

Sinking funds, reserve funds and depreciation charges

RICS information paper

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RICS information papers

This is an information paper. Information papers are intended to provide information and explanation to members of the RICS on specific topics of relevance to the profession. The function of this paper is not to recommend or advise on professional procedure to be followed by surveyors.

It is, however, relevant to professional competence to the extent that a surveyor should be up to date and should have informed him or herself of information papers within a reasonable time of their promulgation.

Members should note that when an allegation of professional negligence is made against a surveyor, the court is likely to take account of any relevant information papers published by the RICS in deciding whether or not the surveyor has acted with reasonable competence.

Introduction

Sinking funds, reserve funds and depreciation charges are all ways of making financial provision for future repairs or replacements. Fraught with financial (particularly taxation) and administrative difficulties, a major problem historically has been understanding the type of arrangement provided for (intentionally or otherwise) under the terms of the lease and the question of who 'owns' the sums collected through the service charge.

The decision in *Secretary of State for the Environment v Possfund* (1997) determined that depreciation charges belong to the landlord absolutely. The more recent decision in *Browns Operating Systems v Southwark Roman Catholic Diocesan Corporation* (2007) has established that monies not expended from a reserve fund upon expiry of a lease revert to the outgoing tenant.

This paper is in two sections; the first of which addresses matters that owners, occupiers, managers and drafting solicitors might like to consider and the second provides further information based on, but developing, the RICS Code of practice, 'Service charges in commercial property'.

1 Making provision for future service charge expenditure

1.1 Lease term, FRI and IRI

It is generally accepted that the average lease length now is about six years which of course means that a substantial amount of leases are shorter than this. This may create difficulties in terms of long term maintenance/repair as a five-year tenant only has a 'transitory' interest in the replacement of say a boiler which has a life expectancy beyond the term of his lease. That tenant is not interested therefore in replacing the boiler at an indeterminate date in the future. Contrast this with an incoming tenant who has signed a new lease giving him repairing and replacement liability and finds the boiler requires replacement in the first year at his expense.

Practitioners have, for many years, recognised an alternative to the Full Repairing and Insuring lease (FRI) (with or without service charge) where the landlord retains responsibility and liability for structural repair and plant repair and replacement with the tenant taking on reduced responsibility for repairing matters; an Internal Repairing and Insuring Lease (IRI). The rent passing for such a lease is usually higher than its equivalent FRI lease as the increased risk and cost of works is transferred from the tenant to the landlord. Those drafting leases might like to consider using minimum performance metrics (similar to those found in service level agreements) to ensure any necessary repairs are carried out in a timely and effective manner having due regard to the ongoing tenant's business.

The tenant gains cost certainty, albeit at an increased rent, avoids any unexpected major maintenance bills but also loses control over the timing and standard of works. The landlord gains an increased rent year on year but takes on additional costs and management responsibility for works that are required to be carried out from time to time and also the possibility of negative cash flow in the event that the cost of necessary works exceed the year on year increase in rent.

Every building will need its own solution. Both landlord and tenant need to consider their respective needs and the benefits to be achieved through the agreed solution.

1.2 Sinking funds, reserve funds and depreciation charges

The foregoing example may not be achievable in multi-let properties. In such buildings repair and replacement is frequently a service charge item and consideration should be given to using sinking or reserve funds or a depreciation charge.

A **Sinking fund** is a replacement fund where the owner builds up a fund to pay for repair and replacement of major items of plant and equipment.

A **Reserve fund** is a fund built up to equalise expenditure with regularly recurring service items to avoid fluctuations in the amount of service charge payable each year.

A **Depreciation charge** enables the owner to include an amount in the service charge to reflect the 'cost' of the annual depreciation of plant and equipment and is based on the initial cost of an installation, rather than the future cost of replacement or repair.

The overview of these three options is as follows.

Sinking (or replacement) funds

There should be a clear policy set out as to the purpose to which the accrued monies are being built up; e.g. to replace the lifts within the building. This will require the landlord to act reasonably in estimating the amount of the contributions due and ideally should set out the basis of calculating the charge. The policy will also set out how the monies will be held, to whose order and how financial matters including interest and tax will be accounted for. Where monies are held to the order of many then they should be held 'in trust'¹ and protected from any liquidation or financial arrangements.

The ownership of sinking fund monies is often poorly defined, particularly when the purpose of the fund has been discharged. A well set up fund will set out what is being paid and by whom to what purpose, and what happens once that purpose has been achieved, or in other circumstances (e.g. demolition) to residual monies and to whom these monies will be disbursed, possibly including former tenants who have contributed to the fund.

The landlord should contribute to the fund for any void properties as if he was the occupational tenant.

¹ 'In trust' may simply be held per instructions in a designated professional's client account properly named and designated as such and so recognised by the bank where it is held. In more substantial funds there may be formal trust deeds setting out the arrangements, trustees, etc.

Even though the monies are named 'sinking fund' they remain part of the service charge and all payments made out of the fund should therefore be clearly communicated to tenants and included as part of the annual reconciliation of the service charge.

