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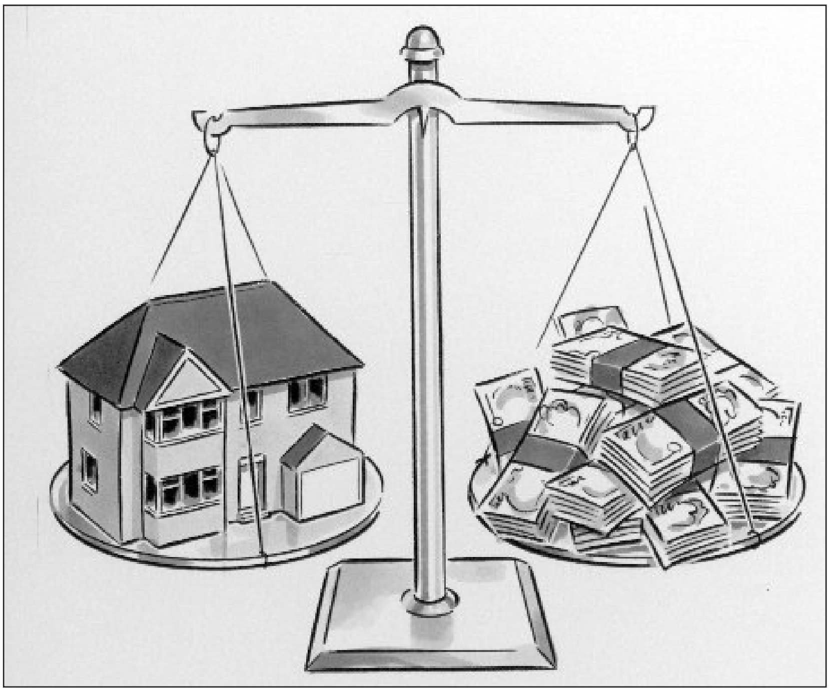
THE LEASEHOLD ADVISORY SERVICE

COMMONHOLD AND LEASEHOLD REFORM ACT 2002

HOUSES

Qualification and Valuation for Enfranchisement



Introduction

This leaflet is not meant to describe or give a full interpretation of the law; only the courts can do that. Nor does it cover every case. If you are in any doubt about your rights and duties then seek specific advice.

Anyone considering enfranchising (buying) the freehold of their leasehold house will probably begin by asking 'How much will it cost?' The valuation process required by the law is complicated, so it is often difficult to form a clear view of the amount at the beginning.

This advice note sets out to describe:

- *Qualification for the right to enfranchise*
- *The statutory bases for valuation*
- *The way in which the price is assessed*
- *The role of the professional advisor in the process*

This note is not intended as a 'do-it-yourself' guide to valuing your own freehold. You should seek proper professional advice at the earliest possible stage.

The law

The Leasehold Reform Act 1967 (as amended) gives leaseholders of houses the right to buy the freehold. In some cases they have an alternative right to extend the lease.

Some freeholders will sell the freehold without the need for a formal claim, but, whether a claim is made or not, the leaseholder should obtain good professional advice to find out roughly what the whole process will cost.

Because the basic right has been extended over the years by various amendments made to the 1967 Act, rules for calculating the price are somewhat complicated. The 1967 Act allowed the purchase of houses at a price which is similar to that at which the freeholder could have sold his interest to anyone else. Qualification under this right required, among other things, certain Rateable Value limits to be met. The Housing Act 1974 extended the right to houses which did not meet these limits and provided that the freeholder and claimant should share the full increase in the value of the house when held on a freehold basis. The Leasehold Reform, Housing and Urban Development Act 1993 extended the right to another group of much larger houses and provided for the additional value to be shared in a different way. The Housing Act 1996 extended the rights further; the Commonhold and Leasehold Reform Act 2002 simplified qualification and provided additional rights.

Qualification

The right to enfranchise is dependent upon a number of qualifications for the house, the lease and the leaseholder; these are set out in full on page 11 of this booklet.

