# CHAPTER 9

# GRANTS OF LEASES – ADVANCED ASPECTS

## 9.1 Duration of Leases

TCGA 1992, Sch 8 Para 8

The lease period is usually obvious and is determined from the contract – ie, the lease agreement. Leases will be for a finite period, and that period will be agreed when the contract is signed. However, for tax purposes, a lease may be deemed to have come to an end at a date earlier than that stipulated in the lease agreement.

A lease will end, for tax purposes, **on the first date at which the landlord has a legal right to terminate the lease.** For example, if a tenant signs a 10 year lease but the landlord has the right to terminate the lease contract after 8 years, for tax purposes we have an 8 year lease.

A lease is also deemed to come to an end on the first date beyond which the agreement is unlikely to continue. For example, if a tenant signs a 20 year lease, but the landlord has the right to, say, treble the rents after 5 years, it is unlikely that the lease will continue beyond 5 years, therefore we have a 5 year lease for tax purposes.

These rules will impact on our tax computations as we shall see below.

**Illustration 1**

Assume a landlord grants a 30-year lease on a property to a tenant, for a premium of £50,000.

The lease agreement contains a clause whereby the landlord may bring the lease to an end after 20 years. The lease also permits the landlord to double the rents due under the lease after 10 years. For tax purposes, as the lease is unlikely to continue beyond the date on which the rents are increased, we have a 10 year lease.

Therefore when calculating the amount of the premium which is taxable as property income, we use a lease period of 10 years in the formula. By using a shorter lease period, a greater proportion of the lease premium is charged to income tax as property income.

| | |
|---|---|
| Premium | P |
| Less: 2% x P x (10 – 1) | (C) |
| Taxable property income | X |

## 9.2 Enhancement expenditure – long leases

If a taxpayer acquires a property under the terms of a lease, then subsequently incurs expenditure in enhancing the value of the property – for example by adding a garage or conservatory - this **enhancement expenditure must be accounted for** when calculating the gain on the eventual sale of the lease.

If, at the point of the disposal, the lease has more than 50 years left to run, **the whole of the enhancement expenditure can be deducted** in arriving at the capital gain. This fits with the general principle that the way we calculate gains on the disposal of a long lease, is the **same as we calculate gains on normal assets**.

## 9.3 Enhancement expenditure – short leases

The position is different if the lease had 50 years or less to run at the date of disposal.

Where a short lease is sold, allowable costs are **restricted by applying the lease depreciation percentages** in Schedule 8 TCGA 1992. The same principle applies to restrict the allowable element of any enhancement expenditure. In this instance, the **allowable proportion** of any enhancement expenditure is determined by:

$$\text{Enhancement expenditure} \times \frac{S}{PE}$$

where

**"S"** = the number of years the lease had left to run at the date of the **disposal**; and

**"PE"** = the number of years the lease had to run **when the enhancement expenditure was incurred.**

Having determined the years, the percentages can be extracted from Schedule 8.

**Illustration 2**

Martin acquired a 45-year lease on a property (non-business asset) on 1 April 1996. The lease cost £100,000. On 1 April 2005, Martin enhanced the property at a cost of £20,000. Martin sold the lease on 31 March 2011 for £275,000.

As we are dealing with the assignment of a short lease, we must first identify the relevant depreciation percentages.

These are as follows:

| *Date* | *Years remaining* | *% per Schedule 8* |
|---|---|---|
| 1 April 1996 | 45 | 98.059 |
| 1 April 2005 | 36 | 92.761 |
| 31 March 2011 | 30 | 87.330 |

| Capital gains computation; | £ |
|---|---|
| Proceeds | 275,000 |
| Less: original cost | |
| $£100{,}000 \times [\frac{30}{45}]\frac{87.330}{98.059}$ | (89,059) |
| Less: enhancement expenditure | |
| $£20{,}000 \times [\frac{30}{36}]\frac{87.330}{92.761}$ | (18,829) |
| Gain | 167,112 |

## 9.4 Grant of short lease from a short lease

TCGA 1992, Sch 8 Para 5

**Special** rules exist to calculate the capital gain when a **short sub-lease** is granted out of a **short head lease**.

