VAT on internal supply of a long-term lease

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An interesting clarification on VAT provisions relating to the taxable amount of internal supplies was issued in April 2016 by the European Court of Justice (ECJ) in its judgment of Staatssecretaris van Financiën v Het Oudeland Beheer BV (Oudeland), case C-128/14.

Facts of the case

Oudeland, a Dutch company, entered into a 20-year lease for a plot of land that included an office building that was under construction. Oudeland would pay an annual ground rent over the 20-year lease period.

The Netherlands had exercised the option in Article 15(2)(b) of the VAT Directive, Directive 2006/112/EC, whereby rights *in rem* over immovable property are regarded as tangible property. Therefore the long-term lease under Dutch law was considered as a supply of immovable property, with the taxable amount equating to the capitalised amount of the ground rent as a whole. Oudeland paid the VAT on that amount to the lessor and deducted it in full in its VAT return.

Oudeland also completed the construction of the office building, incurring VAT, which it also fully deducted. At the time when the completed offices premises were delivered, Oudeland had also paid the first annual ground rent that had become due.

With regards to 12,5% of the total office building, Oudeland, together with the tenants, opted to waive the VAT exemption on the leasing - an option-to-tax allowed for under the Dutch VAT law. The remaining 87,5% was let and this transaction was exempt from VAT.

It considered that at the time of leasing out the building, it had carried out an internal self-supply, as per Article 18(a) of the VAT Directive, and not, under Article 16, which is the legal approach of the Cyprus VAT authorities (this is an interesting point to note as persons are often confused between these two, although an comparison between these two articles is outside the scope of the present article). Under 18(a), the application by a taxable person for the purposes of his business of goods constructed in the course of such business, where the VAT on such goods, had they been acquired from another taxable person, would not be wholly deductible, may be considered a supply of goods for consideration. Oudeland would therefore need to pay VAT on the proportion of the self-supply not covered by the option-to-tax.

The taxable amount of a deemed supply under either Article 16 or Article 18(a), is the same. It must be calculated in accordance with Article 74 of the VAT Directive, with the taxable amount being the purchase price of the goods or similar goods, or in the absence of a purchase price, the cost price, determined *at the time when the application takes place*.

For the purposes of calculating the VAT on this self-supply, Oudeland considered that there was no purchase price of similar goods (probably given the 20-year lease and the unfinished building) and as such, the taxable amount should be based on the cost price. There was no dispute on this point with the Dutch VAT authority. As such, Oudeland, considered the taxable amount to be the entire cost of completing the construction together with the **one** annual rent that had already fallen due before delivery – these two costs making up the cost price at the time when the renting our of the building occurred. The VAT Authorities disagreed, stating that the taxable amount should include the entire capitalized ground rent of the 20-year lease period.

This question over the determination of the taxable amount was one of the maters referred to the ECJ.

Decision of the ECJ re taxable amount

The ECJ noted that the purpose of the specific deemed supply provision was to allow taxable persons, engaged in VAT exempt activities, who cannot deduct the VAT they paid on acquiring their business goods, not to be placed at a disadvantage as compared with competitors engaged in the same activity who use goods which they have obtained without paying VAT, e.g. by producing the goods themselves.

The court also noted that due to the absence of a purchase price, the cost price becomes relevant for the taxable amount.

The court concluded, based on its case law, that where the deemed supply (being the delivery of the offices) does not take place at the same time as the initial grant of the 20-year leasehold, but a year later, then the value of that right to be taken into account in the taxable amount corresponds to the ***residual value*** of the lease, at the time of the deemed supply, being the remaining 19 years.

At the time, when the deemed supply took place, i.e. when the finished offices were delivered to Oudeland, one year of the 20-year lease had passed. If a competitor were granted a long lease agreement over the same property, for the 19-year remainder of the long lease concluded by Oudeland, in order to apply the office building for the purposes of the same business as that of Oudeland, then the cost price of the long leasehold would correspond for the competitor, to the value of that right at the time of its grant. This would be the 19-year residual value.

The court noted that if you only take into account the one year that was paid, as was the suggestion of Oudeland, although this represents the amount actually paid, it does not represent the value of the leasehold at the time of the supply.

On the other hand, if you take into account all 20 years of the lease, as was the position of the Dutch VAT authorities, you ignore the fact that the value of the long leasehold decreases proportionally with the passage of time, and would in effect, ignore the rule that the cost price must be determined at the time the supply takes place.

The court thus concluded that the correct taxable amount should be the full cost of completing the construction of the offices, plus the capitalized value of the remaining 19 years of the ground lease.