Fee Simple and Partial Interests

According to the bundle of rights theory, complete real property ownership, or title in fee, consists of a group of distinct rights. Each of these rights can be separated from the bundle and conveyed by the fee owner to other parties in perpetuity or for a limited time period. When a right is separated from the bundle and transferred or mortgaged, a partial, or fractional, property interest is created.

Property interests may be examined from many perspectives because the ownership, legal, economic, and financial aspects of real estate overlap.

From an ownership perspective, property interests can be divided in various ways. For example, several parties may have undivided partial ownership rights in a specific property through joint tenancies, tenancies in common, or tenancies by the entirety. A land trust is a vehicle for partial property interests in which a group of property owners continues to operate and manage a property, but the legal title is conveyed to a trustee. Other legal arrangements and title-holding entities that divide property rights among groups of owners include corporations, partnerships, cooperative corporations, condominiums, and interval ownerships or timeshares. In these arrangements, property rights or interests are divided among several parties, and an appropriate legal entity is chosen to hold the property title.

The leasing of real estate is one practical and familiar application of the bundle of rights theory. An owner of a complete bundle of rights (the lessor) may convey to a tenant (the lessee) rights to use and occupy a property for a fixed period of time. In return, the tenant agrees to pay periodic rent.

In valuing the economic and legal interests created by leases, appraisers must consider two basic factors: the relationship between contract rent and market rent and the credit rating of the tenant. Both of these factors strongly influence the selection of discount rates and have a lesser effect on the forecast of future benefits.

The financial aspects of property interests have a major impact on real estate investment practices. The analysis of mortgage and equity components is of particular importance. Mortgage funds are secured debt positions, while equity is venture capital. Mortgage and equity components may be subdivided into fee simple, leased fee, and leasehold interests. They may also be broken down according to the proportions of land and building in the overall property. Other possible financial arrangements include senior and subordinated debt, sale-leaseback finance, and equity syndications.

The ownership, legal, economic, and financial perspectives from which lease interests and other fractional property interests can be described illustrate the complexity and usefulness of the bundle of rights. A thorough understanding of the property rights to be valued in an appraisal assignment is needed not only to define the problem but also to produce an appropriate solution.

Leases

Lease Terms

A lease is both a contract and a conveyance. It is a conveyance by which the landlord gives the tenant the right to occupy the property for the terms specified in the lease. It imposes a contractual obligation on the tenant to pay rent to the landlord, and it may contain other promises and agreements between the landlord and the tenant. The legal interest of the tenant, the leasehold estate, is considered personal property.[1]

[1] *Robert Kratovil and Raymond J. Werner,* Real Estate Law, *8th ed. (Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1983), p. 579.*

Leases that cover a period of 1 year or more must be in writing. In some states, leases for shorter periods may be verbal. A lease should describe the rented property with certainty, specifying the geographic location, street address, and condition of the premises. The signatures of the lessor and the lessee effectively establish the legal power of a lease. The tenant's possession generally provides notice that the rights of the leasehold estate are being exercised. Long-term leases are usually recorded documents.

Most leases contain clauses pertaining to the duration of tenancy, rent, security deposits, insurance, payment of public utilities, right of entry, assignment and subleasing arrangements, maintenance and repair arrangements, fixtures, taxes, eminent domain, default, and renewal options. Other contractual clauses may address purchase options, rent escalations, alterations, and use restrictions.

Lease clauses can influence property value. Therefore, it is imperative that appraisers read and understand all leases that affect the property interests being appraised. In some instances it may be advisable or necessary for an appraiser to consult an attorney for assistance in interpreting lease provisions.

By leasing real estate, a lessor receives some advantages, including the receipt of a certain income or annuity, favorable income tax considerations, and the benefit of tenant-built improvements. These can, and frequently do, enhance property value and provide the owner with a hedge against inflation. The potential advantages for a lessee include a minimum equity investment in property, an alternative to costly financing, favorable tax considerations, and reduced management responsibility.

Tenancy

When the bundle of rights is divided into property interests, tenancy is created. In real estate *tenancy* has two meanings: *(1) the holding of property by any form of title, and (2) the right to use and occupy property as conveyed in a lease.* The first definition usually refers to co-ownership of real estate; the second definition concerns the nature of the relationship between a landlord and a tenant.

