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LEASEHOLD REFORM

ENFRANCHISEMENTS AND NEW LEASES – <u>TAX RISKS</u>

Most enfranchisements and new extended leases take place with little or no serious thought about taxation risks.

When a new lease is granted, either following enfranchisement pursuant to S.13 of the 1993 Act, or new leases pursuant to S.42 of the Act, they are treated for tax purposes as a surrender of the old lease and the grant of a new lease unless the grant is at full market value and Extra Statutory Concession ESC D39 applies. (See 'further information' at end.)

As such, a disposal has been made of the old lease which may have been originally bought at a substantially lower price than the flat is now worth, and therefore a capital gain is deemed to have been realised.

Generally speaking, owner-occupiers have the benefit of tax relief because the flat is their primary residence. Generally speaking, those lessees who let their flats have no entitlement to tax relief and ought to be declaring the capital gain on their next appropriate tax return. Anecdotal evidence is that few of them do. Anecdotal evidence is that HMRC rarely take issue. That may change and there are a few cases in which HMRC have taken an interest and are charging tax.

HMRC can retrospectively look back up to 6 years but, if there is evidence of wilful negligence, 20 years!

We are valuers, we are not accountants or solicitors. This note should be treated as no more than a general warning. In appropriate cases, professional tax advice should be taken. The accountant who drew this to our attention and has some experience in these matters is Peter Beddard, FCA of Arundales, Chartered Accountants: email pbeddard@arundales.co.uk.

On the other hand, a retired solicitor who specialised in tax matters and who came across this paper suggested that, whilst it is correct that in land law a surrender and re-grant constitutes a notional disposal, that is a fact of land law and a new lease of the same property is not, in reality, a disposal for a real gain. He has referred us to Inland Revenue Commissioners –v- Burmah Oil Co. Ltd. in which there is a quotation from Lord Wilberforce in an earlier decision known as Ramsay that: *The Capital Gains Tax was created to operate in the real world, not that of make believe. Etc.*

He also referred us to Sargaison –v- Roberts, a High Court decision in which Megarry J stated: *Nevertheless, where the technicalities of English conveyancing and land law are brought into juxtaposition with a United Kingdom taxing Statute, I am encouraged to look at the realities at the expense of the technicalities. The taxpayer's interest has, uno ictu, been merely reduced from ownership of the freehold to ownership of a lease: the whole of his interest in the land has therefore not been transferred to another; and that is the end of the case.*

The potential scale of the problem is not what is being paid for a new lease, which may be a relatively modest sum, it is the difference between what was originally paid to buy the flat lease and what the flat is worth when the new lease is acquired. For the company there is a potential liability to corporation tax on the market value of the lease extension whether or not that is the price paid.

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Therefore, in an enfranchisement, it is probably important to have a participation agreement that a lessee's contribution to the enfranchisement costs is £1 for a company share, and the balance as a deposit for the new lease. That deposit is then part of the cost which can be set off against the gain for tax purposes. If this distinction is not made, then there will be a risk that the entire enfranchisement cost will be treated as a cost of the share capital of the new company and not of the new lease.

There is a tendency for some lessees to take the view that once the enfranchisement has been completed, extending the lease (or renewing it) is not urgent: the lessee has a share of the freehold interest, why pay the solicitors yet another fee? In a rising market, the taxable difference in value between original purchase price and value for a new lease is increasing.

One of the problems is that there is little or no relevant case law. If a lease needs both extending and variation of terms, can the deemed surrender and re-grant be overcome by extending the existing lease by Deed of Variation first and, after a suitable time lapse, then vary the terms by a second Deed of Variation?

A new lease pursuant to S.42 of the Act is probably more straightforward. It is a new lease. A surrender and re-grant has taken place.

If the enfranchisement company buys the freehold and then sells new leases, it will be important how the shareholders paid the enfranchisement premium as previously explained (share capital or payment for new lease). A self-balancing set of transactions ought not to give rise to a corporation tax risk for the company itself. Get it wrong and there is a risk that corporation tax will be payable.

It is often the case that a lessee who occupies the dwelling as their primary residence does not seek to buy a long lease until there is a wish to sell. The acquisition of the long lease is to increase the value of the flat (or house). That dwelling is then sold within, say, a year of acquiring the longer lease. There is a risk that the additional value is a non-exempt gain in that the purpose of acquiring the freehold or longer lease was to make a profit and was not for the purpose of occupying the dwelling as the lessee's principal residence.

It's not the job of HMRC to track down the taxable transactions. It is the tax payer's job to make a full and complete tax return each year. If there is a failure to declare a taxable profit, then there is a risk that interest and penalties may have to be paid in addition to the tax payable.

At present, it seems that the risk is small: its seems that few tax payers in these circumstances declare taxable profits and it seems that HMRC do not take forensic action crystallising uncomfortable consequences. The tax payer brushes this under the carpet at his own risk, or to use a different metaphor, the tax payer may decide to let sleeping dogs lie, but if and when that dog unexpectedly wakes up, it has a habit of biting hard enough to draw blood!

Possible solution: grant the new lease as an intervening lease, do not surrender the old lease, the titles can then be merged when the flat is next sold.

For further information, readers may care to go to:

CG65200 - Private residence relief: purpose of realising gain: introduction
CG65210 – Private residence relief: purpose of realising gain
CG65257 – Private residence relief: realising gain: acquisition of freehold
CG65270 – Private residence relief: realising gain: conversion into flats – example 1
CG65271 – Private residence relief: realising gain: conversion into flats – example 2
Extra-Statutory Concessions, D39. Extension of leases

Where to see copies: google them up.

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