Heads of terms for overage

Henry Goulding | February 2012

The complexities of overage arrangements are legion and, indeed, whole books are written on the subject. The aim of this article is to give land agents and landowners some pointers to be considered early in the negotiations leading to heads of terms. The hope is that this will reduce the scope for a transaction to get bogged down at a later stage when the lawyers start disagreeing over details.

**Detail**

The degree of sophistication and detail required in an overage arrangement will (or certainly should) be proportionate to the likelihood of development taking place. No-one welcomes the idea of sizeable legal fees and anguished negotiations between seller and buyer about an overage arrangement for a development that has little chance of ever happening. The very first point to consider, therefore, is how likely it is that development is going to take place. The more likely it is, the more you go into detail.

**Overage period**

You need to consider how long the overage arrangement should last. Perhaps counter-intuitively, the more likely it is to occur, the shorter the overage period can be (especially if this is coupled with a positive obligation on the part of the buyer to promote and secure a planning permission – in this scenario beware both the tax considerations (see below) and also the danger of creating a joint venture or partnership); the less likely development is to take place, the longer the overage period might be. There is nothing preventing as long a period as the parties are willing to agree.

**Bites of the cherry**

Another key issue is whether or not the overage should bite more than once. If it is to bite only once, there is the technical possibility that a developer might “clear off” the overage by first obtaining a low-value planning permission. Once the overage has been paid pursuant to this low-value planning permission, the developer obtains a high-value planning permission, for example for residential development, but the overage does not bite on it. This may of course just be a lawyer’s suspicious mind at work and, in practice, such deviousness may not be practical. That said, it remains a possibility and, if the overage is only to bite on the first development, then the seller would be well advised to include a good faith clause in the agreement to ensure that the buyer does not exploit this possible loophole. Another option is to include a de minimis provision whereby the overage would not kick in unless there is an uplift of at least, say, 10%. In this way, there is less chance that a low-value planning permission will use up the overage. The best position for a seller is, of course, that the overage can bite repeatedly throughout the overage period.

**Capital or income overage?**

Most overage arrangements seek to claw back a proportion of the capital uplift in a property which arises on a single, discrete occasion, for example the realisation of the value of planning permission for residential development. However, the buyer will not always realise the value of a development as capital and, in these circumstances, the buyer will be reluctant, for obvious cash flow purposes, to pay off the seller with a single capital sum. An example would be where the land is developed as a wind farm. The buyer will be letting the land to a wind farm operator, who will then pay the buyer a turnover rent. In such circumstances, therefore, the parties are going to have to consider more carefully how the overage arrangement should be structured. This might require a lease-back to the seller and a new underlease from the seller back to the buyer, who will then underlet to the operator. In such circumstances, specialist advice should be sought.

**Triggers**
What will be the trigger for the overage payment? A standard position is for overage to be paid either on the commencement of a development (ie the implementation of a permission) or on the sale of the land with the benefit of a planning permission. A buyer should not accept the grant of planning permission as a trigger since (a) it is of course open to a third party to obtain planning permission over another’s land (b) there is no guarantee that the planning permission, once granted, will be implemented and (c) the buyer is unlikely to have arranged its finances to be in a position to pay the overage due at that stage. One concern for a buyer about implementation being a trigger is that the buyer might wish to implement a permission purely to prevent it expiring (an alternative to implementation may be to persuade the seller to accept beneficial occupation as a trigger).

The calculation

As for how the overage is calculated, this really is going to depend on the individual circumstances. Sometimes a very specific development will be in mind and the overage calculation might be quite sophisticated. In other circumstances, where overage is being applied really as a safety measure, the terms might be more broad-brush.

One factor which will, however, figure in all transactions is the extent of the deductible costs which can be deducted from the enhanced value of the land before the overage percentage is applied to the uplift value (ie the difference between the enhanced value and the current value). For example, it would be usual to see the costs of obtaining the planning permission (including professional costs) as a deductible expense, but would, for example, these costs extend to lobbying, or providing circulars to, the local objectors? Should the deductible costs cover only the irrecoverable VAT? What about the costs of marketing? A buyer might want to consider the inclusion within deductible costs of any “abnormal” costs, being costs needed to bring the land up to a state in which it can be developed. These abnormal costs might cover environmental clean-up costs, infrastructure costs (roads, roundabouts, drainage) or the costs of clearing off any ransom (such as a third party access or a restrictive covenant). A seller will want all deductible costs to be made subject to a test of reasonableness.

A possible area of contention is how the uplift value is assessed. This will often be by reference to open market value or it might be based on real figures actually achieved by the developer. Sometimes the parties will have a clear idea of the likely development and can therefore work out a tailored valuation process. In the absence of that, one very useful shortcut is simply to rely on the definition of “market value” in the Royal Institution of Chartered Surveyors’ Red Book. This definition is sufficiently widely drawn for it to provide a reasonable default valuation formula for both parties.

Tax

At the beginning of this article, the word “tax” was mentioned. There is not the space to go into this fully, but the parties are most certainly going to have to consider the tax implications of any overage arrangement and to ensure that it is tax-efficient for that party’s purposes. Of particular concern is the danger posed by Section 756 of the Income Tax Act 2007 whereby, if the seller is deemed to be a party to the development, the returns payable under the overage will be subject to income tax, not capital gains tax. This principally arises where the sums due to the seller are based on the sums generated by the buyer. The view is, in that situation, that the seller is joining in with the buyer in the risk of the development (as HMRC puts it in its guidance, the seller is enjoying “a slice of the action”). If, on the other hand, the overage is attributable solely to the value of the land with the benefit of the planning permission, then the overage will be subject to capital gains tax. This is especially important for charities, which are not exempt from the head of income tax into which such uplift would fall but which are exempt from capital gains tax.

Buyers must also be aware that HMRC considers an overage payment to be part of the original purchase price. Stamp Duty Land Tax is therefore payable on the overage payment at the time of the sale that imposes the overage. Of course, at the time of sale that future payment is both contingent and uncertain. The existence of contingent consideration must be declared to HMRC and an application made for the deferral of the obligation to pay SDLT on the overage payment on the basis that the amount payable by the buyer cannot reasonably be ascertained. HMRC will usually grant this, but buyers must remain aware of their obligation to account to HMRC for SDLT if and when the overage payment is ultimately made.

As mentioned above, in many cases overage will be applied simply as a precaution, in which case the parties can take a more relaxed attitude towards the overage provisions and not get too bound up in the details. It will always be sensible to include a good faith provision together with an obligation on the buyer to disclose all relevant information at all material times. In other cases, however, where development of the land is a real possibility, more detailed and
sophisticated arrangements will be required and agents and landowners would do well to consult their lawyers from the outset and before heads of terms are finalised.

If you require further information on anything covered in this briefing please contact Henry Goulding (henry.goulding@farrer.co.uk) or your usual contact at the firm on 020 3375 7000.

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