A share in the freehold

Indirect Tax | Personal tax

07 June 2021

Ray Magill considers the difficulties that may occur if a lessee chooses to extend their lease or purchase the freehold on their property

Key Points

What is the issue?

In England and Wales, the Leasehold Reform, Housing and Urban Development Act 1993 s 39 gives anyone who has been a ‘qualifying tenant’ of a flat for at least two

years the right to a new lease expiring 90 years after the term date of their existing lease, in return for a premium.

What does it mean for me?

An ‘extension’ involves the surrender of the existing lease as part of the consideration for the grant of a new lease, although normally due to the ESC D39 any gain to the leaseholder would be exempt from capital gains tax.

What can I take away?

The lessees of flats rarely own ‘a share in the freehold’. If lessees are made better aware of the tax effect of the current structure, they might consider exercising their right to buy the freehold. There are similar tax effects to those that arise when extending their leases.

When marketing a flat, estate agents will often say that the seller also has a share in the freehold. In practice, however, that is rarely so. The seller actually has a share in the company that owns the freehold. Typically, there will be one share for each flat’s lessee(s) and the directors will be some or all of the lessees. The difference is very significant, especially for tax purposes.

In most cases, the company owning the freehold will collect service charges and meet the costs of providing services to a building. Generally, these amounts are held in trust under the Landlord and Tenant Act 1987 s 42. The company’s own revenue should be confined to any ground rents payable.

Problems arise if a lessee wants to extend their lease. The remaining tenure of many flats built in the latter part of the 20th century is getting close to the 60 years that many lenders see as offering the minimum security.

Concession for qualifying tenants

In England and Wales, the Leasehold Reform, Housing and Urban Development Act 1993 s 39 gives anyone who has been a ‘qualifying tenant’ [one with a long lease] of a flat for at least two years the right to a new lease at a peppercorn rent expiring 90 years after the term date of his existing lease, in return for a premium determined by a formula set out in Sch13 of that Act.

In England and Wales, at least, an ‘extension’ involves the surrender of the existing lease as part of the consideration for the grant of a new lease. However, the extra-statutory concession D39 will normally apply, so that there will be no capital gains tax consequences for the lessee of the disposal that the surrender represents. To benefit from the concession, the following conditions apply to the transaction:

- It must be on terms equivalent to those that would have been made between unconnected parties bargaining at arm’s length.
- It must not be part of, or connected with, a larger scheme or series of transactions.
- The lessee must not receive a capital sum.
- The extent of the property in which the lessee has an interest under the new lease must not diff er in any way from that to which the old lease related.
- The terms of the new lease (other than its duration and the amount of rent payable) must not differ from those of the old lease, ignoring trivial diff erences.

In many, if not most, cases, however, any gain would be exempt anyway, as a disposal of the lessee’s only or main residence. Even so, there are circumstances where there could be an advantage in the concession not being applied.

Tax implications of lease extensions Stamp duty land tax should only be payable on the monetary consideration for the new lease (Finance Act 2003 Sch 17A para 16).

An extra 90 years added to a lease with only 65 years to go might require a payment equal to 10% of the market value of the flat with an extended lease. That should be paid to the company as freeholder, and will represent a part disposal by the company, resulting in a chargeable gain and a liability thereon for corporation tax.

If all the lessees want to extend their leases at the same time, and the flats all have the same value, the outcome is straightforward. On the assumption that the lessees see no reason for the company to retain the amount paid for the lease extensions, net of tax and any expenses, they could either distribute it as a dividend or wind-up the company and distribute the assets to the lessees/shareholders. This would include the freehold, now much devalued, which the lessees would then hold as tenants in common.

The net result would be for the lessees as a group to recover much of their initial outlay, after allowing for the company's and their own tax liability. However, the amount distributed will not be split according to the value of each flat, but divided equally, as each share in the company owning the freehold will generally have the same value.

Proportional shares

One remedy might be for each lessee to have a number of shares in proportion to the value of their flat. Thus, if there are six flats, respectively valued at 10X, 11X, 12X, 13X, 15X and 17X, there might be 78 shares. The lessee of the most valuable flat would have 17 shares.

This approach works well if all the lessees want to extend their leases at the same time. Otherwise, problems arise. Suppose only one lessee extends his lease, paying £100,000, and the company is able to pay a dividend of £80,000. This will have to be shared by all the lessees, not just the one who has extended his lease.

