

**Sinking funds pay for the repair and replacement of major items of plant and equipment**

**Leases often do not refer to how the landlord should held the sinking fund moneys**

To fit: W: 137mm x H: 98mm

## It all adds up in the end

**Sinking funds** are a way to save up money, so that when repair or maintenance works are needed, the money has already been collected. *Andrew Morley* explains the benefits for landlords and tenants

The RICS *Code of Practice: Service Charges in Commercial Property* (the code) defines a sinking fund as “a replacement fund where the owner builds up a fund to pay for repair and replacement of major items of plant and equipment”.

Collections for the fund are made through the service charge year by year and, when repairs are required, payment is made from the fund.

Service charges normally embrace various operational costs that are incurred annually. However, some expenditure – particularly for the replacement of large items of plant or major repairs to the fabric of the building – occurs less frequently. For such costs, the landlord has two main choices:

- budget and collect for such costs in the year when they are incurred; or
- estimate the likely costs and the future date when work will be required and collect a proportion of those costs in the

intervening years through the service charge, so that when the work has to be done, the money has already been collected.

The landlord can choose the latter method only if the lease enables the use of a sinking fund.

### Sinking fund benefits

Little data is published on the incidence of sinking funds, although, in its 2006 report on service charges, Loughborough University noted that “less than 10% of the buildings in the Loughborough data appear to collect sinking funds”. However, it is likely that more than 10% of leases allow the collection of sinking funds. Simply because the lease provides for the establishment of a sinking fund, does not mean that the landlord has to do so.

Even if a sinking fund is not obvious, some methods of arranging maintenance may include the elements of a sinking fund. For example, comprehensive maintenance

contracts are effectively contracts with a contractor-held sinking fund in that the maintainer accepts the risk of plant needing replacement within the term of its contract.

In this way, comprehensive contracts may fall outside the terms of the lease. Even if allowable within the lease, the landlord needs to effectively regulate and administer this externally operated sinking fund, any sums drawn against it and any residual sum remaining at the end of the contract.

The benefits of sinking funds for the tenant are: first, certainty of cost and the elimination of large peaks and troughs in the trend of service charges for a building across time. Second, for short-term leases, previous tenants will have contributed to the cost of major works that become necessary during the term of the lease.

For the landlord, the benefits are certainty of funding and reduced tenant concerns from

one-off high service charge costs in any one year.

Many sinking fund clauses restrict the purposes for which they may be used. This provides some definition of the category of repairs that the fund can meet and avoids a broad and unregulated approach. One of the aims of these restrictions is to prevent the landlord from using the tenant's moneys to improve the building to enable reletting at a higher rent.

Leases often do not refer to how the landlord should hold the sinking fund moneys. If they are not held in a separately identified bank account in trust for the tenants, they become the landlord's assets. Should the landlord get into financial difficulties, they may be lost to the creditors. Hence, the code now requires moneys in sinking, replacement or reserve funds to be "held in an interest bearing account, held in trust for the occupiers and separate from the owner's own monies".

### Potential problems

Few leases require a transparent accounting process. Thus, how well a sinking fund is being administered is seldom known. Often, its only mention is as a service charge budget/certificate cost item.

There is seldom information about what has been spent from the fund or for what items or for what purpose. There is also little information on the scale of the fund nor interest accrued to it (if any), nor whether the current state of the fund bears any relationship to the purpose for which it is collected.

The code seeks to regulate these issues by requiring owners and managers to: (i) act reasonably in estimating the contributions to the fund; (ii) establish specific purposes for the fund; (iii) provide a clear explanation and calculation of contributions to the fund; (iv) state clearly the contributions to and expenditure from the fund in the annual budget and reconciliation accounts; (v) pay contributions for void premises; and (vi) if selling the property, to pass the fund to the buyer.

