Tax traps for tenant owned flat management companies

Personal tax | Tax voice



27 July 2017

Leigh Sayliss looks at tax traps that can arise for tenants where they have bought the freehold of their property into a tenant-owned flat management company

Introduction

After much negotiation with the landlord, the tenants have joined together, set up a new management company ("ManCo") and bought the freehold from their landlord. They now head off to celebrate. They may vaguely recall their advisers saying something about extending their leases but they fully own their flats now so that can wait until tomorrow, or next month, or next year, or … can't it?

Sadly, in many cases, tenants have left the "formality" of extending their leases as one of those jobs to do at some time in the future and are sitting on a slowly ticking time bomb. Life has continued as before and many of the tenants have even sold their flats, and their shares in ManCo, to new tenants.

However, difficulties can arise where a flat is held on a short lease. Once the residual terms is less than 80 years, the landlord becomes entitled to part of the "marriage value" of the lease, which accelerates the rate at which the cost of extending the lease increases. In addition, some lenders are reluctant to grant a mortgage over a flat with a residual term of less than 60 – 80 years because the decreasing value of the property reduces their security. Therefore, the time will come when one of the tenants wants to sell his flat and the buyer's mortgage provider asks for the lease to be extended before making the loan. This is when the ticking stops.

Buying the freehold – what should happen

Let us take a typical situation of a large London Georgian house that has been converted into five flats. The freehold is purchased by ManCo in 1987, at which time:

- the leases have 90 years left to run;
- the flats are worth £50,000 each (combined value of lease plus reversion);
- the reversion is purchased by ManCo for £5,000, funded by the tenants (£1,000 each);
- ManCo has 5 shares in issue, one held by each flat owner.

There are two main ways in which this can be done.

Nominee Ownership

ManCo could purchase the freehold on trust as nominee for the tenants. In that case, the tenants will truly own the freehold, as expected. When any tenant sells his flat, he will be making two sales – one of the leasehold interest and one of his share of

the freehold reversion. If the property is his main residence, the tenant will be able to claim PRR relief from CGT, otherwise he will pay CGT based on having sold his property interest.

If the freehold is acquired under a statutory leasehold enfranchisement, ManCo will always acquire the freehold interest as nominee for the tenants and so this situation will apply.

Immediate lease extensions

If the tenants negotiate commercially to purchase the freehold, and do not set up nominee arrangements, the alternative is for the tenants to immediately extend their leases to 999 years – effectively reducing the reversionary value to nil.

Under this approach:

- the tenants make loans to ManCo of the £5,000 required to purchase the freehold;
- immediately after the purchase, ManCo agrees to extension of the leases of each flat to 999 years;
- the premium for the extension for each flat is £1,000 – the reversionary value of the flat;
- the premium is used to repay the tenant's loans.

ManCo purchased the freehold for £5,000 and has immediately received a capital sum derived from that asset which is treated as a part disposal under s.22 TCGA. However, as there is negligible value left in the freehold, the full base cost of £5,000 will be deductible against the receipt of £5,000, resulting in there being no chargeable gain.

Where things go wrong

If ManCo does not hold the freehold as nominee for the tenants, problems arise if the tenants do not immediately extend their leases. Over time, the value of the freehold rises for two reasons – property prices rise and the time until the property reverts to the freeholder reduces.

Taking the above example, let us assume that, in 2017, the current tenant of Flat 2 wants to sell his flat, now worth £500,000 (combined value of lease plus reversion).

However, with only 60 years left on the lease – the value of the flat is now split, let us say, £440,000 for the lease and £60,000 for the reversion.

Although the tenant believes that he owns a flat worth £500,000, what he actually owns is:

- a flat on a 60 year lease that is worth £440,000; and
- one out of the five issued shares in ManCo.

It is worth noting here that Manco owns a reversionary interest in the flats, each worth £60,000 – giving a total reversionary interest in the property of £300,000.

At this point, the tenant's buyer asks the tenant to extend the lease to 999 years. All the other tenants are happy for this to happen as long as all the leases are extended at the same time. As they control ManCo, there is no difficulty in arranging the extension and, as the tenants all consider that they own the freehold in their respective flats, they see no reason to charge a premium for the lease extensions.

Capital gains

Extending a lease will, in law, be treated as a disposal of the old lease and grant of a new, extended, lease. If ManCo holds the freehold as nominee of the tenants, each tenant is disposing of the lease of his flat to himself and so there should be no capital gains issue.

However, if ManCo holds the freehold in its own right, it will be treated as acquiring the old lease and making a partial (almost complete) disposal of its reversionary interest by granting the extended lease. As part of the consideration for the extended lease is the surrender of the old lease (and vice versa), s.17 TCGA 1992 deems market value consideration to have been given for each of the surrender and the regrant.