- **the house** — must be a building reasonably considered a house, divided vertically from any adjoining house. It does not matter if it has been divided into flats so long as you own the lease of the whole house.
- **the lease** — must be a long lease, originally for a term of more than 21 years or with a right to renewal. There are

also certain restrictions in respect of leases for original terms of less than 35 years *(see Summary on page 11)*.

- **the leaseholder** to qualify, the leaseholder must own the lease to the house at the time of application and have held the lease for the past two years (or a total of two years in the last 10 years). In addition, where a leaseholder who is eligible for the right to the freehold dies, his personal representatives will be so eligible and may serve a notice for purchase within a period of two years from the grant of probate or letters of administration.

These qualifications not only determine the leaseholder's eligibility for the right to the freehold but also which method of valuation will be applied.

The two valuation methods

The Act provides two distinct procedures for valuation of houses, dependent upon the section of the Act under which the house qualifies. These sections are:

Section 1 – where the house passes the original low rent test and meets certain value limits;

Section 1A – where the house exceeds the value limits;

Section 1AA – where the lease of the house had previously been extended under 1967 Act provisions;

Section 1B – where the lease was granted after 18 April 1980 and is not for a set term but terminable on death or marriage.

The appropriate method of valuation is then decided from the basis of the above qualifications and in accordance with the following:

Section 9 (1) – where the house qualifies under Section 1 it will be valued according to the original valuation basis;

Section 9 (1A), 9(1AA), 9(1C) – where the house qualifies under Section 1A, 1AA or 1B it will be valued according to the special valuation basis.

These two valuation bases are:

- the original valuation basis – the value of the site;
- the special valuation basis – the value of the house, including a share of the marriage value.

The valuation method under which the house is to be valued is not a matter of the landlord's or the leaseholder's choice but is determined by the qualification criteria.

Put simply:

- if the lease satisfies the **original low rent test** and the house satisfies the value limits, then it will be eligible under Section 1 (the original qualification of the 1967 Act) and will be valued according to the **original valuation basis**;
- in all other cases, including cases where the original lease had been extended under the provisions of S14 of the 1967 Act, it will be valued according to the **special valuation basis**.

The special valuation basis of assessment generally means that the price is much higher than that which would be payable under the original valuation basis. It is therefore most important to establish under which basis the house is to be valued.

Under both sets of rules the law requires the freeholder's interest to be valued as if it were being sold in the open market by a willing seller to a willing purchaser. The principles of the Act are not to provide a forced bargain for the leaseholder but adequately to compensate the freeholder for the loss of his property – a fair price based as closely as practicable on open market values. The essential difficulty is the assessment of an open market value in the artificial situation created by the imposition of the leaseholder's rights.

Where the freeholder and the claimant cannot settle the price by negotiation, a Leasehold Valuation Tribunal can be asked to settle the matter. The Tribunal's role is not to decide in favour of either party's valuation but to determine the issues independently; therefore the Tribunal's determination may not necessarily reflect prices proposed by either the claimant or the freeholder.

Once you have begun the process of enfranchisement by serving a Notice of Claim you will be liable to pay the freeholder's reasonable costs in dealing with your notice so you would be wise to find out the likely cost before you begin the process. A valuation surveyor competent in the legislation and with a good knowledge of the local property market will be able to help you.

While LEASE does not recommend any particular professional advisors, lists of solicitors and surveyors claiming expertise in the legislation are available from us.

First steps

First, you need to confirm that you are a qualifying leaseholder and find out whether the house passes the necessary tests and is not a property excluded from the right of enfranchisement.

Secondly, you will need to investigate whether your house meets certain value limits and these vary according to when the lease was originally granted. These two checks will determine your right to purchase and also under which section of the legislation.

Dependent upon the qualifying section there is a further check on value limits to determine the method of valuation.

Gathering information

You will need professional advice to confirm your relative rights and the valuation method.

