TAX PLANNING IN LEASEHOLD ENFRANCHISEMENT TRANSACTIONS PART I

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A residential tenant of a house or a flat held on a long lease may have a statutory right to enfranchise his lease. More precisely, the tenant of a house may have the right to compel his landlord to sell him the freehold, while the tenant of a flat may have the right in conjunction with the tenants of the other flats in the building to compel the landlord to sell the freehold of the building to a nominated purchaser.

This article examines the taxation consequences of such a transaction for the tenants of a block of flats: Part I will concentrate on the capital gains tax aspects and how to avoid making a company distribution; Part II of the article will concentrate on inheritance tax planning, stamp duty, and the tax considerations if there are tenants in the building who do not participate in the enfranchisement. For the sake of simplicity, it will be assumed that there are no intermediate leases between the tenants' interests and the freehold.

The tenant of a house will not normally be in danger of incurring any unusual tax liability as a result of enfranchisement (other than stamp duty); on a subsequent sale of the enfranchised property Extra-Statutory Concession D42, which relates to capital gains tax where a lease has merged with its reversion, will be relevant. As for the landlord, he will have made a disposal of his interest in the land, but roll-over relief under s.247 Taxation of Chargeable Gains Act 1992 ("TCGA 1992") will be available to him in respect of any gain arising — see Statement of Practice 13/93.

Leasehold Enfranchisement — The Law

In the case of both houses and flats there is a wealth of statutory conditions which must be satisfied before the right to enfranchisement arises. The right to enfranchise the lease of a house is governed by the Leasehold Reform Act 1967

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("LRA 1967"), Part I. In the case of a block of flats, the right arises under the Leasehold Reform, Housing and Urban Development Act 1993 ("LRA 1993"), ss.1-38, and this statute imposes the following conditions: the lease must be long, that is, the term at commencement must have been 21 years or more; the rent (not service charge) at commencement must have been low, less than two-thirds of the rateable value or the rack rent, so that the lease would have been granted for a premium; certain types of property are excluded (including buildings of historic or architectural interest designated under s.31 Inheritance Tax Act 1984); and two-thirds of the flats must be tenanted by qualifying tenants, that is, individuals (but not companies or settlements) who have occupied their flats as their only or principal homes for a minimum period of time.

Under LRA 1993 the purchase price of the freehold is determined according to Schedule 6. It includes three basic elements: (i) the open market value of the freehold (assuming the purchasing tenants are not in the marketplace); (ii) 50% of the marriage value, or such higher proportion as would have been agreed between the parties on an open market sale assuming the freeholder were a willing seller, the marriage value in this case being the increase in the value of the freehold when it comes into the control of the tenants, or at least the purchasing tenants; (iii) compensation to the freeholder for any consequential diminution in the value of his other property. If the freeholder and the tenants cannot agree the price then it may be determined by the Leasehold Valuation Tribunal.

If the landlord is unwilling to sell then the procedural hurdles make enfranchisement difficult for tenants: in the case of the tenants of a block of flats, the greatest hurdle is that in order to exercise the right to collective enfranchisement a two-thirds majority of the qualifying tenants is required.

If the landlord is willing to sell, however, the tenant of a flat (but not a house) has a potential right which if it arises is simpler to exercise and may be far more valuable to him. Under the Landlord and Tenant Act 1987 ("LTA 1987"), ss.1-20, a landlord of any premises containing two or more flats (with certain exceptions) may not dispose of the freehold (apart from in certain circumstances, for example by way of gift to a member of his family) unless within the previous 12 months he has offered it to the tenants at the same price and on the same terms: if the disponor landlord defaults, the tenants have rights enforceable against the new landlord. Only a 50% majority of the tenants is required for valid acceptance: on accepting, they nominate a purchaser to whom the landlord must then sell the freehold.

It is worth noting that on a sale to the tenants under LTA 1987 the landlord does not qualify for roll-over relief under s.247 TCGA 1992; this is because he was not compelled to sell, being initially willing to sell although perhaps not intending to sell to the tenants.

Collective Enfranchisement in Practice

The most common practice, whether on a purchase under the 1987 Act or on enfranchisement under the 1993 Act, is for the tenants to form a company ("TenantsCo"), and to nominate that company as purchaser. TenantsCo on purchasing the freehold will immediately grant to each of the tenants a lease extension on favourable terms, for example 999 years at peppercorn rent: in this way each tenant will achieve a secure position, and will have simplified any subsequent conveyance of his flat. TenantsCo thereafter continues in existence purely in order to carry out the landlord's obligations in relation to the building, collecting a service charge to meet the cost of so doing; TenantsCo's interest in the building will be valueless until the far distant future.