ManCo will have incurred a deemed cost of £440,000 to acquire the old lease, and then disposed of the extended lease for £500,000. Allowing for the original acquisition cost of the freehold of each flat (£1,000), ManCo will have realised a gain of £59,000 in respect of each flat – a total of £295,000 (less any other allowable costs). This will give rise to a corporation tax charge of more than £50,000 (£10,000 per flat), which needs to be funded by the tenants. This comes as an unpleasant shock to the tenants, who do not consider that they are paying, or required to pay,

anything for the extensions of their leases.

The capital gains issues do not end there.

As far as each tenant is concerned, he/she is disposing of the old lease and acquiring an extended lease. There is, therefore, a risk that the tenant will realise a capital gain based on the market value of the old lease (compared with the price paid for the flat). As long as the flat is the tenants principal private residence, any gain should not be subject to CGT. However, if the tenant owns the flat as an investment property, or has another property on which he is claiming relief, there is a risk of a capital gains charge.

There is some help here as HMRC Extra-Statutory Concession D39 allows the disposal by the tenant to be disregarded provided that certain conditions are met. However, one of the conditions is that the arrangements are made on terms that are equivalent to those that would have been made between unconnected persons bargaining at arm's length. The CIOT understands that HMRC interprets the requirements of ESC D39 strictly and considers that it would be unlikely to apply if a market value premium is not charged. Therefore, in order to fall within ESC D39, the tenant would have to pay market value (£60,000) for the lease extension.

As the tenant is one of the shareholders of ManCo, he is effectively paying the premium to his own company but releasing the value back into the tenant's own hands raises its own problems.

Distributions by ManCo

If the tenants pay for the lease extensions on arm's length terms (to avoid the capital gains disposal), this will leave approximately £50,000 per tenant in ManCo (once the £10,000 per flat corporation tax charge has been paid). When this surplus is distributed to the tenants, the dividend will be taxable.

Even if the tenants only pay sufficient to ManCo to fund the tax on any capital gain, this does not solve the problem. S.1000 Corporation Tax Act 2010 sets out a list of matters that constitute a dividend. This list includes "*Any other distribution out of assets of the company in respect of shares in the company*" (other than, for example, a return of capital) and "*Any amount treated as a distribution by section 1020 (transfer of assets or liabilities)*".

The distribution by ManCo, to each of its shareholders, of a long lease out of its freehold for below market value is, therefore, likely to be treated as a dividend in its own right.

The CIOT approached HMRC for their view on the capital gains and dividends issues noted above. Unfortunately, the level of sympathy was low. HMRC has acknowledged that the issues constitute real issues and they are simply the result of the arrangements that were put in place.

Stamp Duty Land Tax (SDLT)

As noted above, tenants who do not own the flat as their main residence, may want, for capital gains purposes, to pay market value for their lease extension. However, under the higher SDLT rates for additional properties, there would be an SDLT charge if the premium is in excess of £40,000 (or less, if any of the tenants are connected with each other such that the lease extensions are treated as linked transactions). The tenant appears only to be able to save capital gains tax only at the expense of incurring SDLT.

Annual Tax on Enveloped Dwellings (ATED)

A further concern arises if the value of the reversion to the flats increases to more than £250,000 (or £500,000 where the total value of the flat is more than £2m) – in which case it is necessary to consider ATED.

If the tenants are connected with ManCo – by reason of controlling ManCo between themselves –there is a risk that ATED would apply. Here, HMRC is more helpful. In a formal reply to an enquiry from the CIOT, HMRC responded:

> *… the concern is that under s1122(4)(a) CTA 2010 any two or more persons acting together to secure or exercise control of a company are connected with each other. Therefore, the company is connected to any member of the company under s1122(3) because he, together with persons connected with him, control the company. Having consulted technical specialists in HMRC we think that although this might be possible in the case of these types of companies, it must be unusual. You cite the case of Steele v EVC International NV (69TC88) which looked at the phrase 'acting together'. In that case the two shareholders entered into a shareholders agreement which continued to be*

recognised and implemented by the parties. The shareholders agreement was a very long document making the most extensive provision of the joint venture between two shareholders. It was found on those particular facts that the two were acting together.

It seems unlikely that an ordinary memorandum and articles of association will constitute the shareholders "acting together". In fact, it would be unconscionable because it would follow that all shareholders in a company would be connected. The cases it would affect would be where there is a comprehensive shareholders agreement which would dictate how the company would be run.

Therefore, unless ManCo has somewhat unusual articles of association, or the number of related tenants is high enough to allow them to constitute a majority of the shareholders, the ATED is unlikely to be an issue.