Tenants with strong covenants do not like paying into sinking funds as they feel they can obtain better returns on the cash employed within their business and will make any necessary payment as and when monies are expended from the fund. Such a payment would also need to include for the interest that would have accrued to the fund had the payments been made in the usual way. As recessions show, even the strongest of covenants can fail. In the event of such a concession being agreed there must be comprehensive documentation so that matters such as interest accruing and additional management are covered. What happens to the concession on assignment of the tenants interest in the lease also needs to be agreed and clearly documented. This documentation should be transparent to all who participate in the fund.

Reserve funds

Reserve funds tend to be more short term in nature and created for a specific purpose, e.g. the redecoration of the common parts in an office building, the purpose being to minimise fluctuations in the amount of service charge payable by a tenant year to year as a result of regularly recurring items. As such, a reserve fund can only relate to costs which are reasonably anticipated will be incurred during the term of an individual tenant's lease.

Nevertheless transparency requires there to be a simple document which sets out the purpose of the fund, its life, who will contribute and in what proportion, how it will be managed and termination matters be they of an individual lease or of the fund itself.

Following the Court of Appeal decision in *Browns Operating Systems v Southwark Roman Catholic Diocesan Corporation* (2007) it appears clear that reserve funds are to be regarded as tenants' monies and if the fund has not been expended upon expiry of a lease then the tenant is entitled to repayment of the monies it has contributed to the fund.

Even though the monies are named 'reserve fund' they remain part of the service charge and all payments made out of the fund should therefore be clearly communicated to tenants and included as part of the annual reconciliation of the service charge.

Depreciation charge

Depreciation is the measure of the wearing out, consumption or other reduction in life of an asset. Thus by the definition above this is clearly the landlord's money. Tenants neither favour paying for the initial provision of an item (believing that to be the landlord's task) nor do they wish to pay for something twice. If the landlord is recovering depreciation within the service charge and it is his money it follows that the lease should recognise this situation and be drafted to require the landlord, from his own monies, to carry out these replacements, possibly to pre-agreed service levels, etc.

1.3 Spreading the cost of works carried out (payment plans)

Some modern leases will provide for the landlord, at its discretion, to recover the cost of extraordinary expenditure over a number of years and for the service charge to include interest (actual or notional) to reflect the cost of borrowing.

However, if a landlord decides to recover expenditure over more than one service charge period (perhaps as a gesture of goodwill and to ease the burden on tenant's cash flow) where otherwise the lease is silent, this should be regarded as a concession and is not to be confused with a reserve fund, sinking fund or depreciation charge.

In granting such a concession there needs to be a clear agreement which would often be expressed as being 'personal only' to each tenant. It would be usual to ensure that the period over which the expenditure is to be recovered is within the term of an individual tenant's lease. The agreement should also set out what should happen with regard to payment of any outstanding balance of the original costs owed in the event that the tenant assigns his lease, becomes insolvent or if the lease is otherwise determined.²

² Where a tenant is an individual under certain circumstances such an arrangement could be considered to be a credit agreement under the *Consumer Protection Act 2006* and therefore legal advice should be sought prior to entering into such an arrangement.

2 Service charges in commercial property

2.1 Supplement to RICS Code of practice

In addition to regular expenditure on services, owners and occupiers may need to make provision for occasional one-off outlays on replacing major items of equipment (a heating system, for example). Major expenditure of a regularly recurring nature (for instance external redecorations) can also cause significant fluctuations in the amount of service charge payable each year.

To the extent that these items can be foreseen, it may make sense for both parties to spread the cost over a number of years by setting up a sinking fund, replacement fund or reserve fund, rather than charging the whole cost to the current tenant(s) in the year in which the expenditure is incurred. See Section D8 of the Code of practice.

'Sinking, replacement and reserve funds

58. Any monies accumulated in a sinking fund, replacement fund or reserve fund will be held in an interest-bearing account, held in Trust for the tenants and separate from the owner's own monies.
59. The owner or managing agent will act reasonably in estimating the amount of the sinking, replacement or reserve fund contributions to be included within the service charge which will relate to specifically identified expenditure only (e.g. roof, boiler plant, lift etc.) rather than other unidentified future expenditure.
60. The owner or managing agents will provide a clear explanation of the basis of calculation of the sinking, replacement or reserve fund contribution and the items to which it relates and have regard to a realistic assessment of the anticipated life cycle of the item in question and the funds accumulated from previous service charge periods (including interest).
61. The owner will make all payments into the sinking or replacement fund account for void premises.
62. The annual budget and reconciliation accounts will clearly state contributions to and expenditure from the sinking fund account together with the account opening and closing balances and the amount of interest earned and tax paid in the relevant period.
63. On completion of the sale of a property, the vendor will pass all sinking fund or reserve fund monies held, together with all accrued interest, to the purchaser. Advice should be taken to ensure that any tax liability on the fund is appropriately mitigated and accounted for.

