

**Steering Committee on Harmonisation
(Practice & Procedure) England / Wales, Scotland,
Northern Ireland & the Republic of Ireland**

**Agreed Joint Paper on the
Adjustment of Rental
Transactions for
Non-Domestic Rating Valuations**

5th November 2013



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SECTION 1 – INTRODUCTION

Purpose of this Paper

- 1.1 This paper deals with the adjustment of commercial lease transactions for the purposes of Non-Domestic Revaluation and seeks to promote consistency of approach between Land & Property Services (LPS); Valuation Office Agency (VOA GB), Scottish Assessors Association (SAA) and the Valuation Office Ireland (VO Ireland).
- 1.2 The objective of rental adjustment, within the context of a general revaluation, is to convert rental evidence into a form which is compatible with the appropriate statutory definition of rateable value.
- 1.3 The factors for which adjustment of rental evidence may be required, and the way in which the adjustments should be made, are often a matter of professional judgement. For this reason it is not possible to prescribe precisely how adjustment and analysis should be carried out in every instance. The general guidance given here is not intended to provide specific answers to particular local problems which will be covered, as necessary, by appropriate local instructions.
- 1.4 It should be noted in particular that rental adjustment for the purposes of non domestic valuation in England and Wales is necessarily conditioned by the terms of the Landlord Tenant Act 1954 and Rating (Valuation) Act 1999, neither of which apply in Northern Ireland, Scotland or the Republic of Ireland.

Definitions of Rateable Value

England and Wales

- 1.5 All non domestic properties are required to be valued on the basis of rateable value which is defined in Schedule 6, Paragraph 2(1) of the Local Government Finance Act 1988 as:

“The rateable value of a non-domestic hereditament none of which consists of domestic property and none of which is exempt from local non-domestic rating shall be taken to be an amount equal to the rent at which it is estimated the hereditament might reasonably be expected to let from year to year on these three assumptions:

- i. the first assumption is that the tenancy begins on the day by reference to which the determination is made;***
- ii. the second assumption is that immediately before the tenancy begins the hereditament is in a state of reasonable repair, but***

excluding from this assumption any repairs which a reasonable landlord would consider uneconomic;

- iii. the third assumption is that the tenant undertakes to pay all usual tenants rates and taxes and to bear the costs of repairs and insurance and the other expenses (if any) necessary to maintain the hereditament in a state to command the rent mentioned above.”***

Scotland

- 1.6** The definition of net annual value is contained within the Valuation and Rating (Scotland) Act 1956, Section 6(8), 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 the 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.”

Northern Ireland

- 1.7** The definition of net annual value is contained within The Rates (Northern Ireland) Order 1977, Schedule 12 as:

“The rent for which, one year with another, the hereditament might, in its actual state, be reasonably expected to let from year to year, the probable annual average cost of repairs insurance and other expenses (if any) necessary to maintain the hereditament in its actual state, and all rates, taxes or public charges (if any) being paid by the tenant.”

Republic of Ireland

- 1.8** Under the provisions of Part 2 of the Valuation Act 2001, Section 48(3), net annual value is defined as follows:

“Subject to section 50, for the purposes of this Act, “net annual value” means, in relation to a property, the rent for which, one year with another, the property might, in its actual state, be reasonably expected to let from year to year, on the assumption that the probable average annual cost of repairs, insurance and other expenses (if any) that would be necessary to maintain the property in that state, and all rates and other taxes and charges (if any) payable by or under any enactment in respect of the property, are borne by the tenant.”

Section 50 refers to the use of the Contractors Method and states that net annual value ***“shall be an amount equal to 5 per cent of the aggregate of the replacement cost, depreciated where appropriate ...”***

Method of Rental Adjustment

- 1.9** There are four methods of analysis outlined in the RICS Red Book: ‘Straight Line’, ‘Time Value’, ‘Investment Value’ and ‘Discounted Cash Flow’.
- 1.10** ‘Time Value’ reflects the time-value of cash flow (rent) utilising a discounting yield and is the most appropriate method for non domestic rating valuation.

SECTION 2 - EXTENT OF PROPERTY

- 2.1** It is necessary to note that in some cases the rent passing may relate to property that is larger or smaller than a particular entry in the list or roll. In all cases the analysis should reflect the actual property as let and where significant adjustments are required the resultant answer should be treated with appropriate caution. The most common situations where the rent will need adjustment are as follows:

Domestic Use

- 2.2** That part of the rent paid which is attributable to the domestic portion should be deducted from the overall rent. The amount to be deducted should be based on local market evidence and reflect the fact that the domestic accommodation is part of a larger non-domestic property.

