Flat management companies: extensive difficulties to unlock

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We examine the capital gains tax consequences of typical transactions in respect of flat management companies and reach a conclusion which may come as an unwelcome surprise.

Key Points

What is the issue?

It is very common for leaseholders of a residential building to act together in setting up a management company to acquire the building's freehold, with the share capital of the management company being owned by the leaseholders.

What does it mean for me?

Where a lease is surrendered and a new lease is granted, there is a disposal by the leaseholder of an asset (the original lease) and an acquisition of another asset (the new lease).

What can I take away?

If we are correct, many of the individuals who have entered into typical flat management transactions will actually have created charges to capital gains tax.

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It is very common for leaseholders of a residential building to act together in setting up a management company to acquire the building's freehold, with the share capital of the management company being owned by the leaseholders. Sometimes, the leaseholders are content for the management company to own the freehold beneficially. Normally, however, the company holds the freehold as trustee on bare trusts for the leaseholders as tenants in common in equal shares.

In many cases, the acquisition of the freehold is followed by extensions of the terms of the leases. Often, no consideration is given by the leaseholders for the extensions – or consideration is given which is considerably below market value.

How does UK capital gains tax apply to extensions of leases in these circumstances ('typical flat management transactions')?

Lease surrenders, re-grants and extensions

Where a lease is extended by agreement so as to increase its term or the extent of the demised premises, the law implies a surrender of the original lease and the grant of a new lease in the agreed new terms (*Friends Provident Life Office v British Railways Board* [1991] 1 All ER 336), so the lease extension has the same effects in law as the surrender of the lease and the grant of a new lease.

HMRC and most specialists consider that the grant of a lease is a part disposal of the freehold (see HMRC's Capital Gains Tax Manual paras CG70700 and CG70822). Although there are strong arguments for the contrary view, in the remainder of this

article, we shall assume that this view is correct.

Disposals and acquisitions

On that basis, where a lease is surrendered and a new lease is granted, there is a disposal by the leaseholder of the original lease and an acquisition of the new lease. The grant of the new lease will also normally be a part disposal of the freehold by the freeholder.

The leaseholder

If there is a surrender and re-grant of a lease, the surrender will be a disposal of the original lease in consideration of the grant of the new lease plus any other payment or transfers made by the grantee under the arrangement with the grantor.

Where the surrender and re-grant are not transactions by way of bargains made at arm’s length, they are to be treated as taking place for a consideration equal to the market value of the asset concerned (Taxation of Chargeable Gains Act 1992 s 17). Transactions between connected persons are treated as transactions other than by way of a bargain made at arm’s length (s 18).

Therefore, if the transaction is not between connected parties and is by way of a bargain at arm’s length, the total amount of the consideration given for the disposal of the old lease will include the market value of the new lease. If, however, the transaction is between connected parties or is not by way of a bargain at arm’s length, the disposal will be deemed to take place for a consideration equal to the market value of the old lease.

Similarly, the consideration for the acquisition of the new lease, if the transaction is not between connected persons and is by way of a bargain at arm’s length, will include the market value of the old lease. If the acquisition is between connected parties or is not under a bargain at arm’s length, the acquisition will be deemed to take place for a consideration equal to the market value of the new lease.

Under Extra Statutory Concession D39 (Extension of Leases) (ESC D39), HMRC will accept a modification of the strict technical position in some circumstances. ESC D39 will, however, only apply to prevent the surrender of the old lease under a surrender and re-grant from being a disposal if the surrender is not made between connected parties and is on arm’s length terms. This will not be the case in respect

of lease extensions in typical flat management transactions because they are made for a consideration which is less than market value (or none).

The freeholder

Under a surrender and re-grant, the freeholder makes a part-disposal of the freehold by granting the new lease which, if the transaction is not at arm’s length, will be deemed to take place for a consideration equal to the market value of the lease; that is, for a premium at a market rate.

Where the flat management company is the beneficial owner of the freehold

Where the flat management company is the beneficial owner of the freehold, it is clear that under typical flat management transactions, on an extension of the lease term giving rise to a surrender of the old leases and a grant of new leases, each of the leaseholders makes a disposal of his old lease and an acquisition of his new lease. This has the result that, because the disposal is not one which would take place under a bargain at arm’s length, the old lease is deemed to have been disposed of for its market value immediately before its surrender and the new lease is deemed to have been acquired for its market value on grant.

In extending the terms of the leases, the company makes a part disposal of the freehold for the purposes of corporation tax on chargeable gains. The consideration deemed to be given for the part disposals of the freehold will be equal to the premium which would have been charged for the grant of the new leases if the transaction had been under a bargain at arm’s length.

Where the flat management company holds the freehold on bare trust for the leaseholders

Where the company holds the freehold on bare trust for the leaseholders, the question of whether there is a part disposal of the freehold by the flat management company and a disposal of the old lease by the leaseholders would seem to be controversial.

Some expert commentators seem to suggest it is possible that no disposal is made, based upon the fact that the transaction is one which each freeholder and leaseholder makes with himself. That certainly seems to be the assumption made by the Office of Tax Simplification in its second report on the simplification of capital

gains tax.

Other authors on the subject are less sanguine. We also understand that, in correspondence, HMRC has said that it has ‘concerns’ over the proposition that where a company holding a freehold as nominee of various leaseholders extends the terms of the lease, there is no part disposal of the freehold of the original lease.

