Getting to grips with the option to tax

Indirect Tax



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Neil Warren gives some practical tips on which option to tax forms need to be completed for different property transactions

Key Points

What is the issue?

The amounts of VAT involved with land and property transactions can be high, so an understanding of the main principles of the option to tax procedures is important

What does it mean for me?

If the correct option to tax forms are completed, there is less risk of a business making costly errors or getting lots of queries from HMRC

What can I take away?

An option to tax election lasts for 20 years once made by a business, so it should only be made after all relevant issues have been considered

If you asked 100 accountants to name the trickiest VAT subject they deal with, I think that at least 90 would refer to ‘land and property’ transactions, with emphasis on the procedures of the option to tax regulations.

Why is this topic so difficult?

The answer is because it is one of the few situations in the world of the nation’s favourite tax where a supplier has a choice of whether he charges VAT – and because that decision is binding for 20 years (if an option to tax election is made) it clearly has long-term consequences. In this article, I will consider the range of option to tax forms in the VAT1614 series which need to be completed by property owners and landlords during the course of various deals.

Buying a property for rental purposes

Most commonly, an election needs to be considered when a landlord buys a non-residential property for rental to a tenant.

The landlord often carries out initial building work to improve the property, and he might also have paid VAT on the cost of buying the freehold if the seller had an option to tax election in place as well (or if it is less than three years old where the freehold sale is standard-rated by statute).

So, in order to claim input tax on the cost of buying and improving the property, our landlord must opt to tax it (and be VAT-registered) so that his rental income is standard-rated (taxable) rather than exempt. The relevant form to send to HMRC’s Option to Tax Unit in Glasgow is VAT1614A, which means that the landlord does not need HMRC’s permission to opt because he has not made any previous exempt supplies in relation to the building (see below re: form VAT1614H). The timing of submission is important:

- the first stage is that the landlord makes the decision to opt to tax a property; and
- HMRC must be notified of this decision within 30 days of it being made.

Note – there is scope to make a late notification to HMRC as long as the ‘decision’ stage has been correctly made – and HMRC are satisfied that this was made by the business owner at the time.

Previous exempt supplies

Let’s say a landlord has owned and rented out a property for the past 10 years and never charged VAT on previous rental supplies because he had never opted to tax the building. Now he is planning to spend £100,000 plus VAT on a refurbishment project and wants to claim input tax on these costs, so he must now make an option to tax election.

- The business owner must complete VAT1614A and consider the question on the form as to whether ‘automatic permission’ applies to the option – or whether the business instead needs to complete form VAT1614H and seek HMRC’s permission to opt.
- The relevant section to review is HMRC Notice 742A, s 5, which explains the four conditions. If a business meets one of the conditions listed in Box D of para 5.2, then it ticks the condition on form VAT1614A and no HMRC permission is needed.
- If none of the conditions is met, form VAT1614H needs to be completed to obtain HMRC’s permission to make an election. The aim of HMRC will be to ensure that no unfair tax gain is acquired by the business seeking to opt to tax.

Note – I acted for a farm some years ago that needed to opt to tax some land, but it had earned a bit of past rental income (exempt) by allowing a third party to erect a radio mast on its land. This income was ‘incidental’ to the main use of the land, so we met ‘condition 4’ and did not have a problem with our election.

Non-residential building converted to dwellings

An important form is VAT1614D which applies when a person acquiring an opted building intends to use it as, or convert it into, either:

- dwellings (houses, flats, bungalows); or
- a building for a relevant residential purpose (RRP) (such as student accommodation or a care home).

The result is that the seller's supply of the building becomes exempt from VAT rather than standard-rated, and the election is overridden. The form needs to be given to the seller before exchange of contracts, when the price of the deal is legally fixed. See ***Example 1***.

A key issue with form VAT1614D is that the buyer is certifying his 'intention' to carry out the conversion – there is no need for him to have formal planning permission in place when he acquires the property, and there is not a problem if he changes his mind having acquired the property (say, to convert it into offices rather than flats) as long as he had a genuine intention at the time of the deal. The form is retained by the seller (and not sent to HMRC) as evidence to confirm the property sale qualified for exemption.

Demolishing a building and selling the land

Imagine the following: John from Example 1 has decided to demolish the factory and sell bare land to Mike – and Mike will put up new purpose-built flats (dwellings). Mike again gives form VAT1614D to John. But is this correct? The answer is 'no' – the form is used in connection with buildings only, not land.

But what if the land was sold to a housing association instead of Mike? A housing association that intends to build new dwellings or an RRP building on land can issue form VAT1614G to override the option to tax election of the seller. This means that John's land sale will be exempt from VAT.

Note – an option can also be overridden in relation to land sold to a private individual who intends to construct a dwelling (see HMRC Notice 742A, para 3.7).

Option to tax in place for more than 20 years

Unfortunately for John, he has still not sold his land. But there might be a new window of opportunity because he can reverse his election with HMRC if it was made more than 20 years ago, allowing him to sell it without charging VAT. He must complete form VAT1614J and send it to HMRC in Glasgow.

Taxpayers need to answer five questions before they can sign the form. This is mainly for anti-avoidance purposes to prevent, say, a property owner prepaying an expense that will be attributable to a time period more than 12 months after the option is reversed so that he gets input tax recovery just before his reversal date – see ***Example 2***.

Constructing a new building on opted land

Going back to John, the final twist is that he couldn't sell his land to either Mike or the housing association; instead, he has decided to build an office block on the land, rent it out for three years and then sell it, almost certainly to a bank or other financial institution. Here are the key VAT facts:

- An option to tax election is always made on land – it then applies to any building that is constructed on the land apart from housing.
- So a new office block built on opted land is automatically covered by the original election.
- The only way of avoiding this outcome is if John completes form VAT1614F to specifically exclude the new factory from the original election. The form can be completed as soon as construction on the new building has started (HMRC Notice 742A, para 2.7).

Other forms

Form VAT5L gives taxpayers the chance to tell HMRC about the specific nature of their land and property supplies, together with the VAT liability of those supplies, at the time a business is seeking to register for VAT. HMRC will then be able to verify that a business is making taxable supplies and is entitled to register.

To complete the loop, there are three other forms that are used in limited situations which are mainly relevant to entities with a large portfolio of properties:

- VAT1614B – ceasing to be a relevant associate in relation to an option to tax;
- VAT1614C – revoking an option to tax – six-month cooling off period; and
- VAT1614E – notification of a real estate election – HMRC Notice 742A, s 14.

Example 1

John owns a factory and has an option to tax election in place on the building. He has received an offer from Mike to buy the freehold of the factory and intends to convert the building into 10 luxury flats. In this situation, Mike can avoid paying 20% VAT on the purchase of the building by giving form VAT1614D to John to confirm his intention to convert the property into ‘dwellings’. The property sale by John is now exempt from VAT and the option to tax is overridden.

Example 2

Susan rents out a property to a firm of insurance brokers – the latter cannot reclaim input tax because it is making exempt supplies. She reversed her election with HMRC when it had been in place for 20 years but, on the final day before reversal, she paid a company £50,000 plus VAT to cover the maintenance costs on the property for the next five years – that is, a prepaid expense relevant to a period more than 12 months after her reversal and when her rental income will be VAT exempt. There is no problem with Susan agreeing the contract and prepaying the expense but she will need to confirm to HMRC that no input tax will be reclaimed, otherwise she will be unable to revoke her election (HMRC Notice 742A, s 8).