

# **BASIC PRINCIPLES COMMITTEE**

## **Practice Note 1**

### **REVALUATION 2005**

#### **ADJUSTMENT OF RENTS**

## **INTRODUCTION**

Non-domestic property has to be valued to Net Annual Value which is defined in Section 6(8) of the Valuation and Rating (Scotland) Act 1956 as follows "...the net annual value of any lands and heritages shall be the rent at which the lands and heritages might reasonably be expected to let from year to year if no grassum or consideration other than rent were payable in respect of the lease and if the tenant undertook to pay all rates and to bear the cost of repairs and insurance and other expenses, if any, necessary to maintain the lands and heritages in a state to command that rent."

What is required in rating is to find the rent which the hypothetical tenant might reasonably be expected to pay for the subjects. The actual rent for any property is of significance, but is not conclusive of value. What has to be established is "a general level of value" which is derived from the conspectus of all the rents in a particular area for the class of property being considered.

The adjustment of rents for the revaluation must therefore provide the evidence to achieve a general level of value as required. **It is recommended that all available rents be analysed in the first instance.**

## **1.0 RENTS RETURNED**

### **1.1 Duration**

Although the definition of net annual value states that the rent is "from year to year" the Lands Valuation Appeal Court in a number of cases has indicated **that the rents from leases on the normal five yearly review cycle are acceptable for statutory purposes.** This appears to be a pragmatic approach taken by the judges in Scotland matching the five yearly lease patterns with the revaluation cycle.

Reference: - Simmons Furniture Store v. Assessor for Dumfries (1989)  
Assessor for Strathclyde v. British Railways Board & Others (1990)  
Debenhams Plc. v. Assessor for Grampian. (1989)

### **1.2 New Rents/Review Rents**

Much can be said regarding the differences in rent which may arise as between the rent achieved at a new letting and a reviewed rent. Some of this comment is

made in an attempt to classify one type of rent above the other, implying that it is "a purer reflection of the market".

At the commencement of a lease the tenant does not know the trading potential or the return he will get arising from his occupation and his offer of rent is, of necessity, based on his expectations of the location and the property, together with his management skills. At review, however, the position is known to him and the agreed rent can be based on his continuing the benefits of which he is aware. Also the rents being achieved for comparable properties will have a marked effect on the review rent. In both circumstances the rent has to be agreed between the parties and as such must be, if not a fair reflection of the market, the best or only evidence that is available.

**No distinction should be made between rents at the commencement of a lease or those arising at review.**

Reference: - the R.I.C.S. Red Book defines, in Practice Statement 3.4, 'Market Rent'. The definition applies to the rental valuation of property on the assumption of a new lease. One of the assumptions in the definition is that "the parties had each acted knowledgeably, prudently and without compulsion". (3.2.8 and 3.2.9) At review this could not, of course, be the case as the parties are already contracted to the lease. Normally, however, the review clause in a lease requires the rent to be agreed as "...an amount equal to the market rent at the review date of the premises fully serviced as between a willing landlord and willing tenant if offered on lease with vacant possession ...." , or some similar form of wording which requires a "market rent" to be established. The review rent is therefore deemed to be on the same basis as the rent at the commencement of a lease.

## **2.0 DEDUCTIONS FROM RENT**

Where the rent returned is inclusive of items which do not relate to the occupancy of the property but are in respect of other services, including the incidence of taxation, then these costs must be deducted.

### **2.1 Value Added Tax**

**The hypothetical tenancy is deemed to be net of V.A.T.**

Value Added Tax is imposed on the supply of goods and services and as such is a tax on the final consumer.

The grant of a lease, which establishes a landlord/tenant relationship, will, as a general rule be exempt from V.A.T., subject to certain exceptions. The exception, which is of concern, is when the landlord opts to be taxed. The exercising of this option effectively turns an exempt supply into a standard rated one. The important effect of exercising the option is to make any "input tax" recoverable. The option to

tax does not require the landlord to consult with the tenant to whom the supplies are

made and on whom the tax burden will fall. It is in these cases that V.A.T. becomes an issue.

