the taxable person before the vehicle is allocated to his private assets.⁸²

This means that if the added components have been entirely consumed then there is no obligation to charge VAT on them.

2.2.7 C-269/00 Wolfgang Seeling

Mr Seeling owned a tree-surgery and horticultural business. In 1995, he erected a building, which he treated as forming, in its entirety, part of the assets of his business. Since its completion, he has used it partly for business and partly for residential purposes.⁸³

⁷⁸ Ibid paragraph 68

⁷⁹ Ibid paragraph 70

⁸⁰ Ibid paragraph 76

⁸¹ Ibid paragraph 78

⁸² Ibid paragraph 95

⁸³ C-269/00 Wolfgang Seeling paragraph 15

In his VAT declaration for 1995, Mr Seeling claimed the deduction in full of the amount of VAT paid as input tax for the construction of the building. He declared as taxable personal use the private use of a dwelling in the building.⁸⁴

However, the Finanzamt regarded the private use of part of the building as being exempt personal use and refused the corresponding deductions.⁸⁵

The Court echoed the logic of its previous stance in that where a taxable person chooses to treat an entire building as forming part of the assets of his business and subsequently uses part of that building for private purposes, on the one hand, he is entitled to deduct the input VAT paid on all construction costs relating to that building and, on the other, he is subject to the corresponding obligation to pay VAT on the amount of expenditure incurred to effect such use.⁸⁶

The Court deemed that while authorising a taxable person to treat a building as forming, in its entirety, part of the assets of his business, and thus to deduct input VAT on all the construction costs, by taxing the private use by the taxable person of a dwelling in that building may have the result, as the German Government maintained, that there will be untaxed end use, because the adjustment period is likely to correct to a limited extent only the deduction of input tax made when the building was constructed, that is a consequence of a deliberate choice on the part of the Community legislature and cannot have the effect of requiring that another article of the directive be given a broad interpretation.⁸⁷

In light of this statement, the Court observed that, since May 1995⁸⁸, the adjustment period for capital goods in the form of immovable property may be extended to 20 years and that it was clear from its preamble that this amendment was made precisely in order to take account of the duration of the economic life of such goods.⁸⁹

2.2.7.1 AG Jacobs Opinion

AG Jacobs agreed with the judgement of the Court.⁹⁰

2.2.8 C-434/03 P. Charles and T.S. Charles-Tijmens

Mr Charles and Mrs Charles-Tijmens jointly purchased a holiday bungalow in the Netherlands in March 1997. It was intended both for letting and for private use, and during the period at issue in the main proceedings, namely from 1 April to 30 June 1997 inclusive, the bungalow was so used, to the extent of 87.5% of the time for letting and 12.5% for private purposes.⁹¹

In their VAT declaration for the second quarter of 1997, Mr Charles and Mrs Charles-Tijmens deducted 87.5% of the tax invoiced to them in respect of the bungalow. Consequently, they sought a refund of the amount corresponding to that percentage.⁹²

⁸⁴ Ibid paragraph 16

⁸⁵ Ibid paragraph 17

⁸⁶ Ibid paragraph 43

⁸⁷ Ibid paragraph 54

⁸⁸ Council Directive 95/7/EC

⁸⁹ C-269/00 Wolfgang Seeling paragraph 55

⁹⁰ Opinion of Advocate General Jacobs, C-269/00, paragraph 25

⁹¹ C-434/03 P. Charles and T.S. Charles-Tijmens paragraph 7

⁹² Ibid paragraph 9

By decision of 1 October 1997, the latter granted Mr Charles and Mrs Charles-Tijmens the refund they had requested. Nevertheless, taking the view that the VAT paid by them was 100% deductible, they submitted an application for the additional refund of the amount relating to the 12.5% of the time that the bungalow was used for private purposes.⁹³ This was denied.⁹⁴

The Court reiterated its previous principles by restating that it is settled case-law that, where capital goods are used both for business and for private purposes the taxpayer has the choice, for the purposes of VAT, of (i) allocating those goods wholly to the assets of his business, (ii) retaining them wholly within his private assets, thereby excluding them entirely from the system of VAT, or (iii) integrating them into his business only to the extent to which they are actually used for business purposes.⁹⁵

Accordingly, a taxable person has, first, the right to choose to allocate wholly to his business capital goods which he uses in part for the purposes of the business and in part for purposes other than those of his business and, where appropriate, the right to immediate deduction in full of the VAT due on the acquisition of those goods and, second, the corresponding obligation to pay VAT on the amount of expenditure incurred for the use of those goods for purposes other than those of the business.⁹⁶

2.2.8.1 AG Jacobs Opinion

AG Jacobs notes that it is clear that the availability of a choice as to whether to include mixed-use goods in business or private assets favours the taxable person, who may be expected to opt always for inclusion in business assets. Conversely, fiscal authorities will prefer a compulsory allocation to private assets of a proportion equivalent to that of private use.⁹⁷

