

Real World

Finance and Real Estate News

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HEADNOTE

Taxing Times



by **Andrew Hutchinson**

Apparently, “tax doesn’t have to be taxing”.

What nonsense. As the UK economy expands more slowly than my waistline, consider the following.

If you run a business with a property requirement, employ staff and rely on transport to some extent, then you will have been hit by the following measures, all of which have been announced or implemented since our last edition in January: the introduction, through the green initiative, of the new vehicle licensing scheme, the increase in the level of fuel duty, following the abolition of empty rates relief the business rates revaluation has come into effect based on 2008 rental values, the levels of National Insurance are to be increased (if Labour win the election) and the top rate of income tax has jumped to 50%.

This month also saw the introduction of the CRC Energy Efficiency Scheme, a fiendishly

complex scheme which we reported on in our last edition. It is designed to cut the carbon dioxide emissions of large energy users by making them pay for allowances which will increase in cost as their supply is restricted. Although the scheme is intended to be revenue neutral overall, the inevitable administrative costs involved are bound to ensure that it adds to the financial burden on business.

In this edition, we report on the Budget measures which affect property and a change to the rules on the VAT option to tax, a court decision which means that administrators must pay rent for property they occupy, and an increase in the rent threshold for assured tenancies. We also report on an important decision on the enforceability of some lease guarantees.

By the time we next go to print, we will know the outcome of the general election. Whatever the result, it is clear that there remain taxing times ahead.

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TENANT INSOLVENCY

Administrators Must Pay Rent



by **David Gervais**

In a very welcome decision for landlords, the High Court has ruled that administrators must pay rent as an expense of the administration where the company uses leasehold property for the benefit of creditors. This means

that the landlord will move to the front of the queue of the company's creditors.

Background

Landlords have suffered particularly badly during the recession as large numbers of tenants have gone into administration and stopped paying rent. As unsecured creditors, and with little likelihood of finding an alternative tenant to take the premises in the current poor market, it seemed there was little landlords could do to improve their position. Even if a new tenant could be found, the insolvency rules prevent the landlord from taking proceedings to forfeit the lease without the consent of the administrators or the court. The court has a discretion in such cases and if the company needs to occupy the premises to achieve the purpose of the administration, the court must weigh the interests of the landlord against those of other creditors and the landlord may lose out. That is what happened in the case of *Innovate Logistics (in administration) v Sunberry Properties Ltd*, which we reported on in the spring 2009 edition of *Real World*, where the court refused the landlord leave to bring proceedings to enforce the tenant's covenants.



Rent as an Administration Expense

However a case decided at the end of last year, *Goldacre (Offices) Ltd v Nortel Networks UK Ltd (in administration)*, redresses the balance in favour of the landlord. The High Court decided that where the company continues to use the premises the rent payable falls within the category of "necessary disbursements" under the Insolvency Rules and must therefore be paid as an expense of the administration. As a result the landlord's claim for rent will take priority over the claims of other creditors without any need for the court to exercise its discretion or to balance the landlord's interests against those of other creditors.

Use of the Premises

The obligation to pay the rent arises only if the premises are being used. So if the business closes and the premises are vacated, further rent payments will not qualify as an expense of the administration. A purchaser of the business is sometimes allowed into occupation of the premises as licensee pending the assignment of the lease. It is thought likely that such occupation by the purchaser would qualify as use by the company for this purpose.

No Apportionment

The administrators in the *Goldacre* case tried to argue that they should pay only a proportion of the rent because the company was occupying only a small part of the premises. However the court made clear that it had no jurisdiction to apportion the rent and it must be paid in full. In the same way there will be no apportionment if the company's use of the premises ends part way through a rent payment period; rent for the whole period must be paid. However rent which fell due for payment before the administration began will not rank as an expense of the administration. Only rent actually falling due while the company is in administration and using the premises is covered.

Other Payments

The *Goldacre* case deals only with the payment of rent. However the same principle ought also to apply to other sums payable under the lease, such as service charge and insurance payments.

