

RICS Practice Standards, UK

Tenant alterations

Information Paper



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Service charges and tenant alterations

RICS information paper

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RICS information papers

This is an information paper. Information papers are intended to provide information and explanation to members of the RICS on specific topics of relevance to the profession. The function of this paper is not to recommend or advise on professional procedure to be followed by surveyors.

It is, however, relevant to professional competence to the extent that a surveyor should be up to date and should have informed him or herself of information papers within a reasonable time of their promulgation.

Members should note that when an allegation of professional negligence is made against a surveyor, the court is likely to take account of any relevant information papers published by the RICS in deciding whether or not the surveyor has acted with reasonable competence.

Introduction

The fair and equitable apportionment of the costs incurred by a landlord in dealing with common parts works and services is often relatively straightforward. The most common and simplest method of apportionment is based on floor area, i.e. the proportion the tenant bears is the ratio that the floor area of the premises bears to the aggregate floor area of the whole building or scheme.

However, where a tenant carries out alterations to premises which increases (or decreases) the floor area of the premises (e.g. the installation or removal of a mezzanine floor within the tenant's demise) issues can arise as to the extent to which the tenant's proportion of the landlord's service charge should be increased or decreased, and the potential impact upon the proportion of the service charge payable by other tenants.

Tenants carrying out alterations often argue that they should not be penalised by paying an increased service charge for making efficient use of the accommodation or for carrying out works that effectively improve the value of the landlord's reversion.

However, if the status quo were to be maintained, neighbouring tenants would object to what would be viewed as subsidising a tenant who is operating from larger premises.

Conversely (although in practice probably less common) where a tenant carries out alterations which reduces the floor area of his premises (e.g. the removal of a mezzanine floor) other tenants might object to seeing their service charge increase as a result of their neighbour's actions which would be beyond their control.

The landlord would be keen to ensure that the apportionment of the service charge costs remains fair and reasonable.

The type and nature of alterations carried out and the type and nature of the scheme itself might also determine whether adjustments to tenants' service charge apportionments would be appropriate.

For instance, in the case of a warehouse/distribution centre, the introduction of additional mezzanine space, in preference to full eaves height racking, may not affect or increase the utilisation of the premises and therefore the use and benefit derived from common services.

However, a mezzanine floor installed in retail premises located in a shopping centre or retail park might generate an increase in customers to the store with a commensurate increase in use and benefit of common services such as parking, security, cleaning, etc.

These issues are vexed but the answer, as ever, will often lie in the precise wording of the lease.

1 Tenant alterations

Most leases restrict the tenant's right to alter premises. Such a covenant can be absolute (not to make any alteration to the premises) or qualified (not to make any alteration to the premises without the landlord's consent). However, in some instances the lease may not require the tenant to obtain landlord's consent for certain alterations.

Where the alteration is an 'improvement', section 19(2) of the *Landlord and Tenant Act 1927* provides that:

'in all leases containing a covenant condition or agreement against the making of improvements without licence or consent such covenant condition or agreement shall be deemed, notwithstanding any express provision to the contrary, to be subject to a proviso that such licence or consent is not to be unreasonably withheld; but this proviso does not preclude the right to require as a condition of such licence or consent:

- (i) the payment of a reasonable sum in respect of any damage to or diminution in the value of the premises or any neighbouring premises belonging to the landlord,
- (ii) the payment of any legal or other expenses properly incurred in connection with such licence or consent, and
- (iii) in the case of an improvement which does not add to the letting value of the holding, the right to require as a condition of such licence or consent, where such a requirement would be reasonable, an undertaking on the part of the tenant to reinstate the premises in the condition in which they were before the improvement was executed.'

Where alterations require the landlord's consent it would be usual for the licence for alterations to provide that the tenant's alterations are to be disregarded when assessing the rental value of the premises at subsequent rent review(s).

Therefore the tenant would not be penalised at review by paying rent on additional lettable area created at its own cost but neither would the landlord suffer a reduction in rent otherwise achievable as a result of a decrease in the lettable area resulting from the tenant's own occupational requirements.

2 The apportionment of the service charge – basic position

Whatever basis of apportionment is used it must be demonstrably fair and reasonable to ensure that individual tenants bear an appropriate, fair and reasonable proportion of the total service charge expenditure that reflects the benefit of the services enjoyed.

Landlords should apply the method and basis of apportionment consistently throughout the scheme which should have regard to the physical size, nature of use, and benefits to and use by occupiers.

