Fee simple: Where are we now?

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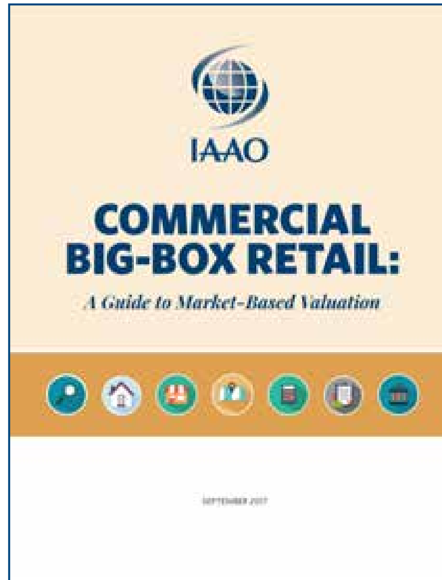
A lot has changed in the world in a relatively short period of time.

The same can be said about the appraisal world, which has seen a flurry of activity, much of it relating to the concept of fee simple absolute estate, also known as fee simple estate.

This issue has been particularly controversial in the property tax arena.

This article will look at activity taking place since the August 2019 release of the International Association of Assessing Officers' paper, "Setting the Record Straight on Fee Simple."



IAAO big-box retail position article

The precursor to "Setting the Record Straight on Fee Simple" was "Commercial Big-Box Retail: A Guide to Market-Based Valuation," published by IAAO in September 2017.

In addition to providing guidance on numerous issues reflected in big-box valuation for property tax purposes, the paper also identified the fee simple controversy as being a central theme in these tax appeals.

This issue arises from interpretations of the Appraisal Institute's (AI) current definition of the term fee simple, which is:

> *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.*[1]

In big-box property tax litigation, some property owners allege that the Appraisal Institute's inclusion of the "unencumbered by any other interest or estate" language in the definition of fee simple mandates that in a sales comparison approach of a fee simple estate, the appraiser cannot use comparable sales of property encumbered by a lease.

Other practitioners take the further step of alleging that only vacant properties are proper fee simple comparables, because for owner-occupied single-tenant properties valued by an income approach, the premise requires the property be appraised as if vacant and available for lease (i.e. not "encumbered" by a lease).

By this logic, deductions are taken for lease-up costs and carrying costs incurred to bring the property from vacant to occupied by a future, prospective tenant. The approach is similar to what lenders call a go-dark value.

The confusion surrounding this term has led to many contentious property tax disputes, and the International Association of Assessing Officers recognized the need to identify the problem and clarify this in a follow-up paper titled "Setting the Record Straight on Fee Simple."

IAAO circulated a draft version of the big-box retail position paper to members before its publication.

The industry took notice of the draft's fee simple discussion and in September 2017 the Appraisal Institute convened a Property Rights Symposium, at which fee simple was the primary topic.

Appraisal Institute's Property Rights Symposium

In December 2017, a draft Property Rights Symposium discussion paper was circulated to members that included a summary of the symposium and proposals to resolve the fee simple issue. Included was the following:

> *After deliberating, the Fee Simple Definition Work Group presented a proposed new definition, as follows:*
>
> > *Fee simple estate. The highest estate allowed by law. An inheritable ownership interest of indefinite duration.*
>
> *In addition, it was suggested that the valuation profession discontinue the terms leased fee and leased fee estate.*
>
> *... Another potential implication of the proposed revision to the definition of fee simple estate is that the terms leased fee and leased fee estate would not be needed; in fact, such terms would be inappropriate and would not be used.*
>
> *A lease is simply an interest in property, albeit a possessory interest. When a property is leased, the lessor retains the fee simple estate, though the rights (interests) to use and occupy the property are transferred to the lessee.*
>
> *The lessee now has a leasehold estate, but it lasts only until the end of the lease, at which point the rights of use and occupancy revert to the lessor. "Leased fee" would be presented instead as a fee simple estate subject to a lease.*[2]

Had the Appraisal Institute adopted those proposals, it would have resolved the issue.

However, no such action was taken, and the draft was never approved or finalized.

August 2019: IAAO's "Setting the Record Straight on Fee Simple"

In August 2019, IAAO published its white paper titled "Setting the Record Straight on Fee Simple," exploring in greater detail the matter first raised in the previous big-box paper.

Important concepts in the Fee Simple Paper include:

- The definition of fee simple in the appraisal industry should not differ from its definition in the legal realm and in other parts of the real estate industry.
- The phrase "unencumbered by any other interest or estate" included in the Appraisal Institute definition of fee simple has been interpreted inaccurately and should probably be removed from the definition.
- As previously stated in "Commercial Big-Box Retail: A Guide to Market-Based Valuation," a lease does not factor into the definition of fee simple absolute.
- Appraising the fee simple estate in real estate is not necessarily equivalent to appraising the property as if it is vacant.

