Property Rights Brought to Light: Principles and Misconceptions

by Gary E. Heiland II, MAI, AI-GRS

Abstract

One of the most important components of any real property appraisal is a solid understanding of property rights. The root of inconsistent valuation methodologies often is found in differing understandings and misconceptions regarding property rights. Does an appraiser value real estate or real property? Does the market value of the leased fee interest plus the market value of the leasehold interest equal the market value of the fee simple estate? What is "dark store theory"? This article addresses the basics of property rights, the relationship of partial rights and the fee simple estate, proper application of the approaches to value, and common misconceptions relating to property rights.

A solid understanding of property rights and the application of appropriate valuation techniques are paramount to developing a credible real estate/real property appraisal. Property rights are one of the most important aspects of every appraisal assignment—but unfortunately, many misconceptions exist. These misconceptions can lead to erroneous appraisals. This article discusses principles related to property rights, and common issues and misconceptions related to the understanding of property rights and appraisal terminology.[1]

Real Estate versus Real Property

Do appraisers appraise real estate or real property? *Real estate* is defined as "an identified parcel or tract of land, including improvements, if any."[2] Real estate is tangible. It is the soil, rocks, trees, bricks, etc. The term *real estate appraiser* is commonly used by both practitioners and users of appraisal services. The Appraisal Institute's predecessor organizations were the American Institute of **Real Estate** Appraisers and the Society of **Real Estate** Appraisers. The Appraisal Institute's authoritative texts are entitled *The Appraisal of* ***Real Estate*** and *The Dictionary of* ***Real Estate*** *Appraisal*. Additionally, all of the forty-one individual appraisal regulatory agencies in the United States and Puerto Rico have "real estate" in their names.

In *The Dictionary of Real Estate Appraisal*, sixth edition, *real property* is defined as follows:

1. An interest or interests in real estate.
2. The interests, benefits, and rights inherent in the ownership of real estate. (USPAP, 2016–2017 ed.)
3. All rights, interests, and benefits related to the ownership of real estate. (IVS)[3]

1. This article focuses on issues affecting surface rights only and does not explore issues involving subsurface rights, mineral rights, air rights, water rights, etc. Readers with an interest in those topics are encouraged to explore the Appraisal Institute's Y. T. and Louise Lee Lum Library catalog for materials. See for example, Joseph B. Lipscomb and J. R. Kimball, "The Effects of Mineral Interests on Land Appraisals in Shale Gas Regions," *The Appraisal Journal* (Fall 2012): 318–329; "Identifying Rights and Interests to Be Appraised in Rural Property," *The Appraisal Journal* (Winter 2017): 40–50; and Bernie Shaner, "Appraisal of Underground Gas Storage Rights in Depleted Reservoirs," *The Appraisal Journal* (Spring 2016): 133–140.
2. Appraisal Institute, *The Dictionary of Real Estate Appraisal*, 6th ed. (Chicago: Appraisal Institute, 2015), s.v. "real estate," quoting the Uniform Standards of Professional Appraisal Practice (USPAP), 2016–2017 edition.
3. *The Dictionary of Real Estate Appraisal*, 6th ed., s.v. "real property."

The Uniform Standards of Professional Appraisal Practice (USPAP) points out, "In some jurisdictions, the terms *real estate* and *real property* have the same legal meaning. The separate definitions recognize the traditional distinction between the two concepts in appraisal theory."[4] It is important that appraisers understand this distinction. But which term is more applicable: Do appraisers appraise "bricks and sticks" (real estate) or interests and rights (real property)?

To understand these terms better and to answer these questions, the concept of market value must be examined. Market value is a value-in-exchange concept and reflects the market's perception of something's worth. In order for an item to have value to the typical market participant, it must have the potential to transfer to another party with rights that the market desires. As it relates to the ownership of real estate, this concept of rights is best described by the term *real property*. It is the *rights* in and to real estate that cause the market to recognize value in the tangible real estate. Real estate without any rights (rights of use, occupancy, etc.) has no market value; *The Appraisal of Real Estate*, fourteenth edition, states, "Real estate in and of itself has no value; the rights, or interests, in real estate are what have value."[5]

Consider, for example, what a buyer would pay for a vacant one-acre lot that the buyer could not use, could not sell, could not rent to someone else, could not mortgage, could not physically enter, could not give away, could not enjoy, etc. As a typical market participant, the buyer would pay nothing. Hence, real estate void of rights has no market value. Now consider that same lot with the potential to build a public park, but zoning that will not allow any other use. How much would the buyer pay? What if zoning allowed a parking lot? What if zoning allowed development of a dwelling? What about development of four dwellings or an office building or a retail store? With each of these different rights, a buyer would likely pay a different price, yet the tangible real estate has not changed.

Next, consider a residential dwelling. Suppose similar dwellings typically sell for $250,000 to owner-occupants; however, this particular dwelling is encumbered by a lease for 10 years with the tenant paying only $100 per month. Now consider what a buyer would pay for this property. By generating a gross income of only $1,200 per year over the next 10 years, a buyer is not likely to pay $250,000 but instead something considerably less. Again, the real estate may be identical to others on the same street, yet its market value is different due to the rights that would transfer with it upon a sale.

Appraisers have historically been taught that they appraise real property rights, not real estate itself. In answer to the question, "Precisely what does a real estate appraiser value?" *The Appraisal of Real Estate* responds, "In simplest terms, the real property rights, not the real estate itself."[6] It is further stated that "in an appraisal, a particular set of real property interests—not the real estate—is what is valued."[7] However, is it true that appraisers *only* appraise property rights?