Depreciation charges

- 63A. Charges made in respect of depreciation belong to the owner. Accordingly, where a depreciation charge is made the responsibility for the cost of replacement moves to the owner. The owner or managing agent will act reasonably in estimating the amount of the depreciation charge and will provide a clear explanation of the basis of calculation of the charge and details of the specific items for which the depreciation charge is calculated.
- 63B. Notwithstanding clause 29 of this code of practice, a proper and reasonable depreciation charge should be considered as an annual cost to the landlord and not the initial cost of installation.
- 63C. Depreciation charges and sinking/replacement funds are mutually exclusive. A depreciation charge cannot be made where a sinking or reserve fund is or is intended to be made in respect of a specific item and vice versa.

3 Summary

Whichever of the foregoing methods is the way forward great care must be taken to ensure transparency and full communication of the purpose, modus operandi, and exit route so that all parties to the matter can be clear that they are being treated in accordance with the agreements they have made.

4 Tips

Sinking funds

Ensure there is a clear, transparent policy that sets out the purpose of the fund and the timescale it is anticipated to have, as well as how the money will be held and managed. The policy should also address surplus funds and what will happen to the money in the event the building is demolished or undergoes substantial alteration or change of use (i.e. from offices to residential) such that the original building in effect no longer subsists.

Landlords should contribute for void properties as if they were an occupational tenant.

Example:

Each floor of a 19-year old office block comprising 10 storeys was originally let on a 25-year lease. Each tenant covenants to pay a service charge being 10% of the total expenditure.

The leases provide for a the landlord to include a sinking fund for the replacement of the boiler and over the last 19 years the landlord has collected £10k per annum towards a sinking fund established for that purpose.

One floor became vacant five years ago and remained so until two years ago when the premises were re-let to a new tenant. The landlord made an appropriate contribution each year to the sinking fund in respect of the vacant floor. The new tenant has also paid its proportion of the sinking fund contribution.

There is therefore £190k in the sinking fund (ignoring, for simplicity, any interest).

The landlord has now spent £200k on replacing the boiler.

The new tenant's balancing charge liability for a proportion of the cost of replacing the boiler would therefore be £1,000, i.e. $(£200,000 - £190,000) \times 10\%$.

The proportion of the costs incurred relating to the premises is £20,000 (10%) but the new tenant has only contributed £2,000 (£1,000 towards the sinking fund last year and £1,000 balancing charge this year).

The actual replacement cost of the new boiler was therefore apportioned:

| | |
|------------------------|----------------|
| Previous tenant | £15,000 |
| Landlord (void period) | £3,000 |
| Current tenant | <u>£2,000</u> |
| | <u>£20,000</u> |

Reserve funds

As these are effectively individual to each tenant there needs to be clear agreement as to the purpose of the fund.

Example:

In an identical building to that described above, the service charge clause of the occupational lease include provision for a reserve fund for external redecoration. Over the last five years each occupier has paid £2k into the reserve fund and the landlord has now spent £100k on external redecoration.

The majority of tenants would not receive an additional charge for the external rededs as each would have contributed £10k into the reserve fund.

However, the new tenant's balancing charge liability for the external rededs would be £8k, i.e. $£100,000 \times 10\%$ (£10,000) less last year's payment into reserves of £2,000.³

If the lease obliges the tenant to bear a proportion of the cost of external redecoration the tenant would either accept liability or negotiate a concession to limit its liability.

Depreciation charges

As this is landlord's money once the tenant has made his payment he will have no further claim to it. It is therefore essential that both parties fully understand how the landlord has calculated the charges, to what it relates and that in paying the cost of depreciation the tenant would have no responsibility for any further costs when the item to which the charge relates is eventually replaced.

Landlords must also be aware that they risk a claim for damages for breach of covenant if they do not replace equipment at an appropriate time which results in failure to provide a service to an adequate standard.

In calculating the annual depreciation charge to tenants one suggestion might be to take the anticipated life cycle tables produced by independent bodies such as the Chartered Institute of Building Services Engineers (CIBSE).

Example:

Particular air conditioning plant has an originally anticipated life of 15 years. If the original cost was £300,000 the depreciation charge included in the service charge would be £20,000 for the first 15 years following installation.

If replacement occurs earlier, for instance, due to lack of adequate maintenance the landlord would not have recovered the full depreciated cost of the original equipment. However, if the equipment has been well maintained (presumably at the tenant's cost) the depreciation charge ceases once the landlord has fully depreciated the cost of the equipment. The landlord therefore has a vested interest in ensuring the plant and equipment is adequately and properly maintained throughout its life.

³ In taking the lease it is to be assumed that as part of due diligence the tenant would have arranged for the premises to be surveyed and obtained details of the landlord's PPM programme which would have shown external rededs due in two years time.

Acknowledgments

RICS would like to thank Peter Forrester of Savills UK and Chris Edwards of Commercial Property Advisors Ltd for their contribution to the content of this information paper.

This paper is one in a series of information papers linked to the RICS Code of practice for service charges in commercial property.

To further develop the code the steering group would welcome your thoughts on this paper and any other matters relating to the RICS Code of Practice.

The service charge code of practice can be purchased from RICS Books on www.ricsbooks.com or downloaded via www.servicechargecode.co.uk

If you have any comments on this paper please send them to propertygroup@rics.org