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VAT'S UP

VAT NEWSLETTER

German Federal Ministry of Finance changes principles for VAT classification of rental and leasing contracts

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1 Background

The classification of the transfer of objects within the framework of leasing agreements is a constant issue under VAT law. Is there a supply of goods or a supply of services?

To date, the German tax authorities have based their decisions on general principles of VAT law and income tax rules. According to these, a supply of goods under VAT law has been found to exist if the lessee is entitled to dispose of the leased object like an owner. As a rule, this was assumed if the leased asset was attributable to the lessee for income tax purposes (Section 3.5 para. 5 sentences 1 and 2 old version of the German VAT Circular). The reference to income tax law then often forced the taxpayer to deal with the leasing remissions under German income tax law. The application of the intrinsically autonomous VAT law was thus subject to the dictates of income tax law.

The ECJ decision *Mercedes-Benz Financial Services UK Ltd.* (judgment of October 4, 2017, C-164/16) led to a departure from this principle. According to this decision, the classification for VAT purposes based on income tax law was no longer tenable. For a long time it was unclear how the German tax authorities would deal with the ECJ ruling. At the beginning of December 2019, a draft letter of the German Federal Ministry of Finance was circulated which provided for the German VAT Circular to be changed in accordance with the statements of the ECJ ruling. Now, the German Ministry of Finance has published its final letter at 18.03.2020 with a supplement that is of significant practical importance.

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2 Changes to German VAT Circular

The German Ministry of Finance's new letter essentially amends section 3.5 paragraphs 5 and 6 of the German VAT Circular. According to these amendments, the transfer of goods under leasing procedures only constitutes a supply of goods if the two conditions detailed below are met. The principles apply analogously to the transfer of goods outside leasing procedures. For example, they also apply to rental contracts (sec. 535 German Civil Law) with the right to purchase.

2.1 Clause on transfer of ownership

The contract must contain an explicit clause on the transfer of ownership of the leased asset from the lessor to the lessee. Such an explicit clause also exists if the contract contains an option to purchase the asset.

2.2 Automatic transfer of ownership

The terms of the contract must clearly state that ownership is to pass automatically to the lessee if the contract is fulfilled according to schedule. The contract conditions objectively applicable at the time of signing the contract are decisive. In the case of a formally non-binding purchase option contained in the contract, this condition should be fulfilled if the exercise of the option appears to be the only economically rational option for the lessee. The contract must not offer the lessee a real economic alternative at the time the option is exercised, e.g. a return or further rental. For example, there should be no real economic alternative if, at the time the option is exercised, the sum of the contractual instalments equals the fair value of the asset, including financing costs. In this case, the lessee should not have to pay a significant additional amount due to the exercise of the option. In the draft of the letter, it was not yet clear from which order of magnitude a substantial additional sum would be given. The Ministry of Finance has now added a definition. According to this definition, a substantial additional sum is paid if the amount to be paid exceeds 1% of the market value of the object at the time the option is exercised.

3 Application

The principles of the letter must be applied in all open cases. However, a non-complaint clause applies to leasing and rental agreements concluded before 18.03.2020. This also applies for the purposes of input VAT deduction.

4 Practical consequences

With the new letter, there is now no longer a synchronization between income tax and VAT. The taxpayer no longer has to/can base his VAT treatment on the income tax principles and national and international accounting standards. This clarification is to be welcomed unreservedly in the sense of a uniform, consistent VAT law. However, entrepreneurs must now check whether their rental and leasing contracts still meet the conditions for accepting a supply of goods or supply of service. In particular, the 1% limit for additional payments when exercising an option must be observed. In this case it is necessary to determine an appropriate market value of the leased asset at the time the option is exercised. New contracts can be structured in such a way that they result in a supply of goods or a supply of services. This can be of particular interest in cross-border constellations (e.g. cross-border leasing) in order to have the place of supply in a certain country.

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