Agricultural and Other Non Rateable Use

- 2.3** The amount of rent applicable to any part of property, which is not a rateable subject or is exempt, should be deducted from the rent.

Extensions and Alterations

- 2.4** Where the tenant has carried out extensions or alterations, the rent paid may only relate to part of that larger property, or for the site only. An adjustment will be necessary to ensure that any analysis relates only to the part actually rented or the premises as demised.

Where Rent Includes More Than One Property

- 2.5** A rent may include more than one property. In such cases this should be noted and consideration given to whether a quantum discount, or other factors, may have been applied in setting the rent.

Where the Property Has Been Subject to a Subletting

- 2.6** In this instance the rent may relate to a property which is larger or smaller than the entry in the 'list' or 'roll' and should be adjusted to reflect the property as let, or demised.

SECTION 3 - CONSIDERATIONS OF RELIABILITY

- 3.1** The basis upon which rents are paid varies considerably and consequently the reliability of those rents as indicators of rateable value also varies. A thorough knowledge of local market conditions at the relevant valuation date is important, for example, the current economic climate has resulted in more flexible leasing arrangements. The most common types of rents to be considered are as follows:

Rents on New Lettings

- 3.2** These rents can be considered the most reliable form of evidence providing they are open market lettings with vacant possession between willing parties and with a current normal review pattern.
- 3.3** Care will still need to be exercised in certain circumstances. For example, in the case of shopping centres the rent agreed on some of the new units may be set at a level designed to attract an 'anchor tenant' and the rent paid should be examined to discover if:
- i. the rents were agreed before other lettings in the development. If so the rents may require adjustment to bring them into line with other rents agreed when the development was completed or near completion; or
 - ii. there are other rents paid by similar tenants. These should be considered to determine whether an overall pattern exists which could be adopted; or
 - iii. it is important to establish whether the rent relates to the property in a shell condition or fully fitted out.

Rental evidence from new lettings should be considered in conjunction with evidence from other types of rents described below.

Rents on Lease Renewals

- 3.4** These rents are paid when a lease has been renewed. Where the basis of renewal is open market rental value, assuming vacant possession and a current normal review pattern, then the rent can be regarded as reliable evidence.
- 3.5** If the lease provides for renewal it is important to ascertain whether there are any improvements or alterations carried out by the tenant, the value of which is to be disregarded under any relevant landlord and tenant legislation, in setting the rent upon renewal of the lease.

Rents on Review

- 3.6** Where a rent has been reviewed during the course of a lease it is essential that the precise terms upon which the rent was fixed are carefully examined. Where the basis of review is open market rental value, assuming vacant possession and a current normal review pattern, then the rent can be regarded as reliable evidence.
- 3.7** Abated Rents – the rent agreed may be abated on review, see paragraph 8.8 below.
- 3.8** Formula Rents - If the reviewed rent is fixed by formula agreed at the commencement of the lease the reviewed rent may not be equivalent to open market rent.
- 3.9** Upward only reviews - Where the terms of the lease permit upward review only and there has been little growth, or in fact a fall in rental levels, the rent passing may be in excess of open market rent.

Stepped Rents and Geared Rents

- 3.10** ‘**Stepped Rent**’ – This is where a lease provides for increases (or decreases) in rent to fixed sums at specified future dates. In these cases it is possible that the stepped rent may not represent open market rental value at that time.
- 3.11** ‘**Geared Rent**’ – Where the lease provides for the rent to be assessed on a percentage of open market value the rent may be of use. Highly geared rents will be the most helpful whereas rents which represent a small fraction of full rental value should be treated with caution (see ‘turnover rents’ below).

Rents Agreed by Independent Experts, Arbitrators, Courts, Tribunals

- 3.12** These rents although useful should be treated with appropriate caution. An independent expert employs his own knowledge; conversely an arbitrator is obliged to determine a rent based only on the evidence presented, though he/she must use his/her expert knowledge to evaluate the evidence produced.

Sale and Leaseback

- 3.13** Sale and leaseback arrangements become an attractive option where there is limited availability of finance in the market place. In recent years sale and leaseback transactions have become an established part of many investment markets.
- 3.14** It has traditionally been considered that the rents paid under such agreements are of limited value. This is because the leaseback transaction

was considered a funding operation, with the initial rent geared to the strength of covenant of the tenant rather than the strength of the property market.