Co-ownership may be described as joint tenancy, tenancy by the entirety, or tenancy in common. *Joint tenancy is joint ownership by two or more persons with right of survivorship.* Under this arrangement, each party has an identical interest and right of possession. *Tenancy by the entirety is an estate held by a husband and wife in which neither has a disposable interest in the property during the lifetime of the other, except through joint action.* It has the same survivorship provision as a joint tenancy, but tenancy by the entirety applies only to spouses. *Tenancy in common is an estate held by two or more persons, each of whom has an undivided interest.* In this estate, the undivided interest may or may not be equally shared by the holders and there is no right of survivorship.

The valuation of undivided partial interests poses a problem for appraisers. Because no party can exercise complete control, the interest of each party is usually not worth as much as the corresponding fraction of the property's market value. Minority interests have little market appeal, so the appraiser must decide how to judge the appropriate adjustment. Because each party can bring legal action to divide the property, which is known as *partition*, the cost of this proceeding is one measure of value diminution. However, a sale in partition is a forced event, so it does not reflect free market action. Due to the lack of pertinent market transactions, valuations of co-ownerships are often somewhat subjective.

An appraiser may value an undivided partial interest by the sales comparison approach, if market data are adequate, or by the income capitalization approach. The difference between the property's earning capacity and the cost of its operation and maintenance may be regarded as the monetary benefit of ownership. To estimate the probable duration of the income from a life estate, an appraiser must rely on life expectancy statistics from actuarial studies. Once the benefits and duration of the estate are established, an appropriate discount rate can be selected and applied.

The length of the relationship between a landlord and a tenant varies and is periodic in nature. *Tenancy from period to period* and *tenancy for years* are two legally recognized ways to describe this relationship. In tenancy from period to period, the leasehold interest owner pays rent periodically and each payment renews the interest for an additional period. The ultimate length of the leasehold interest is not stated. In a tenancy for years, the beginning and end of the estate are clearly specified. If the tenant does not default, the estate continues until it expires on the specified termination date.

Rental Payments

There are two basic kinds of leases, which are distinguished by who is financially responsible for property expenses. Gross leases and net leases delineate different responsibilities. *A gross lease is a lease in which the landlord receives stipulated rent and is obligated to pay all or most of the operating expenses and real estate taxes. A net lease is a lease in which the tenant pays all property charges in addition to the stipulated rent.* Typical property charges include real estate taxes, insurance premiums, assessments, and the costs of maintenance and structural repairs. In net lease arrangements the tenant assumes the risk that taxes may increase or the building may be destroyed. If the building is destroyed, the tenant may be obligated to rebuild the building and to continue paying rent during its construction.

The level and schedule of rental payments also vary. *A flat rental, or level payment, is a specified level of rent that continues throughout the lease term.* In contrast, the payments required by a step-up or step-down lease change at specific points in time. *A step-up or step-down lease provides for a certain rent for an initial period, followed by an increase or decrease in rent over stated periods.* Other types of leases may stipulate that adjustments be made, although not necessarily at specified intervals. *An index lease provides for period rent adjustments based on the change in an economic index.* The Consumer Price Index (CPI) is frequently used to set rent levels in long-term leases. *A revaluation lease provides for rent adjustments at periodic intervals based on a revaluation of the real estate.* Rent payments can be annual, semi-annual, quarterly, monthly, weekly, or even daily. They may be required at the beginning of the specified rental period (ordinary annuities) or at the end (annuities due).

An appraiser valuing a partial interest must know what is expected of the lessor and the lessee in fulfilling the obligations delineated by the lease. Lease terms shape the quantity and quality of future benefits likely to flow to the interests created by the contract. Thus, the agreement provides that the lessor will received specified rent or services during the term of the lease and a reversion of the tenant's rights of use and occupancy when the lease expires. The contract gives the tenant exclusive rights of use and occupancy during the lease term, subject to the rent or service obligations. Many other divisions of rights are common. For example, an original tenant may sublet the property and both the leased fee and leasehold positions may be mortgaged. (Analysis of income and expenses and the procedures for valuing leased fee estates are discussed in Chapters, 18, 19, and 20.)