At first sight, the assertion that there is a disposal of the old lease and an acquisition of the new lease in these circumstances would appear to be incontrovertible. Before the surrender and re-grant, the freehold would be subject to the various rights of the leaseholders under the old leases, which will differ according to which area of the building is the subject of a particular lease. After the re-grant, the various rights of the leaseholders under the new leases would still differ according to which area of the building is the subject of each particular new lease but would now be for a longer term.

It would seem to follow therefore that each leaseholder would have made a disposal of his 100% interest in his old lease to the freeholders and acquired a 100% interest in his new lease from the freeholders. Each leaseholder will not have made a disposal of the old lease solely to himself but disposals to each of the freeholders as tenants in common. Similarly, the part disposals of the freehold which results from the grant of new leases will be disposals by all the tenants in common in the freehold to each particular holder of each lease.

To the extent of the interests of the other leaseholders in the freehold, therefore, it would seem that any particular leaseholder will not have made a part disposal of the freehold to himself. That follows clearly from the fact that the leaseholders each own the whole interest in a lease but only an undivided share in the freehold.

This is further supported by a consideration of the effect of the transaction on the market values of the freehold and of the leases. The market value of the leases will vary between themselves according to the particular characteristics of the demised premises, so the increase in value of the leases arising from the re-grant will vary from lease to lease. The decreases in value of the leaseholders’ interests in the freehold as tenants in common, assuming they are interests in equal proportions, will all be of the same amount. Therefore, they will not match the increase in value of a particular individual’s lease.

Warrington v Brown

Why then do some commentators consider that there cannot be such disposals on the grounds that, if they did occur, each individual leaseholder would make a disposal to himself, a transaction which is impossible in law? It may be that the opinion is based on the case of *Warrington v Brown* [1989] 62 TC 226).

This case concerned family members who owned various parcels of farmland, farmed as a family farming unit. To facilitate the management of this farmland, the family members transferred their interests in the land to trustees to hold on bare trusts for the transferors (the '1971 transfers').

Under the bare trusts the settlors did not continue to have a 100% interest in the farmland which they had contributed but a percentage interest in all the land held under the bare trusts, determined as being the proportion which the value of the land that they had contributed bore, at the time the trusts were made, to the value of all the land contributed to the trust at that time.

In 1980, by agreement between the family members, various of these shares in the trust fund were advanced to their beneficial owners (the '1980 advances'). The rights under the advances were satisfied by the appropriation of particular areas of land, the value of which was equal to the value of the percentage interest in the fund of the family member concerned at the time of the advances.

So before the 1980 advances, each owner of a share in the land subject to the bare trust had a percentage interest in all the land held on the trusts. After the 1980 advances, those who had previously held shares in the land held on bare trusts and who received advances had absolute interests in particular parcels of land reversing the effect of the 1971 transfers.

HMRC argued that each of the 1980 advances constituted a disposal by every beneficial owner under the bare trusts of the advanced land to the particular person to whom the advance concerned was made. This was on the basis that before the 1980 advances, each beneficiary had a right as beneficial tenant in common to a fixed percentage of all the land held on the bare trusts, whereas after the advances each beneficiary to whom an advance was made held an absolute interest in a particular area of land.

In the High Court, Knox J decided that there were no disposals by the beneficiaries (except to the extent that the shares of some of the family members were, with their consent, advanced to settlements for their children).

In our view, *Warrington v Brown* was concerned only with a narrow class of arrangements under which assets are transferred to a bare trustee by various individuals or by trusts under which they obtain interests proportionate to the value of the assets which they contribute; and their interests in the trust fund are later advanced to beneficiaries by the trustees appropriating particular assets to satisfy the proportionate interests in the fund. In such a case, where there is a clear cut and simple relationship between the value of the assets contributed and the individual's interest in the fund, and the transactions are transactions only between the beneficiaries and the bare trustees, it may well be capricious to tax such a technical disposition as one producing a capital gain.

Typical flat management transactions

Such arrangements, however, are very different from typical flat management transactions in which:

- the bare trust involves only one interest in land (the freehold), which is acquired at the time the bare trusts are created and has not previously been owned by the leaseholders;
- the transactions involved are not simple transfers of the whole beneficial interest in the land concerned;
- the aggregate value of each leaseholder's interest in the freehold and in his lease are changed by the transaction; and
- each leaseholder's rights as lessee are changed by the transaction with the burden on the freehold of those rights being similarly changed so that the value of the leases in aggregate is increased and the value of the freehold is decreased by the transaction.

We do not therefore consider that *Warrington* v *Brown* is authority for the proposition that the surrender of a lease in a typical flat management transaction is not a disposal of the lease by the leaseholder or a part disposal of the freehold by the freeholder.

In our view, the results, in respect of tax on chargeable gains, of a typical flat management transaction where the management company holds the freehold as bare trustee for the leaseholders are the same as where the management company owns the freehold beneficially – except that, in the former case, the part disposal of the freehold is made by the individual leaseholders who are parties to the arrangement and any gain is subject to capital gains tax, whereas in the latter case, it is made by the flat management company and any gain is chargeable to corporation tax .

An unpleasant surprise?

Many individuals have entered into typical flat management transactions, under which the flat management company holds the freehold as nominee for the leaseholders, thinking that their arrangements will prevent lease extensions from being disposals of the original leases and part disposals of the freehold. If we are correct in our conclusion, they will actually have made such disposals and have created charges to capital gains tax. Whether HMRC will – now or in the future – assess such gains and impose penalties in respect of the assessments remains to be seen.