For this you will need to gather a certain amount of information. A professional adviser will be better equipped to help if he has the relevant information to hand. It is suggested that before consulting a valuer or solicitor you spend some time amassing the relevant facts. Some will be readily to hand, some will need research; the following checklist should be useful:

i) details of the lease

- what was the date of the lease, or the commencement date if this is different? (ie the date of the original lease, not the date that you acquired it.)
- what was the original ground rent payable at the start of the lease?
- was any premium included in the lease?

All this information should be on the first page of the lease document itself. If you do not hold the lease you will need to obtain a copy from your mortgagee (the bank, building society etc), your solicitor or whoever holds it.

ii) rateable values

- what was the rateable value of the house on the first day of the lease (if it had one), or 23rd March 1965, whichever is the later?
- and what was the rateable value on 31st March 1990?

You should be able to obtain this information from your local authority. In some cases, local councils do not keep older records and the information can be obtained from the local Valuation Officer of the Inland Revenue.

The Original Valuation Basis (site value)

The original reasoning behind the 1967 Act was that the freeholder owned the land, but the leaseholder owned the house. So, at the end of the lease, the freeholder would be left with a vacant piece of land which he could let at a 'modern ground rent'.

The reality is, of course, rather different, but the principle remains the same: to assess today's value of the land on which the house stands in terms of the ground rent the landlord could receive, at today's rates, forever.

> ***Example 1***
>
> ***The original valuation basis procedure can be illustrated as follows: assume a house with 36 years presently left on the lease, a fixed annual ground rent of £15 and an estimated freehold vacant possession value of £75,000.***

i) calculating the term

The freehold interest in a house occupied by a leaseholder is an investment. The freeholder's money is tied up in the ownership of the house and in return he receives a rent. The rent, divided by the value of the interest, is called **the yield**. This is a similar concept to the interest received on a building society account, where the rate of interest an investor receives on his money is also the yield. If building societies are currently offering accounts at 10% per annum, the account yields 10% on the money invested. Investors look at the property interest in much the same way and what they are prepared to pay for them depends upon the yield they are seeking. From his knowledge and experience of the investment market, the valuer will determine the yield the freeholder could expect to receive for the rent payable under the lease and, by multiplying the rent receivable by the yield for the remaining term of the lease (the **Years Purchase** – a figure which can be found from valuation tables) will calculate the value of the freeholder's interest during the term of the lease.

For the example the yield is assumed at 7%.

Ground rent £15 per annum

Years Purchase for 36 years @ 7% (from tables) is 13.035

So, £15 x 13.035 = <u>£195</u>

The calculation provides a figure representing compensation to the freeholder for his loss of the rental income over the remaining period of the lease. Therefore £195 is taken as a today's value of the right to receive £15 a year for the next 36 years. It is not correct just to multiply the ground rents by the remaining years of the term.

ii) calculating the reversion

The next step will be to value the modern ground rent. The whole valuation is carried out at the date of claim and values are not projected forward in time. Therefore the valuer is looking for the value of the land on which the house stands at the date of the Notice of Claim. There is rarely any evidence available of sales of individual plots of land; therefore the only way of deciding on the value of the land is to look at it as a percentage of the value of the house. The valuer will have to assess the value of the house on a freehold basis assuming there is vacant possession, and, under this basis of valuation, that the house has been developed to its full potential.

Having valued the house, the valuer will then use his local knowledge and experience to determine what percentage of that value will be attributable to the cost of the land – the site value. Depending upon the location and nature of the house, the percentage is likely to be between 30% to 50%. Having arrived at a site value, he will then 'decapitalise' it, probably using the same yield as for the ground rent, in order to arrive at the modern ground rent.