The release of the Fee Simple Paper sparked a reaction, including the publication of several articles and a written response to IAAO from the Appraisal Institute.

The big question remained: What changes, if any, would be present in the soon-to-be released 15th edition of The Appraisal of Real Estate?

The Appraisal of Real Estate, 15th Edition

The year 2020 brought the release of the 15th edition of The Appraisal of Real Estate, which includes enhanced discussion about fee simple not found in previous editions. And while the text holds firm on its definition of fee simple, it now includes some interesting additional discussion on the topic.

The 15th edition maintains the Appraisal Institute's post-1983 definition of fee simple, specifically:

> *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.*[3]

The text acknowledges that the definition of fee simple used therein differs from the legal definition "because legal definitions generally serve a different purpose," noting that, "whereas definitions of fee simple used by appraisers highlight the encumbrances on property, legal definitions tend to focus on duration."[4]

However, the text does not explain why the legal definition should serve a purpose different from the appraisal definition. In fact, not so long ago the legal definition and the appraisal definition were identical.

Fee simple and the Appraisal Institute: A brief history

One of the more interesting aspects of the IAAO Fee Simple Paper is an analysis of how the current Appraisal Institute definition of "fee simple" came about.

For many years, whether the real estate was owner-occupied or leased, the real property interest appraised was the fee simple estate.

From the early beginnings of the American Institute of Real Estate Appraisers (AIREA) and the Society of Real Estate Appraisers (the Society), the definition in their dictionary-type publications, most of them produced jointly (Appraisal Terminology, Appraisal Terminology and Handbook) had their roots in the legal profession (Black's Law Dictionary).

A list of the fee simple definitions in the joint AIREA and Society publications, as well as definitions in dictionaries published by the AIREA and the AI, is shown in the IAAO paper "Setting the Record Straight on Fee Simple."

From the 1962 Appraisal Terminology and Handbook through the 1981 Real Estate Appraisal Terminology, Revised Edition, the fee simple definition was identical to the legal definition:

> **fee simple.** *An absolute fee; a fee without limitations to any particular class of heirs or restrictions, but subject to the limitations of eminent domain, escheat, police power, and taxation. An inheritable estate.*[5]

In the 1983 eighth edition of The Appraisal of Real Estate, published by the AIREA, the definition was shortened to:

> *A person owning all of the rights is said to have fee simple title. Fee simple title is regarded as an estate without limitations or restrictions.*[6]

Up to this point, the appraisal definition of fee simple was still identical to the legal definition of fee simple.

Then, in 1984, the AIREA published the first edition of The Dictionary of Real Estate Appraisal separate and distinct from the previous joint publication with the Society.

The 1984 and subsequent editions of The Dictionary of Real Estate Appraisal and The Appraisal of Real Estate texts published by the AIREA and the AI contained a new revised fee simple definition in 1984 read,

> **fee simple estate.** *Absolute ownership unencumbered by any other interest or estate; subject only to the limitations of eminent domain, escheat, police power, and taxation.*[7]

This fee simple definition eliminated the language addressing inheritability and added the "unencumbered by any other interest or estate" phrase that exists today.

But while the wording in the definition changed in 1984, there was no intention to change the meaning of the term: The changes were intended to be only refinements.

As a member of the committee that developed the 1984 dictionary, one of the authors of this article can attest to these facts.

The 1984 fee simple definition, like its predecessors, was not meant to be interpreted as requiring a subject property be considered as if vacant to be a fee simple ownership estate.

It was intended to have the same meaning as in publications from 1962 to 1983, i.e., the legal definition. The wording "without limitations to any particular class of heirs or restrictions" from previous publications became "unencumbered by any other interest or estate" in the 1984 dictionary.

Had the Appraisal Institute intended to change the meaning of fee simple in 1984, one might think that it would have provided additional discussion or explanation.

Yet none exists.

Moreover, the subsequent and faulty interpretations did not come about im-

mediately after the 1984 definition was published but emerged years later in appraisals prepared on behalf of big-box retailers in tax assessment appeals.The current Appraisal Institute version is as set forth above.

Although some argue that the appraisal definition of fee simple is and should be different from the legal definition, those arguments fail to explain why up until 1984 the legal and appraisal terms were synonymous.