USPAP requires appraisers to identify the real property interest to be valued.[8] This is necessary so the context of the appraisal can be understood. The appraiser must understand whether the appraisal is of real estate subject to rights held as a fee simple estate (ownership interest in real estate that is not leased), a leased fee interest (ownership in leased real estate), or a leasehold interest (a tenant's interest in the real estate). Does this mean that real estate is not what is appraised? To answer this question, consider typical appraisal requests. Appraisal clients generally want to know what particular *real estate* is worth, subject to rights that would transfer with it under a hypothetical sale. The client may ask, "What is 123 Main Street worth?" or "What is the value of the industrial property at Market and Penn Streets?" A market value opinion should reflect what the typical buyer would pay for the *real estate* that would transfer to a typical buyer in a hypothetical sale *along with all applicable rights*. Consummating the typical transaction

4. Appraisal Standards Board, Definition of "Real Property" Comment, *Uniform Standards of Professional Appraisal Practice*, 2018–2019 ed. (Washington, DC: The Appraisal Foundation), Lines 162–163.

5. Appraisal Institute, *The Appraisal of Real Estate*, 14th ed. (Chicago: Appraisal Institute, 2013), 4.

6. *The Appraisal of Real Estate*, 14th ed., 3.

7. *The Appraisal of Real Estate*, 14th ed., 4.

8. Standards Rule 1-2(e)(ii), *Uniform Standards of Professional Appraisal Practice*, 2018–2019 ed., Line 475.

involves payment for the tangible real estate, generally in cash or its equivalent, and transfer of legal title of the real estate to the buyer via deed. Important here is that the tangible real estate is transferred, not just the rights. However, the market value of the real estate is dependent on the rights that would transfer with it.

USPAP Advisory Opinion 23 clarifies that not only are rights appraised but also the real estate. "The subject of a real property appraisal has both physical and legal characteristics....Appraisers and property owners often discuss a subject property in physical terms, such as *my home*, *the residence*, *my land*, or *the building*. However, a physical object, alone, is not what is being appraised."[9] As such, and as is explained herein, when an appraisal addresses a fee simple estate or a leased fee interest, it is real estate that is appraised, subject to transferable rights.

Appraisers commonly make statements in appraisals such as "this is an appraisal of the *fee simple estate* in 123 Main Street," or "this is an appraisal of the *leased fee interest* in 123 Main Street." While this is commonplace, appraisers and users of appraisals should remember that the tangible real estate is also appraised. As such, both "real estate appraiser" and "real property appraiser" are accurate descriptions for appraisal professionals. Conversely, as is explained later, when appraisals address leasehold interests, appraisers are only appraising *rights* to real estate, *not* real estate subject to rights. This is because in a leasehold transaction, only the *interest* in the real estate is transferred; the real estate is not transferred. In a leasehold valuation appraisers are only acting as real property appraisers as they are only appraising a tenant's rights to real estate. To further unpack the idea of property rights, the bundle of rights concept is reviewed next.

Bundle of Rights Theory

Property rights can best be understood by an examination of the *bundle of rights* concept. Under this concept, which is familiar to most appraisers, the various property rights in the real estate are represented as sticks in a bundle, with each stick representing a separate right. These "sticks" include, but are not limited to, the following:

- The right to use the real estate
- The right to sell it
- The right to lease it
- The right to mortgage it
- The right to enter it
- The right to give it away

Note that these are things that can be done to or with the *real estate*.

When an owner holds the entire bundle of sticks (all rights in the real estate except the governmental powers), then the owner's interest is known as a fee simple estate. The appraisal profession defines *fee simple estate* as follows:

> Absolute ownership unencumbered by any other interest or estate, subject only to the limitations imposed by the governmental powers of taxation, eminent domain, police power, and escheat.[10]

Once an owner conveys rights to a tenant for use and occupancy via a lease, the fee simple estate becomes bifurcated: the owner's interest becomes a leased fee interest, while the tenant, who holds the rights of use and occupancy, has a leasehold interest.

Fee Simple Estate

Confusion exists as to definitions and interpretations of the term *fee simple estate*. First, note that the definition of *fee simple estate* used in the appraisal profession and quoted above differs from that used in the legal profession. *Black's Law Dictionary* ("*Black's*") defines *fee simple* as follows:

> An interest in land that, being the broadest property interest allowed by law, endures until the current holder dies without heirs; esp., a fee simple absolute. —Often shortened to *fee*. —Also termed *estate in fee simple*; *tenancy in fee*; *fee-simple title*; *exclusive ownership*; *feudum simplex*; *estate in fee*.[11]

9. Appraisal Standards Board, Advisory Opinion 23, "Identifying the Relevant Characteristics of the Subject Property of a Real Property Appraisal Assignment," *USPAP Advisory Opinions*, 2018–2019 ed. (Washington, DC: The Appraisal Foundation, 2018), AO-23 Lines 34, 37–38.

10. *The Dictionary of Real Estate Appraisal*, 6th ed., s.v. "fee simple estate."

11. *Black's Law Dictionary*, 10th ed., s.v. "fee simple."

