# Fair Market Value and the Hypothetical Buyer

**By: William D. Shepherd, General Counsel, Hillsborough County Property Appraiser**

## Fair Market Value Definitions

In Florida, as in many states, ad valorem property taxation is based upon a determination of fair market value.[1] Fair market value was defined by the Florida Supreme Court as,

> …the classic formula that it is the amount a 'purchaser willing but not obliged to buy, would pay to one willing but not obliged to sell.

Walter v. Schuler, 176 So. 2d 81, 86 (Fla. 1965) [Cf. Florida East Coast Railroad v. Department of Revenue, 620 So. 2d 1051 (Fla. 1st DCA 1993)][2]

The Department of Revenue's definition is slightly different, but the same in concept,

> [T]he price at which a property, if offered for sale in the open market, with a reasonable time for the seller to find a purchaser, would transfer for cash or its equivalent, under prevailing market conditions between parties who have knowledge of the uses to which the property may be put, both seeking to maximize their gains and neither being in a position to take advantage of the exigencies of the other.

F.A.C. 12D-1.002(2).

The Appraisal of Real Estate, 14th Edition, 2013, defines market value as follows:

> The most probable price, as of a specified date, in cash, or in terms equivalent to cash, or in other precisely revealed terms, for which the

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[1] The Florida Constitution requires a valuation based upon the property's "just value." Fla. Const. Art. VII, Sec. 4. The term just value is synonymous with the term "fair market value." Walter v. Schuler, 176 So. 2d 81 (Fla. 1965)

[2] The Walter v. Schuler definition can be traced back to Root v. Wood, 21 So. 2d 133 (Fla. 1945). However, the first ad valorem tax case to define fair market value (and a more expansive definition) was apparently City of Tampa v. Colgan, 163 So. 577 (Fla. 1935), where the Florida Supreme Court stated, "By 'fair market value' is meant the amount of money which a purchaser willing but not obligated to buy the property would pay to an owner willing but not obliged to sell it, taking into consideration all uses to which the property is adapted and might in reason be applied." Id at 582.

> specified property rights should sell after reasonable exposure in a competitive market under all conditions requisite to a fair sale, with the buyer and seller each acting prudently, knowledgeably, and for self-interest, and assuming that neither is under undue duress.

Numerous other authorities give slightly different definitions, but all are essentially the same in this aspect: Fair market value reflects the amount that the property would transact for in a hypothetical sale on the date of valuation.

This concept of a hypothetical sale is so familiar and basic that most of the time appraisers hardly give it any thought. However, delving a little deeper into the concept of a hypothetical sale can help the appraiser answer some of the more challenging questions being raised in property tax matters across Florida and the rest of the nation.

There are two particular, and common, instances, where a closer analysis of the concept of the hypothetical sale may help guide the appraiser to the best estimate of fair market value.

The first is the valuation of a special use or limited use property, where few if any comparable sales exist. Maybe it's a large manufacturing plant, or a large single tenant office building. In that case, the argument typically goes like this: Since this property was designed for a unique purpose, and the limited number of market participants existing already own their own locations, who would buy this property?

The second is where sales exist of similar properties, however those sales are typically of dark, non-occupied locations. These may be a big box retail building, a restaurant property or a national drug store chain property. In that case, the argument goes like this: This property is no different that all these other dark locations that sell at a heavy discount and the sale of those properties should be reflective of the value of the subject property.

## The Three Components of the Hypothetical Sale

I believe there are three components to a hypothetical sale and each must be analyzed in the above circumstances: They are the hypothetical seller, the hypothetical buyer and the non-hypothetical physical and economic conditions affecting the property. Let's begin with the last one: the physical and economic conditions surrounding the hypothetical sale.

### A. Market Conditions and Physical Aspects of the Property

Although the appraiser is hypothesizing a sale of the property, what should not be hypothetical are the physical aspects of the subject property and the economic conditions surrounding the subject property.

The appraiser cannot ignore physical depreciation, or functional obsolescence in the hypothetical sale. Nor can location or economic conditions be ignored.

### B. Market Demand for the Property under a Hypothetical Sale

Perhaps the most overlooked aspect when contemplating the hypothetical sale of the property is market demand for the property. The appraiser must determine, as of the date of valuation, the market demand for the subject property. In order to fully address that issue, the appraiser must first consider the identity of the hypothetical seller and the hypothetical buyer.