If the tenant is a taxable person then he will be able to recover his input tax. In this situation there is no problem as the rent being paid is for the property alone. If the rent returned is inclusive of V.A.T. then the tax is deducted. The current rate of V.A.T. is 17.5%. Care should be taken when making this adjustment to ascertain if the figure quoted is also inclusive of any service charges as V.A.T. would, in this case, be paid on these charges as well as the rent.

If the tenant is not a taxable person, then two situations are possible.

1. The tenant's trading position is insufficient to reach the registration threshold, which currently stands at £56,000 gross "taxable turnover". In this situation it is recommended that further inquiries be made to ascertain whether or not the tenant was aware of the tax liability when the lease was agreed. If he was not aware of this liability then the tax should be deducted. If, on the other hand, he was aware of the incidence of the tax then the usefulness of the rent is put into question. The inclusive rent should be compared to the rent of similar properties, if there are any. Regardless of the comparison the best course of action is possibly to disregard the rent.
2. The tenant is exempt. In other words he falls into the category of those who supply "exempt supplies". The major areas of exempt supply include land, insurance, betting, finance and education. With the finance sector being prominent players in the property market there was a possibility that a dual market would emerge with the finance sector paying a lower level of rent than other sectors due to having to pay V.A.T. on top of the rent. This, however, does not seem to have emerged. It is obvious in these cases that the parties to the lease knew the situations before entering into the lease. The rent being paid under the lease should be checked against the rents being obtained for similar properties in the locality but occupied by standard rated tenants. This will show whether or not there is a dual market in this location. Care should be taken with any rent in this category, as it may not be in line with "the general level of value in the area."

References: - V.A.T. - Notice 700/1 May 2002

## **2.2 Service Charges**

**The rent under the hypothetical tenancy does not include service charges.**

Services provided by the landlord are normally charged for separately from the rent. In these cases no action is required. Where, however the rent is inclusive of the cost of such services, then these costs will have to be deducted to arrive at the rental figure for the property. In these cases the actual costs should be deducted. If the actual costs are not known, then an estimate should be made. Every effort

should be made to ascertain the actual costs, or as great a part of them as possible so that any estimate can be as accurate as possible.

## **2.3 Rates**

**The rent under the hypothetical tenancy does not include rates.**

If the rent returned does include an amount for rates then it should be ascertained if the annual figure paid each year remains the same or whether the amount is varied depending on the amount to be paid in rates. If it is varied then the amount paid in rates for the year to which the rent applies should be deducted from that rent. If, however, the figure remains unaltered throughout the whole lease, or the lease term, then the amount paid in rates (with or without transitional relief) for the year in which the rent was struck should be deducted from the rent. This amount should be obtainable, either from the tenant, or the Director of Finance.

## **3.0 RENT PAID FOR THE PROPERTY**

This figure is the annual sum, based on the rent returned, which is attributable to the property. In addition, however, there may be incentives or capital sums, which impinge on the rent. Whether they do affect the rent or not has to be considered and if they do, to what extent, and how do we adjust the rent to allow for this?

## **4.0 DEDUCTIONS**

Under this head there is no difference between "inducement", "incentive" or "concession".

Reference: - This topic was the subject of R.I.C.S., Red Book, Guidance Note 4, 'Analysis of Commercial Rental Transactions & Lease Inducements'. The guidance note has yet to be reformulated in the revised Red Book and the old guidance has therefore been followed for the basis for these notes. It is recommended that anyone wishing to go into this topic studies Note 4 in detail.

GN. 4.5.1. "It is important to the assessment of the effect of inducements upon rental value, to find out which of them have been agreed, and why, and to the extent to which (if at all) they "drove" the transaction. This will help the valuer to reach a conclusion concerning the degree to which each reason affects (a) the equivalent rent, (b) the analysis of evidence and (c) the weight and reliability of the evidence. It might be that the terms of a particular transaction are not representative of the general market, and might, for instance be indicative of the financial conditions or position of one or both of the parties rather than of the rental value. The valuer needs to consider such possibilities."