A lease sets rental terms and presumably indicates gross income to the leased fee. As mentioned previously, appraisers estimating the market value of leased fee interests must always consider two factors: the relationship between contract rent (the actual rental income specified in a lease) and market rent (the rental income a property would most likely command in the open market), and the credit rating of the tenant.

The lease for a single-tenant building may obligate the tenant to pay rent in excess of market levels. If the tenant has a low credit rating, an appraiser may not give much consideration to the lease arrangement. If the same lease provisions are assumed by a tenant that is a major business entity with a triple A credit rating, the appraiser would give significant weight to the lease terms. The outlook for future income benefits is much clearer in this case, and the value of the leased fee may exceed the market value of the property unencumbered by the lease.

Other complex interrelationships may create quite different situations. For example, a below-market contract rent to be paid by a tenant with a poor credit rating may be more certain than an above-market contract rent to be paid by a tenant with a good credit rating.

Lease terms sometimes create advantages for the leasehold position to the detriment of the leased fee position. If the lessee has a rent advantage, this is assured by the leasehold interest, which often has a value in the market. A leased fee burdened with a fixed rent that is below market rates may be worth less than the unencumbered fee estate.

Several specialized lease interests are briefly discussed in the following section.

Specialized Lease Interests

Leasehold Position

The most important obligation associated with the rights to the use and occupancy of a leasehold interest is the payment of rent. *Contract rent is the actual rental income specified in a lease.* Rent is commonly paid by the tenant or tenants to the lessor according to a specified schedule. A leasehold interest usually has value when contract rent is less than market rent. *Market rent is the rental income that a property would most probably command in the open market.* Only in an ideally negotiated lease would contract rent equal market rent.

When market rent exceeds contract rent, the leasehold interest may have value, assuming that the lease term is long enough to be marketable and the lease allows for subletting or assignment. When contract rent exceeds market level, the leasehold may have a negative value.

Subleasehold Position

Normally, a tenant is free to sublease all or part of a property, but many leases require that the lessor's consent be obtained. *A sublease is an agreement in which the lessee in a prior lease conveys the right of use and occupancy of the property to another. An assignment is a written transfer of the rights of use and occupancy of the property to be held by another legal entity or to be used for the benefit of creditors.* Leases usually provide that the lessor's consent "will not unreasonably be withheld." Over the years, court decisions have established that subleasing is relatively free. To deny permission, lessors usually must show that the security of their position would be impaired.

In a sublease, the original lessee is "sandwiched" between a lessor and a sublessee. The original lessee's interest has value when the contract rent is less than the rent collected from the sublessee.

Different discount rates are used in valuing different lease interests because the rates selected reflect the risk involved. Generally, a lessor's interest, the leased fee, entails less risk than a lessee's interest, the leasehold. The lessee, in turn, assumes less risk than the sublessee, whose position is exposed to the greatest risk.

A lease contract may contain a provision that explicitly forbids subletting. Without the right to sublet and a term that is long enough to be marketable, a leasehold position cannot be conveyed and, therefore, has no market value and may diminish the value of the leased fee. The leasehold position does, however, have a use value to the lessee.

Mortgaged Lease Interests

Leasehold mortgaging is a type of mortgage-equity financing in which a lessee, or tenant, agrees to subordinate the leasehold interest to a mortgage covering leasehold improvements placed on the property. It is important to remember that, in this situation, it is the lessee, not *the lessor*, who is subordinating the leased fee to a mortgage. The leasehold mortgagee may be protected by a "nondisturbance" clause in the lease or by a subordination of the lease to the leasehold mortgage. A "nondisturbance" clause gives the mortgagee the right to cure any default(s) by the lessee upon appropriate notice. In a lease subordination arrangement, the leasehold mortgagee can foreclose on the leasehold interest subject to the lease. Often leasehold mortgages are obtained by lessee developers with the lessors' consent as part of a ground lease, which grants the right to use and occupy the land.