The 15th edition expounds on fee simple discussion

While the 15th edition clings to the notion that it is appropriate to retain the "unencumbered by any other interest or estate" language, it notes the following:

By this definition, a fee simple estate includes the full 'bundle of rights' with no exceptions other than the four specified governmental powers. Strictly interpreted, even minor encumbrances like public utility easements or reciprocal access agreements would result in something less than a fee simple estate.[8]

Thus, the text acknowledges that by its own definition essentially no property an appraiser ever encounters is held in fee simple (in spite of what the deed states), stating, "... by this measure, few properties and few sales transactions involve a fee simple estate."[9]

The text then goes on to explain that the "unencumbered" language in its definition is not truly adhered to by the appraisal profession:

Nevertheless, as a practical matter, most appraisers refer to all fee interests in real property as fee simple, regardless of the encumbrances... .[10]

In other words, most appraisers abide by the legal definition of fee simple, which recognizes that a fee simple estate remains, even if the property is subject to encumbrances.

The text also states that although some encumbrances can be ignored and still be considered a fee simple estate, other encumbrances, primarily leases, cannot be ignored, even though the text's "unencumbered" phrase makes no such distinction.

Next the text makes this statement:

A lender requesting a valuation of the fee simple estate likely intends to refer to an unencumbered interest, whereas a deed that conveys fee simple title would generally be understood to mean an interest that will endure indefinitely, including all encumbrances.[11]

However, it is the experience of the authors of this article that a lender seeking an appraisal of the fee simple estate of a property most certainly wants the valuation to recognize and take into consideration the existence of encumbrances on the property.

What lender wants a value of a shopping center ignoring deed restrictions, reciprocal parking easements, etc.? In fact, lenders seeking the market value of a fee simple estate in a shopping center want leases to be considered as well.

Ultimately though, the 15th Edition acknowledges that merely identifying what is to be valued as the fee simple estate is not sufficient.

In addition to identifying the estate, the appraisal assignment must identify what interests the estate is subject to. The text now states:

An estate is what is owned, including the right of possession and the power to exclude others. And interests are rights in real property that can benefit or burden the land and affect the value of an estate. What is valued in a real property appraisal is an estate subject to specified interests. Therefore, an appraiser's task is to identify not only the estate ... but also the interests associated with the real estate, such as leases, easements, restrictions, encumbrances, reservations, covenants, contracts, declarations, special assessments, ordinances, or other interests of a similar nature.[12]

Thus, in the final analysis, the text recognizes that fee simple (or any other estate) can exist, even when it is subject to various interests, be they easements, restrictions, leases, etc.

This statement appears to be contradictory to the "unencumbered by any other interest" language set forth in the definition but is consistent with the proposals set forth in the unadopted Property Rights Symposium discussion paper.

The special impact of fee simple on property taxation

It may well be that the Appraisal Institute will not revert to the pre-1984 definition of fee simple that existed for decades and aligned with the legal definition.

For the most part, in the appraisal world outside property tax it is less of an issue. Lenders and appraisers working for lenders understand the goal of the assignment regardless of whether the property rights are identified as fee simple or leased fee.

The scope of work and values sought (go-dark, value based on rents in-place, liquidation value, assuming market rents) are less related to identifying the property rights than they are to what value(s) are requested by the assignment.

But in the property tax arena, it is a different matter.

Because of the remaining "unencumbered" language in the Appraisal Institute definition, and despite clarifications in the 15th Edition, some practitioners in the property tax field are still exploiting the "encumbered by any other interest or estate" language to devise methods of achieving reductions in property value that were never intended.

Therefore, the property tax field must adhere to and continue to reinforce the legal definition of fee simple absolute.

The ultimate resolution of this issue will come by adoption of the legal definition of fee simple absolute by recognized authorities in the property tax field, clarification of the term by local jurisdictions and their respective legislative bodies, and through decisions made by the courts.

Of course, in property taxation one overriding principle has always been that property is assessed to one owner, despite certain transfers of interests (via easements, leases, mortgages).

Emphasizing that concept helps diminish the argument that a leased property must be treated differently from an unleased property.

Fee simple in the courts

These issues are working their way through the courts. In a recent decision in Ohio, the court of appeals succinctly concluded:

In other words, 'as if unencumbered,' means that if the subject property is encumbered, the appraiser adjusts for the effects of those encumbrances. It does not mean, however, that the appraiser must assume that the property is vacant or ignore the fact that the property could be leased at market rent. Thus, such adjustments are adjustments to account for market rent and occupancy levels, not

adjustments to simulate vacancy.

