The Personal Tax Planning Review

TAX PLANNING IN LEASEHOLD ENFRANCHISEMENT TRANSACTIONS: PART II

Conrad McDonnell[1]

In Part I of this article (PTPR Volume 4 Issue 3) it was assumed that all the tenants in a block of flats would participate in a purchase of the freehold. But what happens if they do not all wish to do so? The ones who do not participate will not receive 999 year lease extensions but will continue to occupy their flats under their present leases, paying ground rent for the privilege. The freehold will thus have some value since it encompasses the reversions on those leases.

The immediate problem will be how to fund the purchase of the freehold in respect of those non-participating flats. And, in the medium term, there may be a capital gains tax problem since the freehold will rise in value considerably as the term of each non-participating lease expires - and a participating tenant's share in the freehold will presumably have to be transferred at the same time as his flat is sold, but without being eligible for private residence relief (s.222 TCGA 1992).

The most convenient source of finance for a non-participating flat, although perhaps the hardest to find, is an investor who wishes to purchase the reversion. One of the participating tenants, or perhaps a small consortium, could choose to invest in this way, or it could be some outsider. A pension scheme (but not a Small Self-Administered Scheme, since such a scheme is prohibited from investing in residential property) might be a suitable investor, particularly if the scheme retirement dates all fall after the end of the term of the lease, in which case by retirement the scheme will either have received a substantial premium for the extension of the lease, or perhaps will have come into possession of the flat: on the other hand, if the lease term is very long then the reversion may not be easily marketable before the retirement date, in which case it would not be a suitable investment for a pension scheme.

Whoever it is to be, the investor would be granted a 999 year lease of the flat in question subject to the present occupation lease, in just the same way as the

[1] Conrad McDonnell, Barrister, Gray's Inn Chambers, Gray's Inn, London WC1R 5JA. Tel: (0171) 242 2642 Fax: (0171) 831 9017.

participating tenants are to be granted lease extensions (see Part I of this article). The investor, unless exempt, would of course be liable to income tax under Schedule A on any rent arising, and (if resident) to capital gains tax on the eventual disposal of the investment.

A reversion as a form of investment is inherently likely to yield chargeable gains since its value, particularly as the end of the lease term draws near, is likely to rise faster than the rate of inflation. Nevertheless, if the reversion is to be held for a long time, it cannot be said that the main object of acquiring the reversion is to realise a gain from disposing of the land, so s.776 ICTA 1988 ought not to apply. This being so, the investor who invests in a reversion would particularly benefit from capital gains tax planning techniques.

If no suitable investor can be found then the participating tenants will between them have to finance the share of the purchase price attributable to the non-participating flat. This is particularly likely to occur where the value of that reversion is low due to the length of the non-participating tenant's lease, perhaps because the non-participating tenant has already opted for a long lease extension rather than seeking to purchase the freehold.

If the participating tenants are to invest in the non-participating flat in this way, they could either make the investment through the vehicle of TenantsCo, or they could use a separate trust arrangement. The disadvantage of using TenantsCo, is that it will give the shares in TenantsCo some value and (as noted above) this value is likely to increase in a way that will give rise to capital gains tax as and when each participating tenant sells his shareholding (and presumably he would be bound to sell the shareholding at the same time as he sells his flat).

An alternative would be to use a form of trust whereby the participating tenants hold the reversion rather like tenants in common: the terms of the trust would provide that the tenants of the participating flats would be the beneficiaries. It should be possible to draft the terms of the trust in such a way as to ensure that the beneficial interest automatically belongs to the tenant for the time being of a participating flat, by virtue of his occupancy: in this way the beneficial share will pass, on sale of that flat, without the tenant having to make a disposal of any asset for capital gains tax purposes. This should ensure that the outgoing tenant neither surrenders any rights (s.22(1)(c) TCGA 1992) nor disposes of an interest under a settlement (s.76(1) TCGA 1992); note that the participating tenants must never become absolutely entitled as against the trustees (s.60(1) TCGA 1992).

If the trust is drafted in this way, the value will reside not in the beneficial interest, but in the ownership of the participating flat which entitles the tenant to share in the beneficial interest. Thus the value of the tenant's own flat will rise. But any chargeable gain arising on sale of the tenant's own flat will generally qualify for principal private residence relief.

Of course, it may not be necessary to go to these lengths, particularly if no individual will realise a gain in excess of his annual exempt amount.

Stamp Duty

Turning now to stamp duty, let us assume again that every tenant is to participate in the freehold purchase, being granted a long lease extension by TenantsCo on the same day as completion of the freehold purchase. It may be that the total stamp duty on the transaction will be 2% or more of the freehold price. This is because stamp duty will be payable on the conveyance of the freehold to TenantsCo; but stamp duty will also be payable on the grant of the lease extensions to the tenants.

The *ad valorem* stamp duty payable on a grant of lease extension is calculated by reference to the premium that must be paid; and the premiums in aggregate will amount to slightly in excess of the freehold price if costs are included as well. Incidentally, it should be noted that although on one view the consideration given for the long lease which a tenant receives is equal to (a) the premium plus (b) the surrender of the existing lease, the Stamp Office concedes (*Tax Bulletin*, August 1995, para. 13) that s.77(1) Stamp Act 1891 should apply so that only (a), the premium, is chargeable with duty.

