

The “collective leasehold” – does it fix your lease renewal problem? – Part 2

In part one of this blog we addressed several legal errors in a recently published **Article** in an English language news publication in Thailand. Now we turn to what the Article’s substance, the commonly marketed “collective leasehold” structure. The Article claims that:

“Collective leasehold structures provide owners in villa developments the legal means to have a greater say in their villa projects. Importantly, this means that owners have increased control over the renewal of their leases, thus mitigating a major risk associated with long-term leases in villa developments.”

We disagree. In our opinion, this structure creates a false sense of security for the investor—and, therefore, a poor “product” for the developer. A “collective leasehold” will *not* meaningfully mitigate the risk that your lease will not be renewed. To understand why, we need to cover a bit of background.

Long-term leaseholds are a popular mode of investing in Thai real estate for foreigners. This is largely due to the fact that the law, with some limited exceptions, prohibits foreign freehold ownership of land in Thailand. However, under current Thai law the maximum lease term is a mere 30 years. Thus, it has become rather common for developers who are marketing to foreigners to offer a long-term lease of 30 years with two additional successive 30-year terms. Usually, the rent for all three terms is “pre-paid” (i.e. before or on registration of the first term) and the lease agreement provides that almost all of the rent is paid for the first 30-year term with the parties agreeing to some nominal amount e.g. THB 100,000 for the rent for the second 30-year term and e.g. THB 100,000 for the rent for the third 30-year term.

However, as provided by Section 540 of the Civil and Commercial Code (“CCC”) any such additional term is not an “extension” of the lease—rather it is merely a “renewal” of the lease. This means the new term is essentially a new contract. The result is that if the owner of the property changes during the first lease term, the new owner will *not* be obliged to honor the renewal of the lease *even if* the lessee has already pre-paid the original owner for the renewal term. This is because the new owner never offered to renew the lease and the law does not oblige the new owner to honor an offer made by the original owner and lessor.

As mentioned, in an effort to address this insecurity many developers offer you a “secured leasehold” structure or as the Article referred to it, a “collective leasehold” structure. You are promised not only a lease but also acquisition of a shareholding ownership interest in the Thai limited company that owns the land that you will lease. The other development purchasers would then do the same. And then, “collectively”, you all will control the land owning/lessor company. Purportedly, this would then ensure that all of these lessees would have their leases renewed for the two successive 30-year terms—“guaranteeing” the full 90 years. But this structure does *nothing* to address the most significant risks that your lease will not be renewed.

Perhaps the biggest reason why the said structure is not truly secure is the potential tax liability that the land owning/lessor company will incur. For discussion purposes let us assume that you paid THB 10 M for the first 30-year lease term and that your lease contract provides for a rent of THB 100,000 for the second 30-year term.

Section 40(5) of the Revenue Code of Thailand (“RC”) authorizes the Revenue Department (“RD”) to assess any lessor for what it considers to be the reasonable value for the rent of immovable property in Thailand. There is of course an appeals process when a taxpayer is so assessed. However, under Section 31 of the RC, this appeal does *not* allow the assessed taxpayer to defer payment of the additional tax resulting from the assessment. Any amount not paid within the short window provided in the assessment notice, is deemed an “arrears of taxes”. Under Section 12 of the RC the RD can then immediately—i.e. without a court order—seize and sell by auction any property belonging to the delinquent taxpayer in order to satisfy the arrears tax and applicable penalty and surcharge.