Black's goes on to define *fee simple absolute*:

> An estate of indefinite or potentially infinite duration (e.g., "to Albert and his heirs"). —Often shortened to *fee simple* or *fee*. —Also termed *fee simple absolute in possession*.[12]

These legal definitions of fee simple differ from the definition used by appraisers in that they do not include the concept of *unencumbered* ownership. To distinguish the difference between ownership with the full bundle of rights (fee simple) and ownership where rights of use and occupancy have been granted to a tenant, the appraisal community uses the term *leased fee*, essentially leased fee simple (as defined by *Black's*), or fee simple subject to a lease or leases (*fee simple* as defined by *Black's*). *The Dictionary of Real Estate Appraisal*, sixth edition, defines *leased fee interest* as follows:

> The ownership interest held by the lessor, which includes the right to receive the contract rent specified in the lease plus the reversionary right when the lease expires.[13]

While it could be argued that legally all real estate, regardless of lease encumbrance, transfers fee simple per the *Black's* definition, recognition must be made that the market value of real estate is dependent on rights that transfer with it and that, as previously demonstrated, physically identical real estate can have drastically different market values depending on whether a lease encumbrance exists. It is this recognition that has caused the appraisal profession to devise and use the distinctions of fee simple estate and leased fee interest, which distinguish when ownership of real estate is and is not encumbered by a lease.

Under a strict interpretation of the unencumbered fee simple definition, encumbrances such as public utility easements or reciprocal access agreements that would survive a hypothetical sale would be excluded. However, most developed or marginally developed properties have encumbrances such as these easements and agreements. It is clear that the intent of using two definitions (unencumbered fee simple and leased fee) is only to distinguish whether real estate is unencumbered by a lease or encumbered by a lease. Note that the other encumbrances (easements, agreements, etc.) are generally not at issue in the valuation of leased fee interests because the only meaningful difference between the two definitions is lease encumbrances.

Unless otherwise noted, throughout the remainder of this article, the term *fee simple estate* will refer to fee simple estate as defined in *The Dictionary of Real Estate Appraisal*, sixth edition. Fee simple estates are an economic reality when the owner holds the entire bundle of rights. Whether the owner occupies the real estate as an owner-occupant or the real estate is vacant and not leased, the owner's interest is an unencumbered fee simple estate.

One common misconception related to fee simple valuations is evident in the valuation of rental apartment properties and the identification of the appropriate property rights to appraise. When asked to appraise the property owner's interest in a rental apartment property, many appraisers incorrectly believe that, because apartment leases are generally short term, the fee simple estate should be identified and appraised. However, one must remember that a fee simple estate is *unencumbered* by any other interest or estate. Occupied apartment units are leased, and even if the leases have short terms or are market oriented, they are, nonetheless, encumbrances on the fee title. The rights to use and occupy the apartment units have been transferred to the tenants, and the property owner's interest should be identified as a leased fee interest. If an appraisal assignment involving a tenant-occupied apartment property is to value the property owner's interest, as is the case with most appraisals commissioned for rental apartment properties, the property owner's interest should be identified as a leased fee interest. While it is permissible for an appraisal to address the unencumbered fee simple estate in a leased property, it may not be applicable for the intended use of the assignment. In a fee simple valuation, a property must be valued as if unencumbered, despite the fact that the property is occupied by tenants. The Interagency Appraisal and Evaluation Guidelines (Guidelines) support the position that fee simple ownership relates to property that is unleased. The Guidelines state,

12. *Black's Law Dictionary*, 10th ed., s.v. "fee simple absolute."

13. *The Dictionary of Real Estate Appraisal*, 6th ed., s.v. "leased fee interest."

> Fee simple interest refers to the most complete ownership unencumbered by any leases or other interests. It is subject only to the limitations imposed by the governmental powers of taxation, eminent domain, police power and escheat. Leased fee interest, on the other hand, refers to a landlord's ownership that is encumbered by one or more leases.[14]

A common misnomer relating to fee simple ownership is "go dark value." This term is occasionally used by appraisers, brokers, and users of appraisal services to identify hypothetical situations when a property, often a retail property, might be vacated by the owner or tenant and "go dark." When a leased property goes dark, i.e., is vacated before the lease's expiration, the provisions of the lease may provide that the lease is extinguished, expires, or remains in place even though the tenant no longer physically occupies the space. If the lease remains in place, the owner's interest remains a leased fee. However, if the lease is extinguished or expires, "dark value" then equates to the market value of the unencumbered fee simple estate. Appraisers should be very careful using a term like "go dark," since it does not adequately identify the property rights being appraised. When an owner-occupied property goes dark but no sale occurs, the owner has simply turned off the lights and vacated. There is no change in property rights that would transfer upon a hypothetical sale. The owner still possesses an unencumbered fee simple estate whether they choose to occupy and use the property or not.

"Dark store theory" is a concept that has recently been promulgated by some in the tax assessment community. They suggest that the fee simple estate (typically relating to retail properties such as big-box stores and drug stores) should not be valued by the sales comparison approach using sales of other properties that sold vacant, or "dark." Paraphrasing any number of news articles that can be found online, one would find "dark store theory" described as a valuation loophole exploited by major retailers to get a reduction in their taxes by valuing their properties using sales of vacant stores located in failed locations that are encumbered by deed restrictions and reflect different highest and best uses than the subject property. Furthermore, according to the International Association of Assessing Officers (IAAO), dark store theory "suggests that occupied big-box stores should be valued as-if-vacant and available for sale or rent to a future hypothetical user rather than in the current use, which is often a functioning, occupied store."[15] However, dark store theory is not actually a theory, but a label that stigmatizes the valid and appropriate practice of using comparable sales reflecting unleased fee simple estates to appraise the unleased fee simple estate in a subject property.

