Property VAT: option to tax rules

Property Tax | Indirect Tax



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We emphasise the importance of the option to tax procedures for a business with an interest in property because an election, once made with HMRC, remains in place for 20 years.

Key Points

What is the issue?

An option to tax election on a property should only be made by a business if there is an input tax benefit that would not otherwise be available. For example, if a landlord buys a commercial property to rent out, they will be blocked from claiming input tax on the purchase of the property and other costs if the rent is exempt rather than standard rated.

What does it mean to me?

There is no such thing as an opted property. Each business with an interest in a building will decide to opt to tax or otherwise. For example, a landlord might opt to tax a building and charge VAT to their tenants; the tenants might not have opted, meaning that income they earn from sub-tenants will be exempt.

What can I take away?

There are two stages to an option to tax election: the decision to do it; and the subsequent notification to HMRC, usually on form VAT1614A. In cases where the decision has been made but the business has forgotten to notify HMRC, the department will usually allow a backdated notification as long as proof is given that the decision to opt was made at the time.

A well-known English dictionary defines the word ‘option’ as ‘the power or right to choose’. In the mysterious world of VAT, the option to tax legislation for land and property is unique: it is the only situation when a supplier has the opportunity to charge 20% VAT on their income when it would otherwise be exempt. In other words, a taxpayer has – back to my dictionary – the power or right to choose to opt or not.

In this article, I will consider the key issues with the legislation and dispel some common myths.

Two stages: decision and notification

A successful option to tax election with HMRC requires two separate stages to be carried out:

- The business has **decided** that it is in its best interest to opt to tax a building or plot of land.
- Within 30 days of making that decision, the option is **notified** online to HMRC at optiontotaxnationalunit@hmrc.gov.uk

Most elections will be notified to HMRC on form VAT1614A. However, if a business has earned past exempt income from the building in question, it might need to get HMRC’s permission to opt and will therefore complete form VAT1614H.

A common situation occurs when a business has decided to opt to tax a property – claiming input tax on expenses and charging VAT on rental income – but has failed to notify HMRC of its decision. The oversight is usually identified many years later, often when a building is being sold and the buyer's advisers ask to see evidence – quite rightly – of the seller's election. HMRC will usually allow a backdated election if it is given proof that the decision-making stage was carried out; i.e. it was an oversight with the paperwork that caused the problem, rather than any attempt to make a belated election after the horse has bolted from its stable. See HMRC manual VAT Land and Property VATLP22400.

Some advisers incorrectly think there is such a thing as an 'opted property'; i.e. if the seller or landlord has opted, then the buyer or tenant must also opt as a *fait accompli*. However, the correct outcome is that each taxpayer with an interest in a property makes their own decision about whether they opt or otherwise. Another school of thought – also incorrect – is that a buyer must always opt to tax a property in order to claim input tax. See ***Bill and Ben: should they opt to tax?***

Bill and Ben: Should they opt to tax?

Bill trades as a computer wholesaler and has purchased a warehouse for £300,000 plus VAT, which will be used for his trading activities. There is no need for Bill to make an option to tax election; he can claim input tax of £60,000 because he is wholly using the warehouse to make taxable sales. The fact that the previous owner opted to tax is irrelevant.

Ben trades as a computer consultant and has purchased a two-floor office block for £400,000 plus VAT. He will trade from the ground floor and rent out the first floor to a firm of accountants. If Ben opts to tax the property, the rental supplies to the accountants will be standard rated rather than exempt. He will therefore avert a partial input tax block on the £80,000 VAT paid on the building cost because there are no partial exemption issues.

Note: Bill and Ben must review their input tax over the next ten years with the capital goods scheme because both properties cost more than £250,000 excluding VAT. This could produce an input tax repayment in some situations; for example, if Ben ceased to trade as a computer consultant before the end of the ten year period and used the building for an exempt activity such as an insurance broker.

Motive for opting to tax

When an accountant asks me for advice about whether a client should opt to tax a property, my first question is always the same: ‘Will the client get a worthwhile input tax benefit from opting?’