Furthermore, the Advocate General notes that whilst it may legitimately be contended that goods put to private use, or the proportion put to that use, should be placed outside the VAT system from the moment of acquisition, so that there is never any deduction of input tax, that does not take account of the fact that where goods are included in private assets there is no adjustment mechanism to deal with situations where they are subsequently put to business use.⁹⁸

Jacobs concluded therefore that a taxable person's choice of whether to include capital goods used for business and private purposes in either his business or his private assets is justified by the fact that, although it may provide him with a possible tax advantage, the alternative would impose on him a disadvantage which is incompatible with the principles of VAT and which cannot be remedied. Nor does any other solution consistent with the principle of fiscal neutrality appear to be available under the existing legislation – or indeed perhaps at all.⁹⁹

⁹³ Ibid paragraph 10

⁹⁴ Ibid paragraph 11

⁹⁵ Ibid paragraph 23

⁹⁶ Ibid paragraph 30

⁹⁷ Opinion of Advocate General Jacobs, C-434/03 paragraph 78

⁹⁸ Ibid paragraph 79

⁹⁹ Ibid paragraph 82

3 Consequences of the asset labelling doctrine

3.1 The Lennartz principle

The Lennartz principle can be described as the following; when a taxable person, acting as such, allocates an asset entirely to his business assets he is in principle able to deduct immediately and in full the input VAT. When however it is used for private and for taxable uses he is still able to deduct full input VAT immediately but he must account for output VAT on personal use.¹⁰⁰

As seen in the case law above this means that the benefits which are granted to taxable persons are that when they choose to construct an immovable property which they intend to use for mixed purposes, they are entitled to deduct full input VAT. This is the case no matter how little the property in fact will be used for business purposes.¹⁰¹ In order to deduct this full input VAT according to the Lennartz principle, the taxpayer need only allocate the asset entirely to their business. This does generate a number of cash-flow advantages such as the 10-year interest free loan and the potential for untaxed end use (see below).

Furthermore, a taxpayer may choose to allocate the goods wholly to business use, wholly to private use or partly to business and partly to private use.

When the goods are allocated wholly to business use then VAT is due in full on their disposal, and when the asset is allocated to part business and part private use then VAT is due only on the proportion that is allocated to business use. This applies whether the input VAT was deductible or not, however where no deduction was possible the asset can be transferred to the private assets without incurring VAT and will therefore after that be outside the scope of VAT and as such not liable to any further VAT implications, as are assets that are from the beginning allocated wholly to private use.¹⁰²

3.2 Increases in business use

An increase in business use does not mean an increase in the right to deductions; because the right to deduct arises at the moment of the deductible tax becomes chargeable¹⁰³ based on the capacity in which the buyer was acting at the time. Therefore, when this moment has passed, there is no longer any way in which to change it. Therefore, there is no adjustment mechanism to increase the amount of the initial deduction.¹⁰⁴ Once that initial deduction has been made, any part of the asset that is in the private sphere will remain there. The adjustment mechanism in that system only recognised an increase in private use –through the self-supply rules¹⁰⁵. For this reason, there would always be, when any business use was planned or likely, an incentive

¹⁰⁰ Terra p. 458

¹⁰¹ Case C-97/90 Lennartz paragraph 29

¹⁰² Terra p. 460-461

¹⁰³ Article 167 RVD

¹⁰⁴ C-460/07 Puffer paragraph 44

¹⁰⁵ Article 26 and 75 RVD

to allocate entirely to business assets for mixed use and not at all to private assets as the moment an asset is allocated to private assets, to the extent that it is not allocated to the taxable persons business assets, the possibility to deduct is lost forever.¹⁰⁶

3.3 10-year interest-free loan

The issue was raised of the possibility of a 10-year interest-free loan arising when a taxable person was allowed to deduct immediately all input VAT by allocating goods for mixed use to his business assets.¹⁰⁷ This would occur as there would be the immediate deduction of all input VAT¹⁰⁸, followed by a staggered repayment of the deducted input VAT over the 10-year adjustment period¹⁰⁹ (or longer) if the asset was then used entirely for private use in the form of assessment according to the self-supply rules. As there was no interest charged on this amount it effectively amounted to an interest-free loan, quantified at a 5% advantage.¹¹⁰

This is undoubtedly one of the certain constructions designed to create an unjustified cash-flow advantage¹¹¹, which the Amendment was referring to given its potential inequity. This is because it means that a self-employed (and therefore taxable) person may construct a house at a cost of €5 000 000, deduct the full input VAT on construction costs at €1 000 000, thereby paying €4 000 000, and then paying the remaining €1 000 000 back over a 10 year period without interest as application for private use payments. Alternatively, even more advantageously, in Member States where the 20 year adjustment period has been implemented; over that period.