In most cases where dark store theory is alleged, the underlying valuation is the market value of the fee simple estate in an owner-occupied or leased property. Owner-occupied properties and vacant (unleased) properties are all held as unencumbered fee simple estates because under both scenarios the properties are not leased and the owners hold the full bundle of rights.

At first glance, sales of physically similar, but vacant, properties do not appear comparable because the subject property is physically occupied and the comparable sale is vacant/unleased ("dark"). However, market value is a value-in-exchange concept and a hypothetical sale of the subject property must always be presumed.[16] A hypothetical sale of an unencumbered fee simple estate is the sale of the real estate without a lease. Upon such a sale, all rights in the bundle transfer to the new owner as the hypothetical buyer would purchase an unencumbered, physically and economically vacant property. When an unencumbered fee simple estate sells, the property is always vacant at the time of transfer except for circumstances when a going concern is purchased and the sale includes real estate as well as

14. *Interagency Appraisal and Evaluation Guidelines* (SR 10-16, December 2, 2010), 36, issued by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Administration; available at http://bit.ly/appraisalguidelines.

15. International Association of Assessing Officers (IAAO), *Commercial Big-Box Retail: A Guide to Market-Based Valuation* (Kansas City, MO: International Association of Assessing Officers, September 2017), 5; available at http://bit.ly/IAAO-bigbox. See also IAAO draft exposure report, *Setting the Record Straight on Fee Simple* (May 2019), available at http://bit.ly/2za5HDt.

16. "Market value always presumes the transfer of a property as of a certain date, under specific conditions." Advisory Opinion 22, "Scope of Work in Market Value Appraisal Assignments for Real Property," *USPAP Advisory Opinions*, 2018–2019 ed., AO-22 Line 111.

furniture, fixtures, and equipment, and the business enterprise. Therefore, regardless of occupancy, when the fee simple estate is being valued, the value premise is that there is no lease encumbering the real estate and the property should be valued in the same manner. Hence, while the comparable sales are "dark," the buyers of these properties purchased the real estate subject to the same rights as those being appraised, including the right to turn on the lights.

Discussion of so-called "dark store theory" generally focuses on big-box retail; however, the validity of this methodology can be easily examined in terms of how other types of real estate are appraised. For example, consider a two-story dwelling in a single-family neighborhood and the dwelling is for sale because the current owner is relocating to a different area. The owner controls the full bundle of rights and owns the property in fee simple. When the sales agent brings prospective buyers to see the house, the seller's furniture is still present, family photos are on the wall, and people are living in the house. The property is physically occupied but is not leased by anyone. A sale price is agreed upon and the parties go to settlement. At the settlement table, the buyer tenders a check to the seller and the seller gives the buyer keys to the property. When the buyer leaves the settlement table and arrives at the property, the seller's belongings are no longer present nor is the seller. The property is physically vacant, just as the buyer was expecting it to be. It is "dark," waiting for the new owner to turn on the lights. An appraiser valuing this property for the purchase financing would use sales that reflected similar fee simple estates and would not be accused of employing "dark house theory."

This is no different than when an owner-occupant sells its industrial property, big-box retail property, or office property. Unless a sale-leaseback is negotiated, these properties are physically vacant and unleased when they sell. Therefore, when appraising these fee simple estates, the ideal sales should be of similar fee simple estates. Note that a sale-leaseback does not represent a fee simple sale and should not be treated as such since the sale is subject to a lease. Additionally, significant care should be employed whenever considering a sale-leaseback as a comparable sale in any valuation as the leases and sale prices may not be reflective of a market transaction.[17]

Some would argue that it is appropriate to assume that an owner-occupant would lease back the property at market rent, and therefore an owner-occupied property should be valued as if leased at market. Even if there is no explicit assumption called out in an appraisal report, the valuation methodology reflects that premise. However, if the valuation context reflects the notion that the property had already been exposed to the market, the economic reality is that there is no lease. Appraising a property as if leased at market rent when no lease exists would require employment of a hypothetical condition, as one would be appraising the property in a way that is contrary to what is known by the appraiser.

It is also a misconception that fully owner-occupied properties represent stabilized occupancy because the property is physically occupied at the time of the appraisal. *The Dictionary of Real Estate Appraisal* defines *stabilized occupancy* as follows:

> 1. The occupancy of a property that would be expected at a particular point in time, considering its relative competitive strength and supply and demand conditions at the time, and presuming it is priced at market rent and has had reasonable market exposure. A property is at stabilized occupancy when it is capturing its appropriate share of market demand.
> 2. An expression of the average or typical occupancy that would be expected for a property over a specific projection period or over its economic life.[18]

Owner-occupied properties cannot be considered stabilized as they are not encumbered by a lease. If the assignment is to value the owner's interest in an owner-occupied property, the property should be valued as unencumbered (unleased).

While leased properties are held as leased fee interests, appraisers are often asked to appraise the fee simple estate in a leased property. For example, some state statutes require fee simple valuations for property tax assessments, even when the property is leased. In these assignments, the definition of *fee simple estate* is paramount.

17. Martin A. Skolnik and Gary E. Heiland II, "Big Box Retail Properties: Pitfalls of Valuation," in *Proceedings of the 1998 Annual Conference of the International Association of Assessing Officers* (Orlando, FL, September 1998), 360–372; paper reprint available at http://bit.ly/1998paper.

