

# Riding the waves

Problems can arise when an activity straddles the boundary between a hobby and a business.

**JULIE BUTLER** notes some recent cases and considers the lessons to be learned.

Income tax loss claims arising from anything that amounts to a 'hobby' – for example, yachts and horses – have recently come under close scrutiny by HMRC, and this is reflected in a number of tribunal cases. The equine activities in **Three Cases** such as *McMorris* (TC04204), *Thorne* (TC03851) and *Murray* (TC03474) – where large tax losses were claimed sideways (under ITA 2007, s 64) against total income – have seen commerciality called into question and loss relief denied. Yachts are under similar scrutiny on the same commercial basis (see *A and J Rowbottom* (TC4817), *Taxation*, 11 February 2016, page 7) although, in the case reviewed here, the focus is on the eligibility of VAT claims.

The VAT treatment in relation to the private use element of a 'hobby' type of business was illustrated in *TJ Charters LLP* (TC4011) – a precursor of the *Rowbottom* case – in which a limited liability partnership bought a yacht for its chartering business (including the full amount of input tax on the VAT return). However, it also planned to use the yacht for private purposes and applied **The Lennartz Mechanism** to calculate this.

In *Lennartz v Finanzamt Munchen III* [1995] STC 514, the European Court of Justice ruled that a taxable person is entitled to recover input tax incurred on the purchase of goods, regardless of how little they were used in the business, provided there was some business use.

## KEY POINTS

- Sideways loss relief claimed from activities that might be classed as hobbies are likely to come under scrutiny from HMRC.
- Three recent First-tier Tribunal cases illustrate refusal of loss relief.
- An explanation of the Lennartz mechanism.
- Forward planning and ability to justify loss claims is essential.
- Activities will need to be considered in the round to determine whether a business is being carried on.



In *Charters*, HMRC did not agree with the business's calculations and increased the VAT on private use, asking for more input VAT.

The partnership appealed on the basis that the *Lennartz* method of calculation should not apply after all because, in essence, the boat was used solely for business with a commercial rate being paid for any private use.

In *Charters*, the First-tier Tribunal provided positive guidance for taxpayers with assets that are used in a business and have a private use. The tribunal agreed that output tax was due on private use by the taxpayer, but disagreed with HMRC on the periods when the vessel was lying idle. The tribunal decided that VAT need only be declared if goods (in this case a

## THREE CASES

### *Dr ELJ McMorris v HMRC* (TC04204)

Dr McMorris submitted a tax return claiming loss relief on the ownership of a racehorse. HMRC rejected the claim on the basis that this did not amount to trading. The First-tier Tribunal dismissed McMorris's appeal.

### *R Murray v HMRC* (TC03474)

Mr Murray submitted tax returns for 2007/08 to 2010/11 claiming substantial losses from a trade as a breeder and trainer of racehorses. Following an enquiry, HMRC issued a closure notice denying relief on the basis that the trade had not been carried out on a commercial basis. The First-tier Tribunal dismissed Murray's appeal, finding that he 'did not demonstrate sufficiently that his activities were carried out on a commercial basis with a view to the realisation of a profit of a trade'.

### *J Thorne v HMRC* (TC03851)

The First-tier Tribunal reached a similar decision as in *R Murray v HMRC* above.

## THE LENNARTZ MECHANISM

In *Lennartz v Finanzamt Munchen III* [1995] STC 514, the court ruled that a person who had a genuine intention to use a car partly for business and partly for private purposes had a right to a full and immediate input tax deduction in respect of VAT incurred on the purchase of the vehicle. Note that, unlike the UK, Germany did not have a specific restriction preventing deduction of VAT in respect of cars purchased for business use.

The UK restriction prevents use of Lennartz VAT accounting on cars intended for business and private or non-business purposes.

The court also ruled that VAT incurred on goods acquired solely for a private or non-business purpose is not recoverable, even if they are later put to a deductible business use. This is because the right to deduct VAT arises, and is exercisable, at the time when the VAT is incurred.

It should be noted that:

- The choice to use the Lennartz mechanism must be made at the time the input tax is incurred (that is, in sufficient time for the VAT to be deducted in the return period in which the VAT was charged). The input tax claim cannot be re-visited at a future date even if business use of the asset subsequently increases. If the choice is not made, the apportionment route must be followed should the taxable person seek to deduct any of the VAT. The taxable person should therefore retain contemporaneous evidence of a decision to treat the goods as wholly a business asset, to support the resulting input tax claim.
- The Lennartz mechanism can be used even if the use to which the goods will be put will be overwhelmingly private, as long as some genuine business use intended.
- A taxable person cannot use the Lennartz mechanism if the only business use of the asset is exempt.
- Where the mechanism is applied, the taxable person is then obliged to account for output tax in respect of any private or non-business use over the economic life of the goods. Records must be kept showing how the relevant asset has been used.

## Defining private use

It can be argued that idle periods can be defined clearly by a diary, but identifying the private use can be more difficult. An example is horse competition. This is quite a critical consideration in light of, say, the Olympics which, some would argue, has increased the value of horse sales, with many buyers trying to find the best horse at any price. This can return full circle to the question of the professional sports competitor and VAT treatment. The case of *Sharkey v Wernher* [1955] 36 TC 275 comes into play in considering the distinction between competitive horse ownership for pleasure and competitive horse ownership for increased profitability.

**“It has been argued that ‘competing’ represents private use and that the input VAT should be restricted.”**

Although the activity of competing in the local gymkhana or show-jumping competition might appear attractive to an outsider, or indeed to an HMRC officer, the reality for the professional show-jumper is that the travel involved is gruelling. Likewise, the pressure to achieve success – while adding value to the horses so they can be sold for more money – and the constant commercial pressure, takes pure hard work and a dedicated business strategy. It has been argued that ‘competing’ represents private use and that the input VAT incurred on this proportion of the total operation should be restricted in recognition of this personal element.

The business of competing must be able to show commerciality. This can be further complicated for the overseas competitor because their income tax treatment will often be complex. This can be caused by the income tax that is withheld from prize money by some foreign jurisdictions. Obviously, there is a spectrum where, at one end, is the very commercial ‘hard-bitten’ professional, while at the other there is the amateur. In the latter case, some parts of the activity are commercial and some parts are private use.

Each commercial operation should therefore be examined on a case-by-case basis, both in terms of income tax and VAT.

## A practical approach

The key for all VAT and income tax treatment is to consider the business ‘in the round’, with a clear understanding of the operation. Consistency of treatment and reasoned identification of what is really happening, together with supporting evidence, is essential. ■

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yacht) were used for private purposes, rather than when there was a *possibility* that they might be so used.

## Equine strategy

At a time when equine loss claims and assets used in a business are coming under such close scrutiny, it is essential that all arrangements should be planned in advance. Further, consideration should be given to how private use will be dealt with in VAT returns and how income tax loss claims can be justified to HMRC.

With regard to the sideways loss claim, one way to prove commerciality is to make a profit, and another is to produce a business plan which shows that a profit can be made, and that the plan is realistic.