Cloud Cuckoo Land – An Overview of the Method of Valuation for Local Property Tax (Rates) in the United Kingdom

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Key words: local authority taxes, rates, valuation, land taxation.

SUMMARY

The United Kingdom (UK) system of rates i.e., the taxation of non-domestic property, dates back to 1601, and, over time, has developed into a large and detailed body of statutes, regulation and case law, which implicitly seeks to ensure that all hereditaments (taxable properties) are taxed based on their open market rental values assuming existing use. Thus, in order to ensure equity of treatment, a series of assumptions are made about each property and traditional methods of valuation are adapted to reflect those hypothetical conditions.

This paper discusses both the fact and the fiction of UK rating valuations and the some of the criticisms which are leveled against the system, and which are causing pressure for change. Land Value Taxation is a potential solution which reflects sustainable principles, and is discussed as a replacement for rates in order to achieve an equitable tax which reflects sustainable principles and achieves the optimum use of urban land.

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1. INTRODUCTION

This paper presents a brief overview of the rating system, which is a system of land taxation levied on the occupiers of non-domestic property operated in the United Kingdom (UK). It discusses the basis of assessment and assumptions which the law requires valuers to make and to which the traditional methods of valuation are applied. There is a separate system of taxation for occupiers of domestic property (Council Tax) which is not the main topic of this paper, although reference to Council Tax is made to indicate significant differences and, particularly, later when the subject of reform is discussed.

Dating back to 1601, rates are levied on the occupiers of all taxable units of property (hereditaments) which are not exempt. It follows, therefore, that vacant land and derelict property for which no-one would give a rent in its current state are not liable to rates. Also, within the rating system itself, there is a range of exemptions from the tax and reliefs from full liability. Notable exemptions from rates include agricultural land and buildings, places of public religious worship, empty industrial units and there is a reduction of 50% of the tax for hereditaments which are not occupied (this tax is paid by the owners).

Since 1990, the level of rates is fixed by central government, but it is levied, collected and spent by local authorities, according to the requirements of central government. There is a system of pooling the revenue, so that if an authority collects more than it needs, the excess is passed on to central government; and if an authority is permitted to spend more than it collects, an amount from the pool is passed on to that authority. Despite this level of central government control, rates are generally perceived to be a local property tax. In fact, the only local property tax in the UK is the Council Tax, the level of which is fixed by local authorities in relation to their own spending needs.

The taxable unit, or hereditament, is strictly defined, as is the nature of the occupation which gives rise to the rate liability (refer, for example, Plimmer, 1998). Similarly, there are well-defined procedures for challenging the tax liability and for collecting and enforcing the collection of the tax due.

All hereditaments are valued every five years, with the current list taking effect on 1 April 2000 and the next list due to take effect on 1 April 2005. List are unaltered during the five year period, except to take account of physical changes, such as new properties coming into rating, existing properties being enlarged, demolitions taking place or areas of occupation changing.

The principle features of the system (for the purposes of this paper) are the limitation of the tax to certain property types (for example, agricultural land and buildings, derelict and unused land are not liable to rates) and the fact that the basis of assessment (rateable value) reflects only existing use of the hereditament.

This paper focuses on the issues for property valuers in fixing the taxable value on which the rates paid are based and considers its future in the light of pressures for sustainability in tax regimes.

2. BASIS OF VALUATION – RATEABLE VALUE

The value for the taxable property which is what rates are based on is the Rateable Value (RV). The government fixes the level of rates for each financial year and that amount (currently 0.445p for England) is multiplied by the rateable value of a property, to give the amount of tax payable. The role of the valuer is to fix the rateable value of the property and statute (Local Government Act 1988, as amended) provides the following definition:

”Rateable Value is ... the rent at which it is estimated the hereditament might reasonably be expected to let from year to year [assuming]

- the tenancy begins on day by reference to which the determination is to be made;
- the hereditament is in a state of reasonable repair, but excluding ... any repairs which a reasonable landlord would consider uneconomic;
- the tenant undertakes to pay all usual tenant’s rates and taxes and to bear the cost of the repairs and insurance and the other expenses (if any) necessary to maintain the hereditament in a state to command the rent ...”Rateable Value is the rent which is reasonably expected, not necessarily the rent actually payable, nor the legally payable rent. Despite the fact that it is the rent paid on a ”year to year” basis, rateable value assumes a reasonable prospect of continuance. However, it is important to remember that, because it is a rent, rateable value is not affected by matters which influence the capital value of the hereditament. Significantly, rateable value is the rent paid for the hereditament in its existing state and for its existing use.