Of course, in many transactions no tenant will pay a premium of more than £60,000 for his lease extension, and therefore the duty on each grant of lease extension will be reduced to nil (s.55 FA 1963). It will be remembered that in the case of a lease this reduction is available subject to the additional requirement that the rent should not exceed £600 a year (s.55(2) FA 1963).

If the £60,000 threshold is going to be exceeded then it might be possible to structure the transaction in such a way that the lease extensions are granted without there being a stampable conveyance on sale. As a result of s.241 FA 1994 the mutual transfer of undivided interests in land is no longer free from duty. But this section does not catch all partitions of land. If the tenants were to be co-owners of the freehold under a form of trust enabling a lease to be given in satisfaction of an interest in the freehold, and if in pursuance of that power a tenant was granted a lease extension but without expressing this to be in consideration of the release or transfer of any interest in the freehold, then that would be a form of partition (s.73 Stamp Act 1891) but not one for which consideration which "consists of or includes any property" (s.241 FA 1994) is given. It should also be a conveyance falling within Category F of the Stamp Duty (Exempt Instruments) Regulations 1987. Thus it would escape stamp duty.

Another idea might be for TenantsCo to purchase the freehold and then for the tenants simply to liquidate TenantsCo, granting to each tenant a long lease extension in satisfaction of his shareholder's rights (Stamp Duty (Exempt

Instruments) Regulations 1987, Category I). Either a new company, or perhaps one of the tenants, would have to take over the residue of the freehold.

Finally, if the departing landlord is willing, the simplest method of all would be for that departing landlord to grant long lease extensions to the tenants, before the transfer of the freehold. The premiums payable to the landlord, in aggregate, would amount to the same as the freehold price. In this way, whilst stamp duty would be payable on those lease extensions (or those for which the premium is in excess of £60,000), the stamp duty on the conveyance of the freehold would be negligible since it would by then be virtually worthless and transferred for minimal consideration.

Inheritance Tax Planning

Leasehold enfranchisement offers scope for easy inheritance tax planning, along the lines adopted in *Ingram v IRC* [1995] STC 564 but far less contentious. So long as the existing lease has sufficient term unexpired for the present owner to continue to enjoy the use of the property for the rest of his life, it does not **need** to be the present owner to whom the lease extension is granted. Instead, the children, or others whom the present owner wishes to benefit, could receive the lease extension (which, it will be remembered, is a 999 year lease of the flat, but subject to the existing lease). As time passes, that reversionary interest will rise in value and the present owner's lease as it runs out will fall in value but without any transfer of value taking place for inheritance tax purposes (s.3 IHTA 1984).

As can be seen, there is no need for a grant of a lease to the present owner, of the kind which come under attack in *Ingram*. The present owner's lease already exists, and all that will happen is that the present owner, having purchased the right to a lease extension, will exercise that right but nominate his children (or other beneficiaries) to receive the interest in land so purchased. Clearly there will be a transfer of value equal to the premium paid for the lease extension, but nothing more. Alternatively, the children could even provide the funds for the transaction so that there would be no transfer of value at all.

Once the transaction has been effected, the children (or other beneficiaries) will have to be astute that they enforce all the landlord's rights under the existing occupation lease (the covenants of which would continue to have effect). Otherwise it could be alleged that "the property is not enjoyed to the entire exclusion, or virtually to the entire exclusion, of the donor" (s.102(1)(b) Finance Act 1986 - the gifts with reservation section).

As an example, suppose the present occupier of a flat is 60, his lease has 30 years left to run, and the lease extension costs £40,000. By making a transfer of value of £40,000 now, the beneficiaries receive an item of property which the donor does not expect to need. By making this gift well before his death it can be hoped that it will be exempt from inheritance tax altogether. Due to the length of the lease, the donor's occupation of the flat is not threatened during his anticipated lifetime and there is certainly nothing the children can do to force him out, as can unfortunately happen under some other inheritance tax saving schemes. An additional advantage is that the reversion may appreciate in value at a significant rate: in five years' time, the beneficiaries' interest might be worth 60% more than at present, while the value of the occupation lease will barely have kept pace with inflation; and in 25 years' time, the majority of the value will be in the hands of the beneficiaries.

The disadvantage of this inheritance tax planning scheme is that the children may become liable to capital gains tax on the eventual disposal of the reversion: the children will not enjoy private residence relief since they will not occupy the property as their main home. It will be necessary to balance the capital gains tax that may become payable against the inheritance tax saving to be made.

Merger

Since Part I of this article was published, a correspondent has pointed out that where a tenant purchases his own reversion, it is not necessarily the case that merger will take place - it is in fact at the tenant's option. There would appear to be no tax reason to opt for no merger to take place, since ESC D42 makes the capital gains tax position where there is merger equally attractive to that where there is no merger; indeed, merger is more favourable to the tenant if the existing lease has less than 50 years to run (and so is a wasting asset).

Conclusion

Tenants of flats who are in the fortunate position of being able to purchase their own freehold may be able to engage in some effective inheritance tax planning. And, as detailed in Part I of this article, so long as care is taken over the conveyancing of the lease extensions, they are likely to enjoy an immediate rise in the value of their flats which will not be subject to tax.