The primary consideration should be "How common, or representative, is this incentive within this sector of the market?" Where it is common, and the hypothetical tenant could therefore expect his renting of the property to include the same incentive, then an allowance should be made in respect of it. If on the other

hand it is unique, either because it is the exception, or in its terms, then no allowance should be made.

Reference: - Assessor for Renfrewshire v. W.M.Goodfellow (1962).

It may be, however, that although the incentive may be common, it may not affect the rental value of the property.

A landlord has many factors to consider when leasing a property, especially if it is a first letting. The most important is possibly the capital value of the property, or the development, if it is part of a larger scheme. The ways in which he can achieve the maximizing of the capital value will vary. For example, he may grant a rent-free period in return for a higher headline rent so that the rent to be capitalised is greater and the resultant capital value will be greater. In such a case the annual equivalent of the cost of the rent-free period should be deducted from the rent. He may, on the other hand, offer some form of inducement to a particular tenant to achieve an increase in the security of his investment resulting in a reduction in the All Risks Yield (A.R.Y). used to capitalise the income, thus increasing the capital value.

By way of an example, if a property is let at a rent of £60,000 p.a. and the yield drops from 6% to 5.5% then the capital value has increased by £90,000. The landlord is then in a position to grant a rent-free period of one year and still be in pocket. In this case, where the rent has not been affected, no deduction should be made and the agreed rent should be taken to be the market rent.

The decision as to whether or not an incentive affects the rental value is not straightforward and will require investigations as to the driving reason behind the incentive.

On the assumption that the decision has been made that the incentive does affect the rent and an allowance should be made, consideration has to be given to how any allowance is to be made.

Two factors come into play, (1) the length of time over which the allowance should be made, and (2) the rate at which the allowance is made. In both cases the state of the local market for the class of property being considered has to be taken into account and the application of the allowances modified as is appropriate to the market conditions.

**(1) TIME PERIOD** -Three possibilities arise.

- (a) The whole term of the lease is taken. This will normally apply where there is a reasonably balanced market with the intention of the landlord to lock the tenant into a lease. By the very nature of the market there will be few incentives which fall into this category but where they exist it should be quite clear that the whole term is the appropriate time period to apply.
- (b) The period to the tenant's break clause. In these cases the period during which the tenant has been "locked in" has been reduced and it would be

appropriate to make the allowance over the shorter period. Before this is applied care should be taken to ascertain whether or not the break option has value.

- (c) The period to the review following the point where the market rent overtakes the headline rent. This is particularly difficult to calculate as the current market rent, which is being sought, is not known. In these circumstances the valuer's judgement must come into play, paying particular attention to the state of the market for the class of property being considered.

**(2) RATE** - Obviously the rate used in making the allowance will vary according to the class of property and the location. **In the absence of local information it is suggested that, for simplicity and uniformity, the following rates be applied on a single rate basis**

Retail properties - 6%  
 Office properties - 8%  
 Industrial/warehouse properties - 10%

#### **4.1 Types of incentives and their analysis.**

##### 4.1.1 Rent-Free Periods.

These arise where the landlord has agreed to a period, not necessarily at the commencement of the lease, when no rent will be paid.

The most common situation is where the landlord allows a period for "fitting out", usually about three months. **In these circumstances no allowance should be made** and the agreed annual rent, which applies for the first term, without adjustment, should be taken to represent the market rent.

**Where the rent-free period is for a longer period then the rent should be adjusted in the following way.**

Example: An office property let on a twenty five year lease, with five yearly, upwards only, rent reviews. The first year is rent-free and the agreed rent for the remainder of the first term is £53,000. What is the current open market rent?  
 Procedure; - find the capital value over twenty-four years and divide the capital value by the Y.P. for twenty-five years.

Rent (agreed)	£53,000	
Y.P. 24yrs at 8%	10.53	
P.V. 1yr at 8%	0.93	
Capital Value		£519023
div. Y.P. 25yrs.at 8%	10.67	
Open Market Rent		£48,643 say £48,500

Example: - The same property, as above, but with the rent-free period years 3 & 4 and the agreed rent for the first term £56,000

Procedure: - find the capital value for the circumstances as agreed and divide the capital value by the Y.P. for twenty-five years.

