Why bother extending your lease to 999 years after completion when you have just bought the freehold?

Or:

Tax and Lease Extensions

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Introduction – *What is the problem?*

A lot of people think that when they have purchased their freehold to their block that is the end of the story and that they do not need to do anything else to protect their position. However, that is not always quite right as this article explains. There may be a 'sting in the tail' if you delay extending your leases to 999 years having bought out the freehold.

Do we still need the leases? – *We have just bought the freehold, we can just cancel them can't we?*

Firstly, it is important to realise that if you buy the freehold to your building the leases will still need to remain in place, so the leases cannot just be 'cancelled.' The leases will regulate the legal relationship between the flat owners and the freeholder. The freehold owner will normally be a company incorporated by the flat owners for this purpose in which they own a share and which has a separate legal identity.

How to wear two hats

Even in a situation where *all* of the flat owners have taken part in the purchase of the freehold it is important to realise that there are separate and distinct legal relationships and that every person who has taken part in the purchase of the freehold wears 'two hats', one as a shareholder in (and perhaps as a director of) the freehold company and the other, as a long leasehold flat owner.

All decisions relating to the legal ownership of the freehold interest are taken by the company and this includes matters such as the grant of new leases and approvals under the terms of the leases. There will also be separate decisions where there are flats that did not take part about the sale of a lease extension/ share in the freehold company to those flats where valuation advice may be required.

A much overlooked point?

Diminishing lease length may be one reason why the flat owners have chosen to buy the freehold to their building, but this is not always the case and sometimes there are some concerns relating to management as well. However, a ***very key*** point that should not be overlooked is the extension of the leases to 999 years and the reduction of the Ground Rent to a Peppercorn unless the leases are already very long. This is because otherwise, over time the leases may diminish in length to a point at which the capital cost of renewing them would become much more significant. For instance, this would happen if they were to drop below 80 years in length or if there is a big time interval between completing the purchase of the freehold and extending the leases.

Why is this a taxing problem?

If there is a big jump in value between what was paid for the notional 'share of freehold' and the actual value of the lease extension that is received in return, there could be adverse capital gains tax consequences for the freehold owning company.

How does the problem arise?

When the freehold company buys the freehold it has received funds - probably by way of a 'loan' from the participating flat owners - to assist it in the purchase of the freehold. These funds will be used by the company to buy the freehold and in exchange, the flat owners will get back a share in the company. To complete the process they should *also* receive back in exchange an extension of their lease to a term of 999 years.

If this is not done at a time sufficiently close to the purchase of the freehold there is a risk that what they receive back in 'exchange' has a higher value than their original contribution to purchasing their 'share' in the freehold. If this happens the company is conferring a benefit on the flat owner and making a 'disposal' of something of value out of the freehold.

When this happens the company may face a charge to Capital Gains Tax (CGT).

Why is this an issue?

If the company confers a benefit on the flat owner (in other words *grants a lease extension* which is worth significantly more than what was paid for it) then the difference will most likely result in the company facing capital gains tax liability. As the company probably has no assets or cash to pay out on any liability of this sort to HMRC, its only option is to demand a payment from the leaseholder equivalent to the tax liability, before it can grant the lease extension. The directors of the company also need to think carefully about issues such as this as they may otherwise expose the company to liability if they grant lease extensions in a situation where liability may have arisen, but they do not realise.

In any case where there is doubt, valuation advice, as well as tax advice may well be needed to assess the extent of any liability.

Tales from practice

In practice, we do see situations (particularly in London and the South East), where leases have not been extended promptly after completion and where the company then needs to request an indemnity in respect of its tax liability from the flat owner in order to progress the extension of the lease.

What is the solution?

As mentioned above, if there is no way around the problem – i.e. that it has been left 'too long' to be able to account for the difference in value, then the answer is for the company to receive an indemnity in respect of its tax liability. There may be some other approaches that it may be possible to take advantage of, but these are likely to be specific to particular circumstances. If you are facing this issue you should contact us to discuss further so that we can discuss if we are able to assist.

Thinking proactively, the best way to avoid the situation is to ensure that in any freehold purchase, the participation agreement contains a requirement that the leases are extended to 999 years on completion or shortly afterwards so as to prevent this situation from arising.

If you would like to discuss any of the issues raised in this article further by all means do not hesitate to contact us to do so by emailing privateclient@bishopandsewell.co.uk

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