Rateable value is affected by all matters which would be taken into account by a hypothetical tenant in fixing an annual rent for the hereditament and case law has provided a detailed definition of who is the hypothetical tenant of a hereditament.

2.1 Hypothetical Tenant

In order to fix the rateable value of a hereditament and based on the decisions of the courts, valuers are required to assume that there is, in existence, in the property to be valued a tenant (who will pay the rent to be fixed and undertake the repairing liability stated in the statutory definition of rateable value) and a landlord (who is offering the property for rent and who will ensure that the property is in good repair at the beginning of the tenancy). Because a tenancy does not always exists in the property (and because there are some very specific terms implied in that tenancy), this is called the hypothetical tenancy and the parties to it are the hypothetical tenant and the hypothetical landlord. It is the rent which the hypothetical tenant will offer for the property which is the amount that the valuer must assess as the rateable value.

The hypothetical tenant is a typical tenant for the property and it follows that, if a hypothetical tenant is to be assumed, then any actual tenant (or indeed an owner in occupation) may be ignored for the purposes of fixing a rateable value. There is a large body of case law which gives more details about a hypothetical tenant which may or may not match any actual tenant.

Thus, the hypothetical tenant is not necessarily the actual occupier; he agrees to pay the rent and observes the repairing covenant. He is the potential occupier who will pay the highest annual rent for the hereditament in its present state and, in fact, could be the actual owner.

2.2 Assumptions

Case law has amplified the statutory definition of rateable value so that the following assumptions must be made when fixing the net annual rental value of the property. Some of these may be obvious, others less so. Nevertheless, they are required on the rating valuer who is producing a rateable value for a hereditament.

- Individual assessment – i.e. each hereditament must be valued separately. It is not appropriate, for example, to say that property prices have increased on average by 50%, and therefore value all properties by an increase of 50%. Each property must be treated separately.
- Vacant and to let - the fact that it is necessary to assume a landlord and tenant negotiating the fixing of a rent for the property, implies that the property is currently empty and available for letting. Valuers are, therefore, requires to assume that the property is vacant and to let.
- Statutory restrictions apply – because they would affect all occupiers of the property. However, if they affect the level of rent to be paid, they are ignored.
- Personal or private restrictions are ignored – any actual restrictions imposed by the actual lease of the property can be ignored, because they would not exist in the hypothetical tenancy.
- *Rebus sic stantibus* – meaning “things as they stand”, require that the valuer values the property as it in fact is. *Rebus sic stantibus* is applied in three specific circumstances:

- mode or category of use – assume the same use for the property as that for which it is currently being used;
- structural alternations cannot be assumed – only non-structural alterations can be assumed;
- an exception to the *rebus sic stantibus* rule is the state of repair, which is assumed to be appropriate to the age, locality and use of the property. This is because of the statement in the definition of rateable value in which it is specified that the landlord will put the property into good repair and the tenant will undertake a full repairing liability.

- "Fresh on the scene" – the hypothetical tenant is assumed to be newly arrived at the property and the locality and cannot therefore compare existing circumstances with the any past circumstances – unlike an actual occupier or owner.
- Finally, the valuation date is 1 April 1998. Thus the property and the locality and a range of other factors which currently affect the property to be valued must be imagined back in time to the valuation date.