If the answer is ‘no,’ it is usually best practice to avoid an outcome which would mean that all rental income and selling proceeds from that property will be VATable in the next 20 years. Charging VAT will be a problem for buyers and tenants that cannot claim input tax.

To share a tale, a local dentist was buying the freehold of a building for £750,000. The seller initially said it was exempt from VAT but belatedly discovered they had opted to tax the property many years ago. The £150,000 VAT charge would become an extra cost to the dentist because of partial exemption – and that’s not forgetting an extra stamp duty land tax liability because this tax is charged on the VAT inclusive price of a sale. The proposed deal collapsed very quicky!

To highlight an example of when an option to tax election is definitely worthwhile, see ***Property Pat: purchase of office block.***

Property Pat: Purchase of office block

Pat is VAT registered and buying an empty building for £1 million plus VAT because the seller has opted to tax. Pat will spend £100,000 plus VAT on building improvements and rent it out to a firm of lawyers on a ten year lease for £80,000 per annum.

- It makes sense for Pat to opt to tax the property with HMRC for three reasons:
- He can claim input tax of £200,000 when he buys the property and also £20,000 on the building improvements.
- The annual output tax of £16,000 charged to the lawyers will not be a problem because their business is fully taxable without any input tax restrictions.

The property purchase will be subject to the capital goods scheme because it cost more than £250,000 excluding VAT, so input tax must be reviewed and adjusted over the next ten years according to the mix of exempt and taxable use of the

building. However, as rental income for the next ten years will be VATable, the annual adjustments with the capital goods scheme will be nil.

Warning: When Pat buys the property, he must get proof that the seller made an option to tax election with HMRC to confirm that the VAT charge of £200,000 is correct. A business can only claim input tax when VAT has been correctly charged in the first place.

Mixed use buildings

When I worked for HMRC many years ago – or Customs and Excise in those days – I visited a property business in Leicester. They rented out a building that consisted of a ground floor shop and a first floor flat. They had opted to tax the property and were charging VAT to both the shop tenant and a separate tenant in the flat. The VAT charged for the shop was correct but an option to tax election is always overridden for any part of a building that is used for residential purposes; those supplies are still exempt (see HMRC Notice 741A para 3.10).

The director said that the company was charging VAT on the flat rent – despite the legislation – so that it could claim input tax on all of the improvement and repair costs it had incurred. ‘Oh no you can’t,’ I said, adding a bit of pantomime fun to the proceedings. ‘You cannot make an exempt supply taxable by incorrectly charging 20% VAT. Definitely not!’

Revoking the option after 20 years

The option to tax rules were introduced on 1 August 1989, when Margaret Thatcher was Prime Minister. This means that all option to tax elections made by business owners between August 1989 and February 2004 can now be revoked because they have been in place for at least 20 years.

The revocation is made by completing and submitting form VAT1614J to HMRC and all income earned from the building thereafter will be exempt (see HMRC Notice 742A s 8).

Several years ago, I advised a betting shop business, which traded from rented high street shops located across the UK. It paid VAT to most landlords. This was a big cost

to the company with partial exemption because most sales were exempt under the betting and gaming legislation. The company asked all landlords if they could revoke their elections with the 20 year rule and there was a successful outcome for two shops.

Final poser

Here’s a final scenario to test your little grey cells:

- Bet and Alec have decided to buy the freehold of a pub from a brewery and trade as a partnership. However, they will buy the pub in a separate limited company and each own 50% of the shares, renting the property to the partnership on normal commercial terms.
- Mike and Marie have decided to buy the freehold of a commercial property and trade in partnership as a children’s nursery. They will buy the building in a separate limited company and each own 50% of the shares, renting the property to the partnership on normal commercial terms.

You might think that the two scenarios are identical and that the companies will be able to register for VAT and claim input tax on the purchase of the buildings and other costs as long as they opt to tax them with HMRC and charge VAT on the rent to the partnerships.

However, this is incorrect. Mike and Marie will trade as an exempt business, so must consider anti-avoidance rules, which could mean that their company’s option to tax election will be disapplied and it cannot either register for VAT or claim input tax. There is no problem for Bet and Alec because their pub is a fully taxable business (see HMRC Notice 742A s 13).

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