The impact of leasehold: flats and service charge trusts

Property Tax

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We consider the tax implications of living in a leasehold flat, the treatment of service charges and the future impact of leasehold reform.

Key Points

What is the issue?
There are 5.4 million households in England and Wales occupying flats. Many ;are owned either directly by some or all of the lessees as tenants in common or indirectly by holding shares in a company that owns the freehold beneficially.

What does it mean for me?
Service charges when paid are to be held in trust to be expended to meet the lessees' liability for the costs of common parts and/or held in a sinking fund to meet future costs.

What can I take away?

The Leasehold and Freehold Reform Bill, introduced in November 2023, will improve home ownership for millions of leaseholders in England and Wales by empowering leaseholders and improving their consumer rights.

The latest data from the Office for National Statistics says there are 5.4 million households in England and Wales occupying flats, including those owned by local authorities, the Ministry of Defence, police forces, the NHS, housing associations, and so on. Millions are owner-occupied.

The freeholds of blocks of flats are often owned by an investor for the ground rent income and the possible capital growth. But many are owned either directly by some or all of the lessees as tenants in common (perhaps through a company as their nominee) or indirectly by holding shares in a company that owns the freehold beneficially. Consequently, estate agents marketing a flat for sale may say that there is a share in the freehold available. Few buyers grasp all the possible tax implications of their purchase.

They may be granted the lease of a newly built flat or assigned the lease of an existing one, together with a share in the freehold as a tenant in common with other lessees. More often they will acquire shares in the company owning the freehold.

Suppose that in September 2017 twins Evadne and Eleanor took a new lease as tenants in common from Lucrative Mansions Ltd, the company that the developer has set up to own the freehold of a block of flats.

Typically, owning a property as tenants in common involves establishing a trust. HMRC's guidance on trust registration says that '...“co-ownership trusts” where the trustees and beneficiaries are the same persons are excluded from registration' (see tinyurl.com/yty3cb3p). However, there were immediate consequences if the twins had to pay stamp duty land tax on the grant of a new lease. This is because stamp duty land tax specifies that the tax charge on the grant of a new lease is borne by the trustees and not the beneficiaries (a change introduced in 2005 to counter avoidance). This means that there will be a taxable trust that should have been notified to HMRC's Trust Registration Service. The trust registration issue does not arise on acquiring an existing lease, or on receiving taxable rental income.

The twins may have become directors of Lucrative Mansions Ltd (if the developer is passing the freehold to the lessees) and will have learned about possible actions that could affect the company or themselves. They might not immediately appreciate their responsibilities, or the problems that can arise if not all the lessees pay what's due on time.

Buying the freehold

A majority of the lessees can nominate a company or individuals to exercise the right to collective enfranchisement (buying the freehold) on their behalf under the Leasehold Reform, Housing and Urban Development Act 1993.

Extending their lease

Under the Leasehold Reform, Housing and Urban Development Act 1993, an individual lessee who has held their lease for at least two years can exercise a right to a new lease, at a peppercorn rent and a premium, for a term expiring 90 years after the date their existing lease would have ended, in place of the existing lease.

The cost to the lessee will be the premium plus both their own and the landlord's costs (solicitors and surveyors). The Leasehold Advisory Service (see www.lease-advice.org), a non-departmental public body funded by the government, offers a lease extension calculator to give an indicative value range for the statutory premium payable. The 'marriage value' – the increase in the value – will be split equally between the lessee and the landlord. As an example, a premium of about £77,000 is estimated to be payable to extend the lease of a flat with 61 years unexpired which is expected to be worth £600,000 with the lease extended.

Any premium received by the freeholder represents a part disposal for capital gains tax purposes. If the freehold is owned by a company whose shares are owned by the lessees, that company will generally have no other assets. So any tax liability on premiums received for lease extensions would have to be financed by the shareholders. If the freehold is owned by some or all of the lessees as tenants in common, they would have a part disposal whenever a lessee pays a premium to extend their lease.

Appointing a manager

Lessees can form a Right to Manage company under the Commonhold and Leasehold Reform Act 2002 or a recognised tenants' association under the Landlord and Tenant Act 1985 s 29.

Service charge trusts

Of more immediate interest to the twins buying a flat might have been the treatment of service charges. Like most of the leases of the millions of flats in England and Wales, the twins' lease will be subject to Landlord and Tenant Act 1987 s 42. This involves that service charges when paid are to be held in trust to be expended to meet the lessees' liability for the costs of common parts and/or held in a sinking fund to meet future costs.

