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Flat Management Trusts And Their Taxation



HDBK 7

OVERVIEW

- Service charge monies held by landlords and their agents must be held in "trust" by statute.
- The trustees are the landlord or the person named in the lease to whom service charges are payable.
- For tax purposes these trusts are classed as discretionary trusts.
- Tax is payable on interest earned in these trusts at the rate applicable to trusts.
- Managers can deduct agreed expenses from the tax payable.
- The Government introduced a basic tax rate band for income from trusts of £1,000 from 5th April 2006.
- And from 6th April 2007 the rate of tax on all flat management trust income has been reduced to 20%.
- Annual tax returns may be required for financial years ending in 2007, but for 2007/8 there should be no requirement if tax has been deducted at source at 20%.

CREATION OF FLAT MANAGEMENT TRUSTS

S.42 of the L & T Act 1987 requires that landlords must hold variable service charges paid "in trust". Housing associations and local authorities are exempt from this requirement subject to HMRC's views on implied trusts.

Although the heading here refers to flat management trusts, S.42 applies to all types of leasehold dwellings.

S.42 also applies to three party leases where the management duties are devolved from the landlord to a resident management company or named manager. In such cases the obligation to hold funds in trust applies to the named person or organisation in the lease to whom service charges are payable.

WHO ARE THE TRUSTEES?

They are the landlord or the named management company in a three party lease.

WHAT SHOULD AGENTS DO TO COMPLY WITH THE OBLIGATION?

It is necessary to put monies held in trust into a separate client bank account and ensure that the bank where funds are held is aware that the monies are held under a statutory trust. There is no requirement for a trust deed to be drawn up, the trust is created by statute.

SHOULD THERE BE SEPARATE ACCOUNTS FOR EACH TRUST?

There is no requirement at present to open a separate account for each scheme.

However, S.42 is to be extended to add on the requirement that each scheme shall have at least

one separate bank account. The CLRA 2002 allowed for this to happen subject to regulations. A Government consultation paper of June 2004 proposed that such accounts would comply if they had in the title the words "Section 42A".

So in practice to comply with the S.42 new regulations **when introduced** will require at least one separate bank account per scheme with a title of say "Honeymoon Court S.42A account". There are no proposals to insist upon a separate account for reserve funds for each scheme.

No date has been announced for the introduction of separate bank accounts per scheme; indeed, it is not yet even clear that they should include "S.42Account" in the title. ARMA continues to seek clarification on this whole area.

WHAT HAPPENS TO TRUST FUNDS ON REALES?

S.42 of the Act explains that on sale or the termination of a lease the outgoing leaseholder is not entitled to any part of the funds held in trust. No repayment of balances of reserve funds should be made. In addition the Act explains that if in the unlikely event of all the leases in a block terminating and there are no longer any service charge payers, then the balance of any funds belongs to the landlord. (See S.42 (6) & (7)).

TAXATION OF FLAT MANAGEMENT TRUSTS

If you hold funds "in trust" then you are liable for tax on any interest earned at the rate applicable to trusts.

Service charge trusts are discretionary and accumulation trusts and their tax liabilities were summarised by the Paymaster General in August 1999. The income of such trusts belongs to the trustees, rather than the beneficiaries, so it is they who are charged at the rate applicable to trusts.

The key legislative provision is contained in a piece of consolidation legislation section 686 Income and Corporation Tax Act 1988.

The rate of tax applicable to trusts was 40% from 6th April 2004 (previously 34%).

From 6th April 2005 the first £500 of interest earned per trust was changed to be taxed at the standard rate of 20%.

Then from 6th April 2006 a further change was made such that the first £1,000 of interest earned per trust is taxed at the standard rate of 20%.

And now in the budget of March 2007 the Chancellor has conceded that the tax rate is 20% whatever the amount of interest earned.

GUIDANCE NOTE 24/07



HOW TO CALCULATE THE TAX DUE

The Position for the Financial Year 2006/7

Tax will be payable at standard rate for the first £1,000 of interest earned and at 40% thereafter.

