Practice&Law

A STATE OF DISREPAIR

Newbigin Blake Penfold and Roger Cohen identify various cracks in rating law and suggest how they might be fixed

Friday 13 February 2015 could not have been unluckier for ratepayers. On that day, the Court of Appeal handed down a decision that is possibly the worst court decision for ratepayers ever.

Background

The shockwaves that were set off by the decision in *SJ & J Monk (a firm)* v *Newbigin (VO)* [2015] EWCA Civ 78; [2015] PLSCS 57 will reverberate for some time. The effect of the decision makes it a threat to cash flow for owners and occupiers of rateable property that is undergoing, or in need of, works of one sort or another.

While the decision will affect any rateable unit or hereditament which at the relevant (or "material") day happened to be in less than mint condition, the real concern about the outcome of this case is for properties which are either not generating rental income for the owner or are not being used by an occupier for the purposes of its business (and may possibly be incapable of either); or properties where wear and tear over the years has built up to the point where the ratepayer has no alternative but to commission significant works.

Whatever the background, the owner or occupier is faced with the necessity to spend serious money on the building and it is likely that the property will not be occupied for all or part of the period of works.

The old rule that property that was "incapable of beneficial occupation" should not be rateable, or be rated at only a nominal value, was changed by the Rating

PICTURE CREDIT

(Valuation) Act 1999, which introduced an assumed "reasonable state of repair", regardless of the actual condition of the property.

Where a property continues in use, any disrepair may have little effect on value. But when works of repair or refurbishment are under way, owners and occupiers are unable to derive profits from property that is in need of capital expenditure. This decision could also make them liable for empty property rates during the works; and England has a very aggressive empty rates regime, with liability being at 100% of the full occupied rate once any rates-free period ends.

Facts

The location for the events in this case was a floor in an office building in Sunderland. The question was: "What physical state is it to be assumed to be in for the purpose of liability for rates?"

The first floor had been let, but the tenants moved out and later surrendered the lease. The floor consisted of about 800 sq m of office accommodation with raised floors, suspended ceilings, category 2 lighting and comfort cooling.

The owner let a contract for works to remove all internal elements, excluding the lift and staircase, but including a full strip out, constructing new common parts and three self-contained new letting areas on that floor. The majority of the ceiling tiles and suspended ceiling grid and light fittings had been removed together with 50% of the raised floor, the comfort cooling system, all plant, sanitary fittings and wiring.

The owner made appeals to delete or reduce the rating assessment of the first-floor offices and these appeals came before the courts. The Valuation Tribunal found in favour of the Valuation Officer (VO) that the property had still to be valued as though it was in repair. The Upper Tribunal (UT) sided with the ratepayer and held that the property was incapable of beneficial occupation as offices and premises due to its actual physical state; and that in consequence its rateable value should be assessed at a nominal £1.

The VO appealed to the Court of Appeal.

Rating hypothesis

The answer to the question depends on the true meaning and effect of the "rating hypothesis" (paragraph 2 of Schedule 6 to the Local Government (Finance) Act 1988). In summary, the rateable value of a non-domestic hereditament is the rent at which it is estimated the hereditament might reasonably be expected to let from year to year on certain assumptions including:

"Immediately before the tenancy begins the hereditament is in a state of reasonable repair, but excluding from this assumption any repairs which a reasonable landlord would consider uneconomic."

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EXAMPLE 1
Modern office in central London
- 500 sq m, completely stripped out
- Annual value in repair is £800 per sq m, giving a rental value of £400,000
- Cost to put into repair is £1,000 per sq m = £500,000
- Conclusion: repair and reinstatement cost is 1.25 times the value in repair. A reasonable landlord would consider this to be economic.

EXAMPLE 2
Older office in Leeds
- 100 sq m, stripped out and dilapidated
- Annual value in repair is £200 per sq m, giving a rental value of £20,000
- Cost to reinstate and put into repair is £800 per sq m = £80,000
- Conclusion: repair and reinstatement cost is four times the value in repair. Would a reasonable landlord consider this to be economic?

EXAMPLE 3
Workshop unit in Warrington
- 200 sq m, seriously dilapidated
- Annual value in repair is £60 per sq m, giving a rental value of £12,000
- Cost to reinstate and put into repair is £500 per sq m = £100,000
- Conclusion: repair and reinstatement cost is 8.33 times the value in repair. No reasonable landlord would consider this to be economic.

