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Provision of Unearned Increase in Leased Property - Understanding & Effects on Property Valuation

Introduction

The term "Unearned increase benefit" typically refers to a rise in value or financial gain that is not directly related to the efforts of an individual or organization. The unearned increase in value of an asset concerning land and real estate highlights the disparities between wealth created through individual effort and that gained from developments.

In this article, we will discuss the Effect of the Unearned increase of an asset in property Valuation.

Appreciation for Real Estate and Property

The value of land or property may increase due to external factors like infrastructure development & improvement in amenities & facilities, growth of an urban area, zoning changes, or general market conditions etc., rather than any improvements made by the property owner. This appreciation results in increasing the Value of the Property and this enhancement is called the - Unearned increase benefits which is without any effort of the Property Owner on their part.

Provision of Unearned Increase

In many government leases, there is a provision for profit sharing in case of Sale or transfer of the lease. State Government or local authority agencies many-a-times give land for development to individual entrepreneurs or a company by creating long-term leases and by charging a premium at market value or less than the market value of the land at a nominal lease rent of Re.1/- per year. Keeping in view a long-term public interest, and because of the development of an underdeveloped area, such leases invariably consist of a clause of payment of unearned increase, in case of sale / transfer / leasehold interest in land.

This means if the Lessee earns profit on land value, by way of such sale, the Lessor/Government or the Leasing Agency would charge a share in profit. The lessor is entitled to the unearned increase i.e., the difference between the premium already paid and the current market value as the value of the land at the time of transfer; the amount to be recovered being at some fixed per cent of the unearned increase.

This is called a premium for transfer or payment of the unearned increase. This amount is worked out at some fixed percentage of the difference between the original premium rate and the prevalent premium rate at the time of the transfer. In most cases, profit sharing is 50 % of the increased value .

Unearned increase - Effect on Valuation

IIf the property under valuation happens to be a lease hold plot, then a certain percentage, as specified in the lease deed of unearned increase (current market rate less premium paid) is also to be deducted from the land value. The provision of unearned increase exists in the lease agreement, and will affect the value of that asset significantly. The lessor is entitled to claim and recover a portion of the certain percentage as specified in the lease deed of unearned increase (the difference between the premium already paid and current market value) payable to the lessor in the event of sale/transfer.

Let us understand this with an example:
If the land was leased in 1985 at Rs.500/sq. m., and the premium rate today is Rs.5,000/sq. m., then the unearned increase charged to the lessee for the assignment would be, say 50% of the difference, i.e., 1/2 x (Rs.5,000 – Rs.500) = Rs 2250/-

In another case,
A lessee has taken land on lease and in the event of sale or transfer by the lessee, a 50% unearned increase is payable to the lessor, and it is a liability that requires to be deducted.

Let us assume that the land was acquired at Rs 10 Lakh and the current market value of the land is Rs 50 Lakh. This gives an unearned increase of Rs 40 Lakh and 50% of the unearned increase = Rs 20 Lakh.

Hence the value of the lessee's interest without considering an unearned increase is say Rs 60 Lakh. Then after considering the unearned increase, it will be Rs 40 Lakh

Very Popular case related to unearned Increase

C.W.T. vs. P. N. SIKAND 1977 AIR 1657, Supreme Court, 1st April 1977

This Appeal raised an interesting question of law relating to the valuation of a leasehold interest in land. When there is a covenant in the lease that the lessee shall not be entitled to assign the leasehold interest without obtaining the prior approval in writing of the lessor and the lessor shall be entitled to, claim and recover from the lessee ascertain the specified proportion of the unearned increase in the value of the land at the time of the assignment. Unearned increase "payable" to the lessor as per the agreement is deductible out of the valuation for leasehold interest.

In this case the assessee holds the leasehold interest on the condition that if he assigns it, 50% of the unearned increase in the value of the land will be payable to the lessor.

Finally, Hon' Court held that in determining the value of the leasehold interest of the assessees in the land for assessment to wealth tax, the price that the leasehold interest would fetch in the open market would have to be reduced by 50%. of the unearned increase in the value of the land, based on the hypothetical sale on the valuation date.

Conclusion

The clause of payment of "unearned increase" is a charge on the land before the transfer is affected and must be, therefore, deducted from the total value of the property.