- 3.15** Pension funds, however, are now required to ensure that leases are at full rental value. In addition many reviewed rents under these agreements are assessed at full rental value under the terms of the lease. Rents determined on this basis are obviously more useful.
- 3.16** In general, evidence from sale and leaseback transactions should be treated with caution. If possible a copy of the lease should be obtained in order to establish the true nature of the arrangement and weight, if any, to be attached to the rent.

Licences

- 3.17** These agreements are generally short term in nature and do not confer the same control and/or security of tenure provided in a lease. In all cases the particular terms of the agreement should be examined closely to ascertain exactly what rights are conveyed to the occupier.
- 3.18** However, in some cases, such as street trading or pavement seating, the only form of letting is by way of licences, and this may be the only rental evidence available.

SECTION 4 – LENGTH OF LEASE AND REVIEW PATTERN

- 4.1** It will be necessary at the outset to establish the current standard lease length and review pattern for the particular type of property being considered at the valuation date.
- 4.2** Traditionally the majority of leases in respect of non-domestic properties were for terms of between five and twenty-five years with rent review periods generally ranging between three and five years. It is generally accepted with these leases that no adjustment is required to bring the rent into line with the rating hypothesis, which assumes a tenancy for year to year with a reasonable prospect of continuance.
- 4.3** Where there is a longer period between reviews than would generally be the case for the class of property involved, a landlord would normally require the compensation of a higher rent. It may therefore be necessary to make a downward adjustment to reflect what is commonly known as 'overage'.
- 4.4** In making an adjustment the normal rent review pattern for the class of property involved should first be established. The adjustment made should take account of the rate of property price inflation together with an appropriate equated yield.
- 4.5** As this information may not be available a general adjustment of 1% per annum for every year in excess of a 5 year review pattern has traditionally been used. However, this adjustment is not universally accepted and may not be appropriate in the current recessionary conditions. In any event it should be used with caution or amended to suit local market conditions.

SECTION 5 – DEDUCTIONS FROM RENT

VAT

- 5.1** The hypothetical tenancy is deemed to be net of VAT. It should be confirmed whether the rent returned is exclusive of VAT. If inclusive then the tax should be deducted at the prevailing rate at the date the rent was paid.
- 5.2** In markets where the majority of property occupiers are able to recover VAT, the imposition or otherwise, of VAT on rent is unlikely to have an effect on open market rental values.

Service Charges

- 5.3** Where the lease provides that the landlord can recover the cost of services by way of a separate service charge then no adjustment to the rent is necessary. Where the rent includes a service charge it will require adjustment.
- 5.4** The effect of an abnormally high or low service charge may make the rent unreliable as evidence of rateable value. It may be appropriate to treat any exceptional profit made by the landlord on the service charge as being in the nature of rent and add it to the rent passing.

Rates

- 5.5** The hypothetical tenancy does not include rates and the terms of most leases usually provide that the rent passing is exclusive of rates. In circumstances where the lease provides that the rent is inclusive of rates, the rent should be adjusted accordingly.
- 5.6** Where government reliefs or levies exist in the market, especially in regard to the payment of rates, care should be exercised in the analysis of rental information. Recent empirical evidence indicates that local tax incentives are translated into higher rents for the properties involved. In many instances this can be as much as 100%. (The impact of enterprise zone tax incentives on local property markets in England: who actually benefits? Shaun A. Bond, Ben Gardiner & Peter Tyler)
- 5.7** Where there is evidence that the rental level for particular properties may have been distorted by rates reliefs or levies, the rents in question should be carefully considered in relation to:
- i. The statutory definition of the hypothetical tenancy and any relevant case law, and whether such relief or levies would be available to the hypothetical tenant; and

- ii. The degree of permanence of the relief or levy and whether or not it should be considered temporary in nature at the valuation date.

Insurance

- 5.8** The hypothetical tenant is assumed to be responsible for insuring the property under the statutory definition of rateable value.
- 5.9** Where, under the terms of the lease, responsibility for the insurance will be undertaken by the landlord and the cost recovered from the tenant, no further adjustment is required.
- 5.10** Where the landlord insures without directly recovering the premium a specific reduction will be required. As premiums vary widely according to use, construction, age and location it is not possible to provide specific guidance which would cover all possible cases that could occur.
- 5.11** If an adjustment is required regard should be had in the first instance to the actual annual level of insurance premiums for the property under analysis together with other relevant comparables. In the absence of actual insurance premium rates percentage adjustments are commonly used and these will obviously vary by locality, property type and age etc. Any percentage adjustment adopted however should, preferably, be evidence based and is likely to range between 2.5% and 6%.