The choice of method for funding TenantsCo may have tax implications. A sensible choice if the company is to be funded entirely by the tenants is for the share capital of TenantsCo to be small, perhaps even a single £1 share per flat, but for each tenant to make to TenantsCo a loan of the amount which it is expected that that tenant will have to pay for his lease extension. On the grant of a lease extension, TenantsCo will set off the tenant's liability to pay the consideration against its liability to that tenant, thus TenantsCo's liabilities will be extinguished and it will return to being a company with a small share capital and no valuable assets. Clearly it will be desirable that TenantsCo makes neither a profit nor a loss on the transaction, and so the total amount receivable from the tenants should be equal to the price paid for the freehold plus any incidental costs: this is particularly important if TenantsCo is a close company, in which case the participators must make good to the company the expense of providing any benefit to them lest there be a distribution by virtue of s.418 Income and Corporation Taxes Act 1988 ("ICTA 1988"). The total amount required, equal to the freehold price plus costs, will probably be apportioned between the tenants on the basis of the relative value to each of them of receiving a lease extension.

Extending a Lease: The Common Law

The usual way of effecting a lease extension is by the grant of a new lease; the old lease is surrendered in part consideration for the new. The surrender arises because an estate in land, once granted, cannot be varied: to effect a change, a different estate in land must be granted. Any grant of an estate in land inconsistent with the tenant's retention of the old lease gives rise to a surrender of the old lease by operation of law — therefore any purported variation of the length of a lease takes effect as a surrender and regrant (see *Re Savile* [1931] 2 Ch 210, followed in *Baker v Merckel* [1960] 1 QB 657, CA).

It would, instead, be possible to effect a lease extension by conveying to the tenant the reversion of his present lease so that the two interests merge. For example, if the tenant has 50 years unexpired on his current lease he could be granted a lease for 100 years but expressly subject to and with the benefit of the current lease; it would be the same if that 100 year superior lease were granted to a third party, then assigned to the tenant. On this estate vesting in the tenant, the current 50 year lease would immediately merge with its reversion leaving the tenant with a 100 year lease. Clearly, careful conveyancing would be required to effect a lease extension in this way rather than in the way discussed in the previous paragraph. The author is not a conveyancer: it may be that a conveyancer can see some reason why a merger cannot be achieved so simply.

If the parties wish the tenant to remain in possession for longer than the term of his current lease, but with neither a surrender nor a merger of the current lease, then it may be possible for the landlord to grant to the tenant a second lease to commence immediately after the expiry date of the current lease; it should, however, be borne in mind that the grant of a reversionary lease will be void if it is due to commence more than 21 years from the date of grant — Law of Property Act 1925 s.149(3). If it is possible to grant a reversionary lease then, since there would be no overlap with the current lease, there would be no merger and no surrender of the current lease. The tenant would continue to pay rent to the freeholder throughout the term of the current lease; and should the current lease determine earlier than expected, the freeholder would recover possession until the commencement of the reversionary lease — this eventuality, however, is presumably within the control of the tenant unless the current lease contains unusual provisions.

Whether TenantsCo will make a Taxable Distribution to the Tenants

In a context where a tenant is a shareholder of TenantsCo, care will have to be taken that the company grants the lease extension for at least market value lest any element of undervalue constitute a taxable distribution by virtue of s.209(4) ICTA 1988. As mentioned above, the price that each tenant will pay for the lease extension will be a pro rata share of the price paid by TenantsCo for the freehold plus any costs, so that TenantsCo will make neither a profit nor a loss; it would in any event be undesirable for TenantsCo to make a profit since any profit would eventually have to be distributed out to the tenants.

Valuation

Clearly valuation is of critical importance here. So how much is market value for a lease extension (let us say it is to 999 years)? A short answer would be that since the market consists of one person, the sitting tenant, the market value is whatever price that tenant is prepared to pay, the only evidence for which is the price he in fact pays.

This may be too simplistic, since a straightforward lease extension involves both the grant of a new 999 year lease (for which there is a wide market) and the surrender of the old lease. Section 209(4) requires one to consider the market value of the new lease and the market value of the consideration given for it, that is, the old lease and a sum of money. But to take open market value for both the new lease and the old yields the wrong result because the transactions are linked: the sitting tenant would not surrender the old lease unless the new were to be granted. The result of taking open market value for both would be that in order for there not to be a s.209(4) distribution the tenant would have to pay for 100% of the marriage value between the old and the new leases, and this is wrong because even if the price for a lease extension were negotiated between a sitting tenant and an unconnected landlord the tenant would not have to pay as much as 100% of the marriage value. Nevertheless, it is hard to see what the right approach to valuation might be, even taking into account the link between the two transactions.