This rent is then valued as a future income in perpetuity, that is, the value of the site to the landlord today based on his right to receive the modern ground rent forever, but starting at a point in the future – in our example, in 36 years time:

Present freehold vacant possession value of the house	£75,000
Site value taken as 30% of that value	£75,000 x 30%
	<u>£22,500</u>
Modern ground rent taken as 7% of site value	£22,500 x 7%
	<u>£1,575 pa</u>
Years Purchase in perpetuity, deferred for 36 years @ 7% (from tables) is 1.25	
So, £1,575 x 1.25	<u>£1,969</u>

iii) completing the valuation

The purchase price for the freehold is, therefore, the sum of the values of the term and of the reversion:

£195 + £1,969

= <u>£2,164</u>

iv) implications of very short unexpired terms

If the current lease has only a few years to run, the original valuation method may be applied slightly differently, based on the leaseholder's statutory right to a new lease. The right is to an extension of 50 years from the date of expiry of his present lease. The ground rent for the new lease would be assessed on the first day of the lease as a proportion of the value of the land – the site value – and would be a modern ground rent. (A modern ground rent is usually a figure far in excess of the existing ground rent.)

The valuation procedure will assume that the leaseholder takes up his right to the 50-year extension at the modern ground rent, although that will not actually happen. Therefore the freeholder's interest becomes the right to receive the rent and any increased rent on review during the term of the lease, followed by the right to receive a modern ground rent for 50 years, followed by the right to vacant possession of the house at the end of the lease. This is called 'the reversion' because this is when the house reverts to the freeholder.

The valuation will therefore be the sum of the present term, the 50-year extension, and the reversion at the expiry of the extension.

Again this can be illustrated: assume the same house as the previous example, having an annual ground rent of £15 and a freehold vacant possession value of £75,000, but this time with only 10 years left on the lease.

The term is valued and the modern ground rent calculated as before but, this time, the modern ground rent is valued, not in perpetuity, but for the 50-year term and then the reversion calculated at the end of the 60 years (the 10 years remaining on the present lease plus the assumed 50 year extension):

The 10-year term	ground rent x 10 Years Purchase @ 7%	
	£15 x 7.024 (from tables)	**£105**
The 50-year extension		
	modern ground rent (from previous examples) x Years Purchase for 50 years @ 7% deferred for 10 years £1,575 x 7.015 (from tables)	**£10,480**
Reversion after 60 years		
	vacant possession value deferred 60 years @ 7% £75,000 x 0.0172 (from tables)	**£1,290**
	Purchase price	**£11,875**

v) implications of the leaseholder's improvements to the house

The 1967 Act provides no statutory guidance as to the inclusion or not in the calculation of the value of the leaseholder's improvements for valuation under the **original valuation basis** (these are specifically excluded from the special valuation basis).

In the absence of such guidance, the inclusion of improvements may make a difference in the estimation of the vacant possession value of the house, from which the site value is assessed. The matter hinges on the assessing of a **modern ground rent** and the value of the land must be affected by what stands or could stand on it, that is, the value of an average house in the street, or a building appropriate to the area. It is important to understand, when assessing site value, that it is a matter of what could be put onto the site that is relevant, not what stands on it at present. That is, the house a developer would build on the site today, not what he built at the start of the lease.

For example, if all the neighbouring houses have back additions or conservatories but the subject house does not, it would be reasonable to assume that if a house was to be built on the site it would also have the same back addition or conservatory. The valuer has to take the actual or non-existent improvements into account when valuing the house for site value purposes.

Therefore any improvements that have been carried out to the house should be taken into account in relation of what is reasonable for the area. For example, the improvements may comprise the installation of a bathroom and internal WC where none existed before. These would place the house in keeping with the average house in the street, assuming that they have also been brought up to the same standard (bearing in mind the requirement for a modern ground rent). In this case it would be quite legitimate to include the value of the leaseholder's improvements in the valuation.

The only way in which leaseholder's improvements should not be included is where they are of a nature to make the property substantially better than the average.

The Special Valuation Basis (market value)

The alternative method of valuation is rather different and is based on the reality that the freeholder will gain possession of a house and not a cleared site. The method also recognises the leaseholder's special interest in the purchase and this is applied as marriage value to be added to the open market value of the landlord's interest when the long lease expires.

