

## **SERVICE CHARGE ACCOUNTS**

### **Introduction**

1. This note addresses an issue that will be of interest to those who prepare or audit the accounts of property investment companies or property management companies which are involved in the levying of variable service charges on tenants. As more fully explained below, monies received on the service charge account are held in trust for the tenants and are not assets of the company. Therefore, balances and transactions on the service charge account are not included in the statutory accounts of the company. Separate service charge accounts may be prepared and appended to the company's statutory accounts.

### **Definition of variable service charges**

2. Where an amount is payable by a leaseholder, lessee or tenant (referred to as 'tenant' in all legislation) in respect of services, repairs, maintenance, insurance, improvements or costs of management, and the amount may vary according to the costs incurred or to be incurred, this is called a 'variable service charge'. If the service charge is fixed under the terms of the lease or tenancy agreement e.g. as part of rent payable by the tenant, this is referred to as a 'fixed service charge'.

### **The legal requirements**

3. The primary legislation governing variable service charges is contained in the Landlord and Tenant Act (LTA) 1985 and the Landlord and Tenant Act (LTA) 1987.
4. LTA 1985 is designed to protect tenants against costs unreasonably incurred, unreasonably high charges and services and works that are not of a reasonable standard. An important mechanism for giving this protection is to ensure that tenants receive information about the costs to which they are required to contribute when paying variable service charges to the landlord or a management company in accordance with the terms of the lease. Section 21 of LTA 1985 therefore sets out the requirements for the 'summary of costs' that must be provided to tenants on request if the information is not provided voluntarily by the landlord. If the service charges in relation to which the summary of costs relates are payable by the tenants of more than four dwellings, section 21 specifies the report to be given on it by a registered auditor.
5. Section 42 of LTA 1987 is designed to protect tenants' money by requiring service charges to be held on trust.
6. The Service Charge Residential Management Code (the Code) published by the Royal Institution of Chartered Surveyors includes some useful guidance on accounting for service charges and the trust arrangements. The Code was published as an Explanatory Memorandum to The Approval of Code of Management Practice (Residential Management) (Service Charges) (England) Order 2009 (2009 No. 512) and may be obtained from the Office of Public Sector Information at [http://www.opsi.gov.uk/si/si2009/em/uksiem\\_20090512\\_en\\_001.pdf](http://www.opsi.gov.uk/si/si2009/em/uksiem_20090512_en_001.pdf).

### **Landlords that are residents' management companies or similar**

7. The legislation defines the landlord as the person or company which owns and rents or leases a flat or house. This person may also own the freehold of the property or have a superior leasehold interest in it. It is normally this person to whom variable service charges are payable.
8. If the landlord is a company it must prepare annual financial statements in accordance with the Companies Act.

9. The effect of s.42 LTA 1987 is that the landlord, even if it is a company set up and operated by the leaseholders, is not beneficially entitled to the service charges, but holds them on trust. (The Code indicates that service charge monies "should" be held in a separate, designated bank account, but this is not yet a legal requirement, and in practice many small leaseholder-owned management or freehold companies use the company's bank account to hold service charge monies). The only items/transactions that belong to the company are those relating to non service charge transactions such as ground rent if the company owns the freehold of the property.
10. It follows that, as well as not owning bank balances arising from service charges received but not expended, the company does not 'own' service charge arrears or prepaid service charge expenses, and has no liability in respect of items such as service charges paid in advance or accrued service charge expenses.
11. The other effect of section 42 is that service charge transactions do not 'belong' to the company for Corporation Tax purposes. HMRC have confirmed that, in its view, so long as the trust terms are observed, the receipt of service charge payments subject to the section 42 trusts will not give rise to any tax liability in the hands of the payee (landlord, residents' management company, or right to manage company). Any investment income accrued on the service charge trust fund (normally bank interest) is subject to income tax, but not at the special trust rates that would otherwise apply. Instead this income is taxable at the basic rate applicable to other persons.
12. Income that belongs to the landlord, such as ground rent, is not part of the variable service charge and is not subject to the section 42 trusts. It will, therefore, fall within the scope of corporation tax.
13. If the only transactions carried out by the company relate to variable service charges then HMRC will normally indicate that it regards the company as dormant for Corporation Tax purposes, although it may require the directors to confirm from time to time that there has been no change in the company's activities.

**Guidance for ICAEW members on preparing service charge accounts and accountants' reports**

14. ICAEW expected new regulations governing service charge accounts and reports to be made as provided by the 2008 Housing Regeneration Act, which would have enabled TECH 03/07 *The accountant's report on service charge accounts prepared in accordance with regulations made under the Commonhold and Leasehold Reform Act 2002* to be updated and issued as final guidance. However, the regulations have taken far longer than anticipated to develop and there is no guarantee that the draft legislation will survive the General Election. ICAEW has therefore decided to issue a Technical Release on the preparation of service charge accounts and accountants' reports thereon under the current provisions of section 21 LTA 1985. This guidance will be issued as soon as possible, but in the meantime, members can address any queries on service charge accounts to the Technical Enquiry Service.

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