All these assumptions are taken together with the definition of rateable value to create the outline of a scenario in which the valuer must imagine the property and the locality and then, using valuation methodologies, arrive at a net annual rental value or rateable value, in order for the tax to be levied. It is this artificial complexity which led Godfrey JA in *China Light & Power Co. Ltd v Comr. for Rating and Valuation* 1995 to comment that:

The world of rating appears . . . to be cloud-cuckoo land, a world of virtual unreality from which real cuckoos are excluded (although it seems that permission to land will be granted to a cuckoo flying in from the real world if it can demonstrate that its presence in cloud-cuckoo land is essential, not merely accidental . . .) A valuation for rating purposes must be based on hypothetical, not real, facts.

3. VALUATION

Within this hypothetical scenario, valuers are, however, required to value the actual property (although assumptions may need to be made regarding its state of repair) within the actual locality and to use actual market evidence in order to fix a rateable value. Specifically, valuers are required to consider all of the evidence – all of the factors which affect the rental value (other than those which rating law specifically excludes) must be taken into account.

Valuers are, however, given no direction as far as method of valuation are concerned and it is well recognised that all methods of valuation are admissible in court. "*The goodness or badness of them goes to their weight as evidence*" (*Garton v Hunter (VO)* 1969). Thus, the courts rely more heavily on the outcome of one method rather than another, depending on the circumstances and it is clear that certain property types are valued using certain methods rather than others. Thus, shops, offices and general industrial and warehouse premises are valued using open market rental evidence; petrol filling stations, cinemas and race courses are valued using a profits method; and specialist industrial premises, leisure centres, municipal property and plant and machinery are valued using a contractors method.

In fact, there are only two instances when the law intervenes in the valuation process:

- the rateable values of occupational properties belonging to the so-called statutory undertakers (providers of such services as water, gas, electricity, rail) are valued using a statutory formula, which is not a true valuation; and

- within the contractors method, the law prescribes the percentage to be used to convert the capital value to a rental value – (refer Appendix – Example 2).

One of the important issues of any tax is that people should pay proportionately i.e. in the case of a property tax, those who occupy more valuable properties should pay more than those who occupy less valuable properties. Thus, the taxable value needs to reflect that differential in a way and to a degree which is acceptable to the taxpayers and the electorate. For a property-based tax, the open market value of property must be the best evidence on which to base a tax.

3.1 Rental Evidence

It is well recognised within the rating system that, because it is a net annual rental value (a rateable value) which has to be fixed, the best method of valuation must be the use of rents. However, the rents passing must be suitable and reliable. This relates both the nature of the properties on which they are paid – they must, of course, be as similar in all material respects as possible to the property being valued and the rents must be fixed in the open market, at or near the valuation date, relate entirely to the property itself and either reflect the net annual rental value or be capable of adjustment to that definition. Thus a rent which requires the payment of a premium at the start of the lease can be increased by the annual equivalent of that premium to produce the rental equivalent; and rents which include an element of outgoings can be adjusted to net terms.

The use of market-based rental evidence is an important concept for a property tax, because it demonstrates very clearly that the taxable value is one which can be proven. It also means that, within a market value-based tax system, taxpayers pay according to the value placed on their properties by the market and not by any artificial construct.

The only real problem for valuers then occurs when there is no suitable and reliable rental evidence available.

3.2 Profits Method

In such circumstances, a variant of the profits method may be adopted. This normally occurs for property which is used for trading purposes – for example, cinemas, race courses and petrol filling stations – and where there is an element of legal or physical monopoly and where an analysis of the profits which can be made at the hereditament may indicate the level of rent which a hypothetical tenant will offer for the hereditament. The valuer needs access to

three years' of accounts which may need to be adapted. Accounts are prepared for businesses for tax purposes and they should also be investigated to ensure that they reflect:

- the hereditament being valued, and do not include other property; and
- the trading profile of the hypothetical tenant who is of average business competence.

The profits method of valuation is generally only used where rental evidence is absence from the market and is, therefore, some thing of an artificial device to achieve a taxable value. Its assumptions may be reasonable, but it is often necessary to demonstrate comparability within the trade which is occupying the property.

The profits method is illustrated in the Appendix – Example 1.