18. *The Dictionary of Real Estate Appraisal*, 6th ed., s.v. "stabilized occupancy."

Under the *Black's* definition of *fee simple estate*, it may be appropriate to appraise the property subject to an encumbering lease. In contrast, under the definition of *fee simple estate* used by appraisers, these properties should be appraised disregarding the lease, as if unencumbered.

Another common misconception is that the market value of a property leased at market rent is equivalent to the market value of the property's unencumbered fee simple estate. In practice, the market value of the unencumbered fee simple estate is likely not equivalent to the market value of the real estate when leased at market rent. Therefore, when valuing a fee simple estate (either a vacant or unleased property or one that is owner-occupied), sales of properties with leases in place may not be ideal for comparison, even those believed to be leased at market rent. Conversely, when an appraisal addresses a leased fee interest, sales of properties that were vacant or unleased at sale may not be ideal for comparison.

Consider the following scenario, for example. An appraiser is hired to appraise the fee simple estate in two neighboring single-family residential properties that are physically identical in all respects. The intended use of the appraisals is for mortgage financing. The first property has already been vacated and is being purchased as a primary residence. The second property is owner-occupied as a primary residence and the owner is refinancing. In valuing the first property, it is clear that appropriate comparable sales are of similar dwellings that were vacant at the time title was transferred—sales that reflect the transfers of fee simple estates. But what about the second property that is owner-occupied and not physically vacant? It is still a fee simple estate valuation because upon the closing of a theoretical market-oriented transaction, the seller would deliver a vacant property to the buyer. Again, remember that the market value presumption when appraising a fee simple estate is that the property would be unencumbered (vacant) at the time of the presumed market value sale. Therefore, as described in USPAP Advisory Opinion 23, the same comparable sales are applicable.[19]

Now consider another scenario. An appraiser is hired to appraise the leased fee interest in a property improved with a physically vacant home improvement warehouse store. The retailer relocated to a smaller, more modern store one mile away but continues to lease the vacant store property and the lease does not expire for another five years. Even though the property is physically vacant, it is encumbered by a lease. If the owner's interest is to be appraised, the applicable comparable sales would be of similarly leased properties (sales of leased fee interests) rather than unleased properties (sales of fee simple estates), even though the property is physically vacant. Consideration may need to be given for investment risk, credit tenancy, and other factors, but again, USPAP Advisory Opinion 23 supports using leased fee sales when appraising a leased fee interest.

Leased Fee Interests

When a property owner conveys the rights of use and occupancy to a tenant, the owner's interest changes from an unencumbered fee simple estate to a leased fee interest. The income capitalization approach is typically the most applicable approach in the valuation of a leased fee interest. The first step in valuing the leased fee interest via the income capitalization approach is analyzing the contract rent's relationship to market rent. The concept of market rent is similar to that of market value—market rent is the most probable rental income a property would command in the open market.[20] Where market value presumes a hypothetical sale, market rent presumes a hypothetical leasing of the space. Even in situations where the contract rent is for new or build-to-suit space, estimating market rent must assume a re-leasing of the space. In order to estimate market rent, appraisers typically analyze comparable leases found in the market. However, appraisers should be aware of build-to-suit leases and leases from sale-leasebacks that, while abundant, might not be representative of the market for re-leasing space like the subject.

While the income capitalization approach is typically the primary approach in the valuation of a leased fee interest, an abundance of leased

19. The applicability of choosing fee simple sales when appraising a fee simple estate is clarified in USPAP Advisory Opinion 23's subsection "How the Characteristics of the Subject Affect the Scope of Work Decision," in *USPAP Advisory Opinions*, 2018–2019 ed., AO-23 Lines 49–76.

20. *The Appraisal of Real Estate*, 14th ed., 447.

fee sales in a market might make a sales comparison approach credible. The best comparable sales for use in the valuation of a leased fee interest are similar sales of leased fee interests.

Leasehold Interests

Whenever a lease is signed, a leasehold interest is created. At lease execution, the fee simple estate is bifurcated into a leased fee interest (landlord's interest) and a leasehold interest (tenant's interest). *The Dictionary of Real Estate Appraisal*, sixth edition, defines a *leasehold interest* as "the right held by the lessee to use and occupy real estate for a stated term and under the conditions specified in the lease."[21] It is again important to note that an appraisal of a leasehold interest is not an appraisal of real estate, as real estate is tangible. An appraisal of a leasehold interest is an appraisal of the tenant's rights *to* real estate that last for a finite period of time. As such, in an appraisal of a leasehold interest, it would be more appropriate to think of the appraiser as a real property appraiser instead of a real estate appraiser.