From the landlord's perspective, the basis of apportionment should enable 100 per cent recovery of the costs incurred in carrying out works and in providing services to the common areas and facilities of the scheme.

Leases often stipulate that the apportionment of the service charge is to be on a fair and proper proportion and will often make reference to the basis of

apportionment, for instance primarily on the basis of the ratio that the floor area of the premises bears to the aggregate floor area of the whole building or scheme.

Most modern leases will usually describe the premises and the landlord's property as including any improvements and alterations. Therefore, if a tenant installed, for example, a new mezzanine floor this would then be included within the definition of the premises and thus the definition of the aggregate lettable space for the scheme for service charge and similar purposes.

3 Where the lease specifies the basis of apportionment

A new mezzanine floor, for example, would increase the floor area of the premises and thus the total floor area of the scheme.

Depending upon the precise wording of the lease, two completely different outcomes may therefore result.

If the lease makes specific reference to the basis of apportionment of the service charge, e.g. floor area, the landlord would be contractually obliged to adopt the apportionment method specified under the terms of the lease. Therefore, and all other things being equal, by installing a new mezzanine floor the tenant's service charge proportion would be increased, and the apportionments for the other tenants of the scheme would reduce accordingly.

The situation would be the same if the service charge were apportioned by reference to rateable values but, if an alternative method of apportionment were used, e.g. a fixed percentage, and the lease does not provide for the fixed percentages to be reviewed in the event of any alteration to the scheme or other change in circumstances, the service charge apportionments would remain unaltered.

4 Where the lease does not specify the basis of apportionment

Where the lease is silent as to the basis of apportionment and refers, for instance, only to a 'fair and reasonable proportion as determined by the landlord's surveyor', the situation is less clear.

In apportioning the service charge the landlord's surveyor, acting as an expert and not an arbitrator, will be required to fix a method of calculation which conforms with the basic principles of service charge apportionment, i.e. that it must be demonstrably fair and reasonable to ensure that individual tenants bear an appropriate, fair and reasonable proportion of the total service charge expenditure that reflects the benefit of the services enjoyed.

Furthermore, the basis and method of apportionment should ensure, so far as is reasonably practicable, that no one tenant is disadvantaged or that no one tenant secures an advantage, compared with other tenants.

However, in such circumstances where the landlord's surveyor has a degree of discretion in the basis used for the apportionment of the service charge there would be nothing in principle to prevent the introduction of perhaps a weighting or other discount for the treatment of mezzanine floors provided this achieved a fair and equitable result and was consistently applied throughout the scheme.

Where a tenant carried out alterations which might have an opposite effect, e.g. removal of a mezzanine floor, careful consideration needs to be given when granting consent to ensure that a situation does not arise whereby a tenant receives a reduction in his service charge liability, to the detriment of others, through what could be described as ‘constructive vandalism’.

5 Tips

- When dealing with alterations to premises, particularly where these require the prior consent or approval of the landlord, careful consideration should always be given to the potential impact upon the calculation of the service charge to ensure that the apportionment continues to be fair and reasonable, in accordance with the terms of the occupational leases and modern best practice.
- Where it is reasonably envisaged that tenant alterations might affect the fair and reasonable apportionment of the service charge, landlords should clearly communicate from the outset their intended policy for the treatment of tenant alterations within the context of the apportionment methodology for the scheme.
- This would be particularly important where leases permit making such alterations without landlord’s consent – e.g. in the case of a warehouse development, internal alterations such as the introduction of a mezzanine floor (in preference to full height racking) might be ignored, and the service charge calculated on the floor plate area only.
- When considering an application for consent to carry out alterations, the potential impact on the calculation of the service charge apportionments should be communicated by the landlord at an early stage.
- The landlord could consider whether appropriate wording to clarify the position and basis of calculation of the service charge moving forward should also be included within any licence for alterations granted by the landlord.
- In carrying out alterations tenants should be aware that there could be a potential impact upon the calculation of their proportion of the service charge payable as a result of the works carried out. Tenants or their advisors should seek confirmation from the landlord of the potential impact on their service charge liability of such alterations at an early stage.

Acknowledgments

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This paper is one in a series of information papers linked to the RICS Code of practice for service charges in commercial property.

To further develop the code the steering group would welcome your thoughts on this paper and any other matters relating to the RICS Code of Practice.

The service charge code of practice can be purchased from RICS Books on www.ricsbooks.com or downloaded via www.servicechargecode.co.uk

If you have any comments on this paper please send them to propertygroup@rics.org



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