3.3 Contractors Test

If neither rental evidence nor profits are available, valuers are forced to rely on the contractors test, which is a cost-based method of arriving at a value for the property. There is no definitive indication that cost and value are linked, indeed, in some cases it is clear that this is not so, but where there is no other evidence available, the courts will accept the contractors test as a "method of last resort", although each item within the valuation can often be the cause of much discussion. The contractors test also suffers from the failure of the market to provide any kind of evidence to support, either the process involved or the outcome of the method. Indeed, if market evidence of any kind existed, valuers would not use the contractors method. The contractors method of valuation is illustrated in the Appendix – Example 2.

4. SUSTAINABILITY

The rating system has been the subject of much criticism over the last century, resulting in some significant reforms which took effect in 1990 (and later the introduction of Council Tax which is the local property tax levied on domestic property by local authorities). However there are some fundamental issues to do with rates which still attract criticism, including the fact that it discourages improvements to property, by taxing the value of land and buildings together. Also, and of specific concern for the purposes of this paper are the failures of the rating system to reflect the current need for sustainability in taxation because it fails:

- to tax the occupiers of all land and buildings;
- to discourage the withholding of development land; and
- to encourage sustainability within urban areas.

As indicated about, there are certain exemptions from rates, most notably agricultural land and buildings, derelict and unused land and owners of empty industrial and warehouse premises. The reasons for the agricultural and industrial exemptions are historical (although there may be a good case for reducing the tax liability on UK farmers given the recent crises

in agriculture over the past decade) and the failure to tax derelict and unused land stems from the definition of a ”hereditament”, being a unit of property capable of commanding a rent.

Sustainability is interpreted in the UK as including the need to re-use previously developed land (brownfield sites) and, although the planning system is seen as a primary driver in achieving the development of brownfield sites, the UK planning system is reactive, not proactive in its development activities. Thus, a tax system which encourages owners to keep land idle rather than bringing (particularly urban) land forward for development is not considered to be sustainable.

It is also relevant here that the UK has no general system of taxing development value (except for a few non-specific solutions, including Capital Gains Tax and rates, themselves). Thus, when planning permission is given and the market reflects that in higher prices, it is the owner of the land who benefits directly.

Recent transport infrastructure improvements in London (the Jubilee Line) have demonstrated that properties which are located around the nodes of transport (the underground rail stations) have enjoyed increases in value, solely as a result of the new rail link. It is the fact that the properties are located so conveniently to the rail stations that causes the increase in value – thus, it is the value of the land which has increased, not (in isolation) the value of the buildings themselves. Much debate has therefore taken place about how to ensure that such increases in land values are returned to the community which created them. After all, this was not a development for which those landowners had (specifically) paid and therefore, there is an argument which says that they have no rights at all to that increase in property values. Such addtional value should be recovered for the community and spent on further improvements for the benefit of all.

5. LAND VALUE TAXATION

This debate has reignited interest in the UK, about replacing the current rating (and Council Tax) system with a land value tax (LVT), which would tax the owners of land based on the ”highest and best use” of the cleared site only. LVT reflects the principle that the value of the buildings are paid for (and therefore belong to) the owner of the property, but that the value of the land itself is provided by the community, for example, in the form of planning permission, public works (roads, facilities etc.), and the actions/non-actions of local and central government, and that therefore such a value belongs to the community and can be the subject of taxation.

Such a system would allow, within the tax regime, for a number of advantages:

- all government and community actions which increase the value of landed property would be reflected within the taxable value;
- all land would be taxed in this way, thus ensuring that all owners paid according to the value which the government and community gives to the land;

- the removal of improvements (buildings) from the tax would encourage owners to improve their properties and thereby improve the locality;
- owners would be encouraged to offer their land for development.

This latter point is the most significant and perhaps the most controversial. At present, an owner of a vacant site pays no rates and is, therefore, encouraged to keep the land idle within the existing tax system. However, under a land value tax, the land would be valued based on its use according to the planning system, which could be for commercial use. Such an owner would be required to pay tax as if the property were used for commercial purposes and is therefore encouraged within LVT to bring the land forward for development or else pay a high level of taxes for land which earns no income.