Assume a taxpayer purchased a **40-year** lease on a property on 1 January 1992. The lease will **expire** in January 2032, at which point the right to **use** the property will revert to the **freeholder.**

The taxpayer decides to **sub-let** the property, and on 1 **January 2011** he grants a **10 year sub-lease** to another tenant. The **new** tenant therefore has a right to **occupy** the property until **January 2021**. The **grant** of a lease is a **disposal** for CGT purposes, therefore we need to calculate the **capital gain** arising on the grant of this 10-year sub-lease in January 2011.

Firstly, when a **short lease is granted**, **part** of the premium received by the grantor will be **charged to income tax** as property income as below:

| | |
|---|---|
| Premium | P |
| Less: 2% x P x (10 – 1) | (C) |
| Taxable property income | X |

The grant of a short lease is treated as a **part disposal** for CGT purposes. However, because this is a part disposal of a lease with 50 years or less to run, when calculating the gain we must **restrict the allowable cost** by using the depreciation table in Schedule 8. The grant of a short lease out of a short head-lease, therefore involves the **interaction of the grant and assignment rules** covered previously.

We **restrict** allowable cost for CGT purposes by using a new formula as below:

$$\text{Cost} \times \frac{s - x}{y}$$

Where:

s = % for years of head-lease remaining at grant of sub-lease
x = % for years of head-lease remaining when sub-lease expires.
y = % for years of head-lease remaining at date of acquisition.

**Illustration 3**

Mark acquired a 40 year lease in January 1992 costing £50,000. The lease will expire in January 2032.

In January 2011, Mark granted a 10-year sub-lease to a tenant for a premium of £25,000. The sub-lease will expire in January 2021. We need to calculate the capital gain on the grant of the short lease by Mark in January 2011.

First, as Mark has received a premium in return for granting a short lease, part of the premium will be taxed as property income. This is as follows:

| | £ |
|---|---|
| Premium received by Mark | 25,000 |
| Less: Capital element | |
| 2% x £25,000 x (10-1) | (4,500) |
| Property income 2010/11 | £20,500 |

Next we turn our attention to the capital gain. The allowable base cost for Mark will be:

$$\text{Premium paid by Mark} \times \frac{s - x}{y}$$

where:

| | | *Years* | % |
|---|---|---|---|
| "s" = | years remaining at grant of sub-lease in January 2011 | 21 | 74.635 |
| "x" = | years remaining at expiry of sub-lease in January 2021 | 11 | 50.038 |
| "y" = | years remaining at acquisition of head-lease in January 1992 | 40 | 95.457 |

The gain is as follows:

| | £ |
|---|---|
| Proceeds | 25,000 |
| Less: cost | |
| $\pounds 50{,}000 \times \left[\frac{21 - 11}{40}\right] \frac{74.635 - 50.038}{95.457}$ | (12,884) |
| Gain | 12,116 |

We need to recognise that **some** of the premium (ie £20,500) will have been charged to **income tax** in 2010/11. Therefore if we charge the full amount of the premium to capital gains tax, we are **double taxing** the premium. This must be **deducted** from the chargeable gain:

| | £ |
|---|---|
| Gain | 12,116 |
| Less: charged as property income | (20,500) |
| Chargeable gain | NIL |

This has the effect here of reducing the gain to zero. It is important to note that if this happens, **no capital loss is created and there is no possibility of any income tax or CGT being repaid**. Indeed it is quite common for this computation to produce a capital gain of zero because, where the sub-lease is very short, the majority of the premium will be charged to income tax leaving only a very small capital element.

## 9.5 "Excessive" rents under sub-lease

TCGA 1992, Sch 8 Para 4

Where a lease is **granted**, the tenant will pay an **initial premium** for the lease, plus an annual rent under the lease agreement. The **premium** is chargeable to **capital gains tax** and, in some instances, **to income tax as well**. Therefore, if the premium can be **reduced**, this will have the effect of **decreasing the capital gain** (and sometimes the income tax) when the lease is granted. The landlord may therefore be prepared to accept a lower initial premium in return for higher annual rents in order to avoid CGT.

There is an **anti-avoidance** rule at TCGA 1992 Schedule 8 paragraph 4 which applies where a sub-lease is granted, and **the rents under the sub-lease exceed the rents due under the original head lease.** If this is the case, when calculating the capital gain on the grant of the sub-lease, the **allowable base cost** for CGT purposes is **reduced** as follows:

$$\text{Cost} \times \frac{\text{Actual premium}}{\text{Notional premium}}$$

where the **"notional premium"** is the premium that would have been payable by the tenant if the rents under the new sub-lease were the same as those due under the original head-lease.