A leasehold mortgagee who finances building improvements should be certain that the *ground rent, the rent paid for the right to use and occupy land,* is not too high to represent a competitively attractive yield on the land value. The mortgagee should also make certain that the lease terms include the right to cure any lessee default. If compelled to foreclose, the leasehold mortgagee can take possession of the leasehold interest, subject to the terms of the lease, and the improvements, and is only obliged to pay the required ground rent.

In current investment practice, investors seek maximum financing for favorable leveraging and the best tax shelter. Leases, the mortgaging of lease interests, and subordinations provide the necessary tools. For major investment projects, a more complex set of arrangements may be worked out. For example, a property may be divided into a lease fee and a leasehold interest. The mortgage is arranged on the leased fee and a leasehold mortgage is arranged to construct improvements. By using different legal entities, one party can hold both the fee position and the leasehold position. In this situation, expert legal advice will be needed to ensure that the documentation supports the separation of the interests and does not effect a merger.

When appraising a leasehold estate subject to a mortgage, difficulties can arise because the rent provisions of the ground lease may be tied to the CPI, debt service on the fee mortgage may be variable, and debt service on the leasehold mortgage may contain an equity kicker.

Other Fractional Interests

The bundle of rights includes interests other than those created by leases for the use and occupancy of physical real estate. Property ownership may also be divided by vertical interests, easements, and transferable development rights (TDRs), each of which can be considered separately in sales, leases, mortgages, and other realty transactions.

Vertical Interests

An important dimension of real property ownership concerns the distinction between subsurface and air rights.[2] *A subsurface right is the right to the use and profits of the underground portion of a designated property.* The term usually refers to the right to extract minerals from below the earth's surface and to construct tunnels for railroads, motor vehicles, and public utilities. *Air rights are the property rights associated with the use, control, and regulation of air space over a parcel of real estate.* Both of these fractional interests represent portions of a fee simple estate, but each embodies the idea of land as a three-dimensional entity.

The vertical division of real property is based on the legal conception of land as a volume of space with boundless height and depth.[3] This is significant because technological developments continue to expand our ability to utilize the earth's subsurface and atmosphere. In urban areas in particular, engineering advances have dramatically affected land use and, therefore, highest and best use considerations. The development of steel-framed building construction, the passenger elevator, deep tunnel excavation techniques, and communications technology are some examples of

[2] *Rights to surface areas may be divided by horizontal subdivision,* the division of a tract of land into smaller parcels for sale or lease. *A horizontal subdivision, however, is not a partial interest. Usually, a large tract held in fee simple estate is divided into a number of smaller units, which are also held in fee simple estate. Rights of way surface areas may be conveyed by easements, which are discussed later in this chapter.*

[3] *B. Harrison Frankel, "Three-Dimensional Real Property Law: The Truth About 'Air Rights,'"* Real Estate Law Journal, *Spring 1984.*

technological changes that have helped shape our urban landscape.

These changes also reflect the forces and factors affecting value. As the density of building in urban areas increases, fewer sites are available for new construction and land values escalate. This trend has produced a growing interest in developing air rights. As early as 1902, the air rights associated with highly valued land along the New York Central Railroad in New York City were beginning to be developed. Park Avenue is one outstanding example of real estate development built on the acquisition of air rights. Many other examples of development established on air rights can be found in urban areas around the world.

When a large building is to be constructed in a space to which air rights apply, the base of the site is visualized as a platform constructed at some level (e.g., 30 or 40 feet) above the present surface. In the case of Park Avenue development, the platform is actually located below grade, just above the railroad tunnel. The platform must be supported by columns, which normally rest on a caisson foundation built underground. In this manner, a number of discrete, interrelated "lots" are created; the air, column, and caisson lots associated with different portions of the three dimensional space comprise the land or site in question. Figure 1 illustrates a division of vertical space.

