

VAT and Property: the Option to Tax

The aim of this note is to provide a general background to the option to tax rules and set out the operation of those rules in the context of the amendments which were introduced to the VAT Act 1994 (“VATA”) in 2008 and 2009.

Input tax

Any person who has an interest in a building or land (referred to here as a “property owner”) and who makes exempt supplies in relation to the building or land needs to consider whether he can recover the VAT which has been incurred in relation to the building or land (known as “input tax”). VAT incurred as input tax on costs which relate to supplies of land which are exempt from VAT is not recoverable.

Schedule 9 Group 1 of the VATA provides that the following supplies of land are exempt from VAT:

- the grant of any interest in or right over land; or
- the grant of any licence to occupy land; or
- in relation to land in Scotland, the grant of any personal right to call for or to be granted any such right or interest

Note there are exclusions to these exemptions from VAT.

The lack of recoverability of input tax on such exempt supplies of land can be detrimental to a property owner. In order to alleviate this burden HMRC allows a property owner to charge VAT at the standard rate (currently 17.5%) on supplies of property which would otherwise be exempt. This is known as the “option to tax” (previously known as an “election to waive exemption from VAT”). Schedule 10 to the VATA deals primarily with the option to tax on land and buildings.

Physical scope of an option to tax

Broadly speaking, the option to tax is limited to non-residential property. However, where the land or buildings (or civil engineering works) are, or are intended to be converted for dwelling, residential or charitable use, there are limits to when an option to tax can have effect.

Consequences of an option to tax

The option to tax has important consequences as it means that a property owner can recover all or part of its input tax. However, the property owner will also have to charge VAT at the standard rate on the supplies which it makes, for example on the sales price if the property is being sold or on the rent if the property is being leased. If a purchaser or tenant is registered for VAT and can recover VAT on the purchase price or rent (as applicable) the exercise by the property owner of the option to tax should not be problematic other than from a cash-flow perspective. However, if the purchaser or tenant does not have full VAT recoverability then it must bear the irrecoverable element. This may affect the marketability of a property in an already highly competitive market.

Changes to the option to tax rules

There were substantial amendments to the option to tax rules introduced in June 2008 and the VAT (Buildings and Land) Order 2009 of July 2009 has introduced further amendments to those rules.

The changes which took effect on 01 June 2008 apply to supplies of property which are made after that date. The changes are contained in Schedule 10 to the VATA and give a property owner the ability to do the following:

- make a 'real estate election' which means that an option to tax will automatically apply to all properties which are subsequently acquired by the entity which exercises the option to tax and its VAT group;
- revoke an option to tax in the first six months after it is exercised without the need to obtain permission from HMRC (previously three months);
- revoke an option to tax after 20 years without the need to obtain permission from HMRC provided certain conditions are met. In addition, there is an automatic lapse of the option to tax where no interest in an opted property has been held for over six years (subject to certain anti-avoidance provisions);
- treat the option to tax as continuing to apply to the land after the opted buildings on the land have been demolished; and
- exclude new buildings on land which has been opted (including the all the land within its curtilage) provided that notice of the exclusion is given to HMRC in the required form.

How to exercise an option to tax

The exercise of an option to tax involves two stages. Firstly, an option must be exercised (not necessarily in writing) and secondly the HMRC must be notified of the exercise of the option. An option is not valid if it has not been notified to HMRC.

Where a property owner makes a 'real estate election' (which must be in a prescribed form) the option to tax will apply automatically to all properties which are subsequently acquired without having to send notification of each election to HMRC and the option will be deemed to apply to the property with effect from the date the interest in the property is acquired.

Note that there is no provision for the revocation of a real estate election. Individual properties within the real estate election can be taken out of the scope of the election under the normal revocation rules.

Relevant Associates

Generally, where a property owner exercises an option to tax it is only the supplies in respect of the property which are made by the person who has exercised the option to tax that are covered by the option. However, if the property owner has a 'relevant associate' (as defined in paragraph 3 of Schedule 10 of the VATA) then any supplies of the property which are made by the relevant associate may also be bound by the option. For example if a property owner owns a building and grants a lease of the building to a relevant associate, then any underlease of the building which is granted by the tenant will also be bound by an option to tax.

Conclusion

Given the potential VAT savings which can be made by a property owner by exercising an option to tax and the potential pitfalls involved where a purchaser or tenant does not have full VAT recoverability, it is advisable to seek specialist VAT advice before exercising an option to tax.

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