ARHM GOOD PRACTICE NOTE

SINKING FUNDS

A sinking fund is a fund created to save money for infrequent, high value expenditure. It usually covers major structural works like roof and window renewals, or component renewals and refurbishments for example lifts or door entry systems. It can also include saving for cyclical works such as renewal of communal floor coverings, and internal and external redecoration of communal areas.

Sinking funds might be referred to as capital, repair or reserve funds.

The collection of adequate sinking funds benefits the scheme as a whole. Funds spread the costs of major repairs and replacements over the life of the building, ensuring all owners pay a fair proportion. Residents of retirement schemes often have incomes that are fixed or have limited potential for increase. Sinking funds prevent sudden large demands for the cost of repairs.

Managers may have one or more funds per estate. Where one fund is operated it is usual for the sinking fund to also be used to pay for cyclical works. Alternatively, there may be a special reserve fund for cyclical maintenance.

Managers administering leases with a requirement for sinking funds should have a method of calculation of contribution that is reasonable, and that also has a systematic basis behind it.

Managers should review the adequacy of their funds on a regular basis. Failure to review may leave managers open to legal challenge by their lessees.

Any contributions collected towards a reserve fund must pass the test of reasonableness.

ARHM Code of Practice

The Code states that Managers should maintain reserve funds to defray the cost of major repairs and renewals whenever the lease allows.

If a lease says contributions to a reserve fund “shall” or “will’’ be collected, then managers must do so.

Calculating the Sinking Fund

Unless a lease specifies a particular method or manner in which contributions to reserve funds are calculated, contributions to reserve funds for specific building elements and refurbishment of communal areas in particular, should be calculated by using a life-cycle costing method, and should be based on the condition of and be specific to each scheme.

A minimum life cycle of 10 years should be used including all building components.

Life-cycle costing involves estimating the life of each component of the building or scheme and its replacement cost.

A schedule should be put together of the components for the scheme which will demonstrate how much will be required for the replacement of those components as they reach the end of their life, and their anticipated lifecycle.

The calculations should be based on a survey of the condition of a scheme and be specific to that scheme.

The current cost of the repair or replacement of a building element should be based on the particular knowledge of the manager (backed up by evidence) or on data that is accepted in the building industry. E.g. Estimators' Price Books.

The life cycles used should be based on data that is generally accepted, such as National Housing Federation or RICS guidance.

Cost calculations should include VAT and any professional fees that may be incurred in carrying out the work in the future.

One option is to make a life cycle cost calculation of the elements required and then calculate a simple average cost per year. If this is done it will be necessary to review costs regularly, say every 3 to 5 years.

An alternative is to use a life cycle costing method, building in assumptions about the inflation of building costs and the interest earned from funds, and then calculating an average contribution per year for the scheme. The RICS Building Cost Data Service publishes indices of maintenance costs.

A key decision to be taken is how many years forward the life cycle costing should include, and how often it will be reviewed.

If managers decide to change the method of calculation of the sums due for contribution to reserve funds, then they should carry out a consultation exercise with the residents affected.

Leases

If there is no specific clause in a lease allowing for a Sinking Fund then managers cannot and should not implement one. Managers may consider approaching leaseholders to seek a lease variation, but obtaining 100% agreement can be difficult.

Leases may be specific about what items can be collected for as part of the sinking fund. If so managers may only collect for those items or categories of expenditure mentioned in the lease.

Challenge

Any contributions calculated for a reserve fund must pass the test of reasonableness and will be open to challenge at a First-tier (Property) Tribunal (if expressed as part of the service charge). Calculation of contributions should be scheme specific and based on the condition of that scheme.

If a manager is aware that the current level of reserve fund is inadequate, the relevant leaseholders should be informed. Failure to collect adequate contributions to a fund because of failure to plan or review plans, may leave managers open to challenge from leaseholders for breach of covenant.

Many managers use a lower cost limit for expenditure from a reserve fund as it is not intended for minor repairs. Auditors often insist on this.

Investment of Sinking Funds

It is not a requirement to hold reserve funds in a separate bank account to other service charge monies, unless required by the lease or a management agreement.

Reserve funds should be placed in an interest-bearing bank account, which may be the same account as that used for current service charge income and expenditure.

Private companies must specifically hold service charge monies, including sinking funds in 'trust'. In practice this will mean opening a bank account named as in trust for a scheme or group of schemes.

Registered Providers need not hold funds in trust, although many do. If a trust is not set up then Registered Providers have to choose either to protect funds with a guarantee from a parent body where management is by a subsidiary association, or self- protection by adequacy of reserves. Registered Providers are recommended to consult leaseholders upon the options for holding funds.

Where a Registered Provider is managing as an agent for a private landlord then funds should normally be held in trust.

Some leases state that funds must be held in trust. Where this is the case then the manager has no choice.

Sinking funds are in 'trust' for the scheme and should not be returned to lessees upon assignment, or at any time.

Interest earned on funds should be added to the funds unless the lease states otherwise.

Taxation of Funds

If funds are held in 'trust' then a tax will be charged on the interest earned. The interest will be taxed at the rate applicable to trusts.

If funds are not held in 'trust' it is usual that no tax is chargeable on the interest earned.

If funds are held in trust then managers may be able to agree a deduction from the tax payable for the management cost of the collection of the tax.

Insufficient Funds

Where a manager has failed to review the adequacy of funds they may be open to a legal challenge from lessees.

Where works are required and funds are insufficient, the manager may usually collect the shortfall from the leaseholders, as outlined in the lease. Many leases do not permit a one-off charge to be

levied outside of the normal service charge cycle. The correct course in such situations is to add the sum required to the next budget, or to charge as a deficit after the end of the financial year. Section 20 (B) 2 of Landlord & Tenant Act 1985 restricts the charging of costs incurred more than 18 months previously.

Where residents will be placed in financial hardship as a result of such charges then managers should consider ways to assist. Advice about benefits should be given and members may consider offering loans to residents at preferential rates, or agreeing to roll up contributions until resale.

Care should be taken when devising such deferred arrangements to ensure a legally binding contract is entered into and a charge is made on the property. Interest can be added to a contract even if there is no interest penalty in the lease.

In some cases service charge surpluses may be used to top up Sinking Funds, however this must only be done following consultation and full agreement of all leaseholders and is not a substitute for the proper assessment of adequacy of funds. Where a lease is specific about the handling of surpluses then managers must abide by its terms.