The option to tax: a strategic solution

Indirect Tax | Property Tax

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The option to tax is a cornerstone of VAT strategy, enabling recovery of input tax while managing risks in property transactions.

Key Points

What is the issue?
The default VAT exemption for most commercial property transactions prevents recovery of input tax and can trigger significant Capital Goods Scheme clawbacks, making property deals less profitable unless managed carefully.

What does it mean to me?
Using the option to tax can enable input tax recovery and protect against Capital Goods Scheme liabilities, but it brings complexity, including strict notification rules

and risks of disapplication.

What can I take away?
The option to tax is a powerful but technical tool that must be applied correctly and monitored over time. Understanding disapplication risks and transaction structuring is essential, and professional advice is often needed.

For any business involved with property, understanding the VAT implications is critical. The default VAT treatment for most sales and leases of commercial property is exempt.

While this may sound straightforward, it creates a significant problem: any VAT incurred on costs related to that property – such as purchase, refurbishment or professional fees – cannot normally be recovered. This can turn a profitable project into a financial drain.

Furthermore, making an exempt supply of a high-value property can trigger a substantial clawback of VAT recovered years earlier under the Capital Goods Scheme. Fortunately, there is a vital strategic tool that allows businesses to take control of this situation: the option to tax. This article will demystify the option to tax, explaining what it is, how to use it, and the critical pitfalls to avoid.

What is the option to tax?

The option to tax is a choice a business can make to change the VAT treatment of a property. It allows a person to charge standard-rated VAT on supplies of land or buildings that would otherwise be exempt.

The primary benefit is clear: by converting exempt rental income or a sale into a taxable supply, the business can recover the input tax on related costs. This directly addresses the problem of irrecoverable VAT and is the main driver for most decisions to opt to tax.

Crucially, the option attaches to the ‘taxable person’ for that specific property, not to the property itself. An option to tax does not pass automatically with the building and is a choice for each party.

How to opt to tax

Exercising an option to tax is a formal two-stage process that must be followed correctly for it to be valid:

1. **The decision:** The first step is to make a clear decision to opt to tax a specific property. This decision should be formally recorded (for example, in board minutes) and should state the property's address and the date the option is to take effect.
2. **Notification to HMRC:** The option only has legal effect once HMRC has been notified in writing. This notification must normally be made within 30 days of the decision, typically using Form VAT1614A. While HMRC has discretion to accept belated notifications, this is not guaranteed and requires clear evidence that the decision was made at the time claimed; for example, evidence that VAT has been charged and accounted for in line with the option.

An option to tax takes effect from the date specified in the decision, but it can never be applied retrospectively. Once made, it covers all future supplies of that property (including the entire building and its curtilage) made by that person until the option is revoked or disapplied. The option remains in place even if the building is later demolished.

This is a key point: notification can be backdated where you can demonstrate that a decision was made (for example, where VAT has been charged). However, the decision itself cannot be backdated.

It is important to note that HMRC no longer issues letters to acknowledge or confirm the receipt of an option to tax notification. If a notification is sent by email, an automated response will be generated, which serves as proof of receipt. For postal notifications, no acknowledgement is issued. The legal effect of the option is not dependent on this acknowledgement.

When is permission to opt to tax required?

A business cannot always opt to tax freely. If you have previously made exempt supplies, you may be required to obtain prior written permission from HMRC.

Permission is sought by submitting Form VAT1614H. HMRC will grant permission only if satisfied that it will result in a ‘fair and reasonable’ attribution of input tax. This may involve HMRC negotiating a special partial exemption method with the taxpayer to ensure fairness, particularly where the Capital Goods Scheme applies.

However, prior permission is not required if you meet one of the ‘automatic permission conditions’ set out in HMRC’s guidance. These conditions cover situations where there is no prior exempt income or the risk of tax avoidance is low; for example, where the only exempt supplies were incidental to the main use of the property, or where the taxpayer agrees not to recover any pre-option input tax.

Revoking an option to tax

An option to tax is a long-term commitment, but it is not necessarily permanent. It can be revoked in specific circumstances:

- **The 20 year rule:** An option can be revoked 20 years after it first took effect. This is subject to conditions, one of which is that the property must no longer be subject to Capital Goods Scheme adjustments. Revocation is notified on Form VAT1614J.
- **The six month ‘cooling-off’ period:** An option can be revoked within six months of being made, provided no VAT has become chargeable as a result of the option and no additional input tax has been claimed.
- **Automatic revocation:** If the person who opted holds no interest in the property for a continuous six year period, the option is automatically revoked, subject to certain anti-avoidance exceptions.

Disapplying an option to tax

An option to tax is powerful, but it is not absolute. There are important situations where an option is ‘disapplied’, meaning it has no effect and the supply remains exempt by law.