Thus, LVT would both penalize an owner for keeping land idle and also encourage that land to be brought into use. In this way, more brownfield sites would be brought forward for development, thereby improving both the quality and quantity of development within urban areas which, it is speculated, would prevent the drive to expand urban sprawl – also a significant goal to support urban sustainability.

Land Value Taxation would involve significant changes for the UK property tax regime. For example, it is a tax levied on owners, not occupiers. This would not make much difference in the residential sector (Council Tax) because of the high proportion of UK residential owner-occupiers (about 70%). But for commercial property, the shift from taxing occupiers to taxing owners is likely to result in a reduction in the number of taxpayers, and may also result in collection problems for the local authorities.

Land Value Taxation would be governed to a large extent by planning potential because it would be the use as defined by the planning system which would give the valuers the basis on which to fix the taxable value and research is underway to investigate the extent to which the current planning system could support a valuation for LVT.

6. VALUATION AGAIN

This leads into what may be the difficult problem for valuers if LVT is introduced. LVT is levied on the value of the unimproved site, based on open market values. However, there are very few unimproved sites which are sold in the UK and the chances of finding such sites, over a range of property uses in all localities is remote. In the UK, land is rarely sold in isolate from buildings and valuers will therefore be required to devise a system to produce site value from the open market sale price of land and buildings. Valuation methodologies which have been proposed for this purpose include the contractors test (or a similar cost-based method) and the residual method, which is traditionally used for establish the value of land which is to be used for development purposes.

The contractors test has been mentioned already in this paper (refer 3.3 above). Its problems of assuming a link between cost and value and also the failure to find any market evidence to support its outcome remain the most difficult for valuers to reconcile. The current use of the

contractors test is limited to specialist properties, such as industrial units, leisure centers, and municipal properties. It is not a method for use on the majority of property types. Its use may be acceptable because of the historical development of the current rating system, but it is clearly not a method of choice, either for the valuer or the courts.

The residual method of valuation is not currently used in rating – it has not therefore been tested in the courts for local taxation purposes. It is, however, generally recognised that the method relies heavily on predictions (the gross development value, costs of construction, costs of finance etc.) and that developers normally revisit their predictions as circumstances change. However, it is method which is used to fix the value (purchase price) of land being acquired for development purposes and is, therefore, highly appropriate for land value taxation.

There has been only one valuation exercise in the UK to assess the practicality of the valuation process necessary to underpin a Land Value Tax and that was undertaken in 1963 (and updated in 1973) in Whitstable in Kent by an experienced and respected rating valuer (Hector M. Wilks) who used both open market sales transactions and an adaptation of the contractors method (to "strip off" the cost of the buildings from an open market sale price to leave the value of the land).

The valuer who undertook this exercise concluded that the difficulties in producing a site value list were ". . . no more complex or intractable than those met and solved under the present orthodox system" (R&VA, 1964: 13), with 99% of the sites being valued without difficulty.

Nevertheless, the cost-based approach described by Wilks (R&VA, 1964; Land Institute, 1974) demonstrates that, even with a shift to Land Value Taxation, it is likely that methods of valuation will continue to be based on artificial constructs, such as the assumed link between cost and value; and that market evidence will be of little direct relevance.

This makes the basis of the tax hard to justify to an increasingly market-oriented taxpaying population and increases the risk that artificial constructs which produce an artificial pattern on taxable land values, with no market evidence to prove how accurate (or inaccurate) the values are. Once again, there is a danger that valuers will be working in "*cloud cuckoo land, a world of virtual unreality . . .*".

7. CONCLUSIONS

For a property-based tax, the open market value of property must be the best evidence on which to base a tax and it is therefore necessary to use market evidence to fix the taxable value. Currently this is not always achieved, but it may be that the fact that the property types for which the statutory formulae, profits and contractors methods are used are so small in number that any inequalities can be tolerated.