Repairs

- 5.12** The hypothetical tenant is responsible for ongoing repairs to the property. The standard of repair assumed for a rating valuation should have regard to the type and age of the property, its locality and the nature of the tenant likely to occupy it.
- 5.13** It will be necessary at the outset to determine who is responsible for the cost of repairs under the terms of the lease:
 - i. Where the landlord carries out the repairs and recoups the cost from the tenant no adjustment to the rent is required because, in reality, the tenant is bearing the cost. This would be common where the building is let in parts or the letting comprises part of a larger development, for example, a shopping centre.
 - ii. If the landlord carries out some or all of the repairs without a separate charge to the tenant (now comparatively rare) the rent will be higher than if the tenant was responsible for the full cost of maintaining the property and an adjustment will be required.

- 5.14** Where an adjustment is required, in the first instance, the actual annual average repair costs should be obtained. Where these are not available estimates may be made on the basis of market evidence for similar properties and available cost guides, taking account of age and construction of the building and any abnormal repair costs that may be envisaged.
- 5.15** In practice adjustments of between 3% and 7% are typically made for external repairs and a further 1% to 6% for internal repairs. While these adjustments are generally acceptable they should only be used where they are consistent with market evidence and practice.
- 5.16** Where the premises are in a poor state of repair the landlord in the real world may choose to either:
- i. Put the premises in reasonable repair prior to letting. As the premises will be repaired on letting no adjustment to the rent will be necessary; or
 - ii. Let the premises, with an agreed record of condition, with the tenant under no liability to give up the premises in a better state than that recorded at the commencement of the letting. In this case the rent is likely to be discounted to reflect the poor state of repair. In order to use such a rent as a comparable for a rating valuation an adjustment may be needed to bring it to the equivalent of the likely rent if the property was in reasonable repair; or
 - iii. Let the premises in their existing state, on FRI terms, with the tenant as a condition of the lease undertaking to repair the premises. In these circumstances the initial rent will be reduced to reflect the tenant's liability to put the property into the agreed state of repair. The rent will need to be adjusted as in (ii) above.

SECTION 6 – LANDLORDS’ INCENTIVES

- 6.1 A variety of incentives have been devised to attract tenants including reduced rents; stepped rents, rent free periods, capital contributions, reverse premiums and assuming tenant’s liabilities in respect of previous leases.
- 6.2 There are many reasons why a landlord may seek to offer an inducement as part of a rental transaction. These include the ability to maximise the capital value of his investment, the ability to secure funding at a more favourable rate and the benefit of securing a longer lease than would normally be the case. Furthermore an agreed headline rental, when coupled with an upwards only rent review clause, may secure a rental income in excess of the open market rental value of the property for a period exceeding the first or even second reviews.
- 6.3 For a tenant a rent free period, reverse premium or contribution towards fitting out made in return for a higher headline rent is effectively a form of unsecured borrowing.
- 6.4 It is important when considering incentives to understand the reasons why they have been agreed and the extent to which (if at all) they drove the transaction. This will help the valuer reach a decision as to whether any adjustment should be made to reflect the incentive, the means by which it should be calculated and the weight given to the resultant figure.
- 6.5 Given that an incentive affects the rent, consideration needs to be given to the rate and period of amortisation of the incentive.

Rate of Amortisation

- 6.6 The rate used will vary according to the class of property and the location. It should be the market rate expected for such an investment as at the date of the lease derived from local evidence and applied on a single rate basis.

Period of Amortisation

- 6.7 From the landlords point of view the incentive is often regarded as a ‘one off’ payment with the costs amortised over the full length of the lease. The tenant will generally argue that the effect of the incentive should be discounted over the period to the first review because the rent is then subject to review, normally to open market value. In practice the possibilities are as follows:
- i. **The whole term of the lease is taken.** This will apply where, on balance, it is considered that the primary motivation behind the incentive is to lock the tenant into a lease for a longer period of time than would normally be the case. An example of this would be where

an inducement has been made to a high quality anchor tenant whose presence is assumed to bring a benefit to the development for the duration of the lease.