... It has also been understood for some years that 'as if encumbered' does not mean that one is to assume the subject property is vacant or distressed but, instead, means an adjustment in value to simulate market rent and occupancy is appropriate.[13]

In another recent decision, the Oregon Supreme Court recognized that a valuation of the fee simple interest in leased property is "the value of all interests in the property, including those of the owner (ordinarily the lessor) and any lessees."

Similarly, another Ohio case noted, "the phrase 'as if unencumbered' means that if the subject property is encumbered, an appraisal should adjust for the effects of those encumbrances. Such adjustments account for market rent and occupancy levels, and not simply to simulate vacancy."[15]

Other courts have also noted that leased properties are acceptable comparables (with appropriate adjustments) for use in valuing a property's fee simple estate.

Indeed, more courts, including state supreme courts, are noting that, in spite of the "unencumbered" language contained in some fee simple definitions, within the property tax realm certain encumbrances must be taken into account in the valuation of a fee simple estate.

Finally, parties to property tax litigation where the fee simple issue is debated are including the IAAO's paper "Setting the Record Straight on Fee Simple" as a part of their trial evidence.

Resolution

With two distinct definitions of fee simple absolute, where and how does this controversy resolve itself? Here are three options:

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IAAO definition

IAAO should adopt a definition of fee simple absolute, perhaps through the upcoming new edition of the Glossary.

Legislation

Interestingly, many jurisdictions do not actually specify what is being assessed in terms of real estate interests. Those that do often do not describe the interests beyond fee simple.

Local IAAO chapters, along with assessors, can reach out to state legislators, explain the current issue and its impact on the industry and the tax base, and then provide statutory language clarifying the nature of the interest assessed for property tax purposes.

Further, fee simple may be identified in a state constitution, by statute, or by case law, and if that occurred before the Appraisal Institute changed the definition, it clearly suggests the original legal definition is the one adopted by the jurisdiction.

The courts

Finally, this issue can be resolved in the courts.

Of course, the outcome of litigation is never certain, and no jurisdiction should take on this issue alone.

When these issues rise to the appellate level, other jurisdictions and industry associations should step in and lend a hand.

Conclusion

Fee simple was not a contentious issue in the past.

The definition of fee simple, as set forth pre-1984, was clear and understood.

Now, the "new normal" is confusion in the appraisal industry, particularly regarding property tax matters.

That confusion will apparently continue until jurisdictions clarify the definition of fee simple through legislation or court decisions.

FOOTNOTES

[1] Appraisal of Real Estate, 15th Ed. pg. 60, The Appraisal Institute 2020; Dictionary of Real Estate, 6th Ed. pg. 90 Appraisal Institute 2015

[2] Property Rights Symposium discussion paper – draft for discussion purposes, The Appraisal Institute, 2017

[3] Appraisal of Real Estate, 15th Ed. pg. 60 Appraisal Institute 2020; Dictionary of Real Estate, 6th Ed. pg. 90 Appraisal Institute 2015.

[4] Appraisal of Real Estate, 15th Ed. pg 60, Appraisal Institute 2020.

[5] Appraisal Terminology and Handbook, American Institute of Real Estate Appraisers 1962.

[6] The Appraisal of Real Estate, Eighth ed., American Institute of Real Estate Appraisers 1983.

[7] The Dictionary of Real Estate Appraisal, American Institute of Real Estate Appraisers 1984.

[8] Appraisal of Real Estate, 15th Ed. pg. 60 Appraisal Institute 2020.

[9] Ibid.

[10] Ibid.

[11] Appraisal of Real Estate, 15th Ed. pg. 61, Appraisal Institute 2020.

[12] Appraisal of Real Estate, 15th Ed. pg. 59, Appraisal Institute 2020.

[13] *Lowe's Home Centers, LLC v. Brooklyn City School Board of Education, et al.* Court of Appeals of Ohio, decision rendered February 11, 2020, No. 19PA-179.

[14] *Powell St. I, LLC v. Multnomah Cty. Assessor,* 445 P. 3d 297 (Or. 2019).

[15] *Sheffield Crossing Station, LLC v. Lorain Cty. Bd. of Revision*, (10th App. Dist. Oh. 2020).

[16] *Gateway-Walden, LLC v. Pappas*, 127 N.E. 3d 157 (1st Dist. App. Il. 2018).

[17] *Notestine Manor, Inc. v. Logan Cty. Bd. of Revision*, 152 Ohio St. 3d 439 (Oh. 2018); Powell St. I, LLC v. Multnomah Cty. Assessor, 445 P. 3d 297 (Or. 2019)

[18] *Kohl's Ill. Inc. v. Cty. of Dakota*, 2020 WL 6374971 (Tax Ct. Mn. 2020)