

# A Pocket Guide to Lease Transactions



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## Introduction on this Guide

This booklet will give you an overview on a leasing transaction involved in acquiring commercial property in the UK. The process can be lengthy and on occasions complex however it will be necessary and essential to instruct solicitors at an early stage to avoid certain pitfalls.

This is not a full interpretation of the law, but rather a checklist of the major issues you should be aware of.

## Basic Understanding of Leasehold Property in the UK

In England and Wales there are two ways in which a property can be held, freehold and leasehold. A freehold interest means owning the property outright. A leasehold interest means an interest granted by a landlord to a tenant for a defined period of time, usually in return for a payment of rent. The document that governs the relationship between a landlord and tenant is known as a lease.

Office space is usually offered for lease rather than freehold sale. The vast majority of commercial properties are held under leases ranging from 12 months to 99 years.

### Headleases and Underleases

A headlease is a lease granted out of the freehold and an underlease is one granted out of a headlease.

There may be any number of underleases (sometimes described as sub-underleases, sub-sub-underleases and so on), but each underlease must expire before the one out of which it is granted.

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# Preliminary Matters to Consider

## Foreign Companies

There is no restriction on foreign ownership of properties in England and Wales. However, the capacity of a foreign company to enter into a lease or contract in England and Wales may be restricted by its constitution.

Landlords prefer a tenant to be incorporated and registered in the UK because enforcement will be an easier process. We can assist you in setting up a UK entity, if required.

## Exclusivity Agreements

Once you have located a property you may want to consider entering into an exclusivity (or lock-out) agreement in which, for a short period of time, you are granted exclusive negotiating rights. Whether or not this is necessary will depend on the state of the market and whether the property is in high demand.

## Rent Deposits and Guarantees

Regardless of whether you decide to take the lease in the name of your foreign company or a newly incorporated UK entity, it is likely that the landlord will require additional security. This may be waived if you are able to show sufficient covenant strength, normally through the disclosure to the landlord of your financial accounts showing a sufficient level of profit.

Additional security is likely to be in the form of a rent deposit, guarantee or a combination of both.

Rent deposits are arrangements under which you will deposit a sum of money (usually equal to six months' rent) with the landlord (or into a designated bank account) on which the landlord can draw if you fail to pay the rent or any other payments due under the lease. The terms of the deposit will be reflected in a Rent Deposit Deed which will be an ancillary document to the lease.

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With lease guarantees, the guarantor could be the parent company where the lease is granted to a newly incorporated UK entity or company shareholders/directors who then have personal liability. Generally we would advise company shareholders/directors against giving lease guarantees as they would then be personally liable for any non-payment of rent or other payments under the lease by the tenant and if the lease is for any reason disclaimed the personal guarantor may be required to take a new lease from the landlord for the residue of its contractual term.

### **Licences for Alterations/Fitting-Out Works**

Many leases will restrict your ability to make alterations to the property. A common restriction is that alterations to the exterior and/or structure of the property are prohibited but non-structural alterations to the interior are allowed, with the landlord's consent.

It will be an important business issue for you to be able to have the property configured for your needs. If therefore fit-out works are required to be carried out you should agree the works in principal in the Heads of Terms. During the legal process you will need to provide to the landlord a full specification of the works and plans which will form part of an ancillary document to the lease known as a Licence for Alterations.

### **Wayleave Agreements**

If your internet provider needs to install and retain cabling or equipment through the building in order to provide you with an internet supply, an additional document known as a Wayleave Agreement will need to be negotiated and entered into between your internet provider, the landlord and yourself. The time in which it takes to complete a Wayleave Agreement can differ depending on the circumstances of the contract and the cooperation of the internet provider and the landlord. However, it is something to consider at the early stages of the leasing process in order to ensure that the Wayleave Agreement does not delay completion of the Lease.

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## Step One - Heads of Terms

Heads of terms are used by the parties to determine the overall scope of a transaction and to record the main points of principle and commercial matters. The aim of heads of terms is to agree the important deal-making terms. Therefore once you have located a suitable property you wish to acquire you will need to negotiate with the landlord or their appointed agent the terms of the lease which will result in the Heads of Terms being drawn up.