**Illustration 4**

Rose grants a 20-year lease in August 2006 to a tenant, Jack. Jack paid a premium of £25,000. Annual rents under the lease were agreed at £3,000.

On 2 August 2010, Jack granted a 10-year sub-lease to Kate. Kate paid Jack a premium of £10,000, and annual rents of £4,500 per annum were agreed.

As Jack has received a premium for the grant of a short lease, part of this premium is charged to income tax as property income. Jack will also have a capital gain, as he has granted a short lease from an existing short head-lease.

The rents due under the new sub-lease are higher than those under the original head lease. Therefore when calculating the allowable base cost for CGT purposes, the anti-avoidance rule in Schedule 8 paragraph 4 will have to be applied.

If the rents under the new sub-lease would have been £3,000, the premium paid by Kate to Jack for the grant of the new lease would have been £15,000. This "notional premium" will be used to calculate the CGT base cost.

| | |
|---|---|
| Property Income | |
| Rose (2006/07): | £ |
| Premium received August 2006 | 25,000 |
| Less: 2% x £25,000 x (20-1) | (9,500) |
| Property income for Rose | £15,500 |
| | |
| Jack (2010/11): | £ |
| Premium received August 2010 | 10,000 |
| Less: 2% x £10,000 x (10 – 1) | (1,800) |
| | 8,200 |
| Less: allowance for premium paid | |
| $£15{,}500 \times \frac{10}{20}$ | (7,750) |
| Property income for Jack | £450 |

As Jack was granted the lease from Rose, part of the premium he paid was charged to income tax on Rose in 2006/07. As illustrated above, Jack will receive **a deduction for part of the premium he paid.** There was no extra deduction for the amount paid for the lease in illustration 3 as the original head-lease was assigned not granted.

The capital gain charged on Jack is calculated as follows:

| | £ |
|---|---|
| Premium received | 10,000 |
| Less: base cost | |
| $£25{,}000 \times [\frac{s-x}{y}] \times \frac{\text{Actual premium}}{\text{Notional premium}}$ | (x) |
| Gain | Gain |

where:

| | | Years | % |
|---|---|---|---|
| "s" = | years remaining at grant of sub-lease in August 2010 | 16 | 64.116 |
| "x" = | years remaining at expiry of sub-lease in August 2020 | 6 | 31.195 |
| "y" = | years remaining at acquisition of original head-lease in August 2006 | 20 | 72.770 |

| | £ |
|---|---|
| Premium | 10,000 |
| Less: base cost | |
| $£25{,}000 \times [\frac{64.116 - 31.195}{72.770}] \times \frac{10000}{15000}$ | (7,540) |
| | 2,460 |
| Less: charged as property income | (450) |
| Gain | £2,010 |

At the end of this chapter is a white summary box containing a leases summary of the main aspects from all the lease chapters.

**Example 1**

Stuart granted a 30 year lease to Suzanne on 1 July 2007 for a premium of £37,500. On 1 July 2010, Suzanne granted a 20 year lease to Sophie for a premium of £30,000. The rents remained the same.

**Calculate Suzanne's chargeable gain.**

**Answer 1**

| | £ |
|---|---|
| Premium | 37,500 |
| Less: 2% x £37,500 x (30-1) | (21,750) |
| Property income 2007/08 | £15,750 |

| | £ |
|---|---|
| Premium | 30,000 |
| Less: 2% x £30,000 x (20-1) | (11,400) |
| | 18,600 |
| Less: allowance for premium paid | |
| $£15{,}750 \times \frac{20}{30}$ | (10,500) |
| Property income 2010/11 | £8,100 |

| Capital gain: | £ |
|---|---|
| Full premium (July 2010) | 30,000 |
| Less: cost | |
| $£37{,}500 \times [\frac{27 - 7}{30}] \times \frac{83.816 - 35.414}{87.330}$ | (20,784) |
| | 9,216 |
| Less: Property income (above) | (8,100) |
| Gain | £1,116 |

**Note**

There is an extra deduction of £10,500 as in this example we have a grant of a short sub-lease from the original **grant** of a short head-lease.

The formula to calculate the allowance for the premium paid is as follows:

$$\text{Property income on the head-lease} \times \frac{\text{Length of sub-lease}}{\text{Length of head-lease}}$$