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Rent free period and lease contracts: new VAT developments

The rent free period commonly granted in office lease contracts has been the source of much heated debate with the Luxembourg VAT authorities. Over the past few months two decisions made by the Luxembourg Tribunal might shed some light on this sensitive topic and a priori open the door to a favorable outcome.

Background

The lease of buildings is as a rule VAT exempt but such VAT exemption can be waived through the exercise of a VAT option under certain conditions:

- both the lessor and the lessee must qualify as taxable persons for VAT purposes; and
- the building must be used by the tenant for the exercise of an economic activity allowing the tenant to predominantly deduct input VAT on costs incurred (minimum 50%).

The main advantage of opting for the taxation of rents notably lies in the granting of an input VAT deduction right to the landlord on its construction and renovation costs.

In both cases brought before the Luxembourg Tribunal, the landlords had opted for the application of VAT on the lease (considering the use of the building for taxable activities) and the VAT options were accepted by the VAT authorities. However, a rent free period exceeding 6 months was included in the lease agreements which led to a regularisation of the input VAT deducted for this period by the VAT authorities and hence, to the initiation of legal proceedings.

Approach of the VAT authorities: denying the input VAT deduction right for the rent free period

The VAT authorities challenged the input VAT deduction right exercised by the landlords for the rent free period in the absence of any economic activities performed during this period.

Indeed, the VAT authorities rejected the analysis whereby a rental activity should be construed as one single global activity and considered that it should rather be divided into two periods: a rent free period and a period subject to rent payment, which entails the application of two distinct VAT regimes depending on

the activity, i.e. a non-economic activity which does not entitle to any input VAT deduction right on the one hand and, on the other hand, a taxable economic activity giving rise to an input VAT deduction right.

According to the VAT authorities, even though the period subject to rent payment does not raise any issue, the absence of output transactions subject to VAT during the rent free period should not entitle the landlords to any input VAT deduction rights, which implies a regularisation of the related input VAT initially deducted by the landlords on a pro rata basis.

Rejection of the approach of the VAT authorities by the Luxembourg Tribunal

In both cases which were very similar, the Tribunal clearly rejected the approach taken by the VAT authorities on the following grounds:

- leasing of a building constitutes one single global activity which cannot be split into economic and non-economic activities;
- input VAT deduction right should not be strictly limited to the actual existence of taxable output transactions but exists as soon as the intention of the taxable person is to perform such taxable activity;
- input VAT deduction right has been confirmed by the European Court of Justice in the context of a building which had remained unoccupied for a long period (where it was established that the taxable person had sought to rent it during that period) and therefore, by extension, this solution shall apply in the context of a rent free period.

Outcome of the two decisions

The two decisions constitute a positive signal for Luxembourg promoters, developers and lessors, who are often having difficulties in claiming input VAT on costs incurred for the rent free period.

This statement should be tempered since the VAT authorities appealed and, therefore, the VAT treatment may be subject to possible developments. In practice, it cannot be excluded that the VAT authorities maintain their approach pending the final outcome of the legal proceedings.

Your Arendt VAT team is at your disposal should you wish to obtain any further information in this respect.

your contacts



BRUNO GASPAROTTO

Principal
Tax Law

[Learn more_](#)



SOPHIE WEYTEN

Counsel
Tax Law

[Learn more_](#)



NICOLAS CONRAD

Senior Associate
Tax Law

[Learn more_](#)



CLAIRE SCHMITT

Senior Associate
Tax Law

[Learn more_](#)



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