A leasehold interest has the potential for market value only if the lease allows assignment. It is a common misconception that if a lease allows subletting, then the leasehold interest has market value. The selling of a leasehold interest, however, is accomplished via lease assignment, not subletting. William Barrett described this in his *Valuation* article "Value Proposition," where he notes, "Many leases also restrict or prohibit the tenant from assigning the lease. Outside of bankruptcy, an anti-assignment clause may render the lease valueless as a right that can be traded; the lease may have value-in-use for the tenant, but that value normally is assessed as part of a business valuation of the tenant's business, and not as part of a valuation of the bare real estate interest."[22]

Much confusion exists as to the differences between lease assignments and subleases. For example, the fifth edition of *The Dictionary of Real Estate Appraisal* defined *assignment* as "a written transfer of the rights of use and occupancy of a property to be held by another legal entity or to be used for the benefit of creditors, e.g., assignments of mortgages, sales contracts and leases."[23] However, the definition was changed in the sixth edition and it no longer addresses the transfer of rights under a lease. (That new definition only addresses "appraisal assignments.") The sixth edition of *The Dictionary of Real Estate Appraisal* does define *sublease* as "an agreement in which the lessee in a prior lease conveys the right of use and occupancy of a property to another, the sublessee, for a specific period of time, which may or may not be coterminous with the underlying lease term."[24] Note that this definition of sublease mentions "a specific period of time." Subleasing is not the means by which tenants transact out of their position. It is by lease assignment that tenants effectuate the "sale" of their position. Understanding the concept of lease assignment is vital to appraisers appraising leasehold interests.

What must be understood is that in an assignment of a lease, the original tenant stops paying rent and the assignee steps into that position and begins to pay rent to the original landlord. In a sublease, the subtenant pays rent to the original tenant per the terms of the sublease, and the original tenant continues to pay rent to the original landlord per the terms of the original lease. Again, consider the bundle of rights concept. In its most basic model, when a lease is signed, the tenant is given the sticks of use and occupancy. When the tenant assigns their interest in the lease to another entity, they give the stick to the assignee, who is now obligated to perform under the lease. However, if the original tenant subleases the property to another tenant, the full stick is not handed over to the subtenant. Instead, the stick is split and the original tenant holds part of the stick and the subtenant holds the remainder.

If a lease precludes subletting but allows for assignment, the leasehold interest can transfer to another party and may have market value. However, if the lease does not permit assignment, the leasehold interest is not marketable and therefore has no market value because control of the interest cannot be transferred. If a lease allows subletting but not assignment, the leasehold interest may have value to the tenant but not market value.

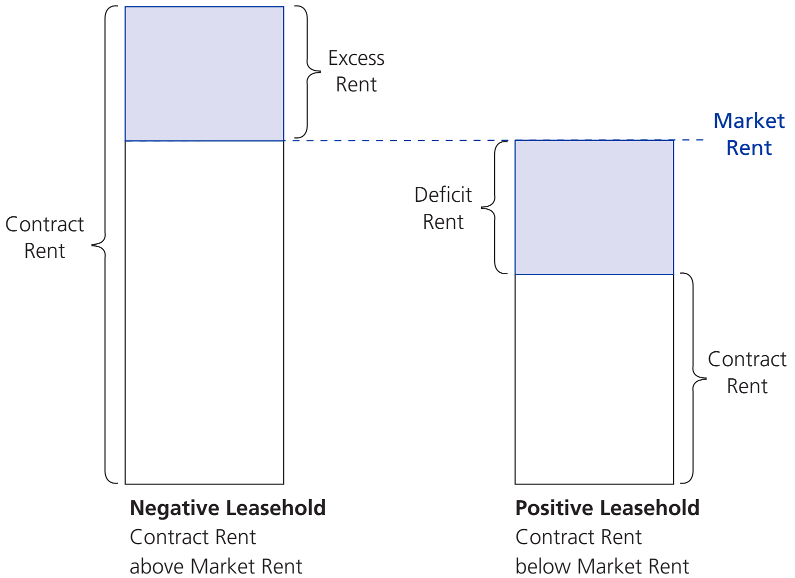
21. *The Dictionary of Real Estate Appraisal*, 6th ed., s.v. 128.

22. William J. Barrett, "Value Proposition," *Valuation* (Q2 2016), 19–23.

23. *The Dictionary of Real Estate Appraisal*, 5th ed. (Chicago: Appraisal Institute, 2010), 13.

24. *The Dictionary of Real Estate Appraisal*, 6th ed. (Chicago: Appraisal Institute, 2015), 224.

Exhibit 1 Positive and Negative Leasehold Interests



Source: Figure 23.1 in *The Appraisal of Real Estate*, 14th ed. (Chicago: Appraisal Institute), 506.

For example, consider a 20,000-square-foot retail building leased to a national retail tenant. The remaining lease term is 10 years. For business reasons, the tenant plans to close this location. The tenant's options are to vacate the space and continue paying rent, sublease the space to another tenant, or assign the lease rights to another party. If the lease precludes subleasing, the tenant's only options would be to vacate and continue to pay rent or assign the lease to another party. In this case, the leasehold interest is marketable. However, if the lease precludes assignment to another party, the tenant has no option but to remain as a tenant and either vacate or sublease to another tenant. If this is the case, the tenant would not be able to transact out of its position, its leasehold interest would not be marketable, and the leasehold interest would have no market value.

Leasehold interests may have positive, negative, or no market value. As demonstrated in Exhibit 1, a leasehold interest has the potential for positive market value when market rent, or subtenant rent, is sufficiently higher than contract rent and, as noted previously, the interest can be transferred. Conversely, a leasehold interest has the potential for negative market value when contract rent is higher than market rent, or subtenant rent. If market or subtenant rents and contract rents approximate one another, a leasehold interest likely has no market value.

