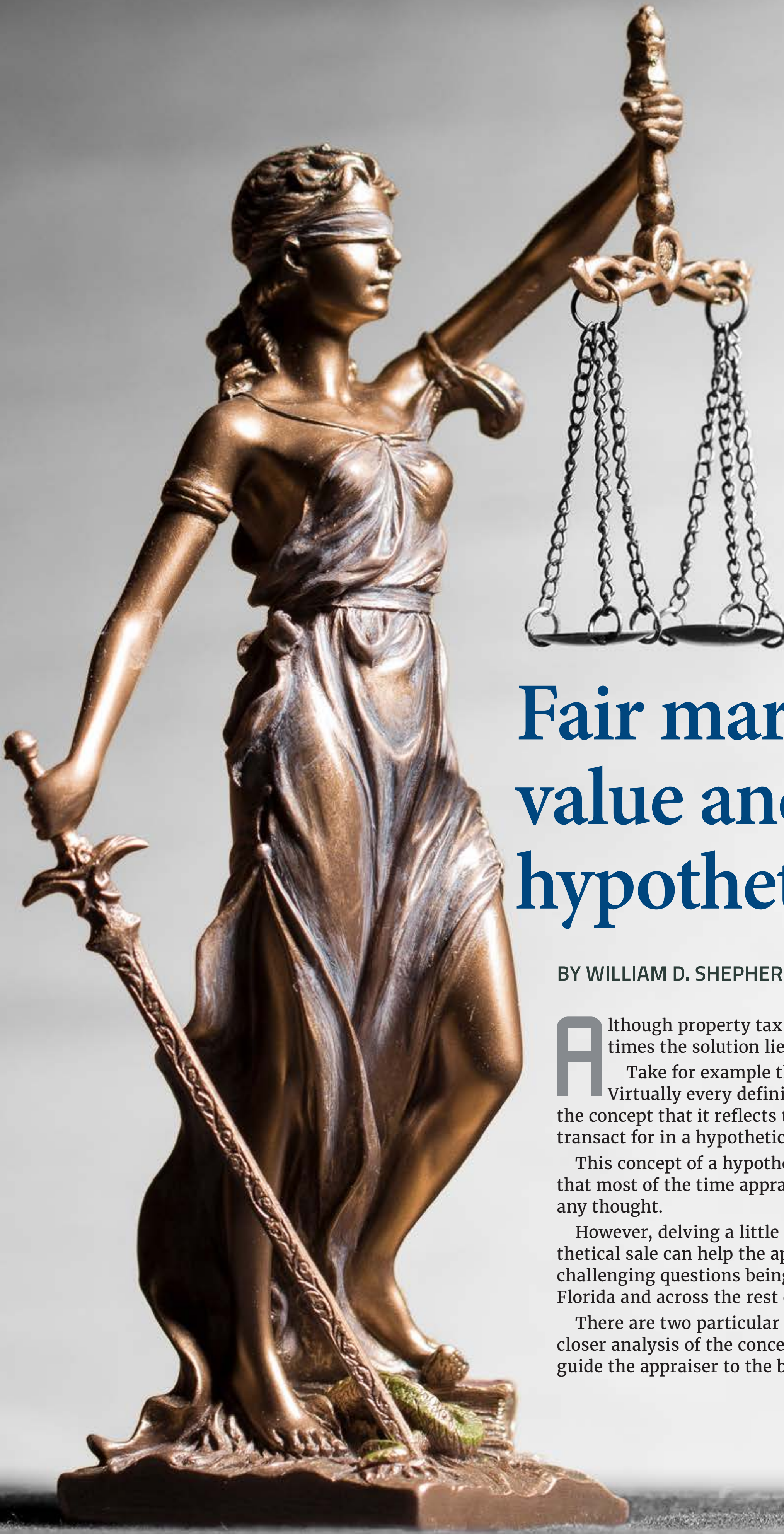

Fair market value and the hypothetical buyer

BY WILLIAM D. SHEPHERD

Although property tax litigation is often complex, sometimes the solution lies in the most basic of concepts.

Take for example the concept of fair market value. Virtually every definition of fair market value includes the concept that it 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 and assessors 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 in Florida and across the rest of the United States.

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

Scenario I

The subject property is an operating freestanding drug store. The owner or tenant responsible for the taxes has filed a property tax challenge seeking to reduce the assessment on the property.

The argument goes as follows: Sale prices of similar drug store properties are far below the value placed upon the property by the local assessor. So, it is readily apparent that the subject property is over-assessed. When these properties sell, they sell at a substantial discount. Clearly, although the subject property performs well currently, the features of the property do not translate upon a sale, thus functional obsolescence.