A practical solution is to ensure that the lease extension does not involve a surrender of the old lease: the extension could be effected either by way of merger or perhaps by way of a reversionary lease. Either way the desired result will be achieved but the landlord company will grant an estate in land to the tenant without accepting an estate in part consideration for this; merger is subtly different from surrender by operation of law, since if a surrender occurs the old lease vests in the landlord for a scintilla of time, whereas if a merger takes place nothing returns to the landlord but both interests merge in the hands of the tenant. On this approach it is much easier to determine whether there is a s.209(4) distribution: only one estate in land needs to be valued, not two, and furthermore it will be an estate which could as easily be sold to a third party as to the sitting tenant, so that the market value should be easier to reckon.

Even if there **is** a surrender of the old lease the same valuation approach should be adopted, since the commercial effects of a lease extension effected by way of merger and of a lease extension effected by way of surrender and regrant are identical.

In determining the market value account must be taken of the sitting tenant's bid — this was decided in *Custins v Hearts of Oak Building Society* (1969) 209 EG 239 in relation to the price that must be paid under LRA 1967, and the same approach should be followed in valuation for tax purposes. The likelihood is that the sitting tenant's bid will be the highest bid, since he will be prepared to pay an element of the marriage value whereas no other purchaser will. The real issue when determining market value is what proportion of the marriage value the tenant would pay. In ascertaining this it is hard to know what circumstances to take into account and what to leave out of consideration: it must be correct to consider the tenant's statutory rights (although these are of course expressly left out of consideration when finding the price for enfranchisement under LRA 1967 or LRA 1993), but it is probably wrong, for section 209 ICTA 1988 purposes, to take into account the fact that the tenant is able to exercise a degree of control over the landlord company.

The proportion of the marriage value that would be paid in an open market transaction between landlord and tenant depends on the relative bargaining positions of the two parties. When determining market value it must be assumed that there is a willing seller and a willing buyer, so that the strengths of the parties' positions are equally balanced, with the result that the proportion should be taken as 50%, all other things being equal — see *Norfolk v Trinity College Cambridge* (1976) 32 P&CR 147.

In the case of a LRA 1993 transaction, the statutory price for the freehold will have included at least 50% of the aggregated marriage values, or even a higher proportion if a higher proportion would have been agreed in an open market transaction: it is of course the proportion that would have been agreed in an open market transaction that should be included for tax purposes. Therefore the same proportion, or perhaps more, of the marriage value will have been included in the freehold price than should be included in the tax valuation. Furthermore, element (i) of the statutory price for the freehold is always slightly more than market value because the statutory price does not take into account the value of the tenants' rights of enfranchisement. Furthermore, the tenants will pay for their lease extensions prices which in aggregate will cover not only the freehold price, but also TenantsCo's costs. For these reasons the price paid by each tenant for his lease extension will necessarily exceed the market value of that lease extension, therefore it should be the case that the company does not make a distribution by reason of section 209(4) ICTA 1988.

What about tenants exercising their right to buy under LTA 1987? The price they will pay to TenantsCo to extend their leases will normally include no part of the marriage value at all. In this case the market value for the lease extension must take into account the tenants' statutory rights under LTA 1987. In the particular circumstances of LTA 1987 purchase, no tenant would be prepared to pay more for his lease extension than a pro rata share of the price TenantsCo paid when acquiring the freehold. Nor is it likely that any third party be prepared to exceed this price — the market value of a 999 year lease would be less than the market value of the corresponding freehold. Therefore the bargaining positions of the parties are not equal: assuming, for valuation purposes, that the landlord, TenantsCo, is treated as being at arm's length from the tenants, nevertheless the landlord must be assumed to be a willing seller and the tenants, knowing that the landlord cannot sell any estate in the land (other than a simple tenancy over one flat — s.4(1) LTA 1987 — which a sale of the reversion of any of the current leases would not be) without the right to first refusal arising, would not be prepared to pay any more than a third party would pay for the same estate. Assuming the tenants bid at least as much as a third party would pay, the landlord has no choice but to take the price offered by the tenants. In this unusual situation, the market value would simply be the price in fact paid by the tenants.

The result is that the transaction would not be caught by s.209(4) ICTA 1988 in this case either.

Conclusion: With Care, There Will Be No Taxable Distribution

It is possible then for TenantsCo to extend each tenant's lease for a price equal to a pro rata share of the cost of acquisition of the freehold without there being a taxable distribution. In the case of a LRA 1993 transaction (enfranchisement) it is arguable that a straightforward surrender and regrant type of lease extension gives rise to no distribution by TenantsCo, but to be on the safe side it is strongly recommended that lease extensions be effected by the grant to each tenant of an estate in land including the reversion of his current lease so that merger takes place, or where the current lease has less than 21 years to run, by the grant to the tenant of a reversionary lease. Conveyancers will need to exercise some care.

