

# RIVERMEAD

COURT

## EXTENDING LEASES – EXPLANATORY DOCUMENT

1. In the last Rivermead Court Newsletter, our Chairman gave a broad outline of the work that has been going on behind the scenes to develop a scheme to extend our leases. The basic proposal is to offer to extend all the leases, on a voluntary basis, to an expiry date approximately 878 years from now. We are now in a position to elaborate some of the detail of what is proposed.
2. First, some history. In 1979, the Prudential Insurance Company, which then owned Rivermead Court, decided that owning these apartments no longer accorded with its investment requirements and offered to sell the entire freehold to the tenants. A small group of tenants saw the opportunity and came together with a view to acquiring the freehold, funding the acquisition by offering to sell long leases to each tenant at a fixed price determined by the assessed value of the property. This was achieved by the formation of a company – Rivermead Court Limited – in which each leaseholder would have a single share. The entire transaction was completed in March 1980 when 181 of the tenants purchased 125 year leases on their flats. This very positive response, along with the sale of a further 13 then vacant flats, realised sufficient funds to buy the freehold. Over the succeeding years, most of the few remaining flats have been leased on the same terms and the sales proceeds have enabled RCL to run and maintain the entire property to a high standard, while putting the company on a sound financial footing.
3. Although we, as leaseholders, are customarily described as “owning a share of the freehold”, technically and legally, what each of us actually owns is one share in the freehold company, Rivermead Court Limited. As the company was originally structured as an independent commercial landlord, this means in practice that extending the leases will, in the eyes of HMRC, be a taxable event.
4. Most landlords will automatically charge a premium for extending their tenants’ leases and there are provisions in the Leasehold Reform legislation for the calculation of the premium. As things stand now, with 87 years remaining, the premium would be approximately 1.5% of the assessed value of the flat (see paragraph 14 below). In round numbers, this results in a premium of £15,000 for a flat valued at £1 million and about £30,000 for a flat valued at £2 million. It is probable that the majority of the properties will fall within this range of values.
5. As the company is a leaseholder-owned landlord, the Board has also considered the desirability of extending the leases at nil premium as this is permitted in the Memorandum and Articles of Association. At first sight, this looks like an attractive idea – why pay up to £30,000 for something you can have for nothing.

### The case for a premium

6. Part of the answer to this question lies in the relative tax positions of Rivermead Court Limited on the one hand and leaseholders on the other. Rivermead Court Limited pays corporation tax on its taxable income and capital gains at the rate of 19% (17% from 1 April, 2020). It is the Board's intention, however, to use the lease extension income (i.e. the premiums) to pay for the pipework project in its entirety up to and including the heat exchanger unit (the HIU). This means that only the internal works of each flat would be met by the owner. As we expect the majority of the heating project work will be regarded as a repair to the existing infrastructure and not an improvement as defined by the tax legislation, it should be allowable as a deduction from the Company's income for tax purposes. The company also has significant unrelieved tax losses on its balance sheet and while we expect some tax to be payable depending on the timing of the income and expenditure, the effective tax rate is expected to be in the low single digits.
7. The other part of the answer to this question of whether or not to charge for lease extensions lies in the use to which the funds will be put. Taking advantage of the company's favourable tax position means that a good part of the legal costs and valuation costs of extending the leases will be met along with all the costs of the pipework. Any surplus arising out of the lease extension income can be used to mitigate rises in the service charge and help to fund major works arising in the future. Most of the lifts, for example, are on borrowed time, and some will need replacing in the very near future.
8. To the extent that Rivermead Court is able to reduce service charges, this will help leaseholders with the internal costs of hooking up to the new system. A well-funded landlord able to bear much of the cost of maintaining a building with an ageing infrastructure, a very long lease and a potentially reduced service charge will ultimately enhance the value of your property to a buyer.

