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Dear Philippa

Companies owning the freehold interest in a block of flats.

Further to the discussions around the Annual Tax on Enveloped Dwellings (ATED) issues that can arise where the freehold of a residential block of flats is owned by a company the shareholders of which are the leaseholders of the individual flats, you indicated that it would be helpful to understand a little more about other tax issues affecting such companies.

Please find attached a note prepared by a member highlighting some of the other tax issues that can arise.

Yours sincerely

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The Chartered Institute of Taxation

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The CIOT draws on our members' experience in private practice, commerce and industry, government and academia to improve tax administration and propose and explain how tax policy objectives can most effectively be achieved. We also link to, and draw on, similar leading professional tax bodies in other countries. The CIOT's comments and recommendations on tax issues are made in line with our charitable objectives: we are politically neutral in our work.

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1. BACKGROUND

- 1.1 It is worthwhile setting out the background to this issue in some detail.
- 1.2 As part of leasehold enfranchisement, many Tenants of residential flats have acquired the freehold of their homes into a company (a “**Freehold Company**”). It has been relatively common for the acquisition of the freehold to be funded by interest-free Loans from the Tenants to the Freehold Company.
- 1.3 The Tenants are generally the only shareholders of the Freehold Company and, when a flat is sold, the outgoing Tenant is required to sell his or her share(s) to the incoming Tenant. The directors of the Freehold Company are generally appointed from among the Tenants. In addition to owning the freehold, the Freehold Company may also arrange the management of the building.
- 1.4 Generally, Tenants who have acquired the freehold of their flats in this way have considered that they now own their flats and have security of tenure. However, as the residual term of the lease reduces below 50-60 years, it can become difficult for a Tenant to sell his or her flat as a bank may be reluctant to lend against a short Lease. Therefore, Tenants are likely to want to extend the terms of their Leases (ideally to 999 years, effectively bringing the full value of the flats into the leasehold interest).
- 1.5 The extension of the Leases can raise tax issues for the Tenants and for the Freehold Company.

2. TAX TREATMENT OF LEASE EXTENSIONS

- 2.1 There are various possible scenarios.
- 2.2 **Acquisition on trust for the Tenants**
 - 2.2.1 The Freehold Company may have acquired the freehold on trust (as nominee) for the Tenants.
 - 2.2.2 For the purposes of direct tax, each Tenant would already be beneficially entitled to a share of the freehold in respect of his or her flat. Therefore the lease extension would be granted by the Tenant (as freeholder) to him or herself (as tenant). Accordingly, there would be no disposal for tax purposes.
 - 2.2.3 Under para 3 of Schedule 16 FA 2003, for the purposes of SDLT the grant of a lease by a nominee is treated as if it were the nominee (i.e. the Freehold Company), and not the beneficial owner, who had granted the lease extension. However, as long as:
 - 2.2.3.1 no consideration is paid (apart from a nominal amount to cover the legal costs of the extension); and
 - 2.2.3.2 the Tenant is an individual (so that the deemed market value rule under s.53 FA 2003 does not apply),no SDLT should be payable.

2.3 Acquisition under commonhold

- 2.3.1 The Freehold Company may have been established as a company under guarantee and acquired the freehold as a commonhold for the benefit of the Tenants.
- 2.3.2 Under commonhold, the Tenants would be treated as owning the freehold for themselves and the Leases would be extinguished. Therefore, there would be no need for any further action for the Tenants to become entitled to the reversion in their Leases.
- 2.3.3 However, commonhold has not generally been accepted in the market (as far as we are aware, there are fewer than 50 commonhold properties registered in the UK).

2.4 Freehold held as an asset of Freehold Company

- 2.4.1 The freehold may have been acquired as an asset of the Freehold Company. On any extension of a Lease, the Freehold Company would be treated as making a disposal for capital gains purposes.

Immediate extension of leases

- 2.4.2 If the Tenants extended their Leases (to 999 years) immediately after the Freehold Company acquired the freehold, the premium for doing so would be equal to the value of the reversionary interest for each Lease. Therefore:
 - 2.4.2.1 the Tenants could use the value of their Loans to pay for the extensions; and
 - 2.4.2.2 the capital receipt by the Freehold Company for the extensions would effectively equal the base cost of the freehold – therefore, there should be no capital gain.

Delayed extension of leases

- 2.4.3 As the residual term of the Leases decreases, the market premium for extending the Leases will increase.
- 2.4.4 If this increase is faster than indexation (which is most likely to be the case), the Freehold Company will realise a chargeable gain on the leases being extended. It does not matter if the Freehold Company does not charge a market value premium to the Tenants for the extensions, because s.17 TCGA 1992 would deem a market value premium to have been paid (see below).
- 2.4.5 A purchaser who bought the freehold of a property as an investment would charge a commercial premium for the extension of any Lease and would realise a chargeable gain when the Tenants pay a premium to extend. The purchaser would be taxed on any gain.

3. THE ISSUE

- 3.1.1 Some Tenants will have extended their Leases immediately following acquisition of the freehold, or will have entered into formal declarations of

trust with the Freehold Company, and so will not suffer any tax charge in respect of lease extensions (for the reasons noted above).

- 3.1.2 However, there are many cases in which Tenants did not immediately extend their Leases and did not enter into a formal declaration of trust. Whilst the Tenants considered that they had bought the freehold for themselves (not properly understanding the legal distinction between the Freehold Company and the shareholders of the Freehold Company), there may be limited (or no) documentation available to evidence a trust arrangement.
- 3.1.3 As the Tenants consider that they already, effectively, own the freehold, they have no wish to charge a premium to extend the Leases – the freehold was not acquired as an investment but merely as a means of acquiring the full value of the flats, and to secure tenure, for the benefit of the Tenants. Because the Tenants control the Freehold Company, they are able to ensure that no premium is actually charged.
- 3.1.4 However, even if no actual consideration is paid, under section 17 of the Taxation of Chargeable Gains Act 1992, where there is a disposal other than at arm's length, the disposal will be treated as being at market value. Therefore, even if the Freehold Company grants the extensions for nominal value, it risks being treated, for tax purposes, as having received the lease premium that would have been charged using normal valuation principles.
- 3.1.5 In addition, as the Tenants are also shareholders of the Freehold Company, and the Freehold Company is disposing of its freehold reversion to the Tenants, it is necessary to consider s. s.1000(1)B Corporation Tax Act 2010. S.1000(1)B states that a distribution includes "*any other distribution out of assets of the company in respect of shares in the company, except however much (if any) of the distribution (a) represents repayment of capital on the shares, or [any new consideration received by the company for the distribution]*". Therefore, to the extent that the extensions to the Leases are being granted at an undervalue, this could be considered as being a distribution to the Tenants in accordance with s.1000(1)B.

4. COMMENTS

- 4.1 There are some investors who purchase freeholds of buildings with the intention of realising a profit when the tenants of flats in those buildings extend their leases. Such investors would be taxed on any gain they realise.
- 4.2 However, where Tenants acquire the freehold of their flats for their personal benefit, it appears contrary to the intention of leasehold enfranchisement that Tenants should be taxed on the value of their own homes when extending their Leases in the circumstances described. Tenants (and their respective freehold companies) who have not sought advice and extended their leases may not be aware of the need to consider the tax position where the lease extensions concern their homes.