In the case of a LTA 1987 transaction (first refusal) it is more important that the lease extensions be effected by way of merger or reversionary lease rather than by surrender and regrant. Furthermore, the tenants would be wise to take steps to strengthen their argument that market value for the lease extension is equal to the price in fact paid: the tenants should improve their bargaining position vis-a-vis TenantsCo. This is most simply done by the tenants funding TenantsCo by means of a loan (which they will probably do in any case): each tenant would be a creditor of TenantsCo in a substantial amount, and TenantsCo would have no assets other than the freehold property, so that as creditors the tenants would be able to exert pressure on TenantsCo to sell (even though the tenants' shareholder control over TenantsCo must be disregarded).

Capital Gains Tax

The tenant will wish to ensure that the lease extension does not trigger a charge to capital gains tax, particularly since any tax charged would be payable at a time when no sale proceeds would be available to pay it.

TenantsCo will not incur any capital gains tax liability so long as each tenant pays for his lease extension the appropriate portion of the price paid by TenantsCo for the freehold. Each lease extension transaction, since it will take place between connected persons (the tenants acting together exercise control of TenantsCo, so section 286(6) TCGA 1992 applies) will be deemed to be for market value — section 19 TCGA 1992. Each grant of a lease extension will be a part disposal by TenantsCo, and, as discussed above, the market value for the lease extension will be equal to, or marginally less than, a pro rata share of the price paid for the freehold, that is TenantsCo's base cost. Therefore TenantsCo will make no gain on the transactions, and technically may even make a small loss on a LRA 1993 transaction where market value for a lease extension is less than the pro rata share of the freehold price.

The tenants have to be more careful, however: the lease extension may involve a disposal of a tenant's present lease. Of course, many tenants will qualify for full Personal Private Residence relief ("PPR relief"), in which case it could be to their advantage to realise a gain which will be free from tax, but even tenants in this position should be careful because, if there is a disposal of their current interest in the land then the "period of ownership" for PPR relief purposes (section 222(7) TCGA 1992) will recommence on their acquisition of the new interest. Different considerations will apply in individual cases.

The Inland Revenue do not normally take the point that a lease extension involving a surrender of the old lease is for capital gains tax purposes a disposal of that old lease — see Extra-Statutory Concession D39. This is very fair, since the tenant who extends his lease before the expiry of its term will not normally have cash in hand to meet any capital gains tax liability. The tenants in a leasehold enfranchisement transaction will be in this position also; however, one of the conditions for the concession to apply is that the transaction should be between unconnected parties bargaining at arm's length, and this condition is not satisfied in the case of a lease extension granted to a tenant by TenantsCo. Although it would be unfortunate if the Inland Revenue were to take the point, because the commercial reality is that no gain can possibly be realised until the new lease is ultimately sold, nevertheless the surrender of the old lease by operation of law is probably, technically speaking, a disposal.

There is a simple answer to this difficulty, which the reader will already have guessed: as is already sensible in order to avoid there being a chargeable distribution within section 209 ICTA 1988, the lease extension should be effected not by surrender and regrant but by granting a superior lease to merge with the tenant's present lease; alternatively by granting a reversionary lease.

There are arguments that a merger of a lease with its reversion is also a disposal of the lease, it perhaps falling within s.24 TCGA 1992; the more general view is that although it may be that as a matter of land law the lease is extinguished on a merger (the word "extinguished" is used in Extra-Statutory Concession D42), from a tax point of view the valuable asset, that is, the right to occupy the land until a certain date, continues to exist. Certainly s.43 TCGA 1992 does not contemplate that there is a disposal of the "other asset" on the occasion of a merger — if there were a disposal, how could any part of the asset's base cost then be attributed to another asset? Although it is fairly certain that a merger does not constitute a disposal of the old lease, if individual circumstances permit it might be safer to effect the lease extension by granting a reversionary lease, in which case there would be no question of a disposal of the old lease.

At such time as a tenant sells his flat, Extra-Statutory Concession D42 will apply to the calculation of the allowable expenditure and the indexation allowance for the extended lease (for a more detailed analysis of ESC D42 see David Goy QC's article in the *British Tax Review* 1992, 6, 361). The tenant would presumably sell his shares in TenantsCo at the same time; if all the tenants' leases have been extended so that TenantsCo has no valuable assets then clearly no gain will be realised on the disposal of these shares (if TenantsCo is a close company it might be important at this point also that all the lease extension transactions had taken place at market value, as otherwise there could be a reduction in the base cost of the shares by virtue of s.125 TCGA 1992). If there is some value in TenantsCo's interest in the land then that is a different story, which will be taken up in Part II of this article.

Comments relating to Part I of this article will be gratefully received, particularly if in time for inclusion in Part II.