3.4 Untaxed end-use

The issue of untaxed end-use is linked to the VAT-free sale of the immovable property. As established above the sale of immovable property is exempt from VAT, except where the taxable person opts for taxation.¹¹²

3.4.1 Supplies made during the adjustment period

If a taxable supply is made during the adjustment period¹¹³ the use for the remainder of said period will be presumed to be taxable and therefore it will entitle full deduction of the input VAT for the remainder of the period.¹¹⁴ In this case the supplier has charged output tax with a corresponding deduction.

Similarly, if an exempt supply is made during the adjustment period, the use for the remainder of the period will be presumed to be exempt and therefore no input VAT deduction will be allowed for the remainder of the period.¹¹⁵ In this case the supplier has not charged output tax

¹⁰⁶ Opinion of Advocate General Jacobs C-291/92 paragraph 49 and Terra p. 978

¹⁰⁷ See C-72/05 Wollny below

¹⁰⁸ Article 167 RVD

¹⁰⁹ C-460/07 Puffer paragraph 20

¹¹⁰ Ibid paragraph 21

¹¹¹ COM(2007)677 p. 3

¹¹² Article 137 (b) RVD

¹¹³ Article 187 RVD

¹¹⁴ Opinion of Advocate General Léger C-72/05 paragraph 64

¹¹⁵ Ibid

and therefore the buyer is forced to account for full private use for the remainder of the period according to the self-supply rules.

It doesn't appear therefore that a sale of the immovable property during the adjustment period can cause untaxed end use. However when sold, free of VAT after the expiration of the adjustment period, there are other risks as seen below.

3.4.2 Incongruence between payments of tax charged on self-supplies and the adjustment period

If the adjustment period ¹¹⁶as set out in the Directive is 10 years, then the periodical payments on private use according to the self-supply rules¹¹⁷ must correspond to the length of this period.

For example, over a 10 year adjustment period the self-supply payments at the end of the each year must be 10% of the deducted input VAT for them to be able to possibly account for 100% of the deducted input VAT over the 10 year period. If however, the rate is set by the national legislations rate of depreciation of immovable property which is likely to be much lower due to a long economic lifetime of such an asset, e.g. 2% as the building will be considered to be fully written off after 50 years, then the payments at that rate cannot ever fully account for the deducted input VAT as there will at most be a repayment of 2% x 10 years= 20% repayment of input VAT despite full private use.

In this way there can be untaxed end use as at the end of the adjustment period there can no longer be any adjustments to this amount which has been accounted for. Alternatively the immovable property could equally well be sold on, exempt to a private person.

3.4.3 Deferred private use

The second way in which untaxed end use may occur is similar to that mentioned above, however, instead it relies on the taxable person constructing an immovable property, deducting full input VAT and then using it for business use for the duration of the adjustment period. At the end of the adjustment period it can then be sold on to a private person exempt of VAT. If this is done then no VAT will ever be paid on the property despite its use for a long time for private purposes, well after the end of the adjustment period.¹¹⁸

3.4.4 Prevention

Both of these could have been militated by the extension of the adjustment period to 20 years,¹¹⁹ however as seen above that would also have made the "interest-free loan" even more advantageous.

It should also be noted that in both of these cases, the seller in the year of the expiration of the adjustment period will be in a more competitive position than private persons who have

¹¹⁶ Article 187 RVD

¹¹⁷ Article 26 and 75 RVD

¹¹⁸ Opinion of Advocate General Léger C-72/05 paragraph 65

¹¹⁹ Ibid paragraph 66

constructed an immovable property and then have decided to sell it but who have had to bear the full costs of the input VAT and as such will pass it on to the buyer.

3.5 Equity of the asset labelling doctrine

Discrimination is when two objectively comparable situations are treated differently, and it is an infringement of the principle of fiscal neutrality. In the situation at hand there are three possible persons; the taxable person who buys and uses an immovable asset for business purposes. He will be able to deduct the input VAT in full immediately, and should he opt for taxation the sale of that immovable property will be subject to VAT.

The second is that of the non-taxable person who purchases an immovable property on which he must pay VAT in full with no chance to deduct. However upon future sale of the asset it will be outside the scope of VAT and as such no output VAT will be levied.

The third option is that of the taxable person who buys an immovable property, allocates it entirely to his business assets and then uses it entirely for private use, and as such must assess that use for VAT for the entirety of the adjustment period.

In terms of equity the Doctrine therefore allows the taxable person who allocated to his business assets and the uses for private purposes benefits such as the 10-year interest free loan, and when the full cost of private use is calculated on a time period longer than the adjustment period, the benefit of never accounting for in full the amount which he originally deducted. These advantages are not granted to the other two.