- ii. **The period to the tenant's break clause.** In this case the period during which the tenant is 'locked in' is reduced. Before this is applied care should be taken to ascertain whether or not there is a realistic possibility that the break clause will be exercised. The effect of the break clause may be significantly weakened by the inability of the tenant to find alternative premises, the need to write off 'fit out' costs over a short period or prohibitive penalty charges.
- iii. **The period to first review.** This may be applicable where the first review is to full rental value. This approach can often produce a low effective rent however and it will be necessary to consider it against the totality of evidence available when deciding the weight to be attached to it. If the resultant rent is out of line with other non adjusted rents the period of amortisation is probably too short.
- iv. **The period to review or break following the point where the market rent overtakes the headline rent.** This is often particularly difficult to calculate, as the current market rent, which is what is being sought, is not known. Where this approach is considered appropriate, market practice appears to have settled on a rule of thumb approach by analysing incentives over a ten year period, or to the second review. Where this approach is used a further adjustment for 'overage' may be required to reflect a more normal five year review pattern.

6.8 In summary the period of amortisation must remain variable in order to reflect the different circumstances which pertain to a particular letting. The correct period will ultimately be a question of judgement based on such factors as; the type of incentive, projected short to medium term rental growth, the timing and the likelihood of exercising break clauses, the terms of the rent review and local market conditions. In any event, the adjusted rent or a range thereof should where possible be tested against rents which provide more direct and reliable evidence.

Rent Free Periods

6.9 Periods of three months are commonly granted by landlords to allow tenants to fit out the property for their own occupation. No adjustment should be made for this period as the concession is only given to allow the tenant to complete works which, under the rating hypothesis, have already been carried out within the principal of 'rebus sic stantibus'.

- 6.10** Only rent free periods in excess of the time reasonably required to fit the property out should be taken into account as a true incentive.
- 6.11** The normal approach is to calculate the present value of the actual rent received over the period to review/end of lease and then take an annual equivalent over that same period. The yield adopted should be in line with the market for the type of interest and category of property involved, see 6.6 above. The appropriate time period over which to base the analysis may typically be based upon the point where the market rent overtakes the headline rent, but will depend upon the individual circumstances of the letting, see 6.7 above.

Stepped Rents

- 6.12** Where a lease provides increases (or decreases) in rent to fixed sums at specified future dates, such payments are referred to as stepped rents. The adjustment to a constant rent is made by calculating the present value of the stepped rents and then taking an annual equivalent over the relevant period. The yield used and relevant period will be as at 6.6 and 6.7 above.
- 6.13** If the time period used for the analysis is to the first review and the equivalent rent needs to grow by an unrealistic percentage to equal the final step, consideration should be given to analysing over a ten year period or to the second review except where there is a reasonably operable prior break clause.

Reverse Premiums

- 6.14** Where a landlord makes a capital payment to a tenant as consideration for taking a lease, such a payment is known as a 'reverse premium'. Expenditure by the tenant on fitting out or in providing rateable fixtures and fittings should be offset against the payment and the balance considered an incentive.
- 6.15** The capital sum can be deducted directly (discounted to present value if necessary) from the value of the rental flow. Alternatively since it is a capital payment given to the tenant that can be used to pay rent, it can be treated as a rent free period.

Contributions to Fitting Out

- 6.16** Where a landlord makes a contribution towards the tenant's fit out costs it is necessary to distinguish between contributions to expenditure which form part of the rateable property and those which are for non rateable fixtures and fittings.

- 6.17** The landlord's capital contribution towards the cost of the tenant's rateable fit out should be offset against the cost of the works. If the landlord contributed the entire amount the rent should be treated as reflecting the fit out. If the contribution exceeds the realistic cost of the fit out the balance should be treated as a reverse premium as outlined above at 6.14.

Assumption of Liabilities

- 6.18** The landlord may assume the liabilities of a tenant in respect of property previously occupied.
- 6.19** In this case it will be necessary to estimate the value of the liability transferred. This will normally include such items as rent, rates and service charges for the period until a new tenant is found. It may also include an amount in respect of dilapidations at expiry of the lease. In addition it will also involve consideration of the expected rental growth over the short to medium term.
- 6.20** Once the total cost and the time period over which the liability will be incurred has been quantified, it can be deducted from the value of the rental flow or alternatively treated as a rent free period as previously outlined.
- 6.21** Due to the highly speculative nature of events likely to occur where the landlord assumes a liability on behalf of the tenant, care needs to be exercised when analysing such an incentive.