Marriage value is a concept used by valuers to describe the increase in value produced when two interests in the same property, formerly owned by different people, come into the ownership of one person. For example, a house with, say, a 60-year lease may have an open market value of £100,000, whereas the same house, in the same condition, might be worth £115,00 if it was freehold. So on purchase of the landlord's interest in the house (the freehold), the value of the house would immediately increase from £100,000 to £115,000. Now, assuming the value of the landlord's interest in the freehold is £3,000, then the leaseholder will, in expending £3,000, make a 'profit' of £12,000 from the uplift in value of the house. It is this profit which is the marriage value and, in this case, the cost of the freehold would be the £3,000 plus half of the £12,000.

In the calculation of the marriage value the leaseholder's and freeholder's valuers will rely on local knowledge and experience to assess the increase in value in the house arising from acquisition of the freehold.

The Act requires that the marriage value should be shared equally between the leaseholder and the freeholder. No marriage value is payable in cases where the unexpired period of the lease is more than 80 years.

Again, valuation by the special valuation basis can be illustrated by an example:

> ***Example 2***
> ***A house with an unexpired term of 65 years and a rent of £50 a year. Its vacant possession value, with the 65 year lease, is estimated at £120,000.***

i) calculating the term

As in the previous example, the future ground rent income is capitalised to produce a value, based on what an investor would be prepared to pay for it.

Ground rent £50 per annum

Years Purchase for 65 years @ 7% (from tables) is 14.11

So, £50 x 14.11 = **£705**

The yield rate of 7% is the same as used in the previous example, although Tribunals are less reluctant to consider higher yields in special valuation basis calculations. In this light, it is worth saying a little more about the effect of varying the yield rate.

The valuer will estimate the assumed yield percentage from a close scrutiny of other transactions, particularly local freehold auction prices, calculating back the yield from evidence of what freehold investments have achieved in the open market. In effect, the valuer, being able to see from the particulars of auctioned properties the unexpired terms and the ground rents and knowing the prices actually paid, will be able to do the above calculation in reverse, producing an indicator of the yield percentage being achieved. It is important in analysing these transactions for the valuer to know the individual circumstances of the sale, as the information obtainable from the auction results may not always provide completely accurate evidence on which to base other calculations. This can lead to disagreement in estimates of yield percentage by opposing valuers working from the same local market information. The yield is a most important element in valuation and one likely to be the subject of difference between the leaseholder's and freeholder's valuers.

It should be borne in mind however that present ground rents are generally low and so their capitalised values are not greatly affected in real terms by the yield rate multiplier. Depending on the length of lease, it is the reversionary value which will be subject to the greatest variations according to yield rate.

ii) calculating the reversion

Unlike the previous method, there is now no assumption that the lease will be extended by 50 years. So, on expiry of the lease, the freeholder will receive the house with vacant possession and will be able to realise its full value. It is therefore necessary to estimate its freehold vacant possession value, deferred until the end of the existing lease.

It is in the nature of a leasehold tenancy for the value to diminish as the lease expires. Therefore, it can reasonably be assumed that, on acquisition of the freehold, the house will be worth more than it is on its present lease. How much more will be heavily dependent upon the unexpired length of the lease at the time of purchase and its general saleability; there are no hard fast rules for assessing the new value. It is this that the valuer will have to establish – the present leasehold value of the house and the potential freehold value, based on his research into sales of local comparable properties.

Although the valuer's figures are not based on a theoretical uplift in value, this is used as the basis of the example simply to demonstrate the principles.

For the purpose of the example, it is assumed that the acquisition of the freehold will produce an increase in value of 10%.

Improved value £120,000 + 10% = £132,000

A valuer may also account for the leaseholder's right to occupy the property after the lease has ended. The law provides that when a long lease expires the leaseholder can continue to occupy the property, under an assured tenancy, paying a market rent. This right can in some cases reduce the value of the freehold interest. This is ignored for the purpose of this example.