Rent (agreed)	£56,000	
Y.P. 2yrs. At 8%	1.78	
		£ 99,680
Rent	£56,000	
Y.P. 21yrs. at 8%	10.02	
P.V. 4yrs at 8%	0.74	
		£415,228
Capital Value		£514,908
div. Y.P. 25yrs.at 8%		10.67
Open Market Rent		£48,257 say £48,250

#### 4.1.2 Stepped Rents.

These arise where, instead of a rent-free period, a reduced rent is agreed for the first year and rises each year for a number of years. This will usually, but not always, occur during the first term of the lease.

Example: - The same property, as above, but with a stepped rent, year 1 - £35,000, year 2 - £40,000, year 3 - £45,000, year 4 - £50,000, year 5 and there after - £52,000.

Procedure: - find the capital value for the circumstances agreed and divide the capital value by the Y.P. for twenty-five years.

Rent (agreed)	£35,000	
Y.P. 1yr. at 8%	0.93	
		£32,550
Rent	£40,000	
Y.P. 1yr. at 8%	0.93	
P.V. 1yr. at 8%	0.93	
		£34,596
Rent	£45,000	
Y.P. 1yr. at 8%	0.93	
P.V. 2yrs. at 8%	0.86	
		£35,991
Rent	£50,000	
Y.P. 1yr. at 8%	0.93	
P.V. 3yrs. at 8%	0.79	
		£36,735
Rent	£52,000	
Y.P. 21yrs. at 8%	10.02	
P.V. 4yrs. at 8%	0.74	
		£385,569
Capital Value		£525,441

div. Y.P. 25yrs at 8%  
Open Market Rent

10.67  
£49,244 say £49,250

#### 4.1.3 Cash Payments

These may take the form of what is known as reverse premiums to assist the tenant with a cash flow problem, fitting out costs, or taking over some liability from the tenant. Where it is felt that an adjustment is required, i.e. that the rent has been increased to compensate the landlord for his capital outlay, **then, and only then, the capital sum should be divided by the Y.P. for the term of the lease or to the first break point, as appropriate.** If the payment is made at a time other than at the commencement of the lease then the period taken should be the outstanding period of the lease from when the rent has been increased to allow for the payment.

### 5.0 ADDITIONS

These arise when, either capital sums are spent on the property in such a way that the rental value has been increased, or a payment has been made by the tenant, the effect of which is to reduce the rent.

#### 5.1 Tenant's Improvements

##### 5.1.1 Extensions, Alterations and Improvements.

Works carried out to extend, alter or improve the property will be deemed to affect the rental value of the subjects. **In such cases the annual equivalent of the capital expended on the property should be found, by dividing the capital sum by the Y.P. for the term of the lease or to the first break point, as appropriate, and adding this to the rent.** Care should, however, be taken to ensure that only expenditure which enhances the value of the property is included.

##### 5.1.2 Fitting Out New Buildings

It is common for new shops and/or offices to be let in a "shell" state with the tenant responsible for "fitting out" the property. This is often carried out to the tenant's own specific corporate requirements. Care should be taken therefore to eliminate from the actual costs incurred any elements of unremunerative expenditure or any amount for non-heritable items.

The initial rent and possibly the review rents will reflect the shell condition and not the fitted unit, and where that is the case the appropriate adjustment will require to be made. **This adjustment will be the cost divided by the Y.P. for the whole term of the lease or to the first break point, as appropriate, and the resultant annual equivalent added to the rent.** Where this adjustment is being applied to a review rent when the fitting out took place at the commencement of the lease it would be appropriate to depreciate the costs. The rate of depreciation should be taken at 5% per annum from year six to year twenty-five.

Where the review rent is to the open market rent for a fitted out unit then **NO adjustment** should be made to that rent.