There is little to suggest that HMRC understands the nature of service charge trusts. In the Trusts, Settlements and Estates Manual, TSEM5710 misjudges their ;status and the consequent income tax position (see tinyurl.com/tenuhsh4).

Perhaps surprisingly, they are not bare trusts. The terms of Landlord and Tenant Act 1987 s 42(6) mean the property held in trust is 'relevant property' – property in which no qualifying interest in possession subsists (see Inheritance Tax Act 1984 s 58). So the trusts are subject to the same tax regime as discretionary trusts.

The settlors are the lessees contributing the service charges. When the trust meets the costs of the common parts for which the lessees are responsible, in strictness there is an exit charge under Inheritance Tax Act 1984 s 65. There will in theory also be a ten-year anniversary charge under s 64.

The payment of service charges seems to be a transfer of value, because the lessee's estate is reduced by the payment, save to the extent it could be said to meet a liability (although normally service charges received by the trustees will be used to meet future costs). However, paying service charges can be argued as not being intended to confer gratuitous benefit and therefore not a transfer of value (Inheritance Tax Act 1984 s 10). Section 42 of Landlord and Tenant Act 1987 refers to defining a gift in relation to a transfer of value, but an unintended gift is still a gift. Thus, if the lessees' payment of service charges is seen as a gift, the trust(s) are

‘settlor-interested’, in that the lessees may benefit from the trusts. So arguably Finance Act 1986 s 102, gifts subject to a reservation of benefit (GROB), applies to the property held in trust as a result of service charges paid by each lessee. Therefore, the property in the service charge trust that is identifiable as coming from each lessee is potentially treated as part of his or her estate for inheritance tax purposes.

The trusts are also settlor-interested for income tax purposes under Income Tax (Trading and Other Income) Act 2005 s 624. So income arising within the trusts will be chargeable on the settlors if UK resident, not on the trustees. This leaves the trustees only liable to income tax at basic rate on the share of income attributable to non-resident lessees and the estates of deceased lessees (see Income Tax Act 2007 s 480(4)(c)).

The service charge trusts don’t have to be registered with the Trust Registration Service because they are not ‘express’ trusts, although they do have to notify HMRC if they have a tax liability, subject to a £500 de minimis.

If this is a correct analysis of the tax issues, and they are not thought acceptable, some remedies are required.

It would be better if Landlord and Tenant Act 1987 s 42 trusts, and any with comparable tax issues, were either totally exempt; exempt save where the figures are ‘significant’ (requiring a definition and new complications); or all treated as bare trusts. Any loss by a lessee of his share of trust property on his lease being forfeit, or coming to an end generally, should not have any inheritance tax effect. This is either because of Landlord and Tenant Act 1987 s 42(6) or because of being without donative intent.

Such simplification of the tax position of service charge trusts is unlikely to have a substantial effect on the country’s finances. As its latest accounts show, even a multi-million block of flats like One Hyde Park only has annual service charges of about £117,000 per lease, and trust property of only about £90,000 per lease. The amounts involved in most blocks of flats will be very much smaller.

Probably, the twins, like most new lessees, will be unaware of the Trust Registration Service requirements, and unconscious of the possible tax aspects of paying service charges. They will be much more concerned on a day-to-day basis with the

management of their block of flats and the quality and efficiency of the managing agents.

They will also be concerned at the possibility of being liable for the *post* Grenfell fire remedial costs, for the removal of dangerous cladding and associated precautionary expenses to be incurred pending its removal. If the block *is* owned directly or indirectly by the lessees, any *post* Grenfell fire risk assessment costs will have to be met by them, subject to any claim against the builder or by the Department for Levelling up, Housing and Communities under the Building Safety Act 2022.

The issues are just as relevant to commonhold land under the Commonhold and Leasehold Reform Act 2002.

Leasehold reform

Although not affecting them, by 2024 the twins will have read about the Leasehold Reform (Ground Rent) Act 2022, the first part of the government's programme of leasehold reform. This put an end to ground rents for most new qualifying long residential leases in England and Wales.

Then the Leasehold and Freehold Reform Bill, introduced in November 2023, will improve home ownership for millions of leaseholders in England and Wales by empowering leaseholders and improving their consumer rights. It will:

- increase the standard lease extension term for houses and flats to 990 years (up from 90 years in flats, and 50 years in houses), with ground rent reduced to a peppercorn upon payment of a premium;
- remove the so-called 'marriage value', which makes it more expensive to extend leases when they are close to expiry;
- remove the requirement for a new leaseholder to have owned their house or flat for two years before they can benefit from these changes; and
- allow leaseholders in buildings with up to 50% non-residential floorspace (currently 25%) to buy their freehold or take over its management.