Coming back to our example it is obvious that if your current rental value for 30 years is THB 10 M, then THB 100,000 for a second 30-year term beginning 30 years

thereafter is highly unlikely to be considered a “reasonable” amount. In fact, it is also very unlikely that even the original THB 10 M you paid for the first 30-year term would be considered reasonable 30 years from now. Thus, for the purpose of our example, we will assume a RD assessed rental value assessment for that second 30-year term of THB 20 M. The tax payable on this amount would be approximately THB 5 M. Let’s further assume that you leased in a medium size development with 20 land plots leased using the Article’s “collective leasehold” structure. The land owning/lessor company—the one that you and the other lessees obtained an interest/shares in—would then face a total rental value assessment of: $20 \times \text{THB } 5 \text{ M} = \text{THB } 100 \text{ MILLION}$. If the corporate income tax on this amount—approximately THB 25 M or almost USD 1 M—was not paid in a timely manner, the scenario above unfolds. If tax is owed, the RD can seize and sell the property by auction to a new landowner to satisfy the debt. And please note—this could easily happen *well before* the end of your first 30-year term if one or more plots were leased a tax year or more before you leased your plot.

No doubt some would argue that the “collective lease” provides for handover of control of the landowner/lessor company and that the lessee could then address the company’s proper maintenance and its legal—including tax—compliance requirements. Any assertion that you and the other lessees in your “collective leasehold” structure development could avert such a catastrophe—by knowing about and, albeit unfortunately, paying this additional tax liability for the company—is highly suspect. Once your developer transfers such control/ownership to you all then he loses, not only control of his development, but also the right to any dividends payable to your shares. Thus, this handover is very unlikely to happen until the development is completely sold—if ever.

Furthermore, even if the said handover to you occurs, one can never know for sure what legal liabilities a company has unless one has full legal control of the company during the company’s *entire* existence. As noted above, you may inherit a landowning/lessor company with significant lease income tax liabilities. But—the company might also have any number of legal obligations and liabilities incurred prior to your takeover—the ones you *don’t* know about?

Another very significant issue with the “collective leasehold” is the shareholding structure itself. The Land Code requires that any land owning Thai company must have at least as many Thai shareholders as foreign shareholders. The Thais must own

over 50% of the company's total share capital. If the company's Thai shareholders are not actual investing shareholders, then they are considered "nominee" shareholders under the law. Thai nominees are unlawful under the Land Code. Thus, to lawfully own—and, therefore, to lease—land, such a company's Thai shareholders must be actual investing shareholders and they must maintain their shareholding for the entire length of the lease including any renewals. If the company does not have such Thai shareholders, it can be divested of the land it owns. If it were divested, the new owner would not have to honor your option to renew your lease, as detailed above. The "collective leasehold" structure does *nothing* to address this very significant issue.

What is more, in our example the lessees' direct share investment in the land owning/lessor company would then require at least 20 actual Thai shareholding investors. This requirement is why a "collective leasehold" structure typically—and as the Article proposes—offers you an "indirect shareholding" in the land owning/lessor company. You become a shareholder in an offshore company that owns the non-Thai shares of the land owning/lessor Thai company. Usually this offshore company is a company registered in a country, which provides flexibility with regard to corporate structuring and a low tax jurisdiction. In our example 20-plot development, the use of such an offshore vehicle would provide you with an indirect control of 5% of 49% of the land owning/lessor company. That means that you would have no direct shareholder rights under Thai law and perhaps even less than "5%" control of the Thai landowning/lessor company. The Article touts your ability to "give your opinion" as such a shareholder—but it must be said, this can be done regardless of *any* such shareholding. The ability to "give your opinion" to the landowning/lessor company does *not* provide *any* security that your lease will actually be renewed. Furthermore, even if you and others acquire shares in this offshore company, any disputes with them or any issues regarding "absentee" or deceased shareholders would be governed by and would have to be dealt with under the laws of and in the courts of the offshore company—e.g. the British Virgin Islands. You would have to go there and resolve any such issues in that country's courts.

Unfortunately the "collective leasehold" does little if anything to address the very real insecurity that your long-term lease will not be renewed. *Fortunately*, however, there are far better legal means than the "collective leasehold" that do provide *actual* long-term lease *security* and without any downside to the developer. This can be achieved by securing the pre-paid renewal terms with a mortgage over the land plot in question. It is a simple and straightforward legal structure that provides security for

the investor and, therefore, a marketing opportunity for the developer. But you should first engage competent legal and tax counsel in order to successfully implement this lease security structure.

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