

## CHAPTER 8

### GRANTS OF LEASES

#### 8.1 Introduction

The grant of a lease is the creation of a new asset. If an individual who owns the freehold of a property grants a lease to a tenant, the tenant has a right of occupation of the freeholder's property for a specified period of time. In essence, the freeholder has created a new asset. The new asset - i.e. the lease - has been brought into existence for the first time.

In return for being granted a right of occupation, the tenant will pay the freeholder a sum of cash. This sum is called a "premium". The premium is a capital sum and will be charged to capital gains tax in the hands of the freeholder. The way we calculate the capital gain, is by **treating the grant of a lease as a part disposal of the freehold**.

[TCGA 1992, s. 42](#)

There are two different rules to consider here, and the way we calculate the capital gain **depends on whether the lease granted is a long lease or a short lease**. A long lease is a lease in excess of 50 years. A short lease is a lease of 50 years or less.

#### 8.2 Granting a long lease

Where a freeholder grants a lease to a tenant, and that lease gives the tenant the right to occupy the property for more than 50 years, we calculate the capital gain using the normal part disposal formula.

[TCGA 1992, s. 42\(2\)](#)

$$\text{Allowable cost} = \frac{A}{A+B} \times \text{acquisition cost}$$

"A" = the gross amount of the premium paid.

"B" = the value of the remainder (the "reversion" or the "reversionary interest").

This reversion consists of two things. The first is the capital value of the property when it reverts back to the freeholder - ie, when the lease has expired. The second is the right to receive future rents under the lease.

[TCGA 1992, Sch 8 para 2](#)

#### Illustration 1

Eric purchased the freehold of a property for £60,000 in January 1987. In December 2010 he grants a lease to a tenant called Ernest. The lease gives Ernest the right to live in Eric's property for the next 60 years. In return for the grant of the lease, Ernest pays Eric a premium of £100,000. Eric incurs legal fees in connection with the drafting of the lease of £2,000. The value of the freehold reversion in December 2010 is £150,000.

The calculation of Eric's capital gain on the grant of this long lease will be as follows:

	£
Gross premium	100,000
Less: legal fees	<u>(2,000)</u>
	98,000
Less: cost	
60,000 × $\frac{100,000}{100,000 + 150,000}$	<u>(24,000)</u>
Gain	<u>£74,000</u>

### 8.3 Granting a short lease

The way we calculate the capital gain on the grant of a short lease, is slightly more complicated. Under the property income rules, if a landlord receives a premium for the grant of a short lease, **part of that premium is chargeable** to income tax as property income. The **remainder of the premium is chargeable to capital gains tax**, ie

[ITTOIA 2005, s. 277](#)

$$\text{Capital element} = 2\% \times (N-1) \times P$$

"P" is the premium received

"N" is the number of years of the lease.

Having identified the amount of the premium that is chargeable to capital gains tax, we calculate the resulting capital gain using the part disposal rules, but this time we change the part disposal formula very slightly.

[TCGA 1992, Sch 8 para 5](#)

#### Illustration 2

Eric bought a freehold property for £60,000 in January 1987. Eric grants a lease to Ernest in December 2010, giving Ernest a right to occupy Eric's house for the next 40 years. Eric has therefore granted a short lease to Ernest. Ernest pays a premium of £100,000. Eric incurs legal fees of £2,000 on the grant of the lease and the freehold reversion is valued at £150,000 in December 2010.

Remember, when a freeholder grants a short lease to a tenant, part of the premium is chargeable to income tax as property income. Therefore the first thing we need to do is to **split the premium** of £100,000 into its income tax and CGT components.

$$\text{Capital element} = 2\% \times (40-1) \times £100,000 = £78,000$$

This will leave £22,000 of the premium chargeable to income tax as property income in 2010/11. This "capital" figure of £78,000 will be the proceeds of sale for CGT purposes.

We next calculate the allowable cost. The grant of a lease out of a freehold, is treated as a part disposal. However when we are dealing with the grant of a short lease, we use a slightly modified formula:

$$\frac{a}{A+B} \times \text{acquisition cost}$$

"A" and "B" are the same as before - i.e. the gross premium and the capital value of the reversion. However the "a" in this formula is the part of the premium which is chargeable to capital gains tax.

The calculation of the gain will therefore be as follows:

		£
Capital element of premium		78,000
Less: legal fees		<u>(2,000)</u>
		76,000
Less: cost		
60,000 ×	$\frac{78,000}{100,000 + 150,000}$	
		<u>(18,720)</u>
Gain		<u>£57,280</u>

**Example 1**

Abigail paid a premium of £25,000 to Nigel in August 2010 upon the grant of a 55 year lease on a shop from which Abigail intends to trade.

Nigel had bought the shop in 1980 for £20,000. It was worth £22,000 in March 1982. The freehold reversion was valued at £75,000 in 2010.

**Calculate Nigel's chargeable gain in August 2010.**

**Example 2**

Rory bought a flat in South London for £95,000 in September 1991. In September 2010 he granted a 12 year lease to Natalie for a premium of £16,000.

The freehold reversion was valued at £94,000 in September 2010.

**Calculate Rory's chargeable gain on the grant of the lease.**

**Answer 1**

Grant of long lease = normal part disposal

	£	
Premium	25,000	
Less: 1982 value		
22,000 × $\frac{25,000}{25,000 + 75,000}$		<u>(5,500)</u>
Capital gain		<u>19,500</u>

**Answer 2**

Capital element = 2% × (12-1) × £16,000 = £3,520

	£	
Proceeds	3,520	
Less: cost		
£95,000 × $\frac{3,520}{16,000 + 94,000}$		<u>(3,040)</u>
Capital gain		<u>£480</u>