The taxable person who uses the asset for taxable purposes for the entirety of the adjustment period but then makes an exempt supply to a private person is also in a more advantageous position than the non-taxable person who, also selling his immovable property at the end of the adjustment period, or even immediately after purchase must bear the burden of the VAT and therefore will pass that on to the purchaser.

As much as these are different advantages not granted to all, however the three persons are not strictly comparable and therefore the principle of fiscal neutrality is perhaps not infringed.

The Doctrine and its shortcomings have now been thoroughly investigated as set out above. A similar study of the pro rata deduction system, with a comparison to what has been found above, is now necessary in order to be able to evaluate the relative meritorious value of the two systems in achieving equity and preventing certain constructions giving rise to unjustified cash-flow advantages.

4 Pro rata deduction

4.1 Case law

Article 168a was introduced in January 2011, and as such it was implemented after the Wollny and Puffer cases which preceded it by a few years, however, interestingly AG Sharpston made reference to the proposal of 168a in his opinion on how the relevant provisions should be interpreted in the Puffer case.¹²⁰

However, it must be noted that the two cases were not decided on the basis of the pro rata deduction method as it was not yet applicable for such goods, but were a part of the asset labelling doctrine. Despite this, it is appropriate to discuss them in this chapter and not one of the two above, as Wollny certainly, and Puffer in a slightly lesser way, introduce 168a and what it stands for as they treat the concept of what is to be considered the full taxable amount for self-supply, whether the Doctrine constitutes infringement of the principle of fiscal neutrality and how it accommodates increases in business use.

4.1.1 C-72/05 Wollny

In 2003, the Hausgemeinschaft Jörg und Stefanie Wollny, a household made up of Mr and Mrs Wollny ('the household'), had a building constructed, which was to form in its entirety part of the assets of its business. That building comprises the privately used rooms of the two members of the household and the rooms of a tax adviser's office, which were let to one of those members. The part which is let constitutes 20.33% of the building. That letting is subject to VAT.¹²¹

In its provisional VAT returns for December 2003 and for the months of January to March 2004, the household deducted the entire VAT charged to it in connection with the costs of constructing the building. Relying on the rate of depreciation for wear and tear of buildings as laid down in national legislation, it considered that the taxable amount for the private use of 79.67% of the building was a monthly amount equal to 1/12 of 2% of the construction costs apportionable to the privately used part of the building.¹²²

The Court declared that the interpretation, in general terms, of the expression "full cost" cannot be left to the discretion of each Member State.¹²³ Therefore, it needed to establish how this expression should be interpreted. Generally speaking, however, it corresponds to expenses which relate to the goods themselves. It includes expenses, such as acquisition and construction costs, relating to the goods in respect of which VAT was deductible, and without which the private use in question could not have taken place.¹²⁴

The Court stated that the aim of the system of adjustment is analogous to that of the levying of VAT on the private use of immovable property. It is a matter, firstly, of avoiding giving an

¹²⁰ Opinion of Advocate General Sharpston C-460/07 paragraph 21 making reference to COM(2007)677 Article 1(11)

¹²¹ C-72/05 Wollny paragraph 13

¹²² Ibid paragraph 14

¹²³ Ibid paragraph 26

¹²⁴ Ibid paragraph 27

unjustified economic advantage to a taxable person by comparison with a final consumer, by obliging the taxable person to pay amounts equivalent to the deductions to which he was not entitled.¹²⁵ Secondly of ensuring a correspondence between deduction of input tax and charging of output tax.¹²⁶

Therefore, a Member State does not misconstrue the discretion which it enjoys in providing that the rules relating to the adjustment of deductions apply for the purposes of establishing the taxable amount for the private use of business goods.¹²⁷

This approach also contributes to reducing the cash-flow advantage which the levying of VAT in instalments gives a taxable person using business property for private purposes by comparison with the final consumer who must pay the whole of the VAT on acquiring or constructing such a building.¹²⁸

This approach, it was argued, would make it possible to preclude cases of untaxed end use in the event that the building was transferred free of VAT at the end of the period for adjustment of deductions. By spreading the levying of the VAT for the private use of the building in question over the duration of that period, it ensures, as regards that use, that the total amount of tax corresponding to the deduction of input tax is levied before a possible resale of the building exempt from VAT takes place at the end of that period.¹²⁹

The Court found that the length of the period for adjustment provided for in the Directive was able to preclude cases of untaxed end use to a limited extent only, in situations where the levying of VAT in instalments for the private use of business property was permitted over a longer period than that of the period for adjustment.¹³⁰

The Directive is therefore to be interpreted as meaning that it does not preclude the taxable amount for VAT in respect of the private use of part of a building treated by a taxable person as forming, in its entirety, part of the assets of his business from being fixed at a portion of the acquisition or construction costs of the building, established in accordance with the length of the period for adjustment of deductions concerning VAT provided for in the Directive. That taxable amount must include the costs of acquiring the land on which the building is constructed when that acquisition has been subject to VAT and the taxable person has deducted that tax.¹³¹

Therefore, the adjustment payments can be set by the Member States as a proportion relating to the adjustment period (i.e. 10% per year for a 10 year adjustment period) and the total cost includes the cost of the land, providing that the amount paid for it was subject to tax and that amount was deducted with regard to the private use.

