CHAPTER 25

LAND AND BUILDINGS – OPTION TO TAX

This chapter looks at a planning point whenever land or a commercial building is supplied as an exempt supply.

25.1 Introduction

Exempt supplies of land and buildings often cause problems due to the fact that any input tax related to that exempt supply is irrecoverable. VATA 1994, s.26

Whenever there is an exempt supply of commercial land or buildings, the trader has the option of changing the liability of the supply to standard-rated. This is called the “option to tax”. VATA 1994, Sch 10

The option allows the trader to choose to eliminate the exempt supply and instead opt to turn it into a standard-rated taxable supply. Once opted, any related input tax can be recovered in full because the supply being made is now a taxable supply.

Once the option is made, it will apply to all future supplies that are then made in respect of that building by that taxable person. There are certain specific circumstances in which the option can be revoked.

The option is made on a building-by-building basis. This means that if an owner of several different buildings wants to make an option to tax, he can choose to make the option over some buildings and not others - it is entirely at his discretion. It is also possible for a person to make a Real Estate Election (REE). This means that every property in which he has an interest is treated as opted. There is then no need to opt to tax properties individually but the option can be revoked on individual properties if the conditions are met. VATA 1994, Sch 10, para 21 and 22

However, if the buildings are linked internally or by a covered walkway, or comprise of a number of units around a fully enclosed concourse, they are regarded as a single building for this purpose. VATA 1994, Sch 10, para 18

If a taxable person opts to tax bare land and later constructs a property on the land, that building is covered by the original option. A new building can however be permanently excluded from the effects of the option provided all the relevant conditions are met.

The option to tax is a useful planning tool – it can change the status of a supply in such a way that a trader can protect himself from suffering irrecoverable input tax.

Illustration 1

Mr Jones owns an office block in Stockport, which is currently let out to two tenants, an insurance company and a firm of accountants. The building needs some renovation, costing £500,000 plus VAT. Renovating and building services are standard-rated supplies, so VAT will be charged to Mr Jones on these costs.
What would be the implication of Mr Jones opting to tax the property?

Since Mr Jones is letting-out a commercial property, he is making exempt supplies within Schedule 9, Group 1.

Because Mr Jones leases the building and hence makes an exempt supply, the input tax on the renovation costs will relate to the exempt supply of that office block and will be irrecoverable.

If Mr Jones were to opt to tax the building, he will then be making a taxable supply. Thus, when the renovation occurs, the input tax he pays will relate to a taxable supply and hence will be recoverable in full.

The option to tax means that any future supply Mr Jones makes in connection with the office block will be a standard-rated supply. The next time he sends an invoice for rent to his tenants, he will have to add 20% VAT on top.

For the tenants, they will suddenly receive an invoice for rent that has gone up by 20%.

One of those tenants is an accountant; accountants make taxable supplies. Therefore, the extra 20% is input tax for the accountant and because the accountant makes taxable supplies, the input tax is recoverable in full. The most that the accountant tenant will “suffer” from the 20% increase is a cashflow disadvantage.

The other tenant is an insurance company, which makes exempt supplies. When the rent goes up by 20%, that increase is input tax which is irrecoverable as it relates to exempt supplies. This will be a direct cost to the insurance company and there is nothing they can do about it.

When the landlord makes an option to tax, he does not have to seek permission from his tenants before doing so. However, the landlord should check the lease agreement because some lease agreements do not allow the rent to be increased (even by VAT). In such cases, the irrecoverable VAT must be met out of the rental profits for the landlord.

If the lease agreement is silent, the landlord can make an option to tax without any permission being given by the tenants.

Example 1

Consider each of these five supplies and decide whether the option to tax will be effective on the supply.

Yes/No

1. Sale of land

2. Sale of a 50 year old terraced house

3. Lease of a 5 year old factory

4. Freehold sale of a 1 year old office block

5. 99 year lease of a 1 year old shop
25.2 Revocable Election?

The option to tax can be revoked in three situations.

1. The option can be revoked within the first six months after making it, provided that no supplies have been made which are affected by the option. The legislation makes it clear that any input tax repayable as a result of this change from taxable to exempt supplies must be repaid.

2. Where no interest has been held in the property for over 6 years the option to tax will automatically lapse.

3. The option can be revoked 20 years after it was made.

The Government introduced the option to tax supplies of commercial property with effect from 1 August 1989; therefore the first options to tax became eligible for revocation in August 2009.

Once an option to tax has been made, it has to be notified to HMRC within 30 days of being made. If a property is currently being let on an exempt basis, HMRC's permission will be required before the option to tax can be made, unless the conditions for automatic permission are met.