Moreover, often these property types sit vacant for long periods of time and often are ultimately retrofitted for an alternative use.

The same type of argument is regularly made with regard to big-box retail stores and restaurants as well and probably many other property types.

Scenario II

The subject property is a large owner-occupied campus style single-tenant office building. It is fully used by the current owner, who has no plans to leave the property. The owner has filed a property tax challenge seeking to reduce the assessment on the property.

The argument goes as follows: Sales prices of similar large office buildings are far below the value placed upon the property by the local assessor. Thus, it is readily apparent that the subject property is over-assessed.

When these properties sell, they sell at a substantial discount. Clearly, although the subject property performs well currently, the features of the property (in this case particularly the size of the property) do not translate upon a sale, thus functional obsolescence. And again, often these properties sit vacant for long periods of time and upon sale undergo a retrofit.

Getting back to basics

Both of those scenarios represent a substantial challenge for the assessor. Market evidence appears to weigh heavily against the assessor. Is the assessor wrong?

Does the answer lie deep in some obscure theory about functional obsolescence?

Let me suggest that the answer can be found in the most basic of concepts: the definition of market value.

This article addresses the topic in terms of both appraisal theory and legal precedent applying that appraisal theory.

Market Value and the Hypothetical Sale

In most states, ad valorem property taxation is based upon a determination of market value. Appraisers are all so familiar with the concept of market value, and the classic "willing seller, willing buyer" definition, that most of the time they hardly give it any thought.

Market Value Definitions

One of many similar definitions of market value is,

> 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 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 neither is under undue duress.
>
> — *The Appraisal of Real Estate*, 14th ed., p. 58, The Appraisal Institute, 2013.

Another familiar definition is,

> The estimated amount for which an asset or liability should exchange on the valuation date between *a willing buyer and a willing seller* in an arm's-length transaction, after proper marketing and *where the parties had each acted knowledgeably, prudently, and without compulsion.*
>
> — International Valuation Standards Council, *International Valuation Standards*, 2011 (London; IVSC, 2011), 12.

The real problem here, as all appraisers know, is that in all likelihood the subject property did not sell on the date of valuation.

Thus, there is no way to truly judge the market demand for the subject property on the valuation date.

It wasn't offered for sale, it wasn't marketed, and possible market participants did not consider the property as a viable option. Moreover, if the property were for sale, how would that fact itself have changed the market? What is it that would have caused the owner to sell? Where was the seller going? Would the seller have stayed in the market and become part of the demand?

As Brandt says in the movie Big Lebowski, "Well, Dude, we just don't know."

Thus, while an actual sale of the subject property meeting the above criteria is the best evidence of the value of the property, such a sale rarely conveniently occurs.

Therefore, in determining value for purposes of ad valorem taxation, the appraiser estimates what price the property would bring in a *hypothetical sale,* between a *hypothetical seller* and a *hypothetical buyer.*

Appraisal Theory

When considering that hypothetical sale and hypothetical market participants, the appraiser is not concerned with the identity of either; indeed, the appraiser does not assume that the current owner of the property is actually the seller, and does not identify a specific buyer for the property. Instead, the appraiser must gauge the demand for the subject property in the market, given the physical features of and the external forces affecting that property.

Supply and demand and use

The "willing seller, willing buyer" criterion is really another way to look at the most basic aspects of value: supply and demand.

The seller is on the supply side of the equation, whereas the buyer is on the demand side of the equation.

> The interaction of suppliers and demanders, whether they be sellers and buyers or landlords and tenants,

constitutes a market.

— *The Appraisal of Real Estate*, 14th Ed., p. 28, The Appraisal Institute, 2013.

A vitally important concept is that,

... the views attributed to market participants are, 'typical of those of buyers and sellers, or prospective buyers and sellers, active in a market on the valuation date, not to those of any particular individual or entity.

— *The Appraisal of Real Estate*, 14th ed., p. 59, The Appraisal Institute 2013, citing International Valuation Standards Council, *International Valuation Standards*, 2011.

In discussing supply and demand, *The Appraisal of Real Estate* notes,

Real property is both a physical commodity and the use of the real estate, so the supply of real estate in a market relates to the usability as well as the physical quantity of available space.

... real property value is created and sustained when the characteristics of a property conform to the demands of the market.

The Appraisal of Real Estate, 14th Ed., p. 29, 33, The Appraisal Institute, 2013.