SECTION 7 – ADDITIONS

Initial Repairs

- 7.1** Where a tenant takes a property in a poor state of repair and as a condition of the lease puts the property into a specified state of repair, the rent paid at the commencement of the lease will normally reflect the original poor state of the building. The rental value passing will therefore need to be adjusted to reflect the improved repair. Depending on the lease terms the cost of the repairs can be amortised over the entire term of the lease, or to the first rent review (if that review is to the open market value of the improved building) or break clause (see 6.7 above).

Tenant's Improvements, Extensions and Alterations

- 7.2** These works should be taken into account to the extent that they increase the rental value of the property.
- 7.3** Generally more weight should be placed on rents paid disregarding improvements and relating to the unimproved building. The more significant the adjustment made, the less reliable the rent becomes.
- 7.4** If possible the value of tenant's improvements should be ascertained by direct comparison. Where this is not possible the cost of the works should be amortised over a period which has regard to the useful life of the improvements, the terms of the lease and the general recommendations at 6.7 above.

Tenant's Fit Out

- 7.5** It is common for new shops and offices to be let in 'shell' condition with the tenant responsible for 'fitting out' the property. The initial rent and possibly any reviewed rent will reflect the shell condition and not the fitted unit. Where this is the case an adjustment will be required.
- 7.6** Where the 'fit out' is to a new building the adjustment will be made by calculating an annual equivalent of the rateable fit out costs over the appropriate term and adding it to the rent passing. Where the adjustment is being applied to a review rent when the 'fit out' took place at the commencement of the lease the cost should be depreciated. The rate of depreciation to be used will vary depending on individual circumstances but one 'rule of thumb' commonly used is 5% per annum from year six to year twenty-five on a straight line basis.
- 7.7** Expenditure on fitting out is likely to vary considerably. Care should be taken to ensure that expenditure on corporate features which are of no market

value is not included in total cost. In addition the cost of tenant's non rateable fixtures and fittings should be also excluded.

- 7.8** Where existing buildings are refitted to an improved standard an adjustment should be made as above. Where an existing building is refitted to the same or a similar standard to portray a new 'corporate image' no adjustment should be made but, of course, no depreciation allowance will be made as the fit out is now new.
- 7.9** Where a previous tenant has assigned the interest, the residual value of the improvements may be taken into account in line with the principles for treating current tenant's improvements as set out above.

Premiums

- 7.10** A premium is generally regarded as a capital sum paid by a lessee to a lessor (or previous lessee) in consideration of the rent passing being fixed at a level below the full rental value of a property. In effect, it can be understood as the tenant purchasing a profit rent.
- 7.11** In practice a premium can be made up of one, or a combination, of the following:
- i. goodwill;
 - ii. tenant's fixtures and fittings;
 - iii. stock;
 - iv. residual value of improvements ignored on review or renewal;
 - v. capitalised profit rent; and
 - vi. key money.

Items (i-iii) should be excluded from the sum to be amortised, item (iv) included if analysing against the improved property, items (v) and (vi) should be included in the sum to be amortised.

- 7.12** Where the premium has been adjusted to reflect only capitalised profit rent it should be amortised over the period to first review, or renewal, where the basis is to open market rental value.
- 7.13** Where the premium has been adjusted and contains both profit rent and key money, the amount attributable to each element should be identified. The profit rent should be amortised to first review as above (7.14). It may be appropriate to amortise the amount attributable to key money over the expected occupancy of the tenant, a period which may extend beyond the length of the lease.

- 7.14** Rental evidence involving premiums, especially large premiums, should be treated with caution. Where the premium is amortised over the period to first review the virtual rent may be very high and unsupported by other market evidence. This may suggest the period used for the analysis is incorrect.
- 7.15** While it will be necessary to consider the resultant rent in the light of all the evidence available, it should not merely be dismissed as it may provide an insight into the demand for, and the value of, a particular property or group of properties.