#### 1. The Hypothetical Seller

When there is an actual sale of a property, the appraiser knows the identity of the seller of the property. However, when hypothesizing a fictional sale of the subject property as of the date of valuation, *the actual owner of the property is not necessarily the hypothetical seller*. Instead, the actual identity of the seller is both unknown and not relevant. However, as the definition of market value requires, that unknown seller is knowledgeable and acts prudently and with self-interest.

Although identifying a particular seller as the hypothetical seller is not important, *understanding the motivations of the seller is important*. And to do that, the appraiser must look back to the market conditions and physical aspects of the property, as mentioned above.

It may be that the building is functionally obsolete and no longer well-serves the purpose for which it was originally designed. It may be that demand or demographics have changed and there is no longer a need for the improvements. Thus demolition or renovation of the improvements may be likely. Under a hypothetical sale, the appraiser must recognize and adjust for these real life issues.

However, what if the property is not functionally obsolete and market demand and demographics have not changed? What if the subject property is occupied, fully functioning and fully serving its purpose. Then the appraiser might ask: What is the motivation of this hypothetical seller in selling the property? In order to do so, the appraiser must eliminate seller motivations for selling the property that do not comport with the actual and existing facts surrounding the property.

There may be no reason relating to the features of the property that would cause that hypothetical seller to sell the property; just as there are no reasons why the actual owner of the property would sell the property. If that is the case, and the property still functions perfectly well for the purpose for which it was designed and market demand is still there, then consider this,

> The performance of the subject property is likely to be the most reliable indicator of current demand for existing properties on the market.

The Appraisal of Real Estate, 14th Edition, 2013, page 310.

Or, stated in terms of highest and best use:

> The highest and best use conclusion would likely include some forecast of continued economic demand, which may be demand for the finished product more than demand for the real estate.

The Appraisal of Real Estate, 14th Edition, 2013, page 355,

In other words, if there is currently demand for the uses and functions of the property, then *why wouldn't* a buyer step into the shoes of the seller and continue on with that profitable venture?

So then, the question becomes: Who would this buyer be?

## C. **The Hypothetical Buyer**

So now we come to the identity of the hypothetical buyer. And again, while it is not necessary to identify a particular potential buyer, it is necessary to analysis that buyer's motivations.

In the scenario of a fully functional property that still performs well for the current owner, who would buy the property? I propose that the hypothetical buyer of that property could be the current owner or could be any hypothetical user willing to fill the niche in the market that the current owner is now serving.

Remember, the appraiser looks to actual demand in the marketplace, not some fictional scenario. And if the subject property is currently a successful venture and is available for sale – why wouldn't another market participant want to enjoy all the benefits that property currently provides?

Another way to view the issue is like this: If the actual owner is not the hypothetical seller, would the actual owner consider acquiring the subject property? And if so, what would its value be to them?

There is substantial support in both the courts and appraisal theory for this proposition. The hypothetical buyer theory is neither new nor unique. Its genesis in the courts dates back to at least 1908 and is recognized by numerous courts throughout the United States.

In Turnley v. Elizabeth, 76 N.J.L. 42, 68 A. 1094 (Sup. Ct. 1908) the New Jersey Supreme Court heard the argument by the owner of a grandiose private residence that because the property was so expensive, the cost could never be recovered on the open market. The court rejected the argument, stating in oft cited language,

> We are not disposed, however, to give much force to the argument that because there are very few actual buyers for so costly a residence the valuation to placed upon it under the statutory criterion should be correspondingly depreciated. The criterion established by the statute is a hypothetical sale, hence the buyers therein referred to are hypothetical buyers, not actual and existing purchasers. If this be not so, a citizen, by the erection of a residence so costly that no one could buy it, would escape all taxation, which is obviously not the intent of the legislature or the proper interpretation of its statute. Taxation normally bears some relation both to the degree of protection required by the taxpayer and to his ability to contribute to such public burden as manifested by the permanent improvement of his real property. Mere costliness, therefore, cannot rationally be made the basis of exemption from taxation.

