James Wyatt investigates important research into the relationship between freehold and leasehold values

Relativity from the real world

Relativity is the name given to the relationship between the value of the freehold of a property and the value of the same property held on a lease. Knowing the correct relativity is vital in establishing the value of a leasehold interest of less than 80 years, but there is much debate over its calculation.

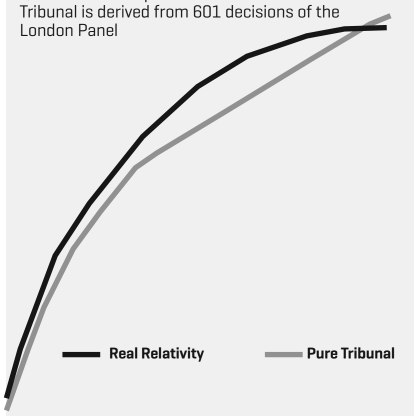
Over the years, various agents have put forward graphs depicting their opinion on relativity. These have been subjective and the majority have been created by agents and surveyors who work for the great estates, e.g. Gerald Eve (Grosvenor), Savills (Wellcome, Phillimore), Knight Frank (Church), WA Ellis (Cadogan and Ilchester) and Cluttons (Cadogan, John Lyons). Opinions can differ and John D Wood & Co removed its name from the Gerald Eve curve, when they subsequently analysed the information and derived a higher relativity.

Aware of the problems in calculating relativity, the UK government commissioned the College of Estate Management to investigate the market evidence, but unfortunately, this report could find no discernible pattern. At the request of the Upper Tribunal, RICS formed a working party to derive a definitive relativity, but this resulted in a collection of individual opinions and no conclusion was formed.

Parthenia's research into relativity, derived from around 8,000 flat and house sales using hedonic regression, examines more market evidence than all the existing graphs combined. In the case of **Kosta v The Trustees of the Phillimore Estate,** this objective independent analysis of the market evidence was put before the Upper Tribunal. The analysis is on actual sales in the market from 1987 to 1992 i.e. from the 'no Act world' and therefore untainted by the rights conferred and the adoption of other graphs of relativity. The analysis of the market evidence suggested the price of the freehold should be reduced by around 31% compared to the existing relativity graphs.

Figure 1

The Market Relativity v Pure Tribunal
The Market Relativity is derived from analysing 7,969 sales from prior to the Act and the Pure Tribunal is derived from 601 decisions of the London Panel



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However, the Upper Tribunal did not find in favour of this real world relativity for four reasons.

1. The valuation date was 2011 and the results of the research only became available in 2012. Therefore, the Upper Tribunal stated the hypothetical purchaser would have had to rely on the existing graphs. By inference, it does mean this new relativity could be used for any valuation from 2012 onwards.
2. The Upper Tribunal stated that some of the point estimates in the model were illogical. However, it was explained a line of best fit was used (regression) and this used the midpoint of the point estimates. The average relativity put forward by Dr Philippe Bracke, now at the Bank of England, is derived from three models and the relativity is increasing at a decreasing rate and is not flat as suggested by the Tribunal (see Figure 1). Bracke pointed out there were no point estimates, confidence intervals or statistical tests of the existing graphs. All the experts agreed hedonic regression was an appropriate technique for deriving relativity and no-one could find any serious errors or mistakes. The Upper Tribunal concluded the research was formidable.
3. A lack of valuation evidence in support of this new relativity was also cited. This reasoning has caused much consternation from surveyors, because what is valuation evidence if not the evidence of actual sales? With more than 8,000 flat and house sales, this new analysis has far more market evidence than all the existing graphs combined, which typically have only a few hundred.
4. The final reason not to adopt this new

> "Surveyors have a duty of care to their clients; at the very least, they should inform and offer them the opportunity of using this research

evidence-based relativity was because relativity may have changed since the 1987-92 period. However, no-one could clarify or quantify whether it has changed and if it has increased or decreased. In addition, it should be remembered the relativity adopted by the Upper Tribunal was based on the subjective analysis of sales, settlements and decisions from a similar period and therefore would be similarly afflicted.

When deciding not to adopt the new relativity, the Upper Tribunal was very careful to state its decision was for the 'present case'. The decision has been criticised by many for being inconsistent with previous rulings, illogical and circular. One of the most respected practitioners in the industry stated: "Its rejection is tantamount to saying that **Arrowdell and Nailrile Ltd v Earl Cadogan** [2009] 2EGLR151 was wrongly decided – albeit in the presence of much inferior evidence."

Parthenia believes that its research is the only objective, statistically robust and peer-reviewed relativity. Although it has yet to find favour at tribunal, several cases have been conjoined and the Upper Tribunal has agreed to hear them in the next few months. Surveyors have a duty of care to their clients and given its potential impact, at the very least, they should inform and offer their clients the opportunity of using this research. Ⓡ

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In a fighting mood

Annis Lampard looks at recent activity by HMRC on property transactions

My article for the *Property Journal* (*Widening the net*, July/August 2014), highlighted major changes to the taxation of property and the consequences for those involved in property transactions.

In the first few months of 2015, a picture has emerged of HM Revenue and Customs (HMRC) activity around property transactions. It is understood that HMRC's 'tax take' for capital gains tax (CGT) resulting from its investigations for the 2013-14 year was a record high of £136m. This was a significant increase from the previous year's level of £110m, which was itself a record high.

It might be expected that this rise was due simply to a combination of rising house prices, share prices and tax rates. However, as some experts have already pointed out, the rise seems due to HMRC's belligerence. This is to be expected, given the high pressure on HMRC from bodies such as the Public Accounts Committee to close the tax gap.

Looking outside CGT at other taxes on property transactions, there are signs that this broader trend may continue. There is increasing momentum behind HMRC's Let Property Campaign *(http://bit.ly/1bBEcwX)* targeting undeclared rental income.

As an example of HMRC's determination, in January it announced that it had arrested two individuals on suspicion of a £1m CGT and income tax fraud relating to properties in east London and Essex. The case is being handled by HMRC Criminal Investigations. Even at this early stage, HMRC appears to be sending a clear message that it takes offences relating to the avoidance of property taxes seriously. A press release specifically mentioned the current taskforce aimed at those suspected of dodging CGT.

A wider message for RICS members is that HMRC may well seek interviews with the professionals involved in any suspected transactions, either to gather more evidence for its case through the use of third-party information notices or to explore how widely any potential fraud may have spread. It goes without saying that the time and effort involved in assisting HMRC with its enquiries is a distraction from normal business.

It is worth noting that any such enquiries are likely to be run through HMRC's Criminal Investigations teams, which will be tenacious in any inspections they carry out. Some members may fear reputational consequences if it becomes known that they assisted HMRC, even in good faith.

If any RICS members are contacted by HMRC to assist with enquiries into third parties, it is recommended that they seek professional advice about the best way to proceed. Ⓡ

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