In this was the Court is accepting deviations from the full cost of providing a service in the strictly economic sense as that would amount to the depreciation costs of the building, and would therefore not correspond to the adjustment period set out in the Directive. Furthermore

¹²⁵ Ibid paragraph 35

¹²⁶ Ibid paragraph 36

¹²⁷ Ibid paragraph 37

¹²⁸ Ibid paragraph 38

¹²⁹ Ibid paragraph 39

¹³⁰ Ibid paragraph 47

¹³¹ Ibid paragraph 53

it also allows deviation from the full cost in the economic sense in that a proportion of the cost of the land is to be included in the full cost of providing the service despite the fact that land of that type will not typically depreciate in value and as such there is no actual cost associated with the use of the land as its value is not effected by its private use in the way that there is for the use of the building.

4.1.1.1 AG Léger Opinion

This conclusion was in line with the opinion of the Advocate General who argued that the cost of the land must be included although it cannot technically depreciate as such, and furthermore that the fixing the repayments to the length of the adjustment period would help prevent untaxed end use.¹³²

4.1.2 C-460/07 Puffer

Over the period from November 2002 to June 2004, Ms Puffer built a single-family house with a swimming pool. From 2003, she used the house as a private residence, with the exception of one part, covering approximately 11% of the building, which she let for business purposes.¹³³

Ms Puffer treated the building as forming, in its entirety, part of her business and claimed the deduction of the full amount of input taxes charged on the construction of the building.¹³⁴

The Finanzamt, first, refused to take into account for deduction purposes the taxes paid on construction of the swimming pool. Second, in relation to the other building costs, it allowed a deduction of the input tax paid only to the extent of the use of the building for business purposes, that is, 11%.¹³⁵

The national court pointed out that the full and immediate deduction of VAT on the building costs of such a mixed-use building and the subsequent imposition of VAT on the expenses pertaining to the part of the building used as a private residence, spread over 10 years, have the effect of granting the taxable person, in respect of that period, an ‘interest-free loan’ not available to a non-taxable person.¹³⁶

It quantified this resulting financial advantage at 5% of the net costs of construction of the part of the building used for private purposes, and argued that it gives rise to the unequal treatment of taxable and non-taxable persons and, within the category of taxable persons, between those who construct a building for purely private purposes and those who construct it, in part, for their business.¹³⁷

The Court concluded that subsequent use for business purposes of the part of the goods allocated to private assets is not capable of giving rise to a right to deduct, because Article 17(1) of the Sixth Directive lays down that the right to deduct is to arise at the time when the

¹³² Opinion of Advocate General Léger C-72/05 paragraph 111

¹³³ C-460/07 Puffer paragraph 14

¹³⁴ Ibid paragraph 15

¹³⁵ Ibid paragraph 16

¹³⁶ Ibid paragraph 20

¹³⁷ Ibid paragraph 21

deductible tax becomes chargeable. There is no adjustment mechanism to that effect under Community legislation as it stands.¹³⁸

Furthermore, it is possible that the provision doesn't ensure, on its own the same treatment of taxable persons and non-taxable persons or of other taxable persons who acquire goods of the same kind on a private basis. This is because the aim to relieve the taxable person entirely of the burden of VAT can give rise to a financial advantage with regard to the private use of those goods by those taxable persons.¹³⁹

However, the characteristics that for example a taxable person is liable to VAT and must collect output tax distinguishes him from a non-taxable person who does not exercise such economic activities, therefore a possible difference in treatment results from the application of different rules to different situations, thus not giving rise to any infringement of the right to equal treatment.¹⁴⁰

The same applies to a taxable person who has allocated the capital goods, in their entirety, to his private assets since he does not intend to use those goods to pursue his economic activities but to use them for private purposes.¹⁴¹

Nor can a different view be reached as regards a taxable person who carries out only exempt operations, since such a taxable person is subject to the same VAT burden as a non-taxable person and his status thus largely similar to the latter.¹⁴²

Finally taxable persons carrying out both exempt and taxable transactions are treated in respect of each category of their economic activities and in relation to the private use of their mixed-use goods, in exactly the same way as persons who exclusively pursue activities connected with one of those categories of activities or use.¹⁴³

4.1.2.1 AG Sharpston Opinion

By ruling this way, the Court was in line with the opinion of the Advocate General who also concluded that there was no infringement of the general principle of equal treatment.¹⁴⁴

The reason that the Wollny and Puffer cases have been included under the chapter on pro rata deduction is that they serve as an introduction of 168a which is the basis for the pro rata deduction scheme as Wollny concludes that the full cost for private use can be calculated by reference to the period of adjustment and that it also includes the cost of the land. Puffer further introduces 168a by confirming that there can be no increase in business use deductions under the asset labelling doctrine.