However, it is clear that rating is not a tax system which supports sustainability and its replacement with Land Value Tax is currently being discussed and investigated (e.g. McGill and Plimmer, 2003; Vickers, 2003). However, despite the laudable aims of sustainability, the tax underpinning that system needs to have a high level of integrity and must be acceptable by the taxpaying public as both robust and ”fair”.

As long as rates are based on open market rental evidence (or, in the case of the Council Tax, open market capital values), the taxpaying public is able to see properties for sale, reported (unofficially) transactions and thereby verify the accuracy (or otherwise) of the taxbase. There is, currently, no clear evidence that a shift to Land Value Taxation, despite its undoubted advantages, will result in the same integrity of the taxbase. This is research still to be done. It is also unclear the extent to which the British Land Value Tax payer will require absolute accuracy of values, or whether a robust and simple system will be adequate. Council Tax is currently based, not on discrete values for dwellings, but on a system of banded values (refer, for example, Plimmer, 2000, McCluskey *et al.,* 2002). With values already over 12 years out of date, the system has received little public criticism (except as far as the actual bills paid are concerned!)

Taxation law and valuation construct imaginative and complex scenarios in order to achieve a high element of equity, ”fairness” and uniformity between taxpayers. However, it is important not to lose sight of what a local property tax should be all about – ensuring that those with an element of ”wealth” pay towards services which are provided for and within the local community; that the system works effectively and efficiently, with maximum service provision and minimum wastage. Land Value Taxation demonstrates that property taxes can be used for other purposes too – to generate development and penalise those whose holding of land is not considered to be supporting sustainable goals. We need to be sure of what the local property tax system should be capable of achieving and ensure that these goals are met effectively and efficiently, and without seeking to achieve too much.

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BIOGRAPHICAL NOTES

Dr **Frances Plimmer** is a Chartered Surveyor and Senior Research Officer at The College of Estate Management, Berkshire, England, who has extensive experience in researching, writing and speaking on matters of real property taxation both in the UK and overseas. Of specific relevance to this paper, she is the author of *Rating Valuation: A Practical Guide* a text book, published by Longman, UK and co-author of two chapters in *Property Tax: an international comparative Review* (Ed. William McCluskey), published by Ashgate Publishing Ltd. UK.

In addition, she was awarded a David C. Lincoln Fellowship for research entitled: "An examination into the effects of Land Value Taxation in the UK: An update of the Whitstable Case Studies" in conjunction with Greg McGill, of The College of Estate Management, Reading, England. She is a member of the International Association of Assessing Officers and has addressed several of their conferences.

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APPENDICES

Example 1: Profits Method of Valuation – Illustrative:

	£
Gross Profit – reasonably maintainable	
Less: Working Expenses (excluding rent and rates)	
Divisible Balance	
Less: Tenants' Share (to reflect risk, remuneration and interest of capital)	
Rent and Rates	
Less: Rates (RV*rate)	
	Rateable Value

Example 2: Contractors Method of Valuation – Illustrative:

	£
Stage One: Cost of Constructing a simple substitute building: Building must be capable for performing the same function. Include rateable plant and machinery, site works, fees but not VAT.	
Stage Two: Deduct for Age, Obsolescence and other occupational factors. This produces the Effective Capital Value - sometimes called the Adjusted Replacement Cost (ARC). The objective of stage two is to convert cost into value.	
Stage Three: Establish the cost of the site clear of buildings with all services available. Value the site *rebus sic stantibus*, as if limited to the existing use.	
Stage Four: Apply the Decapitalisation Rate. The decapitalisation rate converts capital cost into annual cost. The decapitalisation rate is fixed by legislation at 3.67% for educational and hospital properties and at 5.5% for all other cases.	
Stage Five: Take into account all relevant matters not already included, e.g. poor site access.	
Stage Six: Consider the relative bargaining strengths of the parties. Sometimes called the "stand back and look" stage.	
The result should be what it would cost in annual terms the hypothetical tenant to provide the hereditament for himself.	**Rateable Value**