Alphabet shares

An alternative remedy would be to have six different classes of share. The A share would be held by the lessee of the most valuable flat, with its value attributed only to that share and the reversion thereto, and the B share held by the lessee of the next most valuable flat, and so on.

If the 'alphabet share' idea is adopted instead, the extending lessee would receive the whole £80,000 as a dividend, virtually extinguishing the value of his share, which would now only reflect the value of the reversion to his new lease.

Purchasing the freehold

If the lessees are made better aware of the tax effect of the current structure, they (or a majority of them) might consider exercising their right to buy the freehold. To achieve this, there are similar tax effects to those that arise when extending their leases. Unless the amount involved is exceptionally large (when divided by the number of flats in the block), there should not be any stamp duty land tax payable (see Finance Act 2003 s 74).

The company will normally have a chargeable gain and a corporation tax liability, however. Having disposed of the freehold, the company can be wound up and its net

assets distributed to the lessees/shareholders, who themselves will normally have a chargeable gain subject to capital gains tax at up to 20%. This distribution would be to all the lessees/shareholders, not just those involved in the purchase of the freehold. And, unless the ‘alphabet share’ idea has been followed, any distribution would be shared equally, not in proportion to the value of individual flats.

For example, the purchase might be made by the majority of the lessees – say, eight out of ten. The company’s surplus after tax would then be distributed to all ten lessees/shareholders. Suppose the freehold is bought for £1 million and the company’s chargeable gain is £900,000. Its corporation tax liability is 19%, amounting to £171,000. Expenses might be another £9,000, leaving £820,000 to be distributed to the shareholders in a winding-up, amounting to £82,000 for each. The eight lessees who now own the freehold as tenants in common can happily grant themselves longer leases for no consideration, but the other two would have to pay the same premium to their eight neighbours for any extension that they would have had to pay to the company.

Lessees might be tempted to suggest that these tax issues would disappear if the company retained the freehold and nothing were paid for such lease extensions – ‘After all, we own the company, so why charge ourselves?’ If that happens, the tax problems become even greater.

For tax purposes, the open market value would be involved. The market values for tax purposes would be more than the price determined under the Leasehold Reform, Housing and Urban Development Act 1993, as that only applies to leaseholders of at least two years’ standing and reflects a share in the ‘marriage value’. Others would have to pay more.

The lessees would be treated as disposing of their existing leases at market value and acquiring the new leases at their greater value. The unpaid difference would be subject to income tax, either as a benefit in kind if they are directors, or treated as if it were a dividend under Corporation Tax Act 2010 s 1064. If the unpaid difference is treated as employment income, the company would have a liability for Class 1A NIC at 13.8%.

The company would have a liability for corporation tax anyway, with no cash available.

Other considerations

If this were after March 2023, the small profits rate of 19% might not be available. If the company is a ‘close investment-holding company’ (under Corporation Tax Act 2010 s 34), the corporation tax rate would be 25%. The company would be caught if it is ‘connected’ with the lessees (see s 34(3)).

An individual is ‘connected’ with a company if, together with those connected with him or her, such as relatives, etc., the individual controls the company (see Corporation Tax Act 2010 s 1122). Certainly, if most of the individual lessees of flats in a block owned by a company are related to one another, each lessee will ‘control’ the company and will therefore be connected. In addition, even if the lessees are not related, any two or more persons acting together to secure or exercise control of a company are connected with one another, and each is therefore connected with the company.

However, it is thought that HMRC doesn’t take this as applying to the typical situation of a company owning the freehold of a block of flats, whose members are the lessees of those flats. In any case, the extra-statutory concession D39 would not be available, resulting in possible capital gains tax liabilities for the lessees. Clearly, this is not an advisable route.
Although it will rarely apply, one should also recognise the possible relevance of the annual tax on enveloped dwellings (ATED). Corporate lessees of flats of sufficient value should already be aware of any ATED responsibilities. Less obvious is the situation where an individual lessee is ‘connected’ with the company owning the freehold of his flat, as considered above.

ATED applies if the property is worth more than £2 million and the company’s interest is worth more than £500,000 or the property is worth £2 million or less and the company’s interest is worth more than £250,000. The values referred to are normally those at 1 April 2017 or subsequent acquisition (see Finance Act 2013 s 110).