Leasehold enfranchisement: controversial tax implications

Property Tax | Personal tax



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Leasehold enfranchisement, where tenants collectively acquire the freehold through a management company, may result in complex and controversial tax implications.

Leasehold enfranchisement, where tenants collectively buy the freehold of their flats, has complex tax implications under current HMRC interpretations.

When tenants acquire the freehold via a management company, it was assumed that each tenant exclusively owns the reversion of their flat and can extend their lease with no tax consequences. However, HMRC contends that each tenant holds a fractional beneficial interest in the reversions of all the flats. HMRC’s approach has led to multiple tax assessments and appears contrary to the original intention of leasehold enfranchisement, which aimed to grant tenants exclusive rights to their flat’s freehold reversion.

In 2017, I wrote an article for *Tax Adviser* on 'Tax traps for tenant owned flat management companies'. The article focused on problems that can arise if tenants (inadvertently) buy the freehold of their block of flats, such that the management company owns the freehold in its own right. I had considered that if the management company owned the freehold as nominee for the participating tenants, there should not be a problem as, under Taxation of Chargeable Gains Act 1992 s 60, each participating tenant would be treated as:

- owning all rights and interests in the reversion to their own flat (effectively a 'flying freehold' over their flat); and
- having no interest in the reversion to the flats of any of the other participating tenants (as each participating tenant would have exclusive rights to the flying freehold over their own flat).

If there were any non-participating tenants, the participating tenants would jointly own the reversion of their flats as a shared investment in the usual way. Common parts of the property would also be owned jointly but are likely to have only nominal value. Therefore, any participating tenant could extend their lease with no tax consequences for themselves or any other tenant (as granting a lease extension to oneself would be a non-event for the purposes of capital gains). If a tenant sold their flat and the associated freehold interest, the only capital gains charge that would arise would be in relation to their flat (unless they could claim principal private residence relief), plus any reversionary interest in the flats of non-participating tenants.

A question of division

However, in response to a draft of my 2017 article, HMRC put forward the view that, in such a situation, rather than each participating tenant having the exclusive interest in relation to the reversion of their own flat (and no interest in the reversion of the flat of any other participating tenant), each participating tenant holds a fractional beneficial interest in the reversion of every flat, including the flats of the other participating tenants.

I am sure that this comes as a surprise to many tenants (and their advisers) and I have set out below some of the perverse consequences of this view.

To keep matters simple here, I will assume that the relevant capital gain calculation on lease extension is based on the receipt by the freeholder of the relevant lease premium as a capital sum (treated as a disposal under Taxation of Chargeable Gains Act 1992 s 22). I will also assume that the reversion of the freehold of each flat can be treated as a separate asset to the reversion of any of the other flats.

The methodology used by at least one HMRC officer in calculating capital gains on lease extensions involves part-disposal calculations that give further perverse results – but that can wait for another article.

How this works in practice

Take the example of a block of ten identical flats. In 1995, all the tenants participate in buying the freehold under the Leasehold Reform, Housing and Urban Development Act 1993, using a management company (ManCo). All of the documentation makes it clear that ManCo holds the freehold on bare trust for the tenants.

Assume that the market value of a 999-year lease extension of each of the flats, at a peppercorn rent, would be £2,000. (Throughout this article I have tried to use realistic approximations of value based on average London prices and online lease extension premium calculations.)

With ten flats, the value of the freehold would, therefore, be £20,000 and the value of each tenant's investment in the freehold is £2,000, apportioned at £200 per flat per tenant.

The following events then take place:

1. In 1995, immediately after the purchase, Alex extends the lease of Flat 1.
2. In 2025, Sam extends the lease of Flat 2.
3. In 2025, Jo sells Flat 10.

Let us now look at how HMRC views each of these events in turn.

Event 1: Alex extends the lease of Flat 1

Immediately after the purchase, Alex, the tenant of Flat 1, extends the lease to a 999-year peppercorn lease. Because no premium is paid, the transaction is not at arm's length and so the arrangement is taxed as on a market value basis.

HMRC regards this arrangement as Alex (as tenant) entering into lease extensions with each of the ten tenants – effectively 10% each – and each tenant needs to consider their personal tax position.