Consider, for example, a medical practice that leased an acre of land for $20,000 annually, with an absolute net lease for 20 years and options to renew.[25] The practice, at its sole cost, constructs a medical office building totaling 15,000 square feet. Market rent for the improved property is $20 per square foot of building area, with a triple net lease.[26] If the improved property is leased at market rent, assume that the net operating income (NOI) would be $276,600, or $18.44 per square foot of building area after adjustments for collection loss, management, and replacement reserves. The land rent (contract rent) equates to $1.33 per square foot of building area. In this case, the contract rent on the land is clearly below market rent of the improved property, so it would appear that the land tenant's leasehold interest has the potential for having a positive market value. If the land lease allows the land tenant to assign its interest to another party, the leasehold interest would be marketable and could be assigned to another user. In this case, the market value of the leasehold interest would be equivalent to the sum of the present values of the leasehold net income cash flows for the remaining term of the lease.

Leasehold Interests Are Not Synonymous with Buildings

A common misconception relating to leasehold interests is that the market value of the leasehold interest created by a land lease is synonymous with the market value of the building(s) on a site. This has been perpetuated in recent years with the evolution and prevalence of land leasing in the United States, especially with retail development. Under a typical land lease, the owner leases the site to a developer or user who in turn constructs the building at their sole cost. The owner

25. An *absolute net lease* is "a lease in which the tenant pays all expenses including structural maintenance, building reserves, and management." *The Dictionary of Real Estate Appraisal*, 6th ed., s.v. "absolute net lease."

26. A *net net net lease* (also called a *triple net lease* or *NNN lease*) is a type of net lease "in which the tenant assumes all expenses (fixed and variable) of operating a property except that the landlord is responsible for structural maintenance, building reserves, and management." *The Dictionary of Real Estate Appraisal*, 6th ed., s.v. "net net net lease."

might first improve the site by grading it, installing utilities, or otherwise making the site building-ready, but the developer or user actually constructs the building. A developer may already have the building pre-leased, while the user would occupy the building after it is constructed. The owner receives rent for the use of the real estate, and at the expiration of the lease, typically receives full rights to the building that was constructed by the tenant. Despite the land tenant paying for the construction of the building, the tenant does not own the building. The terms of the land lease may grant the tenant an exclusive right of occupancy, but legal title to the real estate, which includes the leasehold improvements made by the tenant, remains with the owner. The tenant only holds rights to the real estate for the duration of the lease. It is noted that many believe that land tenants own the buildings they construct. While many definitions of ownership relate to possession (and in fact, in a land lease, the tenant does possess the property), legal title to the real estate (buildings are real estate) stays with the owner.

Land lease scenarios often create the potential for substantial leasehold market values once a building is constructed by the land tenant, because the market rent/contract rent for the improved property is often higher than the contract land rent. In a land lease situation, the owner's interest is a leased fee interest with the market value equal to the present value of the future net income generated by the land lease, plus the present value of the reversionary rights to the land and improvements. The leasehold market value is estimated by analyzing rights that the tenant controls during the term of the lease. Typically, these are the rights of use and occupancy to the property, including the building, until lease expiration. The net operating income generated by the tenant's position over the remaining term of the lease is discounted back to present value. Note that the contract land rent in a leasehold valuation of this type is treated as an operating expense. All other things being equal, the market value of a leasehold interest continuously diminishes over time because leasehold interests are finite. There is also no reversion in a typical leasehold valuation, because the tenant has no use or occupancy rights at the expiration of the lease.

While a leasehold interest might theoretically be valued using any of the three approaches to value, the income capitalization approach is typically the only approach that can be developed. In order for a sales comparison approach to be developable, transfers of leasehold interests (lease assignments) must be available for analysis. While lease assignments commonly occur, the transactions are rarely reported in public records. Even when uncovered, lease assignments are difficult to analyze as the terms of the lease would need to be similar to the subject lease and all terms of the assignment would need to be known to the appraiser. As a practical matter, it is rare for appraisers to develop sales comparison analyses for leasehold valuations. The cost approach is also not typically developable. It is a misconception that a leasehold interest can be valued with development of either a sales comparison approach or cost approach by subtracting out the value of the site. This is inappropriate and relates to the misguided notion that the market value of a leasehold interest is synonymous with building value and misses the important element of leasehold valuation—that leasehold interests are finite and diminish over time as the lease term shortens. While one could develop a sales comparison approach or cost approach addressing the fee simple estate and then deduct the market value of the leased fee interest to achieve the market value of the leasehold interest, doing so assumes that the market value of the fee simple estate always equals the sum of the market values of the leased fee and leasehold interest. As discussed below, this may not be the case.

Relationship of Interests

It should not be assumed that the sum of the market values of the leased fee and leasehold interests equals the market value of the fee simple estate (as defined by *The Dictionary of Real Estate Appraisal*). The assumption that the sum of the values of the leasehold and the leased fee equals the value of the fee simple estate has not historically been supported by market data.[27] USPAP specifically warns against assuming that the sum of the parts yields the value of the whole: "An appraiser must refrain from valuing the whole solely by adding together the individual values of the various estates or component parts."[28]

27. *The Appraisal of Real Estate*, 14th ed., 505.