25.3 Supplies Not Affected by the Option

There are some supplies which an option to tax does not affect and which remain exempt, even though the option has been exercised on the property in question. VATA 1994, Sch 10, paras 5 to 11

These include the following:

a. Dwellings, etc. Any grant in relation to a building or part of a building if the building or part of the building is designed or adapted, and is intended, for use as a dwelling or a number of dwellings or solely for a relevant residential purpose.

   The most common example would be a shop with a flat above it where an option to tax would make any rent from the shop standard-rated but any rent from the flat would remain exempt.

b. Buildings for conversion into dwellings etc. When a business sells their commercial property, any option to tax can be disapplied if the buyer confirms their intent to convert the building into dwellings or relevant residential.

c. Charitable use. A supply in relation to a building intended for use solely for a relevant charitable purpose, other than as an office.

d. Residential caravans and residential houseboats.

25.4 Sub-Leases

If a landlord makes the option to tax, this will affect all supplies relating to that building – eg, rent charged to existing tenants, any premium or rent charged on a subsequent lease, any proceeds of sale of the freehold, etc.
However, the landlord's option does not bind someone with a different interest in the land.

A landlord may opt to tax the lease, which means that the tenant pays VAT on the rent to the landlord. But, if the tenant sub-leases, then the tenant will have a separate option to tax the sub-lease. If a tenant does not make his own option to tax, then VAT paid to the head landlord will thus become irrecoverable because it relates to the making of the exempt sub-letting. If, however, the tenant does opt to tax then this returns to a taxable supply situation and the input tax is fully recoverable.

Example 2

There are five supplies listed. Decide whether they are standard-rated, zero-rated or exempt and then, if it is an exempt supply, decide whether the option to tax can be made in respect of that supply.

<table>
<thead>
<tr>
<th>Description</th>
<th>S.R</th>
<th>Z.R</th>
<th>Exempt</th>
<th>Option to tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Freehold sale of 2 year old factory</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. Grant of a 21 year lease in a brand new office block</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3. A farmer rents out a plot of land to another farmer</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4. A landlord leases out 2 floors of a building to an insurance company tenant</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5. A landlord leases out a flat in a brand new luxury residential development for 5 years to Mr Smith</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
ANSWERS

Answer 1

Yes/No

1. Sale of land
   Yes

2. Sale of a 50 year old terraced house by a property business
   No

3. Lease of a 5 year old factory
   Yes

4. Freehold sale of a 1 year old office block
   No

5. 99 year lease of a 1 year old shop
   Yes

The sale of land is an exempt supply and the option to tax can be made on this supply.

The sale of a 50 year old terrace house is an exempt supply, but it is a domestic building rather than a commercial building, so the option to tax can be made but will not be effective.

The lease of a 5 year old factory is an exempt supply – because it is a commercial building, the option to tax can be made.

The freehold sale of a 1 year old office block – the sale of a new, commercial freehold is a standard rated supply. It is not exempt so the option to tax is not relevant.

A 99 year lease on a 1 year old shop – this is not the sale of a new commercial freehold, so it is an exempt supply. The option to tax can therefore be made.
**Answer 2**

<table>
<thead>
<tr>
<th>S.R</th>
<th>Z.R</th>
<th>Exempt</th>
<th>Option to tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

1. Freehold sale of a 2 year old factory
   - **Yes**
   - **No**
   - **No**
   - **No**

2. Grant of a 21 year lease in a brand new office block
   - **No**
   - **No**
   - **Yes**
   - **Yes**

3. A farmer rents out a plot of land to another farmer
   - **No**
   - **No**
   - **Yes**
   - **Yes**

4. A landlord leases out 2 floors of a building to an insurance company tenant
   - **No**
   - **No**
   - **Yes**
   - **Yes**

5. A landlord leases out a flat in a brand new luxury residential development for 5 years to Mr Smith
   - **No**
   - **No**
   - **Yes**
   - **No**

The freehold sale of a two-year-old factory is freehold, new and commercial and hence a **standard-rated** supply. An option to tax could be made but would not have any effect.

The grant of a 21-year lease in a brand new office block is an **exempt supply**. As it is an exempt supply of a commercial building, the option to tax will be effective.

A farmer rents out a plot of land to another farmer; renting out the land is an **exempt supply**. The option to tax **can** be made because it can be effective over an exempt supply of any sort of land.

A landlord leases out two floors of a building to an insurance company – it is a lease, it is a commercial building so it is an **exempt supply**. The exempt supply of a commercial building means the option to tax **can** be made and effective.

A landlord leases out a flat in a brand new luxury development for 5 years to Mr Smith. It is a lease but it is domestic property, so it is an **exempt supply**. Zero-rating does not apply as no major interest has been granted. The option to tax is not effective over a domestic property.