It is at this stage when negotiating the Heads of Terms that we would always advise you to instruct a solicitor and surveyor so that guidance and advice can be obtained on the key terms of the lease so as to avoid certain pitfalls. Once the Heads of Terms have been agreed it is then often too late for the solicitor to negotiate a change in the terms of the lease.

### **Standard matters covered by heads of terms are:**

- A description of the property to be leased.
- The term of the lease and whether there are any break clauses.
- The Landlord & Tenant Act 1954 status of the lease. See comments below on 'contract out'.
- The annual rent and any rent-free period and the rent review pattern.
- Whether any additional security is to be given, such as a rent deposit or a guarantee. See comments below.
- Responsibility for insurance, repairs and service charges.
- The permitted use of the property. Your solicitors will check that the premises is legally authorised by the Local Authority to be used for the purpose permitted in the Lease.
- Restrictions on alterations and alienation. We have commented below on alterations. The alienation clause will govern what future dealings with the property are authorised and those which are not. It is normal for the assignment or subletting of part only of the property to be prohibited however assignment or subletting of the whole of the property should be allowed subject to the usual conditions.

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## Salient factors to consider when agreeing Heads of Terms

1. Tenants increasingly prefer shorter leases and on average commercial lease terms are getting shorter. There are a number of reasons for this, including a desire for flexibility, favourable Stamp Duty Land Tax position if a tenant takes a lease with a shorter initial term and changes to lease registration brought about by the Land Registration Act 2002, meaning that there is no requirement to register a new lease granted for a term not exceeding seven years.

If the landlord is insisting on a long term for the lease you should consider seeking a break clause to enable you to terminate the lease early. For example, if the lease is for a term of 10 years you should seek a break clause at the end of the fourth or fifth year.

2. With regard to the initial rent for the property it is recommended that you seek advice from a surveyor to ensure that you are not paying over the odds for the property. Paying a premium rent may have an adverse effect on the future marketability of the Property and therefore your ability to assign the lease.
3. Try to negotiate a rent free period at the start of the lease. A common reason for seeking a rent-free period is to allow the tenant to fit out the property or carry-out alterations for its use. It is fairly common to see a rent free period of 3 to 6 months.
4. For short term commercial leases the landlord will probably want to 'contract out'. Although this is fairly common it is important that you understand what this means. A 'contract out' lease means that the tenant will not have its statutory rights to renew its tenancy under the Landlord and Tenant Act 1954 once the lease comes to an end. Unless the landlord offers the tenant a new Lease the tenant will have to vacate the property and terminate its business from it.

The decision to contract out will have a bearing on how the lease is drafted and how certain terms are negotiated. For this reason, the decision to contract out should be made at the start of negotiations for the tenancy and should be recorded in the Heads of Terms.

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5. A service charge is a mechanism contained in a lease that allows the landlord to recover their running costs from the tenants. Such running costs may include works to the structure of the building, cleaning of common areas, management fees etc. The service charge will normally be calculated on the amount of floor space you occupy. So for example if you occupy 10% of the total floor space in the building, your service charge will equate to 10% of the annual service charges costs. Service charges will vary year to year, however, it is possible to negotiate with the landlord that the service charge be capped, so that there is a restriction on the amount that can be charged in each service charge year. This enables the tenant to anticipate the maximum that can be charged. It is important that you inspect the last 3 years' actual service charge accounts so as to ensure that you are comfortable with the level of the service charges levied for that building.
  6. Dilapidations generally refers to items of disrepair that are covered by repairing covenants contained in a lease.

It is highly likely that the wording of the repairing covenant in the lease will be to 'keep the premises in repair'. This means that the tenant will be under an obligation to return the property to the landlord in a good state of repair and decoration, notwithstanding what condition the property was in at the start of the lease. At the end of the lease term, tenants are therefore often shocked to find themselves in a situation whereby the landlord has served a dilapidations order requiring they undertake repairing and decorative works to hand back the property in a better state than it was at the beginning of the lease. Such costs can be excessive.

You should seek to limit your repairing obligation to keeping the property in the same state of repair as it is at the grant of the lease. This can be achieved through preparing a schedule of condition which is attached to the lease to show the state and condition of the property at the date the lease is entered into. The schedule of condition should be prepared by your surveyor.
  7. If you are proposing to undertake alterations to the property you should ensure that the landlord consents to such works in the Heads of Terms. You will need to provide to the landlord a full specification of the works and plans.

