The Personal Tax Planning Review

ASPECTS OF THE TAX TREATMENT OF SERVICE CHARGES

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Introduction

One of the trickiest problems confronting both solicitors and accountants (and indeed others giving advice in the property market) is that which arises over the correct structuring, for tax purposes, of the service charge arrangement. As ever in the tax maze, different structures produce radically different results and care needs to be taken to achieve the best tax position for the lay client. This article confronts some of the fiscal aspects of such arrangements.

Service charges form part of many arrangements in force between landlords and tenants. "Service charge" is not, for tax purposes, a term of art, though the Housing Act 1980 offers a definition of service charge in another context. No special fiscal provisions have been enacted to deal with the tax problems to which they give rise and consequently their tax consequences must be worked out by reference to the general provisions of the tax legislation.

Typically a service charge will arise under a written lease. It may provide for the payment, either in arrears or in advance or in a combination of the two, of sums above and beyond the rent reserved. These sums are usually intended to facilitate the maintenance, decoration and repair of the common parts of the building and the provision of incidental services such as heat, light and cleaning of the common parts. The precise ambit of any service charge, what it covers and what it does not cover, depends on the terms of the individual lease.

Service Charges and Income Tax : Which Schedule?

Service charges may fall into charge to income tax in one of four ways.

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First, where a service charge is correctly characterised as rent, either because it is reserved as rent (sometimes called service rent) or because it as a matter of construction forms part of the consideration for the subject matter of the grant (see *Property Holding Co Ltd v Clark* [1948] 1 All ER 165, per Evershed LJ), then it will fall into income tax under Schedule A.

Secondly, a service charge may still fall into tax under Schedule A notwithstanding that it is not rent where it qualifies as an "other receipt arising to a person from, or by virtue of, his ownership of an estate or interest in or right over...land" (s.15 ICTA 1988 para 1(c)).

Thirdly, if a service charge is paid in return for services the rendering of which amounts to the carrying on of a trade by the landlord then the service charge income will qualify as the receipts of a trade under Schedule D Case I.

Fourthly, where the service charge is paid in return for the rendering of services in circumstances which do not amount to the conduct of a trade then the sum may well fall into charge under Schedule D Case VI.

Income Tax Consequences

Care should be taken in the drafting of service charge clauses in leases since Schedule A, Schedule D Case I and Schedule D Case VI have significantly different rules for the ascertainment of income tax liability. The following points in particular are worthy of note.

1 Liability under Schedule D Case I is on a preceding year basis, tax being due in two instalments, one on 1st January in the year of assessment, the second on 1st July following the end of the year. By contrast, liability under Case VI is on a current year basis. Schedule A liability is also on a current year basis, the tax due on 1st January in the year of assessment (the assessment usually being provisionally made by reference to the profits of the previous year and subsequently adjusted).

2 Under Schedule D Case I the earnings basis for the computation of profits applies, whereas for Case VI the cash basis is usually used. Schedule A, like Schedule D Case I, is an exception to the rule that "receivability without receipt is nothing" (*Leigh v IRC* (1927) 11 TC 590, 595, per Rowlatt J) : tax is charged on the sums due in the relevant chargeable period, whether or not received. In practice the Revenue may accept an accounts basis (see IR 27 (1984)).

3 Capital allowances may be available under Case I and under Schedule A, but are not available under Case VI.

4 Under s.392 ICTA 1988 Case VI losses may not be rolled back, nor may they be set off against other income : they may only be rolled forward against other Schedule D Case VI income. Under Case I, however, losses may be either indefinitely rolled forward against the profits of the trade, or rolled over (and carried forward for a year) against general income or, in certain circumstances rolled back (e.g., in the early years of a trade under s.381 ICTA 1988 or where the losses are termination losses under s.388 ICTA 1988) or even set against capital gains under s.72 FA 1991. Schedule A losses are the subject of complex rules more restrictive that the Schedule D Case I provisions. Where a loss is incurred in respect of a lease at a full rent which is not a tenant's repairing lease (as defined) then the loss may be set against income arising in respect of another such lease. Where, however, the loss arises in respect of a lease at a full rent which is a tenant's repairing lease then the loss may be set against income arising from another such lease. Where a loss arises in respect of a lease which is not at a full rent then the loss may be set against income arising from the same property during the currency of the same lease only.

