

Revoking option to tax elections

(Lecture B1135 – 11.33 minutes)

Background

The option to tax rules were introduced on 1 August 1989, so will celebrate their 30th birthday this year. The regulations mean that when a VAT registered business or organisation elects to tax land or a building with HMRC, all income from that site becomes subject to 20% VAT, with certain overrides such as income from residential property. Once an election is made, it cannot be revoked for 20 years in most cases. But as well as the 20-year rule, there are two other times when an election can be or is revoked, relevant to 6-months and 6 years since the option date.

The 6-month rule

If a taxpayer meets five conditions (and this is an 'and' situation rather than 'or' so all five must be met) then it can automatically revoke its option:

Condition 1 – the time period between the day that the option took effect and the date that the taxpayer decides to revoke it is less than 6 months.

Condition 2 – the taxpayer must not have made a taxable supply of the opted building that has resulted in a charge of VAT. I recently dealt with a situation where a building purchased by a taxpayer consisted of a ground floor shop and first floor flat. A tenant had been found for the flat but not the shop at the time the client wanted to revoke his option. This was fine because the rental income from the flat was not taxable.

Condition 3 – no transfer of a going concern has occurred.

Condition 4 – the taxpayer must notify HMRC on form VAT1614C.

Condition 5 – this is the most complicated condition and relates to input tax. HMRC obviously wants to avoid the situation where a taxpayer can claim input tax on a lot of property related expenses and then revoke his election a few days later. The taxpayer must meet one of three input tax sub-conditions:

The taxpayer (or any associated business) has not recovered any input tax as a result of opting to tax the land or building in question.

The taxpayer has deducted input tax but will repay it either as part of their partial exemption annual adjustment calculation or under the clawback rules – see Example 1 below.

The taxpayer has deducted input tax and this relates exclusively to one capital item and amounts to less than 20% of the input tax claimed on the capital item.

Note – if a taxpayer meets all of conditions 1 to 4 but cannot meet any of the additional sub-conditions 1 to 3, he may ask HMRC for permission to revoke the option but HMRC might impose conditions before granting any such request (HMRC Notice 742A, para 8.1.5).

Example 1

Mary is VAT registered and purchased the freehold of a vacant office block for £200,000 on 1 January 2019 – the seller had not opted to tax the building so did not charge VAT. Mary's intention was to refurbish the building by spending £100,000 plus VAT and renting it out to a firm of solicitors, so she opted to tax the building in order to claim input tax. However, before she could appoint any builders, an insurance company offered to rent the building in its current condition from April 2019 and did not want to pay VAT on the rent because it is partially exempt.

In this situation, it is likely that Mary would have claimed input tax on conveyancing fees when she purchased the property because it related to her intended taxable supplies. But this input tax will be repaid to HMRC under the clawback rules because her intended taxable supplies have been replaced by actual exempt supplies when she revokes her election. She has therefore met sub-condition 2 of condition 5. She also meets the other main conditions 1 to 4.

The 6-year rule

Imagine that Mary bought a retail unit in July 2006 for £300,000 plus VAT and opted to tax her interest in the building. She rented it out for five years to a tenant (plus VAT) and then sold the building in July 2011 (also charging VAT). It is now July 2018 and Mary has the chance to repurchase the property at a discounted price. What is the position with her option to tax election?

Once a taxpayer has had no interest in a property for six years, their option to tax election with HMRC is automatically revoked. If the period is less than six years, then the original election remains in place. This means that Mary has two choices when she buys the property in July 2018:

She could make a new election with HMRC if there is an input tax motive e.g. she might want to improve the property or add an extension and claim input tax on builder costs and materials. The new election would remain in place until at least 2038 i.e. a new 20 year time period begins.

She could decide not to make an election and therefore all income she earns from the property will be exempt from VAT.

Note – the 6-year rule is subject to three anti-avoidance provisions, which should not be relevant in most situations – see HMRC Notice 742A, para 8.2.2.

The 20-year rule

Until 1 August 2009, this rule was irrelevant i.e. because no options before this date could have exceeded 20 years. But nearly 10 years have now passed, meaning that more and more elections can be revoked. The most important tip on the 20-year rule is that it is equally important for buyers and tenants to be aware of its opportunities as it is for sellers and landlords.

Example 2

Martin is a sole trader dentist and wants to buy a freehold property for £750,000. However, the seller has opted to tax the building so wants to add 20% VAT. Martin should ask the seller if he opted to tax the property more than 20 years ago because his business as a dentist is partly exempt so a VAT charge will leave him irrecoverable input tax. If the answer is 'no' i.e. the sale is subject to VAT, then Martin is best advised to seek alternative premises where the seller has not made an election.

Procedures with the 20-year rule

An election is revoked when the taxpayer completes form VAT1614J and submits it to HMRC. The revocation is automatic as long as four conditions are met:

The 20-year condition – the taxpayer must have held an interest in the property more than 20 years ago and opted to tax it more than 20 years ago as well.

The capital item condition – the capital goods scheme applies to any property costing more than £250,000 excluding VAT or any improvement, refurbishment or extension to the property exceeding this amount. The scheme requires annual adjustments to be made over a ten-year period. If a property is still subject to these adjustments, the capital item condition is not met.

The valuation condition – this condition will not be met if any of the taxable supplies in the previous ten years have been made either below market value or have been made at market value but it is expected that exempt supplies after revocation will be significantly greater than the earlier taxable supplies.

The prepayments condition – this condition is best illustrated by an example.

Example 3

Jim owns an office building which he rents out to betting shops and charges VAT on the rent. He can now revoke his option under the 20-year rule but just before revoking his option, he pays a cleaning company £30,000 plus VAT for the next five years' cleaning services. This advance payment for services means that Jim has breached the 'prepayments condition' because it relates to services beyond the next 12 months. He will need to seek HMRC's permission to reverse his election i.e. it is no longer automatic.

Reference: HMRC Notice 741A, para 8.3.3

Summary

Once an election has been revoked under any of these three rules i.e. 6-months, 6-years or 20-years, then all future supplies made by the property owner will be exempt from VAT rather than standard rated. This means that a business which is only VAT registered because it owns an opted property will need to deregister once the revocation takes effect, assuming it has no intention to make taxable supplies in the future e.g. with a new business venture or another property purchase.

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