So if a block earns £400 of interest in 2006/7 year then the position is unchanged from 2005/6. Tax at 20% is payable in the sum of £80 and is usually deducted at source thus avoiding a tax return.

But if the block earns £1,200 of interest in the year the position changes.

Tax is payable as follows:

20% on the first £1,000	200
40% on the balance of £200	<u>80</u>
Total	£280

The Position for the Financial Year 2007/8

Tax will be payable at the standard rate of 20% however much interest is earned.

So if a block earns £400 of interest in 2007/8 year then the position is unchanged from 2006/7. Tax at 20% is payable at £80 and is usually deducted at source thus avoiding a tax return.

But if the block earns £1,200 of interest in the year the position has changed.

Tax is payable as follows:

20% on the total amount of interest earned ie £1,200 @20% = £240

Note a saving of £40 from the 2006/7 position.

WHAT IF YOUR BANK ACCOUNTS RECEIVE INTEREST PAID GROSS

If the accounts for schemes are paid gross you will be faced with making a tax return for each one even if the only tax payable is at the standard rate. A small scheme with little interest could be involved with the calculation of tax, the completion of a tax return and the forwarding of a cheque to the tax office for very small sums. If you ask your accountant to calculate the tax and make the return the cost to, say, a RMCo may be far more than the tax which is due.

It would be sensible for all bank accounts for leasehold flats to have tax on interest deducted at source particularly for smaller RMCos.

HOW TO PAY THE TAX IN PRACTICE

In practice, managers need to complete an assessment form 'SA900'. One per scheme may be required but you may be able to agree with your tax office a summarised version across all schemes.

The tax (having made an allowance for management expenses and any tax already deducted at source) is payable in two parts, on 31 January and 30 September, each year. The

assessment form should be submitted with the second payment in September. There are fines for late payment.

However, the government has announced it will not expect tax returns for trusts where tax has been deducted at source. So agents may be able to save a lot of paperwork from financial year 2007/8.

FAILURE TO PAY TAX AT THE CORRECT RATE

Most managers hold service charge monies in client or separate scheme bank accounts. Banks often automatically deduct tax on the interest accruing at the basic rate for savings, currently 20%. Other landlords or managers may be companies and have interest paid gross. Managers on behalf of the landlord need to take responsibility for accounting for and paying over the tax needed to be paid at the rate applicable to trusts.

It is good practice to show tax deducted on interest as an item in the annual statement of accounts for schemes and to accrue the additional tax as an item of expenditure even though it will be paid at a later date.

If a manager fails to pay tax at trust rates when legally required, then liability will be determined under the provisions of Section 98 of the Trustees Management Act 1970. Tax penalties can be as high as 100% of the tax liability and the HMRC can backdate claims for a number of years.

TAX FORMS R185 FOR INDIVIDUAL LEASEHOLDERS

Some managers have been advised that they need to serve R185 forms on each lessee to notify them of the interest earned by the trust of the scheme in which they live. This is not the usual practice of managers or normal advice from the HMRC. The normal view is that the interest is earned by the trust, no money is ever given to leaseholders. Interest when spent is spent on the block as a whole not given to individual leaseholders.

This view is supported by the explanation of what happens to the trust fund as set out in the Act. See above about what happens upon resales.

DEDUCTION OF EXPENSES FROM TAX PAID ON INTEREST

Expenses of the collection, reporting and payment of the tax are an allowable deduction from the interest earned. Managers will need to agree a basis for the calculation of such expenses with their tax offices.

The tax payable is then calculated on the interest after deduction of the expenses. The management expenses are a fee payable to the manager.

As the deductible expenses of many of these trusts may exceed the taxable income received, members may wish to see if they can agree a 'de minimis' arrangement with their tax office.

REFERENCES

- The £1,000 standard rate band announced in the 2006 budget can be found in budget briefing notes on www.hmrc.gov.uk, look for BN35 - Modernising the Tax System for Trusts.
- The concession of a tax rate of 20% for all flat management trusts announced in the budget for March 2007 is in Budget Briefing Note 41. See www.hmrc.gov.uk/budget2007.

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