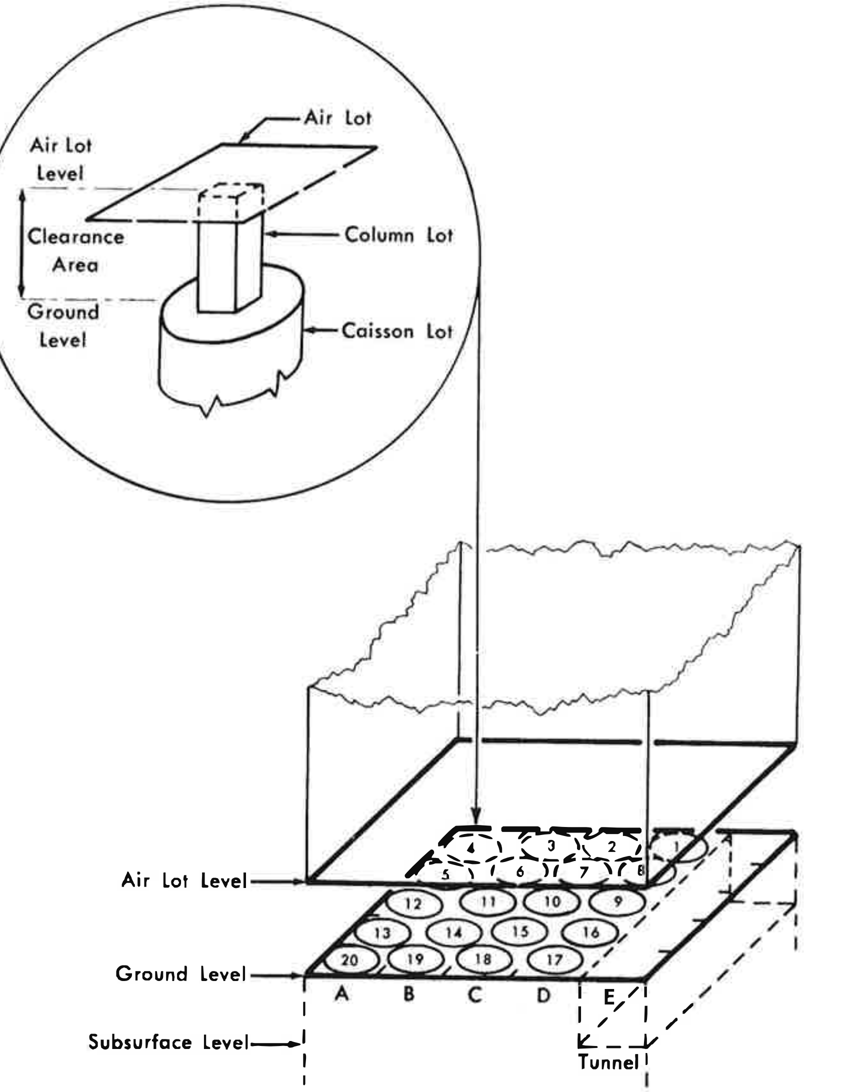

Figure 1. Three-dimensional for air or tunnel rights. As an example, these may be identified as air rights above air lot level; column lots between air lot level and ground(1–20); caisson lots below ground level (1–20); tunnel rights between ground level and subsurface (E).

Air rights can be transferred in various ways. Often, the air rights to one property are shifted to another within the same building zone under legal planning regulations. The transfer of air rights allows developers to adjust the density of land use without putting adverse pressure on owners, neighborhoods, or districts. This practice underscores the importance of local zoning authorities, who regulate building heights, functions, setbacks, and other variables involved in the development of air rights.

Air rights can be sold in fee, with the seller retaining one or more easements for a specialized use, such as the operation of a railroad. Air rights may also be subdivided; in this case the owner of the fee sells or leases only the land and air that are to be occupied by a particular improvement.

Air rights were subdivided to construct The Merchandise Mart in Chicago which is shown in Figure 2. The structure was built between 1928 and 1931 in air space above The Chicago and Northwestern Railroad. The owners of the Mart, which is one of the world's largest mercantile buildings, actually possess 458 caisson lots extending 100 feet below ground, 458 column lots, a small surface parcel that houses building equipment, and the air lot 23 feet above Chicago's city datum, where the building is constructed. The Merchandise Mart typifies the traditional development of air rights over existing railroad track, but other developments may be more creatively designed.

Easements

Easements represent another division of property ownership. *An easement is an interest in real property that conveys use, but not ownership, of a portion of an owner's property.* Easements frequently permit a specific portion of a property to be used for access to an adjoining property or as a public right of way. Although surface easements are the most common, subterranean and overhead easements are used for public utilities, subways, and bridges.