Sources: *Goldacre (Offices) Ltd v Nortel Networks UK Ltd (in administration)* [2009] EWHC 3389 (Ch); *Innovate Logistics (in administration) v Sunberry Properties Ltd* [2008] EWCA Civ 1321.

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LANDLORD AND TENANT

Lease Guarantor May Not Also Act as Guarantor for Assignee



by **Gillian Baxter**

The High Court has ruled that it is unlawful for a landlord to require an assignee's obligations to be guaranteed not only by the outgoing tenant under an authorised guarantee agreement, but also by the

outgoing tenant's guarantor. Any such guarantee is void and unenforceable.

Tenant Release on Assignment

The decision relates to the Landlord and Tenant (Covenants) Act 1995, which abolished the old rule that a tenant remained liable to pay the rent and comply with the tenant's other lease obligations throughout the whole term of the lease, even after the lease has been assigned. The Act provides that for leases granted after 1995 the tenant is automatically released from liability once the lease is assigned. It also ensures that any guarantee of the tenant's obligations will fall away when the tenant is released.

Authorised Guarantee Agreements

There is one exception to the blanket release of liability on assignment: the landlord may require the outgoing tenant to give an "authorised guarantee agreement" (commonly called an AGA) guaranteeing the liability of the assignee. The contents and extent of the AGA are strictly prescribed by the Act. They may not extend to the liability of anyone other than the first assignee or to any time after that assignee is released from the lease obligations.

The Outgoing Tenant's Guarantor

However, the Act does not make clear whether the landlord may require the outgoing tenant's guarantor also to back the obligations of the assignee. Commercially it is important that the landlord should be able to call on the guarantor to stand behind the AGA. The tenant could be a single purpose vehicle with no assets other than the lease, or a company which will cease trading once the lease is disposed of. The landlord might not have accepted the tenant unless a parent company or a couple of directors stood behind it.

The Form of the Guarantee

There are two ways in which the guarantee can be given. The first is a *direct guarantee*, where the guarantor joins in the AGA to guarantee the assignee's obligations. That is what happened in the recent case. However it is more usual for the guarantor not to guarantee the assignee's obligations directly, but instead to guarantee the *assignor's* obligations under the AGA. This is sometimes described as a *sub-guarantee* and it is the way Dechert's leases are drafted.

Direct Guarantees

The High Court decided that a direct guarantee is not permitted and is unenforceable. The reason for the ruling is that the Act contains a wide anti-avoidance provision which declares an agreement void to the extent that it would frustrate the operation of any provision of the Act. The court decided that allowing a guarantor to guarantee the assignee's obligations would frustrate the operation of the requirement that a guarantor's obligations must end on an assignment.



Sub-Guarantees

The ruling does not affect sub-guarantees so they remain enforceable, however the judge commented that it is not by any means clear that they are permitted by the Act. Nevertheless it is believed that sub-guarantees are permitted because the provision which requires the guarantor to be released relates only to guarantees of obligations to be complied with by the current tenant, whereas a sub-guarantee relates to the obligations of the *former* tenant under the AGA. It can also be said that a sub-guarantee is not inconsistent with the policy behind the Act. It does not extend the guarantor's liability beyond the date on which the tenant is released or make the guarantor responsible for the obligations of future tenants.

Implications of the Decision

It is likely that the landlord will appeal against the ruling but in the meantime the judgment has serious implications for landlords. The decision is not restricted to future transactions but applies also to existing arrangements. The outgoing tenant's obligations under the AGA remain enforceable, but the guarantor's liability under a direct guarantee cannot now be enforced. This is likely to have an adverse effect on the value of property where such a guarantee has been given.

The decision may not be entirely good news for tenants either. If landlords become more wary of accepting weak tenants backed by substantial guarantors it may become harder for tenants to dispose of their leases.