4.2 Art 168a

The changes are effected, as stated in the Amendment, by the insertion of Article 168a into the RVD. It states as follows;

¹³⁸ Ibid paragraph 44

¹³⁹ Ibid paragraph 55

¹⁴⁰ Ibid 56 and 57

¹⁴¹ Ibid paragraph 58

¹⁴² Ibid paragraph 59

¹⁴³ Ibid paragraph 60

¹⁴⁴ Opinion of Advocate General Sharpston C-460/07 paragraph 63

1. In the case of immovable property forming part of the business assets of a taxable person and used both for purposes of the taxable person's business and for his private use or that of his staff, or, more generally, for purposes other than those of his business, VAT on expenditure related to this property shall be deductible in accordance with the principles set out in Articles 167, 168, 169 and 173 only up to the proportion of the property's use for purposes of the taxable person's business.
By way of derogation from Article 26, changes in the proportion of use of immovable property referred to in the first subparagraph shall be taken into account in accordance with the principles provided for in Articles 184 to 192 as applied in the respective Member State.
2. Member States may also apply paragraph 1 in relation to VAT on expenditure related to other goods forming part of the business assets as they specify.

As stated above, for reasons stated above, the second part which related to VAT on expenditure related to other goods forming part of the business assets as they specify is outside the scope of this thesis.

The stated intention is that the provision aims to clarify the exercise of the right of deduction when it applies to immovable property intended to be used simultaneously for business and non-business purposes. This is the case in particular for VAT related not only to acquisitions of immovable property but also to services such as construction, renovation or substantial transformations that, in economic terms, can be placed on the same level as the acquisition or construction of immovable property.¹⁴⁵

In cases of mixed use property, it can be deduced from Article 168a, that there is no longer the right to immediate full deduction of VAT as had been possible according to the Doctrine. Therefore, there is now a pro rata adjustment mechanism, which will remain applicable for the duration of the adjustment period. It will recognise changes, both increases and decreases, in the ratio of business and private use. This therefore replaces the tax on private use and replaces it with the loss of the right to deduct.¹⁴⁶

4.2.1 A temporary exemption equalisation

Terra/Kajus have proposed that the new mechanism for private use be dubbed a temporary exemption equalisation¹⁴⁷ as during the adjustment period transactions relating to private use are treated, for calculation of pro rata deductibility purposes, the same as exempt transactions.

Therefore when during a given year, business use increases, and therefore private use decreases in comparison to the initial deduction, the amount of input tax deduction corresponding to that year for that year is adjusted accordingly.

The system works on the basis that during the first year a benchmark is established, known as the initial deduction, which is then used as a point of reference for the subsequent years.¹⁴⁸

4.2.1.1 Calculation of the initial deduction

The first question, now that there is no longer the immediate full deduction of input VAT is how much of the taxable person's input VAT costs should be deducted as a reflection of their taxable transactions, and how much may not be deducted as they are attributable to exempt transactions/private use.

¹⁴⁵ COM(2007)677 p. 8

¹⁴⁶ Terra p. 979

¹⁴⁷ Ibid p. 980

¹⁴⁸ Articles 184 and 185 RVD and Terra p. 980

In this pro rata system a fraction is used to calculate the deductible proportion.¹⁴⁹ In this equation;

The **numerator** is the annual amount, free from VAT, of the sales of goods and provisions of services which allow the deduction of the VAT incurred, and;

The **denominator** is the annual amount, free from VAT, of all transactions related to an economic activity.

Therefore the private use, temporarily equalised to exempt transactions, will be included only in the denominator and not also in the numerator.

The deductible proportion is determined on an annual basis, fixed as a percentage and rounded up to a figure not exceeding the next whole number. The deductible proportion is, in the first year, estimated provisionally under the supervision of the tax authorities, by the taxable person on the basis of his own forecasts. These deductions made on a provisional basis shall be adjusted when the final proportion is fixed during the following year.¹⁵⁰

Therefore if the taxable persons own predictions were incorrect and gave rise to higher deductions than he in fact was entitled to, then this initial deduction will be adjusted accordingly.

4.2.1.2 The adjustment mechanism

However, as use of the asset changes the pro rata system must reflect these changes. This is done as follows; if in the first year the use is 30% private and 70% business then 30% of the full input VAT on the building will be deductible. This may then continue to be true for a few years, therefore incurring no further payment or repayment. In the fifth year however the business use may increase to 50%. This means a 20% increase in business use, and therefore deductibility for that year, and therefore 20% x 1/10 of the full input VAT will be paid to the taxable person. In the sixth year, however, business use may drop to 5% i.e. 25% less than the initial deduction year. Therefore, the taxable person will have to pay the tax authorities the amount of 25% x 1/10 of the full input VAT for that year.

