

Why a “Leased Fee Interest” is Fee Simple Ownership

It is often claimed, and correct so, that a leased fee interest is fee simple ownership of real property. When used in terms of property rights, the Fee Simple Estate (ownership) of a leased property can be split into its two components: Leased Fee and Leasehold. Mathematically this is:

$$\text{Leased Fee Interest} + \text{Leasehold Interest} = \text{Fee Simple Estate} \quad (1)$$

The fee simple estate is considered the highest level of ownership of property. Realistically, the fee simple private ownership estate is not “absolute”, because the fee simple estate is often limited by the four powers of government. Furthermore, in the modern built environment, this private ownership is further limited by other private claims to the property such as easements, liens, etc., but since these private claims are considered common to all owned property, they are assumed not to cause a property’s ownership to be anything less than owned in fee simple. The one major exception to this assumption are the private claims called leases.

The legal owner of real estate controls not only the ability to dispose of real property rights (the primary evidence of true property ownership), but the legal owner also controls the custodial rights (possession) to the property, with possession being the actual holding or occupying (i.e., custody) of something with or without rights of ownership. When possessory leases (representing the actual custody of real estate by a tenant) are added to the mix, appraisers distinctly differentiate the ownership of real property into the fee simple estate (property without leases in place) and the leased fee interest (property with custodial leases in place). As noted in (1) above, the appraisal profession even has a “mathematical” relationship for how these two concepts relate to one another.

Another way to describe the leased fee interest is “fee simple subject to lease”. What this term means is that when a leased property is owned in fee simple, the owner’s leased fee interest is a combination of the owned fee simple estate plus the private lease arrangement between the owner and a tenant (i.e., the possessory, personal property lease contract). The real property is owned, and the personal property lease contract will create potential incremental value gains or losses from leasing the possessory interests to a tenant. It is also commonly known that this marginal benefit from leasing the possessory interests has zero incremental value to the owner of the real property when the contract rent of the possessory lease is equivalent to market rent, resulting in a situation where the value of the fee simple ownership is equivalent to the leased fee ownership. This can be expressed mathematically as:

$$\text{Leased Fee Interest} = (\text{Fee Simple Estate} + \text{Incremental Value of the Lease}) \quad (2)$$

Substituting a value of zero into the Incremental Value of the Lease (when contract rent is equivalent to market rent) into equation (2), we get:

$$\text{Leased Fee Interest} = \text{Fee Simple Estate} \quad (3)$$

This is not a controversial issue in the appraisal profession. When leased properties are sold and that property’s contract rent for possessory use of the property is at market levels, there is no leasehold value

to the tenant and the fee owner's value of the property as leased is equivalent to the property if it were not leased (no value gain because contract rent is at market rent).

Now, let's do some mathematics. If we take equation (1) above and substituting the mathematical definition of leased fee interest from equation (2) above, we get:

$$(\text{Fee Simple Estate} + \text{Incremental Value of the Lease}) + \text{Leasehold Interest} = \text{Fee Simple Estate} \quad (4)$$

Now, let's do one more simple mathematical adjustment to this process. Since Equation (4) is an equality, we can subtract Fee Simple Estate from both sides of the equation, and the equation will not be affected. When we subtract Fee Simple Estate from both sides ($\text{Fee Simple Estate} - \text{Fee Simple Estate} = 0$) we get:

$$(0 + \text{Incremental Value of the Lease}) + \text{Leasehold Interest} = 0 \quad (5)$$

Simplifying and rearranging terms, we get:

$$\text{Incremental Value of the Lease} = (- \text{Leasehold Interest}) \quad (6)$$

Furthermore, what is represented in equation (6) is the commonly accepted relationship between a landlord (the leased fee interest owner) and a tenant (the possessory leasehold interest owner). If a landlord has a positive economic gain from contract rents being above market, the tenant simultaneously has a negative economic leasehold in the property.

However, let's think again about when contract rents are at market rents. In this case, the tenant's possessory leasehold interest has no value and the property owner's incremental value to the lease for giving up those possessory leasehold interests is also zero. When market rent equals contract rent, the Incremental Value of the Lease and the Leasehold Interests are zero; and using equation (4) we get:

$$(\text{Fee Simple Estate} + 0) + 0 = \text{Fee Simple Estate} \quad (7a)$$

$$\text{Fee Simple Estate} = \text{Fee Simple Estate} \quad (7b)$$

Also, when contract rent is at market rent and the incremental value of the possessory lease is zero (0), the following results (using equation (2) above):

$$\text{Leased Fee Interest} = (\text{Fee Simple Estate} + 0) \quad (8a)$$

$$\text{Leased Fee Interest} = \text{Fee Simple Estate} \quad (8b)$$

What equations 8a and 8b show is that the leased fee interest is the fee simple estate when the contract rents for a property are at market levels. The "conceptual" difference between the two solely relate to the possessory rights associated with the lease contract, and it has nothing to do with the real property ownership rights of the real estate. In other words, there are no ownership-rights differences between leased fee and fee simple, only possessory rights associated with the custody of the real estate.