Seventy-three years later, a Michigan appellate court dealt with valuation of an industrial plant in Clark Equipment Co. v. Township of Leoni Cnty. Of Jackson, 318 N.W.2d 586 (Mich. App. 1981). In Clark Equipment, the property owner again argued that because of the unique features of the industrial plant, the property would not readily sell on the open market. The court's response firmly rejected the property owner's theory,

> The problem with valuing large industrial plants is a problem with the statutory standard itself. The reality is that these types of industrial plants are rarely bought and sold, so that a determination of 'usual selling price' constitutes a metaphysical exercise which puts the Tax Tribunal in the position of having to resolve a question somewhat akin to how many angels can dance on the head of a pin. Petitioner may well be correct in its assertion that there is no market for its industrial plant at its current use. However, as we construe [the statutes] to the extent that an industrial plant is not so obsolete that, if a potential buyer did exist who was searching for an industrial property to perform the functions currently performed in the subject plant, said buyer would consider purchasing the subject property, the usual selling price can be based upon value in use. To apply [the statute], a hypothetical buyer must be posited, although, in actuality, such a buyer may not exist. To construe [the statutes] as requiring the taxing unit to prove an *actual* market for a property's existing use would lead to absurd undervaluations. Large industrial plants are constructed to order, in accordance wit the exact specifications of the purchasing user. Such plants are not constructed like small commercial buildings or residential structures with only a mere hope or expectation on the builder's part that the plant will be sold. When a large corporate entity such as Ford or General Motors builds a factory, it is probable that absolutely no market exists for the resale of that factory consistent with its current use. It is ludicrous to conclude, however, that such a brand new, modern, industrial facility is worth significantly less than represented by its replacement cost premised on value in use because, in actuality, such industrial facilities are rarely bought and sold. Thus, we hold that, to the extent a large industrial facility is suited for its current use and would be considered for purchase by a hypothetical buyer who wanted to own an industrial facility which could operate in accordance with the subject property's capabilities, said facility must be valued as if there were such a potential buyer (and therefore no such market) actually exists.

Id at 588-589.

Often, owners of elaborate buildings argue that the property is effected by "functional obsolescence." In CPC Int'l Inc. v. Bor. Of Englewood Cliffs, 473 A.2d 548 (N.J. Sup. Ct., 1984, the court considered the assessment of the plaintiff's international corporate headquarters, consisting of 22.6 acres occupied by four multi-storied buildings connected by enclosed bridges. Both parties agreed that the highest and best use of the property was its current use as a corporate headquarters. However, the owner argued that the expense incurred in the construction of the building's campus-style headquarters, with its elaborate features, general overbuilding, high-tech climate control system, duplication of facilities and features generally not found in an office building would never be recovered in a sale on the open market.

Again the court rejected the owner's claim that such a spectacular building should receive a greatly reduced value under a fair market value/willing buyer/willing seller scenario. The court noted,

> Built to plaintiff's specifications, these lavish improvements serve purposes which, from plaintiff's perspective, are highly utilitarian. Plaintiff is a large international business enterprise, and under worldly standards its interest are concretely promoted by identifying itself with an image of institutional grandeur. Though many features of these structures greatly exceed the bare necessities of a general office building, they clearly serve plaintiff's purpose of visibly enhancing its prestige in the business community by an artful blend of function and aesthetics. Such benefits have been held to constitute a value intrinsic to the building itself. Plaintiff argues that by taking the foregoing factor into account the applicable test of market, for tax assessment purposes, is displaced by the test of vale to the owner. For taxation purposes fair market value is the price which could be obtained for the property, in money, at a fair sale between a willing seller not obliged to sell and a willing

> buyer not obliged to buy. Plaintiff maintains that the likelihood of a buyer with requirements comparable to plaintiff's is so remote that the cost of the buildings' indulgences and special purpose features is not recoverable on the market and was therefore properly adjusted by the Tax Court for functional obsolescence. The argument overlooks two governing propositions. The first is that the sale contemplated as the criterion of market value is a 'hypothetical sale; hence the would-be buyers are hypothetical buyers, not actual and existing purchasers. From the context in which it was made we can only understand this reference to a hypothetical buyer to contemplate one whose requirements are reasonably accommodated by the property in question.

Id at 551-52.

One of the most common applications of the hypothetical buyer theory is in the valuations of newly platted subdivisions. In such cases, the owner argues that a discounted cash flow method is appropriate because of the extended marketing time to sell all the lots. Very simply, the owner argues that a sufficient quantity of buyers do not exist at the time of assessment, thus a discount is appropriate.

In St. Leonard Shores Joint Venture v. Supervisor of Assessments of Calvert County, 514 A.2d 1215 (Md. 1986) the court rejected the owner's argument that his unsold lots should be discounted to consider the "sell-out period" and said,

> …[T]he assessor should assume that a willing buyer and a willing seller wish to engage in a hypothetical sale of the property to be assessed.
>
> In disputing the Supervisor's assessment of the 105 unsold lots, appellant emphasizes that '[t]he problem… is that you didn't have 105 buyers, you had twelve- seven the first year and five the next year.' Appellant's argument misses the point. Regardless of whether a buyer for each lot actually exists, the assessor is required to assess each lot *as if* a buyer for each lot actually exists. This is not to say that a glut on the market should not be considered. We think, however, that the condition of the real estate market is adequately reflected in the price that the hypothetical buyer

> would be willing to pay. Therefore, we reject appellant's contention relating to the 'sell-out period' of the lots.