28. Standards Rule 1-4(e), *Uniform Standards of Professional Appraisal Practice*, 2018–2019 ed., Lines 543–551.

Exhibit 2 Direct Capitalization Comparison: Leased Fee Interest and Fee Simple Estate

Property A **Direct Capitalization (Leased Fee Interest)**		**Property B** **Direct Capitalization (Fee Simple Estate)**	
Potential Gross Income (Contract Rent)	$400,000	Potential Gross Income (Market Rent)	$400,000
Vacancy/Collection Loss	–12,000	Vacancy/Collection Loss	–12,000
Effective Gross Income	388,000	Effective Gross Income	388,000
Expenses	–11,640	Expenses	–11,640
Net Operating Income	376,360	Net Operating Income	376,360
Overall Rate	÷ 8.0%	Overall Rate	÷ 8.0%
Market Value of the Leased Fee Interest	$4,704,500	Market Value Assuming Market Rent Tenant	$4,704,500
		Rent Loss during Lease-Up	–200,000
		Lost Reimbursable NNN Expenses during Lease-Up	–100,000
		Leasing Commissions to Secure Market Tenant	–80,000
		Entrepreneurial Incentive on Lease-Up Costs	–38,000
		Market Value of the Fee Simple Estate	$4,286,500

It is also not appropriate to assume that the market value of a property that is leased at market rent is equal to the market value of that property's fee simple estate. In his 2009 *Appraisal Journal* article, David Lennhoff articulated this concept saying, "Even if the lease is at market rent, the fee does not necessarily equal the leased fee."[29] Lennhoff further clarified this point in another article where he states, "The owner of the fee interest retains the right to sell, lease, occupy, etc. Therefore, the fee refers to the building/property vacant and available to be leased. It does not refer to being leased at market rates."[30] For example, consider the properties in Exhibit 2, two 100,000-square-foot warehouses that are identical in all respects, except Property A is encumbered by a lease at market rent (Owner A has a leased fee interest) and Property B is vacant/unleased/unencumbered (Owner B has a fee simple estate). Assume that typical absorption in the market is six months and leasing commissions equal 4% of rent over a typical five-year term and are paid as a lump sum in advance. Market rent is $4.00 per square foot, triple net (NNN), and flat over the five-year term. Stabilized vacancy is 3%, and non-reimbursable expenses are 3% of effective gross income. The applicable stabilized overall capitalization rate is 8%. Would an investor-buyer pay the same price for each property?

The income capitalization approach reflects the actions of an investor-buyer, not a user-buyer. Property A would generate rental income to the buyer from the first day of ownership. In contrast, while Property B may eventually achieve market rent, the buyer will likely have to wait six months and pay leasing commissions to begin receiving it. If the typical lease for this type of property is NNN, the buyer of Property B during the absorption period must also pay out of pocket for the expenses that a tenant would typically pay directly or reimburse. Even if a market is extremely strong and properties are leased as soon as they are exposed to the market, leasing commissions would still need to be paid. As demonstrated, the market value of the fee simple estate may not be equivalent to the market value of real estate that is already leased at market rent. The example also shows that the sum of the market values of the leased

29. David C. Lennhoff, "You Can't Get the Value Right If You Get the Rights Wrong," *The Appraisal Journal* (Winter 2009): 61.

30. David Charles Lennhoff, "Valuation of Big-Box Retail for Assessment Purposes: Right Answer to the Wrong Question," *Real Estate Issues* 39, no. 3 (2014): 23.

fee and leasehold interests does not equal the market value of the unencumbered fee simple estate since the market value of the leasehold interest in Property A would likely be zero since the contract rent is at market rate.

Conclusion

Real estate alone does not have inherent market value unless rights to the real estate exist and can transfer with the real estate. Appraisers, when appraising fee simple estates and leased fee interests, appraise real estate subject to property rights and, as such, can be called real estate appraisers or real property appraisers. However, when appraising a leasehold interest, appraisers act only as real property appraisers since the tangible real estate is not being appraised.

Appraisers should not be in the dark when it comes to property rights. Identifying and understanding the appropriate property rights to appraise is vitally important to every appraisal assignment. While many misconceptions exist relating to real estate, real property, and the application of appropriate approaches to value, having a solid understanding of property rights will result in increased appraisal credibility.

About the Author

Gary E. Heiland II, MAI, AI-GRS, is co-owner of Mid-Atlantic Valuation Group, Inc., specializing in complex commercial appraisal, consulting assignments, and litigation support. Heiland is a licensed appraiser in Pennsylvania and Maryland. He regularly provides appraisal services to property owners and taxing authorities in tax assessment appeal matters. Heiland is a graduate of Shippensburg University, with a bachelor of science degree in business administration and a major in real estate. He is a Designated member of the Appraisal Institute and served as president of the Central Pennsylvania Chapter of the Appraisal Institute in 2009. **Contact: gheiland@mvginc.com**

Additional Resources

Suggested by the Y. T. and Louise Lee Lum Library

Appraisal Institute

- **Education**
  http://www.appraisalinstitute.org/assets/1/7/aiedcat.pdf
- **Guide Notes to the Standards of Professional Appraisal Practice**
  https://www.appraisalinstitute.org/assets/1/7/AI_Guide_Notes.pdf
- **Lum Library External Resources Knowledge Base [Login required]**
  - Information Files—Special use properties/retail properties/big-box stores
  - Information Files—Taxation and assessment
  - Information Files—Value
- **Property Rights Symposium Discussion Paper**
  http://bit.ly/SymposiumPaper

Calkain—Net Lease Investments Explained
https://www.calkain.com/net-lease-101/

CCIM Institute Site to Do Business
https://www.stdb.com/

Federal Reserve of St. Louis, FRED Economic Data
https://fred.stlouisfed.org/

National Real Estate Investor—*Net Lease Trends Reports*
https://www.nreionline.com/nrei-research-series/net-lease-trends