Alternative Solutions

One possibility is for the landlord to take an alternative form of security, such as a large rent deposit or a bank guarantee. But these will inevitably be limited in amount and so will not provide the same level of security as a parent company or personal guarantee. They will also be unattractive to tenants as they will require large amounts of capital to be tied up.

Another option is for the guarantee given on the assignment to be by a different party from the one that joined in the lease. This would not fall foul of the anti-avoidance provision in the Act because the guarantor would not be covered by the wording which requires the lease guarantor to be released on assignment. A large organisation is likely to include more than one substantial company which could provide a guarantee but this route would probably not be possible for smaller tenants.

If the case is not quickly overturned on appeal, landlords may consider including in new leases a tenant's obligation not only to enter into an AGA, but also to procure a guarantee of the AGA obligations by an entity acceptable

to the landlord which has not also guaranteed the tenant's lease obligations.

Sources: *Good Harvest Partnership LLP v Centaur Services Ltd* [2010] EWHC 330 (Ch).

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VAT

Revoking the Option to Tax



by **Daniel Hawthorne**

From 1 April 2010 use or occupation of land no longer prevents revocation of the option to tax during the six month "cooling-off period".

The exercise of an "option to tax" (sometimes described as an "election to waive the exemption") has important consequences for the ability of a landowner to recover its input tax. Where a landowner intends to make supplies of land or buildings that will be exempt supplies for VAT purposes (as will ordinarily be the case for such supplies), it can exercise an option to tax. The effect of the option is to turn what would have been an exempt supply into a taxable, standard-rated supply. The option to tax rules are complicated and have been subject to a number of recent technical amendments. Most significantly, from 1 April 2010, changes were made to the rules concerning the ability of a landowner to revoke an option to tax.

There are very limited circumstances in which a landowner may choose to revoke an option to tax. One of the circumstances in which an option to tax can be revoked is if the revocation takes place within a six month "cooling-off" period starting from the effective date of the option and provided that certain conditions are satisfied. Prior to 1 April 2010, one of the conditions was that the taxpayer must not have used the land (including occupying it) since the effective date of the option. In practice, this limited the ability of many landowners to revoke an option to tax where a proposed development failed to materialise. With effect from 1 April 2010, this condition ceases to exist, though additional legislation may yet impose further conditions.

Source: *Value Added Tax (Buildings and Land) Order 2010* (SI 2010/485).

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TAX

Budget 2010

by **Daniel Hawthorne**

On 24 March, the Chancellor of Exchequer delivered his 2010 Budget statement. As was widely predicted, the Chancellor did not announce any dramatic changes to the UK tax system before the general election.

However, the Budget did include some measures of relevance to the finance and real estate industry and this article summarises those measures.

Stamp Duty Land Tax

The Budget included no significant amendments to the stamp duty land tax treatment of commercial property. However, as was predicted, significant amendments were made to the regime applying to residential property. In particular relief from SDLT was given for purchases of residential property up to £250,000 where the purchaser is a first time buyer and intends to live in the property. The relief is limited to a two-year period with effect from 25 March 2010. This measure will offer a SDLT saving of up to £2,500 for those able to take advantage of it. Unfortunately, the relief does not extend to property acquisitions where the consideration exceeds £250,000.



This measure to provide relief at the first time buyer end of the residential property market has been paid for by a new five percent SDLT rate for purchases of residential property where the consideration exceeds £1m. This rate will apply to acquisitions completed on or after 6 April 2011. The increase from four percent to five percent will result in an additional charge to SDLT of £10,000 for the purchaser of a £1m property.

Separately, HMRC announced that new legislation will be introduced in Finance Bill 2010 to extend the SDLT anti-avoidance rules to prevent the exploitation of the special SDLT rules which apply to partnerships. This measure demonstrates HMRC's continued use of new legislation and the existing disclosure of tax avoidance schemes rules to legislate against aggressive SDLT planning.

Real Estate Investment Trusts

UK Real Estate Investment Trusts ("REITs") were introduced in 2006 to provide a tax efficient vehicle for regulated collective investment in real estate. The effect of entry into the REIT regime is that shareholders receiving distributions from a REIT are taxed as though it was income from property. This gives investors a return similar to investing in property directly.