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## Outline of a straightforward transaction

In conveyancing terms, the grant of a lease is the acquisition of an interest in land by the tenant. In a simple transaction:

1. Preliminary documents, such as heads of terms, will be dealt with, not always by the lawyers, however it is at this stage that we recommend that you instruct a solicitor and surveyor.
2. The draft lease and any ancillary documents to be entered into by the landlord and tenant are produced by the landlord's lawyers.
3. The tenant's lawyers investigate title to the property and carry out relevant searches and enquiries. The tenant and its surveyors arrange any inspections and surveys.
4. The terms of the lease and the other documents are negotiated and settled.
5. There may be an 'Agreement for Lease' to be exchanged.
6. Pre-completion searches are carried out by the tenant's lawyers, including a Land Registry priority search where relevant.
7. Engrossments of the documents are circulated for execution, having been prepared by the party who produced the draft.
8. Completion of the grant takes place. Other ancillary documents, such as rent deposits and licences for fitting-out works, will usually be completed at the same time as the lease.
9. Post-completion matters are dealt with such as submission of a Land Transaction Return and payment of SDLT and registration of the lease or the easements in the lease at the Land Registry.

It is difficult to give an exact timeframe for the legal procedure to be completed. In our experience a leasing transaction can usually take between 6 to 8 weeks to reach completion.

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## Step Two - Due Diligence

A full investigation of the property will cover:

### Title investigation

We will examine the official copies of the landlord's title register, the title plan and any documents which are referred to on the register. If, during the course of investigating the landlord's title, there are any matters that are not clear or are not satisfactory, further enquiries will be raised with the landlord lawyers. The purpose of investigating the landlord's title is to ensure that the landlord has been right to grant the lease and to ensure that there are no easements, covenants or other rights which might affect the tenants use and enjoyment of the property.

### Enquiries of the landlord

Part of the process of investigating a commercial property involves raising pre-contract enquiries about the property. There is no prescribed form for pre-contract enquiries in relation to commercial properties. However, the Commercial Property Standard Enquiries (CPSE) are now the industry-standard for commercial transactions. The CPSE are a suite of documents prepared by the London Property Support Lawyers Group and endorsed by the British Property Federation. They contain over 100 questions concerning such matters as boundaries, contents, utilities and services, fire certificates and means of escape, planning and building regulations etc.

### Searches and enquiries of statutory bodies and other third parties

Various searches may need to be carried out as part of an investigation of a property. What searches are undertaken will depend on the type of property that is being leased and its location. Generally the following searches are undertaken:

- a. A local authority search. This will reveal important information about the property and its immediate surroundings, such as planning consents, building regulations, proposals for road schemes and environmental notices. The search takes the form of a set of standard enquiries addressed to the local authority for the area in which the property is situated and is combined with the local land charges search. The local authority search should be done as part of every property investigation.

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- b. The Drainage and Water Search. This is in a standard form and is raised directly with the relevant Water Service Company. The replies will reveal important information about the water and drainage services at the property under investigation.
  - c. A Commercial Environmental Search. This search is undertaken to establish the risk of land being contaminated.

### **Survey or Schedule of Condition**

Whilst there is no obligation to obtain a survey it is always recommended. The principle of caveat emptor (buyer beware) applies, so the tenant will take the property in the physical condition that it is in. A survey should identify present physical defects in the property including structural defects, warn of potential structural problems and major and minor repair works that may be needed in the near future. It should also warn of factors that may indicate third party rights, confirm whether the actual physical boundaries correspond with the boundaries shown in lease and warn of issues, of which the surveyor may have local knowledge that may affect the decision to take the lease - for example, the existence of rivers or rail links or planning proposals.

As stated above, a survey or schedule of condition can prove useful to reduce the tenant's liability under the repairing covenant in the lease.

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## **Step Three - Negotiation and Settlement of the Documents**

The tenant's lawyers will seek to amend and negotiate changes to the lease aiming to make its provisions more tenant-friendly. This can be a time consuming process as it is quite normal for a lease to consist of 50 or more pages. The supplemental documents will also need to be perused and amended to ensure that its terms are not overly onerous.