As with the previous example the full present value of the house is deferred to produce an investment value – what is the promise of £132,000 in 65 years time worth today? The multiplier, taken from tables, is applied at the same yield rate used for capitalising the rental income:

Present Value £1 deferred 65 years @ 7% = 0.0123

So, £132,000 x 0.0123 = <u>£1,624</u>

iii) the investment value of the freehold

The investment value of the freehold – the freeholder's interest – is therefore represented by the sum of the values of the term and of the reversion:

£705 + £1,624 = <u>£2,329</u>

and is the amount that the interest is likely to achieve in an open market sale.

iv) calculating the marriage value

As described earlier, marriage value is the increase in the value of the property following the completion of the enfranchisement or a lease extension. This reflects the additional market value of a longer lease or the freehold. In that this potential 'profit' only arises from the freeholder's compulsion to sell, the legislation requires that it be shared equally between the parties.

Taking the figures from the previous example above:

The improved value of the property is	£132,000
From this is subtracted:	
the leaseholder's present interest	£120,000
and:	
the freeholder's interest	£2,329
In this case the marriage value is	£9,671

With the 50:50 split between the freeholder and the enfranchising leaseholder, the leaseholder would have to pay half this figure – £4,835 – in addition to the value of the freeholder's interest.

In this example it can be seen that marriage value can considerably exceed the value of the freeholder's interest. Its calculation is dependent upon the relative values of the house with its present lease and the house after acquisition of the freehold and, clearly, the lower the gap between these values, then the lower will be the marriage value. This is an area where the input of a valuer with local knowledge is of paramount importance to both parties in order to provide substantive comparable evidence of the local market and how, if at all, house values will be affected.

As the length of the current lease increases, so the difference between its value and the freehold value becomes smaller until eventually the marriage value disappears.

v) exclusion of leaseholder's improvements

In calculations under the special valuation basis any additional value in the property arising from improvements by the leaseholder should be ignored; the leaseholder should not pay any additional premium in respect of value added by improvements carried out at his own expense, or that of a predecessor to the lease.

vi) completing the valuation

The purchase price for the freehold is, therefore, the sum of the values of the freeholder's interest and the equal share of the marriage value:

Landlord's interest	£2,329
Marriage value x 50%	£4,835
	= £7,164

The area for difference between the parties will be obvious from the example: the potential increase in the value of the house after enfranchisement.

The role of the valuation surveyor

Given the complexity of the leasehold reform legislation it is important to have good professional advice. A valuer can offer assistance in the following areas:

i) to advise on whether the leaseholder qualifies under the Leasehold Reform Act and the basis for valuation;

ii) to carry out the valuation;

iii) to advise on the possible purchase price, based on experience and preparation of 'best and worst case' valuations;

iv) to advise on the offer to be made to the freeholder in the Notice of Claim;

v) to advise on the response to the freeholder's Counter-Notice;

vi) to conduct negotiations with the freeholder on behalf of the leaseholder;

vii) to provide expert evidence at the Leasehold Valuation Tribunal.

You would be prudent to consult a valuer who is a qualified surveyor – a fellow or associate of the Royal Institution of Chartered Surveyors.

Not all surveying practices specialise in this kind of work and you should make careful enquiries relating to the practice's experience of the legislation before proceeding. Advice on local practices can be obtained from the professional body referred to above or from the list of surveyors produced by LEASE.

Summary

1. Qualification requirements

To be a qualifying leaseholder you must:

- have a long lease

or

- have a lease which was originally granted for a term of more than 35 years unless it is covered by the rural exclusion* or is a shared ownership lease granted by a registered social landlord or, in some cases, by a local authority;
- have the lease of the whole house;
- have owned the lease for two years (or periods amounting to two years in the last 10);

* the rural exclusion relates to a house which is within an area designated as a rural area and the freehold of the house is owned together with adjoining land which is not occupied for residential purposes. Information about rural area designation is available from local Leasehold Valuation Tribunals.