Clearly, a property that acquires an easement is the beneficiary of additional rights; one that is subject to an easement is burdened. Easement rights can be conveyed in perpetuity or for a limited time period. An easement can be created by a contract between private parties or it can be arranged by states, municipalities, or public utilities through the exercise of eminent domain. In any case, a valuation is needed to estimate the price the easement beneficiary should pay to the burdened party.

An easement that affords ingress and egress to an otherwise landlocked parcel increases its value. Easement rights to a development's recreational facilities normally enhance the value of plots that have

Figure 2. The merchandise mart in Chicago.

this advantage. The value of an easement is usually estimated as some part of the amount of value it adds to the property it benefits; the burdened property's loss in value can also be used to indicate the value of an easement. The value of an easement reflects the basic economic concept of contribution. No one would pay more for an easement than the amount of value gained by the property it benefits. Similarly, no one would pay the exact amount of the benefit to break even. The holder of an easement realizes a gain by paying less than the added value.

Preservation easements are used to protect certain historic properties by prohibiting physical changes to the property. Usually, the owner must maintain the condition of the property at the time the easement is donated or immediately after a proposed restoration. Under federal law, a preservation easement can be deeded to properly qualifying nonprofit organizations or government agencies. In such instances, the property owner donates the easement and receives an income tax reduction that can be equal to, but not more than, the market value of the real property rights donated.

The economic theory that underlies the valuation of preservation easements is generally the same as that which governs eminent domain appraising, although the acquirer of a preservation easement receives rather than takes rights. Each easement document contains specific controls and restrictions. An appraiser must carefully analyze a deed of easement to determine how it affects the encumbered property. The effect of historic district controls or individual landmark designations should be related to the subject property and to the provisions of the easement.

Transferable Development Rights

Transferable development rights (TDRs) emerged in the real estate industry during the 1970s. *A transferable development right is a development right that cannot be used by the landowner but can be sold to landowners in another location.* Some TDRs are used to preserve property uses for agricultural production, open space, or historic buildings. Through a TDR, a preservation district and a development district are identified. Landowners in the preservation district are assigned development rights which they cannot use to develop their land, but can sell to landowners in the development district. These landowners can use the rights to build at higher densities than zoning laws in the development district would normally permit.

Appraisers can value TDRs with ordinary sales comparison techniques if there is a sufficient number of transactions to constitute a market. When the market is inadequate, appraisers may use the income capitalization approach. In such cases, the economic concept of contribution provides a foundation, and the value added to a property through the acquisition of a TDR is adjusted for administrative, legal, and other costs incurred. Some, though not all, of the property's net value increase can be attributed to the TDR; no one is likely to undertake such a complicated procedure without the prospect of a reasonable profit.

Legal Entities Affecting Ownership

Stock Corporations

One common form of partial ownership is a stock corporation. A stock corporation may be organized to hold title to a single asset, such as a parcel of real property, or it may have a portfolio of investments. Corporate ownership is divided into partial interests by selling shares to an investment group. Any specific stock holding represents a percentage of total corporate ownership, which is derived from the ratio between the number of shares owned by a particular interest and the total number of shares issued by the corporation. The percentage is an ownership share in the corporation, and its book value is usually found by multiplying the corporate net worth by the ownership percentage.

The market value of a share of stock in a corporation that has a parcel of real estate as its sole asset may be higher or lower than its book value. *Book value is defined as the capital amount at which property is shown on the account books.* Book value usually equals the original cost of the asset after subtracting reserves for depreciation and adding allocations for capital recapture. Book value and market value are usually not the same, so the values of the pro rata shares of ownership associated with each differ.

Fractional corporate interests—i.e., shares of stock—typically sell for less than their pro rata value because a minority interest does not have the ability to control the investment. In a closely held corporation such as a real estate venture, additional discounts are required to reflect illiquidity because the market for shares is often limited.

Because stock market values often represent a discount from actual corporate net worth, the accounting profession and the Securities and Exchange Commission allow publicly owned real estate corporations to show both the book values and the current market values of assets of their annual financial statements. This practice, which is sometimes referred to as *current value accounting,* frequently reveals that present market values greatly exceed book values (i.e., cost less accumulated depreciation). Therefore, a corporation may have greater net worth than is indicated by book figures. Publicly owned real estate corporations employ professional appraisers to estimate the current market values used in these reports.