### **The Agreement for the Lease**

It is not necessary to have an Agreement for Lease and many leases are entered into without one. Agreements for Lease tend to be used where there is a time gap between the terms of the lease being agreed and the lease being granted and where one or both of the parties needs the certainty of a contract. A typical example of where an Agreement for Lease may be used is where there will be a delay because outstanding construction works need to be completed by the landlord before the lease can be granted.

### **Rent Deposit**

DeedThis Deed records the amount of deposit to be held by the landlord as security and the circumstances in which the landlord can draw on the money if the landlord considers the tenant to be in default under the lease covenants. Typically, a rent deposit would be the equivalent of 6 to 12 months of the annual rent.

### **Licence for Alterations**

Under the term of this Licence, the landlord will consent to you carrying out the works you require to the property. As mentioned already you will need to provide to the landlord full specifications of the works as well as plans. Your surveyor will be able to assist you in this respect. It is important to note that under the terms of this Licence the landlord may require that you remove the works at the end of the lease term and reinstate the property to the condition and layout it was prior to the execution of the works.

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## Step Four – Post-completion matters

Once a lease has been granted, the following issues must be dealt with:

### Stamp Duty Land Tax ('SDLT') and Land Transaction Returns

The grant of a lease will be notifiable to HMRC for SDLT purposes and the tenant will have to submit a land transaction return, unless it falls within an exempt category e.g. disadvantaged areas relief, if the property falls within one of nearly 2,000 disadvantaged areas, transfers to charities, transfers between public bodies.

We have commented further below on the SDLT rates.

### Registration

- (a) Substantive registration will be required if the lease is granted for a term of more than seven years.
- (b) Noting of lease on the superior title will be required if the lease is for more than three years but no more than seven. Once noted, the lease will have overriding status meaning that the landlord's Title will be subject to the lease even though it does not appear in the register.
- (c) Registration of easements in leases is required for leases of no more than seven years.

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## Taxation

The main taxes that arise in connection with and following the grant of a lease are:

### Value Added Tax

The grant of a lease of a commercial building is, in general, an exempt supply for VAT purposes. However, the landlord may exercise an option to tax and if the landlord does so, then the rent (and any premium payable on the grant) will be liable to VAT at the standard rate and the tenant will have to pay VAT in addition to rent. If the rent is subject to VAT then any service charge will be as well.

### Stamp Duty Land Tax ('SDLT')

The grant of a lease is a land transaction for the purposes of SDLT. SDLT is payable by the tenant and is charged on both the rent and on any premium.

The SDLT rates on acquisition are currently as follows for commercial property:

- nil if the price is £150,000 or less and the annual rent is under £1,000
- 1% if the price is £150,000 or less and the annual rent is £1,000 or more
- 1% if the price is more than £150,000 but not more than £250,000
- 3% if the price is more than £250,000 but not more than £500,000;

and

- 4% if the price is more than £500,000

There is also a SDLT charge on the rental element of new leases. The charge will be on the rent over the term of a lease discounted to a net present value. Tax will be due at 1% of the net present value of the rent in excess of the £150,000 threshold.

If VAT is payable on the price/rent, SDLT is charged on both the consideration and the VAT thereon.

SDLT is payable within 14 days of completion otherwise interest and penalties will become payable to HMRC.

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## **Business Rates**

The occupier of a property is liable for business rate (sometimes referred to as NNDR or the National Non-Domestic Rate). The amount payable is based on the rateable value of the property multiplied by a nationally-set rate in the pound. Rateable values are revised every five years. In practice, leases of commercial property will make the tenant expressly liable to pay business rates.

## **Corporation Tax**

Most tenants will be able to deduct rent any service charges payments as expenses when calculating their liability to Corporation Tax.

## **Capital Allowances**

A company that spends money on certain capital assets, including plant and machinery, is entitled to deduct a proportion of those costs from its profits and thereby reduce the amount of Corporation Tax it has to pay. These deductions are known as capital allowances and can be very valuable. If a tenant incurs fit-out costs on assets that qualify for capital allowances, it will pay less Corporation Tax.

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## Oury Clark Business Property Team

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### **Tax Services:**

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- Trusts and offshore structures
- VAT advice and mitigation
- Stamp duty land tax advice and mitigation
- Capital gains tax mitigation
- Capital allowances

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# For More Information Contact One of Our Partners Today



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