

POSSIBLE MISPERCEPTIONS ABOUT SPLIT PURCHASES OF TERM-OF-YEARS AND REMAINDER INTERESTS IN PROPERTY

Accounting and finance professionals often misperceive the legal and economic substance underlying the separation of property ownership into term-of-years and remainder ownership interests. Such misperceptions usually are due to a misunderstanding of the nature of property ownership in Anglo-Saxon legal systems. This article addresses the most common of these misunderstandings. For the sake of simplicity, the discussion will be restricted to the case in which the property is real estate, although it applies essentially to all forms of tangible property.

In Anglo-Saxon common law, real estate ownership consists of a bundle of property-related rights and obligations. A *real ownership interest* in real estate consists of ownership of any subbundle of these rights and obligations and is signified by a written deed to the specified subbundle. Although it is frequently convenient to think of a single entity as "the owner" of the real estate, in many cases the bundle of property rights and obligations can be separated into several subbundles and corresponding ownership interests, with ownership of each real interest signified by a separate recorded deed.

Separation of property ownership into subbundles of rights and obligations is more frequent than most real estate market participants realize. For example, ownership of the surface rights to nearly all real estate in the western United States was detached from ownership of the associated subsurface mineral rights in the 19th Century. Separate markets exist for deeds to the surface rights and the subsurface minerals, and in most cases the holder of the deed to one subbundle of surface rights and obligations has neither any awareness nor interest about the holder of the deed to the corresponding subsurface subbundle.

The holder of the subbundle of surface rights to western real estate is usually viewed as "the owner" of the real estate for purposes of convenient description. However, this is not strictly accurate, since the bundle of real estate rights and obligations includes subsurface property rights. In reality, in such cases "the owner" has been replaced with at least two owners of real interests in the property that are only slightly related in an economic sense. Each real estate interest is a component of the fee simple real estate.

Economic intuition developed by examining the separation of real estate ownership into surface rights and obligations and subsurface mineral rights and obligations applies without significant modification to the separation of ownership of leased real estate into term-of-years and remainder ownership interests. Once again, "the owner" has been replaced with at least two owners of real interests in the property that are only slightly related in an economic sense.

In both types of component ownership, the economic rights and obligations of component ownership are established for investors at acquisition. Accordingly, an ownership transaction in one component is a legal and accounting nonevent for the owner of the second component, provided the second component owner is unrelated to the transaction principals.

Similarly, in the case of real estate separation into surface and subsurface ownership, changes in mineral extraction activities and capabilities are legal and accounting nonevents from the perspective of surface ownership changes. In particular, the exhaustion of subsurface mineral resources does not constitute a legal or accounting event for the surface component owner, despite the fact that the subsurface component has no remaining future property rights. Since no transfer of ownership rights or obligations to the surface owner is triggered by the exhaustion of subsurface mineral resources, it is apparent that the legal and accounting interpretations are consistent with the economics of the situation.

Analogously, in the case of real estate separation into term-of-years and remainder interests, no transfer of ownership rights or obligations from the term-of-years interest holder to the remainder interest holder is triggered by the expiration of the term-of-years interest. The remainder interest holder does not acquire any rights and obligations represented by the term-of-years. It follows that, in contrast to a sale event, the term-of-years interest owner does not relinquish any rights to economic benefits generated by the property prior to term-of-years expiration but not yet received.

The term-of-years interest holder also cannot transfer any ownership rights or obligations represented by the remainder interest, because the term-of-years interest holder never owns nor controls those rights. Accordingly, the expiration of the term-of-years does not constitute a legal event for the remainder interest owner despite the fact that the term-of-years interest component has no remaining future property rights, and the expiration should not constitute an accounting event from the perspective of the remainder interest. It is apparent that these are the only legal and accounting interpretations that are consistent with the interpretations accorded the separation of real estate into surface rights and subsurface mineral rights and with the economics relating to expiration of the term-of-years.