The International Assets Valuation Standards Committee (TIAVSC) was formed in 1980 to establish worldwide standards for the valuation of fixed assets in financial statements. Under international accounting standards, fixed assets are divided into tangible assets, intangible assets, and financial assets. Many in the accounting and financial communities believe that evaluations of the current and historical performance of businesses should be made with reference to the current value of their assets. In the United States, historical costs are commonly used to report the value of fixed assets.

Land Trusts

Trust are sometimes used as legal vehicles for partial ownership interests in real property. *A land trust is often a legal vehicle for partial ownership interests in real property in which independently owned properties are conveyed to a trustee. Land trusts may be used to effect a profitable assemblage or in some cases to facilitate the assigning of property as collateral for a loan.* The trustee holds legal title in the property for a specified time and performs only the functions outlined in the trust agreement. The trustee may or may not actively manage the property or collect rent; when not carried out by the trustee, these duties remain with the beneficiaries, who are the original owners. One important legal aspect of a trust arrangement is that a judgment against a beneficiary is not a lien against the real estate.

To value a beneficiary's partial interest, an appraiser must first estimate the market value of the total property. The appraiser then adjusts the estimate to account for any effect on value that may result from the trust indenture provisions, which identify the rights and obligations of beneficiaries. The beneficiary's minority position will call for significant downward adjustment.

General and Limited Partnerships

Partnerships are used extensively in real estate acquisition because they pool funds for property ownership and operation. In a general partnership, all partners share in business gains and each is fully responsible for all liabilities.

To value a partner's partial interest, an appraiser estimates the market value of the partnership's total real property assets and adjusts the estimate to reflect the partner's percentage of ownership. Other adjustments are made in light of the terms of the partnership agreement, which define the partners' rights and liabilities in sales and liquidations. The ability or inability to control business operations (i.e., to decide when to sell, to select property managers, and to approve or disapprove prospective leases) has a major effect on the value of a general partnership. Another important aspect of a partnership is that it automatically terminates when a general partner dies. Because the provisions of partnership contracts shape and limit ownership benefits, they also influence the value of the partial interests involved.

Limited partnerships have both general partners and limited partners. The general partners manage the business and assume full liability for partnership obligations. The liability of each limited partner, however, is restricted to his or her capital contributions.

The investment value of limited partnership interests, or syndicate shares, often includes income tax shelter benefits. It is not unusual for such an investment to offer small income returns, at least during the early years, when the value of the investment is perceived to be largely in the income tax benefits of building depreciation, mortgage interest, and other tax shelters. These tax deductions may offset the investor's income from other passive sources of income that are subject to certain limitations and restrictions. The resulting tax deferrals are seen as earnings of the partnership interest, even though the dollars involved do not flow from partnership property.

Frequently tax law changes alter the value of various shelter benefits. Early property disposition or foreclosure can damage shelter advantages due to tax law recapture provisions. These considerations should be weighed in rating the risk of partnership investments. The Tax Reform Act of 1986 significantly reduced the income sheltering benefits offered by real estate.

Equity Syndications

Another popular financial division of property interests is the equity syndication. *A syndication is a private or public partnership that pools funds for the acquisition and development of real estate projects.* Syndications, which may be referred to as partnerships, are established when an individual or group purchases interests in real estate for the purpose of transferring them to a limited partnership. The limited partnership interests are then sold to investors.

Such arrangements appear simple, but they may be very complex because syndications frequently purchase more than real estate, and the value of the interests in real estate and the aggregate value of the limited partnership interests differ in quality as well as quantity. Syndications create property interests, which are grouped as "securities." Their value depends not only on the underlying real estate, but also on the additional, or more limited, rights created by contracts and other nonrealty considerations. Accordingly, the valuation of syndicated property, other than market valuation of fee simple rights, involves valuing more than real estate.