SECTION 8 – MISCELLANEOUS

Turnover Rents

- 8.1** Turnover rents occur where the rent payable is determined, in part at least, by the actual turnover achieved by the tenant. They are typically used in retail premises with catering leases and franchises; food courts, concessions within department stores and factory outlet retailing. Although turnover rents are not new they are becoming increasingly common due in part to the current economic climate encouraging more flexible leasing arrangements.
- 8.2** There are two principal types of turnover based lease:
- i. where rent is wholly based upon turnover, commonly employed in food courts; and
 - ii. where the rent is based on turnover combined with a minimum base rent.
- 8.3** The base rent is generally determined as a percentage of open market rental value or a price per square metre. Base rent is often in the region of 70%-80% of open market rent and the turnover percentages normally range between 5%-15%. Alternatively a lower base rent may be agreed combined with a higher percentage of the tenant's turnover.
- 8.4** Turnover figures in shopping centres are obtained by direct reference to receipts otherwise provision is made in the lease for regular statements and turnover certificates from the tenant's accountant. The figures obtained are subject to deductions in respect of VAT, sales to staff and returned goods. Specific reductions may also be given where there are high proportions of credit card sales to reflect the charges made by credit card companies.
- 8.5** Care should be exercised where there is a mix of turnover leases and traditional leases within one development. This can arise through one or a combination of the following circumstances:
- i. the landlord's policy;
 - ii. the refusal of some retailers to enter into turnover leases; or
 - iii. where the rent cannot be easily related to turnover for a particular occupier, for instance a travel agent.

Clearly identifying those properties let on turnover rents will ensure that base rents are not adopted as being full rental value and leases where a full open market rent is paid are not grossed up further.

- 8.6** Where the lease provides for a turnover rent with a base rent geared to open market rental value, the most reliable route to rateable value will be to gross up the geared rent paid. Base rents at or about the valuation date should be used. Obviously the lower the gearing the less weight should be attached to the grossed up rent. Where possible, grossed up rents should be tested against rents for similar properties which have been let at open market value in the same development to gauge reliability.
- 8.7** Where base rents are not geared to open market rental value close to the valuation date regard should be had in the first instance to the levels of rents actually paid. These rents can be analysed to give an initial indication of what might be paid for the properties on the statutory terms. If the analysis is distorted by a small number of very high or very low rents these rents may need to be excluded. Rental analysis should ideally focus, where possible, on at least three years around the valuation date in order to identify any trends which may need to be taken into account.

Abated Rents

- 8.8** In the current recessionary climate many tenants are renegotiating their rents between reviews and obtaining reduced or abated rents for varying periods of time. In the absence of other rental evidence, abated rents represent some evidence and they will have been agreed by a specific existing tenant and are not as such truly open market rent. Any abated rent used should have been in place at the valuation date and be for a period of at least one year. They should be treated with suitable caution and always considered in relation to other comparable rental evidence where it exists. A full understanding of the circumstances including any back letters/side agreements is critical.

Order of Adjustment

- 8.9** There are no set rules governing the order of adjustment other than the adjustment for repairs should be made last (*F W Woolworth and Co. v Peck* VO 1967 LT RA 365)
- 8.10** The VOA and the VO Ireland have adopted a consistent approach to the order of adjustment as shown below:
- i. VAT;
 - ii. Rent free periods/stepped rents;
 - iii. Premiums paid by and to the tenant;
 - iv. Tenants improvements;

- v. Value of any surrendered lease;
- vi. Overage or other lease terms;
- vii. Domestic accommodation;
- viii. Non domestic rates and other payments;
- ix. Repairing and insuring liabilities.

SECTION 9 - SUMMARY

- 9.1** There is no single correct approach to adjustment of rents and methods may vary depending on the circumstances of individual cases and market practices in different areas and sectors. In addition, changing markets may mean that an approach adopted previously may not be appropriate several years later.
- 9.2** It is also worth repeating that even where a property is let on terms similar to the definition of rateable value, it will still be necessary to have regard to other open market rental evidence. This recognises the fact that actual rents are the product of individual negotiations, the outcome of which may be influenced by a variety of factors. It is necessary to look at the totality of rental evidence to form a view as to the general level of rental value for the type of property concerned within a particular locality.
- 9.3** Rents vary greatly in their reliability and it is essential that all rents are carefully considered before identifying those which will be relied upon to create a valuation list or roll. As a general rule the more adjustment that is required, the less reliable the rent will be.
- 9.4** Skill, care and a sound knowledge of local property markets are required in the approach to rental adjustment. Through this, a proper understanding of the transaction being analysed, the intentions of the parties involved and the true value of costs or incentives concerned can be obtained before proceeding to the mathematical adjustment.