Where the leaseholder of the whole house is a head-lessee of a house divided into flats let on long leases, then the leaseholder (head-lessee) does not qualify unless he or she lives in a flat in the house and has done so for two years (or periods amounting to two years in the last 10).

2. Long leases

A long lease is:

- a lease of a term of years absolute in excess of 21 years* from the date of grant (the lease runs from the date of grant not from the commencement date of the term);
- a shorter lease which contains a clause providing a right of perpetual renewal;
- a lease terminable on death or marriage or an unknown date (including the so called 'Prince of Wales' clauses);
- a shared ownership lease where the leaseholder's share is 100%.

* The present unexpired term is not relevant, qualification is governed by the original term of the lease when first granted.

3. How to establish which valuation method should be used

Most houses qualifying under the legislation will be valued according to the **Special Valuation Basis**, including marriage value.

For the house to be eligible for the **Original Valuation Basis** (site value) it will need to meet the following qualifications, based on rent and values, plus the further value limit:

i) The original low rent test*

- Leases granted before 1 April 1990 – the annual ground rent, payable on the date of service of the Tenant's Notice and for the two years previous qualifying period, must be less than two-thirds of the rateable value of the house on the latest of these dates:

  a) 23 March 1965

  or

  b) the first day the house appeared in the valuation list

  or

  c) the first day of your lease

but if the lease was granted between 1 September 1939 and 31 March 1963, the rent must also be less than two-thirds of the letting value. It is up to your landlord to show if this test applies.

- Leases granted on or after 1 April 1990 – the rent on the day you serve your notice on the landlord must be less than £1,000 in Greater London or £250 elsewhere. (Your local authority will be able to provide the rateable value details, but only a valuation surveyor can advise you on letting values).

* The original low rent test has been abolished for eligibility for right to acquire, but still plays a part in setting the means of valuation.

ii) Value limits

These are dependent upon when your lease was granted.

- **if your lease was granted on or before 8 February 1966:**

  a) if your house first appeared in the rating list before 1 April 1973, its rateable value on 23 March 1965, or on the first date it appeared in the rating list, if later, must not have been more than £400 in Greater London or £200 elsewhere;

  or

  b) if the house first appeared in the rating list on or after 1 April 1973, its rateable value on the first day it appeared on the list must not have been more than £1,500 in Greater London or £750 elsewhere.

- **if your lease was granted after 18 February 1966 but before 1 April 1990:**

  a) if your house first appeared in the rating list before 1 April 1973, its rateable value on 23 March 1965, or on the first day it appeared on the rating list, if later, must not have been more than £400 in Greater London or £200 elsewhere;

  or

  b) if your house first appeared in the rating list on or after 1 April 1973, its rateable value on the first day it appeared on this list must not have been more than £1,000 in Greater London or £500 elsewhere.

- **if your lease was granted on or after 1 April 1990 then you must first work out the value of R using the following formula:**

  $$R = \frac{P \times I}{1-(1+I)^{-T}}$$

  P is the purchase price paid when the lease was granted (if none was paid, P is 0)

  I is 0.06

  T is the number of years granted by the lease

  R must not be greater than £25,000.

iii) Further value limits

Where the house satisfies all of the above qualifications, it will qualify under Section 1, but must meet the following further limits to be valued by the original valuation basis:

- if your house had a rateable value on 31 March 1990, the rateable value must have been below £1,000 in Greater London or £500 elsewhere.
- if your house did not have a rateable value on 31 March 1990, the value must be no more than £16,333 for **R**, using the formula above.

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The Leasehold Advisory Service

31 Worship Street, London EC2A 2DX
Tel: 0845 345 1993 or 020 7374 5380 Fax: 020 7374 5373
Email: info@lease-advice.org Website: www.lease-advice.org