

VAT EXEMPTION ALSO FOR LETTING OF BUSINESS FIXTURES? TAKEAWAYS FROM ECJ JUDGEMENT C-516/21 (FINANZAMT X) DATED 4 MAY 2023

The VAT exemption for the leasing and letting of real estate shall also apply to the letting of permanently installed equipment and machinery where that letting constitutes a supply ancillary to a principal supply of leasing of real estate, carried out under a leasing agreement concluded between the same parties.

On 4 May 2023, the European Court of Justice (ECJ) decided on a request for a preliminary ruling from the German Federal Fiscal Court (*Bundesfinanzhof*) made on 26 May 2021 (V R 22/20).

THE UNDERLYING FACTS

The owner of real property let, in the context of a lease, a turkey-rearing shed with permanently installed equipment and machinery. The equipment and machinery were specially adapted for the use of the building for the rearing of such poultry. According to the provisions of the lease agreement, there was no dedicated allocation of the rent to the property (rearing shed) and to the equipment and machinery, but only one consolidated amount of rent.

The lessor was of the view that the whole of his leasing service was exempt from VAT. However, the German tax office argued (in accordance with the German administrative VAT guidelines) that the leasing of the equipment and machinery was a separate supply not exempt from VAT and applied VAT on the part of the consolidated amount of rent they considered to be allocated to the leasing of machinery and equipment.

According to the German local fiscal court (*Finanzgericht*), the letting of the equipment and machinery constituted a supply ancillary to the provision of the rearing shed (i.e. forms part of the leasing and letting of real estate) and had to be exempt from VAT on the same basis. Therefore, it took the view that the leasing service at issue should be fully (i.e. including to the extent comprising the letting of the machinery and equipment) VAT-exempt.

Key issues

- Clarification of the application of VAT rules to leases of real properties together with permanently installed equipment and machinery (business fixtures), in particular, for landlords letting to VAT-exempt tenants
- German tax authorities must reconsider their legal interpretation
- Trade tax remains unaffected

THE QUESTION OF THE GERMAN FEDERAL FISCAL COURT

The referring court (German Federal Fiscal Court) was of the view, that two interpretations of Article 135(2), first subparagraph, point (c) of the VAT Directive (which generally stipulates that the letting of permanently installed equipment and machinery is not exempt from VAT) are possible in this context.

First possible interpretation: The principles applicable to determine the existence of a single economic supply allow an exemption from VAT for a supply which should in principle be subject to VAT under Article 135(2), first subparagraph, point (c) of the VAT Directive where it constitutes a supply ancillary to an exempt supply.

Second possible interpretation: Article 135(2), first subparagraph, point (c) of the VAT Directive entails splitting single economic transactions – by distinguishing supplies exempt from VAT – under Article 135(1)(l) of that directive, from supplies subject to VAT under Article 135(2), first subparagraph, point (c) of that directive.

Therefore, the German Federal Fiscal Court referred corresponding questions to the ECJ.

THE DECISION OF THE ECJ

The ECJ ruled that Article 135(2) of the VAT Directive is not a provision from which it follows, as the German Government claims, that a single economic transaction must be divided into separate supplies.

If the Member States were allowed to subject the various elements making up a single supply to different VAT rates, this would amount to allowing them to artificially split that supply and would risk distorting the functioning of the VAT system.

The referring court has to decide whether the services constitute a single economic supply. If the services constitute such single economic supply, the referring court has to decide whether the supplies making up such a single economic supply are principal or ancillary.

The ECJ ruled:

Article 135(2), first subparagraph, point (c) of Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax must be interpreted as not applying to the letting of permanently installed equipment and machinery where that letting constitutes a supply ancillary to a principal supply of leasing a building, carried out under a leasing agreement concluded between the same parties and exempt under Article 135(1)(l) of that directive, and those supplies form a single economic supply.

CONCLUSION

For the parties of a lease agreement regarding immovable property together with permanently installed equipment and machinery – as in the case at hand – this decision provides more legal certainty. In essence, in these cases the VAT exemption also applies to the letting of equipment, machinery and/or business fixtures if such letting is ancillary to the letting of the actual real estate. This interpretation may, in particular, have an impact in cases where the leasing of the real estate is exempt from VAT (and e.g. no option for VAT

has been or could be applied). However, if the letting of such equipment, machinery or business fixtures is (as ancillary services to the VAT exempt lease) VAT exempt, no input VAT deduction will be possible in this respect.

There may still be cases where there are discussions with the tax authorities as to whether or not a bundle of services constitutes a single supply and which of the elements of such bundle of services is the principle service and which is to be regarded as ancillary service. However, these discussions can be expected to be more straightforward as there are applicable court decisions and guidelines by the tax authorities.

Of course, German trade tax remains unaffected from the ECJ decision. The letting of operating facilities (*Betriebsvorrichtungen*) is, in principle, harmful for the application of the extended trade tax exemption (*erweiterte Gewerbesteuerkürzung*) for real estate companies, unless this exceptionally is an absolutely necessary – *i.e.* indispensable – part of an economically reasonable own real estate management and use pursuant to applicable case law of the German Federal Fiscal Court. Based on a change of the German Trade Tax-Act which entered into force as of 11 June 2021 and applies to the tax assessment period 2021 and later periods, income resulting from direct contractual relationships with the tenants, e.g. leasing and letting of fixtures to a tenant, will not be detrimental for purposes of the extended trade tax exemption, provided that this income does not exceed 5% of the total rental income resulting from the leasing of own real estate during the same financial year. At least for these purposes, it may be recommendable to split the remuneration to the actual real estate and the fixtures. However, it is important to ensure that the splitting of the remuneration is not used by the tax authorities as an argument to try to separate this single letting supply into two separate supplies from a VAT perspective (in order to try to apply VAT on the letting of the fixtures).

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