Decision and reasons

How did the assumption that the property was in a state of reasonable repair operate in this case?

The leading judgment was given by Lewison LJ, a landlord and tenant specialist. The starting point is that property is in a state of reasonable repair when having regard to the age, character and locality of the property, it would be reasonably fit for the occupation of a reasonably-minded tenant of the class who would be likely to take it. Repair is the converse of disrepair, which connotes a deterioration from some previous physical condition. If the property is worse than it once was, it does not matter why the deterioration has occurred.

The floor in Sunderland was worse than it once was. It did not matter that this was as a result of the decision to strip out, nor why that decision was taken. The intentions of the owner or ratepayer are irrelevant since value must be objectively assessed and we are in the hypothetical parties' world.

The UT had decided that in cases of reconstruction/refurbishment the works required to make the property capable of beneficial occupation are not works of repair. The Court of Appeal's conclusion was that reinstating stripped out services would not result in a building of a different kind from what was there before. Therefore, the floor was in disrepair by reason of the strip out and the rating assessment must assume that the property is put back into repair.

Valuation Office Rating Manual

The Valuation Office Agency publishes, in its Rating Manual, its guidance on rating law and practice. The Court of Appeal was referred to two extracts from the manual which suggested:

- Regard should be had to whether the outcome of an ongoing scheme of works would result in a different hereditament. If it would, then the works required to complete the scheme are not works of repair. The Court of Appeal said that this was wrong because "the rateable quality of land is not to be determined by what it once was or by what it may become." (see Lush J in *Metropolitan Board of Works* v *Overseers of West Ham* (1870) LR 6 QB 193 at 198.)
- The intention of the particular ratepayer or building owner about the end product of a partly executed scheme or works is a relevant factor. The court did not agree.

By the time the case reached the Court of Appeal there was no suggestion that a reasonable landlord would consider the repairs to be uneconomic.

Implications

This is an important case because it is the first time that the assumed "reasonable state of repair", has been tested at this level. The decision gives clarity on the repairing assumptions that are to be made, but the clarity will not be welcome to property owners who are carrying out repairs or refurbishments.

This affects buildings:
- in disrepair;
- being refurbished (works pending);
- undergoing alterations;
- (allegedly) obsolete.

Uneconomic repair

As we reflect on the outcome, the more difficulties present themselves, some of which suggest solutions.

First, in some schemes, the argument that a reasonable landlord would consider the repairs to be uneconomic will be available. A recent UT case (*Thomas & Davies (Merthyr Tydfil) Ltd* v *Denly (VO)* [2014] UKUT 146 (LC)) considered what might reasonably be viewed as "economic". In that case the repairs were considered economic because the cost of the work equalled about three years' rental income and a reasonable landlord would commit to those costs.

There can be no single definitive ratio of reasonable cost in relation to rent. Each case will need a review of the costs to put in repair and the reasonably expected value in a repaired state (see box above for examples).

Secondly, is there still a hereditament? How does this decision, about what works constitute repair and are therefore to be assumed when valuing for rating purposes, sit with more fundamental case law relating to what constitutes a hereditament? On an extreme view of this decision, a property where all but the shell had been consumed by fire would have to be assessed as being in a reasonable state of repair. A solution to this absurdity is needed.

What happens next?

The Valuation Office Agency is rewriting its manual to take account of the feedback from the Court of Appeal. In the meantime, VOs are taking a tough line, insisting on assessing the property as if in repair, no matter what condition it is in or the future potential of the site following redevelopment. Expect that tough line to be reflected in the manual.

Newbigin is not beyond challenge. The decision, though binding any future Court of Appeal, may one day be reviewed by the UK Supreme Court. The ratepayer has sought permission to appeal.

There are likely to be important areas of dispute in respect of works that involve alterations as well as repair and refurbishment. Alterations are different to repair and, unlike disrepair, their effect on value has to be taken into account. There will also be disputes when works extend outside the hereditament because the assumption of a reasonable state of repair only applies to the hereditament, not to matters external to it.

Also, if properties undergoing refurbishment are to remain in assessment during the works, what happens to their value when the works are completed? If the works are to be treated as repair, and if all properties are assumed to be in reasonable repair, will this mean that both refurbished and non-refurbished properties have to be valued at the same value?

The curse of Friday 13 may be imaginary, but the turbulence in the hypothetical world of rating is at present all too real.

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