The interests of real estate and the interests of the limited partnership differ in value because many non-real estate items or conditions are involved. In addition to the real estate interests conveyed, most sales of limited partnership interests by a syndicator include other items such as management services, the ability to invest in a major property that an investor might not be able to invest in alone, and the potential for improved liquidity. Potential capital appreciation and eligibility for tax benefits, which are not limited to syndications, also influence investors and may affect market value. These factors and conditions are difficult to isolate, so analyses of comparable sales may be difficult.

Decreased inflation, the prosecution of abusive tax shelters, and the failure of financial institutions have brought some mortgage and syndication practices into question. Appraisers must exercise great care in determining the exact nature of the interests to be valued in any assignment involving partnerships; they should avoid presenting the market values of syndication interests as though they represent an assembled ownership of real estate assets.[4]

[4] *Guide Note 1 to the Appraisal Institute's Standards of Professional Practice addresses the valuation of real estate interests intended for syndication and the valuation of real estate partnership interests.*

Summary

Property rights consists of ownership, legal estate, economic benefits, and financial components. Ownership may be held by an individual, a partnership, or a corporation, and undivided ownership rights may belong to two or more parties in tenancies. Legal estate and economic benefits refer to the disposition of the rights to property use and occupancy as well as the income generated from rent or percentage of profits. The financial components of a property consist of the equity and mortgage funds that secure it. The equity and mortgage components of property may be further divided into *leased fee* and *leasehold interests* or into land and building portions.

Lease interests result when property rights are separated by legal contracts. The rights of the *lessor*, the leased fee owner or landlord, generally include the right to collect rent for the lease period; to repossess the property when the lease expires or the tenant defaults; and to dispose of the property through a sale, mortgage, or bequest during the lease period. The *lessee*, the leasehold or tenant, has the right to use and occupy the property for the lease period and may have the right to sublease it and improve it. In return, the lessee is obligated by contract to pay rent, to surrender possession when the lease ends, and along with the lessor, to abide by the lease conditions. Other lease provisions may address required security deposits; payments for utilities, maintenance and repair; rent escalations; and renewal or purchase options.

Tenancy is the right of use and occupy property as conveyed by a lease. The length of the leasing period may be renewed periodically or it may be clearly specified. Tenancy can also refer to a variety of arrangements involving property ownership by two or more persons—e.g., *joint tenancy, tenancy by entirety*, and *tenancy in common*. The valuation of co-ownerships involving undivided partial interests may be especially difficult because no one party can exercise complete control.

Leases may be *gross* or *net leases*, depending on whether the landlord or the tenant pays the operating expenses and taxes for the property. Lease provisions may call for level payments (flat rental), step-up or step-down payments, or payments that are periodically adjusted to an economic index or to a revaluation of the property.

The market value of a leased fee interest depends on how *contract rent* relates to *market rent* and on the credit rating of the tenant. A leasehold interest may acquire value if the lease allows for subletting or assignment and the term is long enough to be marketable. *Subleasehold* and *sandwich leasehold positions* are created through subleasing and assignment. *Leasehold mortgaging* is often arranged for lessee developers who, with the lessor's consent, subordinate their leasehold interest to any mortgage covering the cost of improvements they build on the property.

Partial interests also include vertical interests, easements, transferable development rights (TDRs), and interests resulting from specialized fractional ownership. Vertical interests refer to *subsurface rights* e.g., for mining or construction of transportation tunnels) and *air rights* for the use, control, and regulation of air space. *Easements* generally permit use of a portion of a property for access (e.g., for public utility lines, subways, or bridges). Preservation easements, which are deeded by donors to nonprofit organizations or government agencies in return for tax write-offs, prohibit certain physical changes to historic properties.

Stock corporations, land trusts, general and limited partnerships, and equity syndications are legal entities that create partial ownership interests. Corporate shareholders own stock, but the market value of this stock is generally different from its *book value*. *Land trusts*, which are performed to effect a profitable assemblage or to assign a property as loan collateral, convey legal title to a trustee, while property management and rent collection are retained by the beneficiaries. *Partnerships* are classified as general or limited depending on the partners liability for possible losses. *Equity syndications* are partnerships set up to pool funds for the acquisition and development of real estate projects. Syndications are created by contracts and provide more benefits than real estate ventures.

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