Id at 1217. [See also Edward Rose Building Co. v. Independence Township, 462 N.W.2d 325 (Mich. 1989)(Board of Equalization of Salt Lake Cnty. V. Utah State Tax Commission, 864 P.2d 882 (Utah 1993)("Absorption valuation errs in its premise that a 'willing buyer' must actually exist.")]

The "hypothetical buyer' theory is generally recognized across the United States, with decisions from states including North Carolina, New Hampshire, Maryland, New Jersey, Minnesota, Massachusetts, and Utah.

Given its apparent genesis at the turn of the century and application across the United States, it is fair to say that the hypothetical buyer theory is neither novel nor unique.

Skeptics will argue that considering a hypothetical buyer is simply placing a "value in use" assessment on the property as opposed to its fair market value. However, every one of the cases cited herein are from states which require a valuation based on fair market value. Moreover, basic appraisal theory notes that a value in use and fair market value are not necessarily different in all cases.

The Appraisal of Real Estate, 11th Ed. 1996 notes,

> Large manufacturing plants, railroad sidings, and research and development properties are examples of limited-market properties that typically appeal to relatively few potential purchasers. However, this is not to imply that they have no market value.
>
> Some practitioners effectively argue that, in certain situations, it is possible to estimate two or more *market values* depending on how the market is defined. For example, an appraiser is called to value a home that is

> specially designed for a person who uses a wheelchair. The property is attractive to the limited market of other wheelchair users who would probably be willing to pay more for it. An estimate of the home's market value based on this limited market would therefore be higher than the market value based on the broader market of home buyers for whom the special design features would have no appeal and would likely represent a penalty.

Id at 25. Thus, the Appraisal Institute couches the theory in terms of a sale to a buyer within a "limited market."

In the case of McCannel v. County of Hennepin, 301 N.W.2d 910 (Minn. 1980) the court specifically rejected the taxpayer's claim that the hypothetical buyer theory was really a value in use assessment of an airport.

> Northwest argues that the trial court's method of valuing its property as unique property violates the general rule that property should be valued at its market value rather than its intrinsic value. Although the concepts of intrinsic value and unique property are closely parallel in cases such as this, the trial court did value the property by determining its reproduction cost, an accepted method of estimating market value. To state it differently, the trial court determined the value of the property according to its highest and best use as an airport facility without regard to who might own it. The fact that its intrinsic value to Northwest Airlines might be equal to a hypothetical buyer as an airport facility does not render the trial court's method of valuation invalid.

Id at 924-925.

In fact, the McCannel case suggests that failure to apply the hypothetical buyer theory may not be merely a difference in appraiser opinion or methodology, but may be improper. The court noted,

> [T]he trial court was convinced that Northwest's (the property owner's) expert's used functional and economic obsolescence to consider changes which would have to be made to adapt the property for a *different* use. The trial court's conviction that Northwest's experts manipulated

> these concepts to *impermissibly* interject an allowance for modification for a different use buyer finds support in the expert's own testimony. We therefore conclude that in this case the trial court acted well within its discretion in rejecting Northwest's expert testimony on functional and economic obsolescence.

Id at 924.

Keep in mind the hypothetical buyer theory does not permit the property appraiser to ignore property conditions. If the subject property is functionally obsolete, even a hypothetical buyer will take that obsolescence into account.

Similarly, a "glut" of similar properties over and above what market demand indicates should not be ignored by the property appraiser under the hypothetical buyer theory. The assessment should reflect the condition of the real estate market. In other words, when valuing subdivision lots, although the value should assume a current buyer for each lot, the value should be based upon sales of similar lots, which reflect the buyer's market. See St. Leonard Shores Joint Venture v. Supervisor of Assessments of Calvert Co., 514 A.2d 1215 (Md. 1986).

**Conclusion**

In situations where the appraiser is faced with the valuation of a currently functioning property with few if any sales or income data, or with sales of physically similar, but vacant properties, recalling the basics of a hypothetical sale may help the appraiser get to the right valuation answer.

Moreover, when hypothesizing a sale of the property, if the existence of the current owner is ignored as a part of the market demand, then the appraiser is improperly analyzing the market demand for the property.