5 Finally, the rules relating to deductible expenditure differ greatly as between the three possibilities. With regard to Schedule D Case I the general rules relating to deductible expenditure are to be found in s.74 ICTA 1988 and the related sections. Broadly speaking, to be deductible under the Case I rules expenditure must generally (a) be incurred for the purposes of the trade, (b) be wholly and exclusively so incurred, (c) be of a recurrent or "income" nature and (d) not be disallowed under any of the provisions of s.74. By contrast, Schedule D Case VI has no specific statutory provision permitting or regulating the deduction of allowable expenditure. Rather the courts have chosen to construe the words "profits or gains" in the charging provisions so as to provide a rule that necessary expenditure may be deducted in the computation of Schedule D Case VI liability. Under Schedule A, where the question arises in respect of liability in respect of profits attributable to rents, provision is made for the deduction of sums in respect of costs attributable to maintenance and repairs, insurance, management, services provided by the taxpayer, rates (if any) and analogous payments and rent payable under a superior lease. Schedule A provides slightly different deductions rules in the case of profits arising from receipts other than rents.

Service Charges and Reserve Funds

Care again needs to be taken in connection with attempts to build up a reserve fund or sinking fund by means of a service charge payment. Where a landlord seeks to create such a fund by including in the service charge an element for contribution to a reserve fund, that contribution to the fund will qualify most probably as his Schedule A income in the usual way since he is beneficially

entitled to that sum under the terms of the lease in the same way as he is to that part of the service charge which is attributable to the cost of repairs, etc. As such he will be obliged to pay income tax in respect of it since there is no specific provision for the deduction by landlords of contributions to reserve funds. He may still however be obliged by the terms of the lease to set the sum aside in full in the reserve fund. He will therefore find himself in such circumstances paying income tax on the element set aside out of his own resources.

To avoid this problem provision is sometimes made in leases for the payment of the reserve fund element in the service charge to the landlord in a fiduciary or similar capacity. Where the landlord receives the reserve fund element as trustee then the reserve fund element should escape a charge to income tax since it has the status of a capital contribution to a fund.

The fund itself, however, may produce income if it is invested. This income will be trust income in the usual way and will attract basic rate income tax at 25% and, if the terms of the trust are such that it satisfies the conditions in s.686 ICTA 1988 so as to be an accumulation settlement or discretionary trust, additional rate tax at 10%. If this is the correct construction of the trust then the expenses of managing the trust itself will be deductible in computing the additional rate liability, though not in computing the basic rate liability. If, however, the trust is not within s.686 then it may be that the income of the trust will be directly attributed to the beneficiaries, rendering them liable to income tax at 25% on their share of the income of the fund. Needless to say, such trusts enjoy no special status for IHT or CGT purposes either and consequently the pitfalls associated with them do not end with the income tax problems.

Probably the most satisfactory solution to the tax difficulties arising from the creation of reserve funds is the creation of a management company whose function will be to provide the services for which the service charges are paid and to act as custodian of the reserve fund. In providing the agreed services in return for the service charges the company is likely to be found to be trading for the purposes of Schedule D Case I or to be in receipt of funds within Schedule D Case VI. Where the company is trading it will either be liable to corporation tax on its profits in the usual way or, as is likely to be the case where the company is owned by the leaseholders themselves, its surplus of income over expenditure will be protected from any charge to tax by the application of the doctrine of mutual trading. In respect of the capital of the sinking fund the company is likely to be a trustee. As a trustee the company will be liable to income tax and capital gains tax (and not corporation tax) on the income and gains of the trust fund in the manner outlined in the last paragraph.