The UK REIT legislation currently requires that a UK REIT distribute, for each accounting period, 90 percent of the profits from its property rental business by way of a dividend. The Budget announced that legislation will be introduced in the first finance bill of the next parliament to allow UK REITs to issue stock dividends in lieu of cash dividends for the purposes of meeting the requirement to distribute 90 percent of the profits of the property rental business. This measure will give REITs greater flexibility and make satisfaction of the distribution requirement and compliance with the REIT rules easier.

As is often the case in an election year, it is expected that a further Budget will take place shortly after the outcome of the general election. It is likely that, whichever way the election goes, the next Budget will have a considerably more significant impact on the UK tax landscape than the recent Budget. *Real World* will provide an update of any significant measures introduced in the post election Budget.

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LANDLORD AND TENANT

Statutory Protection to be Extended to Many More Residential Tenants (Including Existing Tenancies)



by Jon Bola

The maximum rent threshold for assured and assured shorthold tenancies in England is to be increased to £100,000 per annum with effect from 1 October 2010. The change will bring many existing as well as new tenancies within the scope of statutory security of tenure and the regulation of tenancy deposits.

Assured Tenancies

Since January 1989, residential tenancies granted to individuals who occupy the premises as their principal home have qualified as assured tenancies unless they come within one of a number of statutory exceptions such as holiday lettings or resident landlords. One of the main exceptions was originally that the rateable value was above a certain limit, but following the abolition of domestic rates that was replaced in 1990 by a maximum rent threshold. Tenancies granted on or after 1 April 1990 could not be assured tenancies if the rent was more than £25,000 per annum.

In the twenty years since the rent limit was introduced, it has not been increased. In 1990, a residential rent above £25,000 per annum was very high and was payable for only a very small number of properties, but nowadays it is relatively common. Regulations have therefore been made to increase the rent threshold to £100,000 per annum with effect from 1 October 2010. The regulations apply only in England.

Security of Tenure

The main significance of a tenancy being an assured tenancy is that the landlord can only regain possession by establishing one of a number of statutory grounds for possession. However, where the tenancy qualifies as an assured shorthold tenancy the landlord has an automatic right to possession where a fixed term has ended and the tenant has been given at least two months' notice. Before 28 February 1997, a tenancy could only be a shorthold if it was for a fixed term of at least six months and the landlord gave the tenant a notice in a prescribed form when the tenancy was granted. But all assured tenancies granted after that date are automatically assured shortholds. Therefore tenancies granted before 28 February 1997 under which a rent of more than £25,000 but less than £100,000 per annum is payable may be converted into assured tenancies in October but cannot be shortholds because the prescribed notice will not have



been given when they were granted. The tenants under those tenancies will therefore acquire full security of tenure. If granted after that date the tenancy will become an assured shorthold with only the limited security of tenure described above.

Tenancy Deposits

Since 6 April 2007, an important consequence of a tenancy qualifying as an assured shorthold has been that tenancy deposits must be protected under an authorised tenancy deposit scheme. If the landlord fails to do so, he may be ordered to pay the tenant a sum equal to three times the deposit and he will be unable to give notice to regain possession at the end of the tenancy. The explanatory memorandum issued with the new regulations by the Department for Communities and Local Government states that these rules will apply to tenancies which are converted into assured shortholds by the increase in the rent threshold. It is, however, arguable that the Department's interpretation is not correct because the statutory provisions dealing with tenancy deposits apply only to deposits "paid ... in connection with a shorthold tenancy" and a tenancy converted into a shorthold by the rent threshold increase was not a shorthold when the deposit was paid. Nevertheless it would be safest for landlords to comply with the tenancy deposit rules as the penalties for failing to do so are serious.

Source: *The Assured Tenancies (Amendment) (England) Order 2010 SI 2010 No. 908.*

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About Dechert LLP

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