Certain supplies are always exempt, regardless of whether an option to tax is in place. The most common example is the supply of a building intended for use as a dwelling or for a relevant residential purpose (such as a care home).

There are other ways, typically involving certification, to disapply an option to tax, but there is a commercial risk to be aware of. These forms are designed to reinstate the exemption and prevent irrecoverable VAT being charged to certain buyers, but they can have an unexpected financial impact on the seller. The most common certificates include:

- **Form VAT1614D:** issued by a person intending to convert a non-residential building into dwellings;
- **Form VAT1614G:** issued by a housing association acquiring land or buildings to construct affordable housing; and
- **Notification from a charity:** A buyer or tenant can disapply the option by confirming that the building will be used for a relevant charitable purpose (other than as an office). While no specific form is mandated, written confirmation is essential for the supplier's records.

When a seller accepts one of these certificates, they are legally prevented from charging VAT and the supply becomes exempt. This is where the link to the Capital Goods Scheme becomes critical. An exempt sale of a property that is still within its ten year Capital Goods Scheme adjustment period can trigger a clawback of previously recovered VAT.

Consider a developer who bought development land for £2 million plus £400,000 VAT three years ago, recovering the VAT in full and making minimal taxable supplies. They now agree to sell it for £2.5 million to a housing association, expecting to charge VAT. However, the housing association issues Form VAT1614G, disapplying the option. The sale is now exempt.

- **The consequence:** The exempt sale triggers a clawback of the VAT attributable to the remaining seven full years of the adjustment period.
- **The clawback calculation:** This amounts to:
  (£400,000 VAT / 10 years) x 7 years
  = **£280,000**.

The developer is suddenly faced with a £280,000 VAT liability. The guidance makes clear that disapplication cannot be agreed once the price has been settled. The seller must be given the opportunity to consider the impact of making an exempt sale so that it can increase the price or withdraw from the deal.

In this example, the developer would have needed to increase the exempt sale price to £2.78 million to achieve the same net return. This demonstrates the risks of accepting a disapplication certificate, and the need to assess any financial impact of disapplication before contracts are concluded.

The strategic dimension

The option to tax is not just about recovering VAT on day-to-day costs; it is also a crucial defensive tool. For example, a fully taxable business that buys a warehouse and recovers the VAT in full could face a significant Capital Goods Scheme clawback if it later sells that property without an option to tax in place. By exercising an option *before* the sale, the supply would have become taxable and the clawback would have been completely avoided.

The rules are also designed to prevent abuse. A complex anti-avoidance test can disapply an option to tax. This is primarily aimed at arrangements where a property is developed and then occupied by the developer, a connected person or a financier for exempt or non-business purposes.

The test is triggered if, at the time of the grant, the following apply:

- The property is, or is expected to become, a capital item for Capital Goods Scheme purposes.
- The grantor, a development financier or a person connected to them intends to occupy the property.
- The occupier’s use is not ‘wholly or substantially wholly’ for making taxable supplies (known as ‘eligible purposes’), with ‘substantially wholly’ defined as at least 80%.

If these conditions are met, the option is disapplied, the supply becomes exempt and input tax recovery is blocked. There are, however, de minimis thresholds that can prevent disapplication, such as occupation of no more than 2% of a building by a grantor or of 10% by a financier.

Transfers of a going concern

The interaction between the option to tax and transfers of a going concern (TOGC) rules is a critical area where mistakes can have disastrous consequences. For the sale of a property rental business to be treated as a TOGC (and therefore outside the scope of VAT), specific conditions must be met.

If the seller has opted to tax the property, the buyer must also opt to tax the property and notify HMRC before the ‘relevant date’ (usually the date of completion or, if earlier, the date a deposit is paid directly to the seller). The buyer must also notify the seller that their option will not be disapplied under the anti-avoidance rules.

Failure to follow this sequence can be costly. If the buyer opts to tax after completion, the TOGC conditions are not met. The transaction becomes a standard-rated supply, and the seller is then normally required to charge VAT on the full sale price. This leads to a huge, unplanned VAT liability for the buyer and potentially significant additional stamp taxes.

In conclusion

The option to tax is an indispensable tool for managing VAT on property. It enables recovery of input tax that would otherwise be lost and provides a vital defence against the long-term hazards of the Capital Goods Scheme.

However, this is not a decision that can be made and then disregarded; it requires ongoing diligence. The rules are complex and the commercial implications – particularly the risk of disapplication and the strict requirements for TOGCs – are significant. Understanding when an option can be overridden by a buyer is essential for protecting the financial outcome of a deal.

Due to the substantial sums often involved, businesses should always seek professional advice before making, or refraining from making, an option to tax.

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