### 5.1.3 Fitting Out Existing Buildings

Where an existing fitted out property is refitted to portray a "corporate image" **NO adjustment** to the rent should be made for such expenditure on the basis that there would be no advantage to the hypothetical tenant.

## 5.2 Premiums

This is where the tenant pays a capital sum to the landlord instead of rent. It can be understood as the tenant purchasing a profit rent. Inherent in this is the fact that the rent is reduced because of the payment of the premium, therefore an adjustment to the rent is required. Obviously if the premium, or part thereof, is paid in respect of items other than a reduction in rent, then these should not be included in any add back factor. **The amount to be added back should be found by dividing the premium by the Y.P. for the term over which the reduction in rent has been purchased.** For example if the reduced rent is only for the first term, i.e. the reviewed rent is to be the full market rent, without reduction, the Y.P. should be for the term only.

## 6.0 EQUIVALENT RENT PAID FOR THE PROPERTY

After these adjustments to the rent the figure that we now have is the equivalent rent for the property. All that remains is for this rent to be expressed in the term of net annual value which is, in effect, the rent on a full repairing and insuring basis. This, of course, means that the tenant has to meet these expenses, over and above the rent. Where they are paid for by the landlord, out of the rent, then the cost of these items must be deducted from the rent.

## 7.0 DEDUCTIONS

### 7.1 Repairs

Every effort should be made to get the actual cost of the repairs arising from the lease. Where these are not available the costs should be estimated by reference to the available cost guides. **As a last resort the annual repair and maintenance of property may be estimated from the following table.**

Standard of Property	City and New Town Central			Inner Urban, Suburban & County Towns etc.		
	Outside	Inside	All	Outside	Inside	All
New, relatively modern or modernized	-2.75%	-2.75%	-5.5%	-3.75%	-3.75%	-7.5%
Old, unimproved	-6%	-6%	-12%	-7%	-7%	-14%

### 7.1.1 Actual State

The definition of net annual value refers to the tenant being responsible for the repairs and insurance within the context of maintaining "the lands and heritages in a state to command that rent." The implications of this are that the initial rent reflected the state of repair of the property when let and that it has been maintained in such a state. This is in line with the legal position as it is a common law requirement on a landlord to provide the tenant, at the commencement of the lease, with a property reasonably fit for the purpose for which it let. He also has a common law duty to keep the let property in tenantable repair and wind and watertight. In a lease, of course, he generally seeks to pass this liability on to the tenant, as indeed the definition of net annual value envisages.

In our analysis of rents, however, we may not be fully aware of the state of a property when let, other than to assume that it was the same as it is now. No attempt should be made to reflect any differences regarding the state of repair between properties; this is a matter relating to how the analysed rents are grouped when establishing a general level of value in an area.

### 7.2 Insurance

Most landlords undertake the insuring of their property and recover the cost, separately from the rent, from their tenant. In these cases no adjustment is required, as the situation is what is envisaged by net annual value.

In the rare event that the landlord insures without directly recovering the premium, a specific deduction will need to be made from the rent. Premiums however vary widely according to the use, construction, age and location of the lands and heritages and no specific advice can be given which will cover all cases that could occur.

Where an adjustment to rent is deemed appropriate, **consideration should firstly be given to any evidence available of insurance premiums.** In the absence of information a deduction of 7.5% should be made from the stipulated rent.

## **8.0 THE RENT IN TERMS OF THE RATING HYPOTHESIS.**

What we now have are the building blocks of valuation. It is at this point, and not before, that we must now look at the evidence in a critical way. In valuation one never discards the evidence without looking at it. The evidence must be allowed to speak to the valuer without the valuer superimposing his own, possibly preconceived, ideas on the evidence. It is valid, however to discard evidence provided there is good reason. Keep in mind that although a particular rent may have to be discarded, say for being out of time, it may be of use in some other way, as for example, indicating a trend.

### **8.1 Assembly Of Data**

The data should be grouped in its use classification (as described in the valuation roll), for any given location, and ordered chronologically. This allows the valuer to gain an appreciation of how the rents within each class, in each location, have changed over the period from the last revaluation allowing an opinion to be formed as to where changes in value have occurred and the extent of these changes.