The asset may, upon the expiry of the adjustment period, be transferred to the taxable persons private assets without incurring any tax as the supply is exempt.

4.3 Does it solve the issues with the former system?

In order to assess the success of this new system in light of its objectives set out earlier in this paper, namely to achieve greater equity and prevent unjustified cash-flow advantages it is now necessary to analyse to what extent certain constructions designed to create an unjustified cash-flow advantage are still possible.

¹⁴⁹ Article 174 RVD

¹⁵⁰ Article 175 RVD

4.3.1 10-year interest free loan

The 10-year interest free loan relied on the immediate deduction of all input VAT with a staggered imposition of VAT on private use over the adjustment period amounting to the sum originally deducted as the asset had been used exclusively for private use.

This is no longer possible under 168a as the initial deduction seeks to accurately represent the actual proportions to which the asset will be used. Therefore, if the asset, despite being allocated entirely to a taxable persons business assets, is used entirely for private purposes then there will be no right to deduction, as opposed to the assessment of VAT on private use.

Furthermore, even if the taxable person predicts an artificially high taxable use on the first day of deduction in conjunction with the tax authorities, it will be corrected at the end of the first year if it does not correspond to the actual use.

It may be possible to still achieve this if the taxable person consciously makes an effort to use the asset entirely for taxable purposes during the first year, however that would not be within the scope of this thesis.

4.3.2 Untaxed end use

The problem of untaxed end use under the old rules was discovered to be possible in two ways; through incongruence between payments of tax charged on self-supplies and the adjustment period, and through deferred private use.

4.3.2.1 Incongruence between payments of tax charged on self-supplies and the adjustment period

This was a problem when input VAT was deducted immediately in full and then paid back over the adjustment period in the form of VAT assessment on private use, however the full cost of private use was calculated on for example the rate of depreciation of the asset which is determined by the relevant Member State's domestic legislation at for example 2% of the cost of the building and not a proportion of the adjustment period. At such a rate there is no way that the VAT assessed on private use could ever correspond to the amount originally deducted as the period on which the cost was being calculated was longer than the adjustment period set out in the Directive.

This again should no longer be possible under the new system as there is not the option to deduct immediately and in full.

4.3.2.2 Deferred private use

The deferred private use however, relied on a taxable person deducting the input VAT in full and using the asset for taxable purposes for the entirety of the adjustment period, then at the end of it making an exempt supply to a private person, with the adjustment period being so short that the asset would still have a large proportion of its economic lifetime left.

This is still possible as the pro rata rules can in no way militate this problem without extending the adjustment period to the full length of the economic lifetime of an immovable asset.

4.4 Evaluation

In light of the function of the pro rata deduction system the question must be answered as to how equitable it is. As seen in the Puffer case, the three different persons are not in fact comparable and as such they cannot be expected to be treated the same, nor can the failure to treat them the same constitute infringement of the principle of fiscal neutrality.

The taxable persons who acquire an immovable property and allocate it to their business assets and then use it for mixed purposes will only have to bear the VAT costs in proportion to the private use. However, it could be argued that as the deduction can only be adjusted at the end of the year, that is after the transactions which determine the deductible amount, then the taxable person will be forced to bear the costs of the input VAT relating those transactions during that period when such business use is greater than that in the initial deduction.

The initial deduction now far more closely reflects the business use of the asset as in the former system the full deduction was applicable no matter how small the actual business use was.

4.4.1 Justification

The Commission rather cryptically concludes that the new rules are compatible with the principle of proportionality as the proposed measures mainly clarify and simplify current VAT rules, thereby benefiting traders, individuals and public administrations.¹⁵¹

It has also been argued that the pro rata system facilitates the deduction process in such a way that it accounts for changes in the use, and that it constitutes a simplification as not having to tax private (or non-business) use separately constitutes a simplification.¹⁵²

Some may argue however, that simple immediate deduction all input VAT and then assessing oneself for VAT on private use on the subsequent private use might be an even simpler procedure in which case the Commissions point is moot. This was at least the opinion of AG Jacobs in the Armbrecht case.¹⁵³

The Doctrine and its shortcomings have been investigated, as has the pro rata deduction system. The relative merits of the two regimes in achieving equity and preventing certain constructions giving rise to unjustified cash-flow advantages have also been contrasted. Therefore, the questions posed in this thesis can now hopefully be satisfactorily answered and informed conclusions can be drawn.