### The Alternative Case

9. The alternative to charging a premium based on a fair valuation is a nil premium. In this case, we, as leaseholders do not pay the premium but, as shareholders in Rivermead Court Limited, we are deemed to have received value equivalent to the premium. This notional value will be treated by HMRC as a distribution from the company to the shareholder and taxed as dividend income. Under this scenario, the owner of a middling flat (say £1.5 million) will be deemed to have £21,000 or so of notional dividend income in the year in which contracts are exchanged. The tax payable on this notional dividend will depend on the recipient's other income, both non-dividend and dividend income, in the year in which he or she extends the lease.
10. While it is not possible for the Board to know how much income tax will be assessed on each individual, almost everyone will be liable for some tax on this dividend even if the resident has no other income. It is a consequence of our limited company structure that if the leases were to be extended at less than full value the difference

would be treated as a dividend in the hands of the lessee(s) and taxed accordingly. In turn, Rivermead Court Limited may be deemed to have received full market value for its grant of the lease extensions and would risk suffering Corporation Tax on the sum that it ought to have received. This final point has still to be clarified by Counsel. (See Question 9 in the Q&A).

11. With a free lease extension, leaseholders will not only need to pay the tax due on the notional dividend, they will still need to pay for a share of the pipework project and the other service charge costs that the lease extension income would have covered. The valuation costs of their flat and associated legal costs of the lease extension will also need to be met one way or another, along with any tax charged on the company on any sums it is deemed to have received for extending the leases.

### **The Balance of the Argument**

12. The Board has consulted Tax Counsel and we do not yet have his final opinion, but the very clear advice so far is that one way or another extending the leases will give rise to a tax liability either in the hands of the leaseholder or in the accounts of Rivermead Court. The difficulty for the Board is that every leaseholder will be on a different tax band and this cannot be known. It is probable, but not certain, that many will be on a tax rate greater than that of the company where the corporation tax rate is 19%. What we can be sure of is that personal taxpayers will not have any way of mitigating the amount of tax payable on the notional dividend whereas the company can offset its pre-existing considerable tax losses and any other expenditure incurred in the tax year the lease extension income is received.
13. Looking at the company and its shareholders in the round, it seems to the Board preferable to charge for lease extensions, utilise the tax losses and other allowable costs available in the company – including the pipework costs and any other major works expenditure - and ultimately give leaseholders the benefit of any surplus money raised in this offering by way of a reduction in the service charge. It is assumed that leaseholders not extending now will do so in due course resulting in future income streams to keep the service charge burden down. In the free lease extension scenario, the income tax paid by leaseholders will be lost with no offsetting costs, and meanwhile the pipework still has to be paid for as would other expenses that would otherwise be covered from the lease extension income.
14. A key element of the process will be the valuation of the individual flats. The Board has selected, but not yet appointed, a qualified Chartered Surveyor. His clear understanding is that all the flats will be fairly valued both relative to each other and to the market. Rivermead Court Limited is not in the business of extracting the maximum premium from its leaseholders, who are also its shareholders – quite the reverse. The prescribed basis for such a valuation is good, tenable condition before improvements so do not be alarmed if your valuation is assessed below what you think you could sell it for. This is not intended as a sales price. Merely a basis for calculation of the cost of the lease extension.

15. As a final point, the offer will be made to all residents on a voluntary basis. Not everyone will wish to extend at this time and that is entirely their choice. The plan is to keep the offer open at the agreed valuation for a set period. Thereafter, any resident wishing to extend who has not already accepted the offer will still be able to do so but will need to obtain a new valuation. This valuation may have increased or decreased depending on the direction of property prices. The lessee may choose to use the same valuation professional who can model the latest value on a template basis at a reasonable price. In future years, the premium calculation will change as the length of time remaining on the lease declines. In broad terms, other things being equal, the rate of increase is approximately 5% per year until there are fewer than 80 years remaining, at which point the cost of extending rises significantly. (See Question 6 in the Q&A).

**To Summarise:**

16. There are clearly advantages to having a long lease. Properties on long leases are more marketable and more readily mortgaged. There is some evidence that purchasers can be discouraged from buying flats where the lease is shorter, or where there are major unfunded works in the pipeline. Rivermead Court has long had the reputation of being a well-managed block, and sound financial management has been a large part of its success. Charging a fair market rate to extend the leases will settle the funding problem posed by the pipework, help to pay for future major works and give scope to keep the service charge down. Finally, it will give certainty that the major works can be paid for in full, which can only be a benefit both for lessees and prospective purchasers.

**On behalf of the Board of Rivermead Court Limited**

**24 May 2018**