This listing also highlights those rents, if any, which are out of line with either the general level of value or the general trend, thus allowing further inquiries to be made regarding these rents. It may well be that after inquiries there is some obvious reason for them being out of line, i.e. there is some "party interest" linking the two sides together, sale and leaseback transactions or rents for less than one year. If satisfied that the rent is not an open market rent then it should be set aside. Another reason for a low rent being set aside may be that it is obvious that the landlord is not looking after his interests "in a prudent and business like manner."

Tone date is 1 April 2003 and the rents struck closest to that date are of the greatest significance, but as the rents have now all been listed in date order the level at tone date should, given that there are sufficient rents, be reasonably obvious. It is not enough, however, for the obvious to be taken in a subjective manner. A more rigorous objective approach is required. Remember at a revaluation the onus of proof regarding the level of value lies with the Assessor. To achieve a more robust level of value the rents from around tone date, say from September 2002 to May 2003, should be taken for further analysis to arrive at this general level of value. Providing there are sufficient rents, they should be ordered by rate per square metre, and the main emphasis should be placed on the average of the mid quartiles (the middle half!). This figure represents the general level which can be fairly applied to the class of subject, in the given location, which is being considered.

In the landward areas, where there are few rents, the value of having analysed all the rents comes to the fore. Although there may be few or no rents at tone date, the rents which do exist can be placed in the time frame and compared with other rents, from other areas, or classes, allowing a reasoned decision to be made regarding the level of value which pertains at tone date.

## 9.0 MISCELLANEOUS

The length of lease assumed in this instruction is the normal five yearly rent review lease. The question of the adjustment required for periods other than five years must be addressed.

Where the lease term, or review term, is less than five years **no adjustment** should be made and the rent treated as though it were for a five year period.

Where the period of the rent is longer than five years than an adjustment should be made, which will allow the rent to be treated along with the rest of the evidence.

When a landlord agrees to a longer period at a fixed rent he requires to be compensated for this by way of an increased rent. This is, of course, due to "losing out" in the opportunity to benefit from any increase in rent due, largely, to inflation. The rate of inflation, or growth, has therefore a part to play in this adjustment, together with the appropriate equated yield. This information is unlikely to be available and a compromise adjustment is suggested. It should be borne in mind that the resultant adjustment applies at lower rates of growth (around 3% per annum) and in exceptional circumstances of higher rates of growth this may be too low.

(a) periods up to 5 years                      no adjustment

(b) periods greater than 5 years      1% per annum for every year in excess of 5 years

For example - a 21 year fixed term =  $21 - 5 = 16 \times 1\% = 16\%$

## 10.0 TURN-OVER RENTS

Turn-over rents, as applied to retail subjects, are based on applying a percentage figure to the retailer's gross turn-over. This figure is obtained in some cases, especially in shopping centres, by the tills in the retail outlets being directly linked to the computer in the office of the landlord's agent. Otherwise provision is made in the lease for regular turn-over statements and turn-over certificates from the tenant's accountant. The figures obtained would be subject to deductions in respect of V.A.T., sales to staff and returned goods. Specific deductions may also be given where a high proportion of sales are by credit cards to take account the charges made by the credit card companies.

The rent under such arrangements is usually, but not always, made up of two distinct parts;

Firstly there is the "base rent" which is generally fixed at a level of around 75% to 80% of the full market value of the property.

Secondly there is the element which is related to the turn-over where a percentage is paid on the turn-over which exceeds a threshold figure. The percentage paid

varies according to the trade which is concerned and varies from about 1% to 15% with the higher turn-over trades paying the lower percentages.

Regular reviews of the percentage, the threshold figure and the base rent take place. The rent passing closest to tone date should be taken and the modifications detailed above should be applied as appropriate.

The rent passing should be taken as the base rent together with 100% of the turnover element. The pattern of rents established in this way should indicate the level of market rent above base rent.

Reference: Turnover rents in the Lands Tribunal considerations in Morrison EF (GP) Ltd v Assessor for Central Scotland (2003).