At this stage, there is no capital gains tax charge – for Alex this is because a transaction 'from Alex to Alex' is a non-event for capital gains purposes, while for the other tenants it is because there is no actual gain.

The analysis

When the lease is extended, each tenant (other than Alex):

- starts with a base cost of £200 in respect of the reversion of Flat 1's freehold; and
- is deemed to have received a capital sum of £200 (10% of the £2,000 lease extension premium that Alex would have been required to pay to extend the lease on market value terms).

Therefore, the other tenants do not realise any gain.

Event 2: Sam extends the lease of Flat 2

In 2025, Sam, the owner of Flat 2, extends the lease on the same basis as was done by Alex for Flat 1.

This is where the first shock comes to the tenants. By 2025, the value of the reversion of Flat 2 has increased not only because of the general increase in property prices but also because the remaining term of the lease is now 30 years shorter than when the freehold was bought.

For Sam, the extension of the lease of Flat 2 will be a 'Sam to Sam' transaction and a non-event for capital gains purposes (as was the case for Alex with Flat 1). However, each of the other tenants will realise a capital gain on which they will be taxed.

Even if the tenants use their own flats as their home, they cannot claim principal private residence relief because the gain is in relation to an interest in Sam's flat (in which they do not live).

The analysis

By 2025, the market value cost of a lease extension would be £60,000.

Under HMRC's analysis of ownership, each tenant (other than Sam):

- starts with a base cost of £200 in respect of the reversion of Flat 2 (as noted above);
- is deemed to have received a capital sum of £6,000 (10% of the market value £60,000 lease extension premium).

Therefore, all of the tenants (other than Sam) will have realised a capital gain of £5,800.

Event 3: Jo sells Flat 10

In 2025, shortly after Sam has extended the lease of Flat 2, Jo sells Flat 10, which has been Jo's only home since 1995. The sale also includes any interest that Jo has in the freehold.

In HMRC's view, Jo is selling two separate types of asset:

- the (short) lease of Flat 10; and
- Jo's interest in the reversions of the eight flats for which the leases have not been extended.

As Jo is disposing of multiple assets, it will be necessary to apportion the sales proceeds between those assets.

Whilst Jo's lease of Flat 10, and interest in the reversion of Flat 10, are interests in Jo's principal private residence (and hence not subject to capital gains tax), Jo will be taxable on the gain from disposal of the freehold interest in Flats 3 to 9 (principal private residence relief will not be available, as Jo had not lived in those flats).

The analysis

When Jo sells Flat 10, in addition to selling the lease of Flat 10, Jo is also selling an interest in 10% of the value of the reversions of Flats 3 to 9, valued at:
7 x £6,000 = £42,000 (the reversions of Flats 1 and 2 have no value as the leases have already been extended).

Therefore, Jo is receiving £42,000 of the sales proceeds of Flat 10 as payment for the disposal of the reversionary interest in Flats 3 to 9. After deducting £1,400 (the base cost at £200 for each of the seven flats), Jo will have a chargeable gain of £40,600.

What does this mean?

In case anyone thinks that the above analysis is purely academic, I will note here that I am aware of several enquiries in which HMRC have actually raised assessments on lease extensions on the above basis.

I fully accept that, where some of the tenants do not participate in a leasehold enfranchisement, the participating tenants hold the reversion in respect of their flats as an investment. Therefore, where a non-participating tenant extends their lease, it is completely proper that the participating tenants are taxed on their share of the extension premium.

However, I would be interested to know how many people, other than HMRC, consider that it was the intention of freehold enfranchisement under the Leasehold Reform, Housing and Urban Development Act 1993 that, when tenants acquired the freehold of their property, they would each then:

- be taxed every time that another participating tenant extended their lease; and
- be taxed on selling a flat that has been their principal private residence, based on the value of the reversions of leases that have not been extended.

The solution is simple. There is no practical reason why the freehold of each flat cannot be treated as a ‘flying freehold’ with each participating tenant holding the rights in respect of the freehold of their flat – and this must surely more closely reflects the intention of leasehold enfranchisement.

I mentioned above that HMRC has methodology for calculating capital gains on a lease extension that produces perverse results – I will cover that in a future article.

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