¹⁵¹ COM(2007)677 p. 5

¹⁵² Ibid p. 6

¹⁵³ Opinion of Advocate General Jacobs C-291/92 paragraph 49

Conclusion

Through the course of the investigation into the Doctrine it has been established, as scholars confirm,¹⁵⁴ that a taxable person may choose whether or not to integrate into his business, for the purpose of applying VAT rules, part of an asset which is given over to his private use.¹⁵⁵ Furthermore, if the taxable person chooses to treat capital goods used both for business and private purposes as business goods, the VAT due as input tax on the acquisition of those goods is in principle wholly and immediately deductible.¹⁵⁶ Private use of such assets is regulated by the self-supply rules.¹⁵⁷

In the Doctrine, it seems there was a prevailing attempt at equity. Mostly this was achieved through the self-supply rules, which prevented a taxable person deducting input tax and then using them for private use. This was countered through the imposition of an obligation to tax such activities which meant that such a taxable person did not enjoy an advantage over a non-taxable person.

However, as discussed above, there were a number of issues which arose, in which there were significant cash-flow advantages. The two main examples discussed were that of the 10-year interest free loan and the untaxed end use. The 10 year interest-free loan was a huge advantage granted to the taxable person who chose to allocate immovable property among his business assets and then used it for private purposes, thereby accounting for the VAT over the length of the adjustment period with no interest charged – effectively paying back a loan equivalent of 25% of the cost of the immovable property over a period of 10 years with no interest charged on that amount.

The second issue was that of the untaxed end use by which when the personal use was accounted for over a period longer than that for adjustment, it was shown that the property could later be sold on without all the tax being accounted for and therefore untaxed end use. In the example discussed, the immovable property could be sold with only 20% of the VAT on private use being accounted for. This has the effect that when the building is later sold, the seller is in a significantly more competitive position than his peers who have not deducted the full input VAT.

Also, the very fact that the economic lifetime of the asset was likely to be longer than 10 years meant that the person to whom the building was later sold, if after the expiry of the adjustment period, would enjoy untaxed end-use as the taxable person who first acquired it was able to deduct the input VAT in full and use the asset for business purposes for the entirety of the adjustment period before selling to that private person with no tax charged.

Furthermore, there was no adjustment mechanism in the event of an increase in future business use. This meant that, assuming a low initial deduction with high future business use, taxable transactions would be burdened with VAT in that it could not be deducted.

¹⁵⁴ Terra p. 987

¹⁵⁵ C-434/03 P. Charles and T.S. Charles-Tijmens paragraph 23

¹⁵⁶ Case C-97/90 Lennartz paragraph 26

¹⁵⁷ Case 50/88 Kühne paragraph 8

The new deduction system takes the form of a pro rata mechanism, that is that there is an initial deduction based on the use in the first year. This amount is then adjusted every year in comparison to that initial deduction which acts as a benchmark, depending on the changes in use over that one year. The adjustment period is still 10 years, and likewise it is still the prerogative of the Member State in question to decide to increase the length of this period up to, and including 20 years.¹⁵⁸

In terms of equity, the proportionate deduction therefore is far more fair in that the deduction actually corresponds to the use of the asset. Furthermore, it also prevents the cash-flow advantages such as the interest-free loan, however untaxed end use can still not be prevented. This is because an adjustment period which is shorter than the economic lifetime of an asset will always mean that the tax paid on the good must be finalised well before it can possibly be known how the asset will be used.

However, the abolition of the right to full immediate deduction does mean cash-flow disadvantages for the taxable person using mixed-use goods. A fundamental principle of the VAT system is that a taxable person should not have to bear the burden of VAT. Even with the adjustment mechanism, the taxable person still must suffer as the financial charge as the VAT encumbers the property during the period between the initial investment expenditure and the commencement of actual business use.¹⁵⁹ As some have suggested, it may even ultimately be necessary to compensate the taxable person, with interest, for the period in which the tax was non-deductible, to ensure the neutrality.¹⁶⁰ This however seems unrealistic.

Another way in which this affects the taxable person is that if the adjustments are retroactively pro rata then the taxable person has had to bear the input VAT as a cost during that year and is only after the conclusion of that year able to deduct that cost if the taxable use in that year exceeds the taxable use in the year of the initial deduction.

It must be added however, that at least now there is an adjustment for increased business use, something which was not possible under the Doctrine. In that way it is an improvement as in the former system there was an advantage to be gained by the application for immediate and full deduction even when the possibility that the property was not going to be used for business purposes was remote. This was, as explained above, to safeguard the taxpayer's interest as a failure to deduct from the outset meant a failure to deduct at all.

Final remarks

In closing, the author is of the opinion that Article 168a generally provides for a more equitable system with regard to immovable property, allocated entirely to a taxable persons business assets, and used both for taxable and private use.

Furthermore, by its nature of disallowing full immediate deduction it prevents unjustified cash-flow advantages more effectively than the asset labelling doctrine.

¹⁵⁸ Council Directive 95/7/EC

¹⁵⁹ Swinkels, "*Limitations...*" p. 288

¹⁶⁰ *Ibid* p. 289

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