ARHM GOOD PRACTICE NOTE

SERVICE CHARGE FUNDS – TAX ON INTEREST

Section 42 of the Landlord & Tenant Act 1987 requires managers to hold variable service charge funds 'in trust'.

Registered Providers are exempt from this requirement (with certain caveats – see below).

The Position of Registered Providers

Registered Providers need not hold funds 'in trust'. However, advice from the National Housing Federation states that Registered Providers should adopt one of three options for protecting service charge contributions.

- Where there is a subsidiary association managing leasehold property, a guarantee is put in place from the parent,
- Self-protection through adequacy of reserves, or
- The creation of a trust to mirror Section 42

It is also suggested that Registered Providers consult with leaseholders on the option to be preferred.

As a result of the above some Registered Providers do hold funds 'in trust' after consultation or have chosen to do so to reassure leaseholders.

Registered Providers are not exempt from Section 42 trust requirements if they are acting as agent for a third party, or they are not themselves the freeholder/landlord.

If the leases for any scheme say that service charge monies shall be held in trust, then an 'implied trust' is created. The Registered Provider will be holding the funds in trust whatever banking arrangements it makes.

If a Registered Provider opens a separate bank account for a scheme or a group of schemes and uses the words 'in trust' in the name of the account or in a letter to the bank setting up the account, then a trust will be implied.

Taxation of Trust Funds

For funds not held 'in trust', no tax is payable on interest earned.

Funds held 'in trust' are liable for tax on the interest earned at the higher rate applicable to trusts under Section 686 of the Income and Corporation Tax Act 1988.

The reasons set out for this are that the "rate of tax applicable to trusts is not linked to the tax position of any particular beneficiary. It is intended to be an approximation for the rate which would apply if the income belonged to the beneficiary who may pay tax at the starting, lower, basic or high rate, or be a non-taxpayer. The Government considers that the rate cannot be set too low otherwise there could be opportunities to use trusts for tax avoidance purposes".

Deduction of Trust Management Expenses from Tax Paid on Interest.

Section 686 of the Act gives trustees entitlement to deduct trust management expenses (basically the costs of collecting and administering the income) before calculating tax due.

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

How to Pay the Tax in Practice

Managers need to complete a Trust and Estate Tax Return Form (form 'SA900').

One per scheme may be required but it has been known for members to agree a summarised version across their stock.

The tax (having made an allowance for management expenses and any tax 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.

Where a manager has failed to pay tax at trust rates when legally required, then liability will be determined under the provisions of Section 95 of the Trustees Management Act, 1970. Tax penalties can be as high as 100% of the tax liability and the Inland Revenue has been known to go back as far as twenty years in unpaid taxes.