A sinking fund can be only an estimate of likely future costs of repair – much of which is

probably based upon CIBSE tables of expected life of plant and equipment. However, an item is not in disrepair merely because it is old. Well maintained equipment may not need replacing at the time expected and thus the fund may be in excess of needs.

The issue of who owns this excess and whether it should be returned to the tenants that contributed to it, either during or at the expiry of their tenancy has been the subject of court cases. In *Universities Superannuation Scheme Ltd v Marks & Spencer plc* [1999] 04 EG 158, it was established that, absent a clear provision, the landlord should not profit from the services for which it seeks reimbursement.

Further, leases do not prescribe the term of a fund, and in extended terms of say 10-20 years, the actual timing of repairs and costs that will be incurred becomes uncertain.

Because a sinking fund is a service charge item and many managing agents are paid fees (typically 10%) as a percentage of the service charge cost, managing agents may take a 10% fee on collection of the fund. The code has determined

fees based upon a percentage of cost to be inappropriate and that includes sinking funds. The code requires managing agents to be properly reimbursed for the time spent administering a sinking fund.

### Further issues

Evidence suggests that the tax treatment of the collection, holding and interest aspects of sinking funds may not be consistently administered by either HM Revenue & Customs or landlords. HMRC may consider the collection and holding of such a fund to be the landlord's income. Therefore, collections may be deemed rent and subject to corporation tax at the landlord's marginal rate. Tax would also be payable on any interest earned from the fund.

Further issues arise for financial institution tenants that are unable to reclaim VAT collected with sinking funds. These issues of tax treatment need clarification, a subject that the RICS steering group on service charges is reviewing.

Planned preventative maintenance (PPM) is one method of dealing with long-term maintenance requirements transparently. PPM systems can

provide the basis for a sinking fund, but they can equally provide for annual budgeting directly through the service charge, while allowing tenants to plan years ahead for variable maintenance costs.

This method ensures that each asset in a building is listed on a schedule together with the maintenance required and its cost. The schedule shows the asset's expected life and anticipated dates/costs for major repairs or replacement.

The schedule also contains a condition survey of the principal fabric components of the building. Notes against each item on the schedule can indicate a forecasted need for major repair and its likely date/cost. The actual condition of both fabric and plant would then be updated annually and the effect upon the long-term cost plan amended.

Making a summary of this schedule available to the tenants annually fulfils the code's requirements for the owner and manager to manage the building transparently.

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## Why this matters

Sinking funds in themselves are not unreasonable or unfair. A sinking fund could be considered to be fairer than a high-cost recovery through the service charge in one year, particularly for the tenant that has a short lease and has inherited the need for the repair from previous tenants that have not contributed towards the cost of that repair. Sinking funds have received an unfair press owing to poorly drawn terms in the lease, poor management practices and a lack of transparency. Problems have arisen in the past because there was no industry standard as to how such funds should be collected or used, how they should be managed, administered or reported on.

The recent RICS *Code of Practice: Service Charges in*

*Commercial Property*, which was published in June 2006 (effective from 1 April 2007), recognises the value of these funds to both owners and occupiers and includes a section on sinking funds. Some of the issues noted here are also mentioned in the code's technical support "D6" section.

Further problems arise because of the tax treatment of interest earned on funds held by landlords in trust, which has been the subject of a number of court cases – the prevailing judgment being *O'May v City of London Real Property Co Ltd* (1982) 261 EG 1185. The RICS has recognised that these issues need further guidance and the code's working party is currently meeting to determine further advice and, hopefully, standards. Such standards, if implemented, could deal with

the management and transparency issues. However, the need to standardise the terms of the lease requires agreement to model service charge clauses, which are currently the subject of discussion by a joint working party of the Law Society and the RICS.

## Further Reading

**Code of Practice: Service Charges in Commercial Property**

RICS, June 2006

**Service Charges and Management**

Sweet & Maxwell, December 2005

**Not up to standards**

*Estates Gazette*, 11 November 2006, p182