All of the above quotes lead the appraiser to analyze demand for the use of the property, rather than identifying a specific buyer.

And how is demand determined? Perhaps the most telling feature is whether the subject property was being used as of the date of valuation.

If the property was fully functional and operating as of the valuation date, then the appraiser can likely assume that another market participant (the hypothetical buyer) would put the property to the same use if it were to be sold via that hypothetical sale and would be willing to pay a corresponding value.

While it's not necessary to identify a particular buyer, it is necessary to identify a particular use. And if the property is being used on the valuation date, why wouldn't another user desire the use the property in the same way?

This is not to say that identifiable functionally obsolete features should be ignored.

It may be that the market no longer desires some of the features present in the subject property, or that the property lacks certain features.

However, if the market still desires those features (i.e., similar improvements are still being built), then the functional issue is solved. That issue can be resolved by looking to features that the market currently desires.

In other words, if a property serving a similar use were to be constructed on the date of valuation, would it have the same or different features?

It may well be that there is a limited market for that particular type of real estate; however, if the property lends itself to a current use in the market, the value is not necessarily diminished.

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.

— *The Appraisal of Real Estate*, 11th Ed, p. 25, The Appraisal Institute, 1996.

The oldest trick in the book: comparables with different highest and best use.

Scenario I revisited

Applying the appraisal theory above to the freestanding drug store suggests the following:

The drug store (or big-box store or restaurant) at issue is occupied and operational on the date of valuation.

There is no indication that the current user is leaving the property and it appears that business is good. (This can be determined by inquiring into the income produced by the property via sales of goods.) Thus, *there does not appear to be any external obsolescence affecting the property.*

In addition, the design and features of the property still appear to be well-suited to its use. In support of that, evidence shows that new freestanding drug stores are still being constructed using the same design and features. Hence, *there does not appear to be any functional obsolescence affecting the property.*

However, the property owner points to multiple instances of sales of other freestanding drug store properties at values substantially lower than the assessment.

Moreover, these properties appear very similar to the subject property in terms of features.

Inevitably though, there is one critical difference between the subject property and the alleged comparables. That difference is highest and best use.

It is likely that the comparable properties used by the owner took on a different highest and best use after the sale.

Some were converted into bank branches, other into auto parts stores, and still others into different types of retail. That probably resulted in a highest and best use not of continued use (like the subject property), but of modification, conversion, or renovation of the improvements or of demolition of the improvements.

Why is the subject different than the comparables?

Because *there is still demand for the subject property*, it is not actually being sold or contemplated to be sold in the near future.

Nor is any reconfiguration or modification of the improvements anticipated.

Simultaneously the demand for the use for which the comparables were designed no longer exists for those properties.

Maybe the neighborhood demographics changed, maybe the traffic count changed, maybe there was too much competition in the neighborhood. However, the subject property does not suffer from those issues, or it would also be on the selling block.

Said another way, and returning to the hypothetical buyer — if a highly successful property like the subject property were to be sold — why wouldn't another buyer step into the seller's shoes and enjoy the profits and benefits of the ownership and use of that property?

This is not to say that features truly unique to a specific user (signage) should not be accounted for via a downward adjustment.

Scenario II revisited

Scenario II contemplates a large single owner-occupied campus-style single-tenant office building.

Again, the subject property is occupied and appears to function well for its use. Its features are not outdated, and more recently constructed similar properties still contain the same features.

Thus, the property does not seem to suffer from functional obsolescence.

Moreover, the appraiser does not have to identify a particular buyer, it appears that large corporate entities still desire campus-style single-tenant properties.

Now, should large single-tenant campus-style corporate headquarters fall out of favor, the appraiser must then recognize external obsolescence.

Eurofresh Inc. v. Graham County

One should always be circumspect in concluding that obsolescence exists merely on the basis of data from other properties (sales or income) without being able to identify the features or causes of the obsolescence in the subject property.

In *Eurofresh, Inc. v. Graham County*, 187 P. 3d 530 (Ar. App. Div. 1 2007) the subject property was a large hydroponic greenhouse in Willcox, Arizona.

In challenging its property tax assessment in court, Eurofresh claimed that the facility suffered from 40% external obsolescence, as evidenced by sales of other similar greenhouses. Eurofresh's appraisal expert arrived at that conclusion based upon a study of three greenhouse sales, concluding that market-wide obsolescence affected the property.

However, other evidence showed that the subject property was quite successful, and no evidence was presented indicating any particular problems with the subject property.

Did the owner prove obsolescence based solely upon the sales of the other three properties? The appellate court analysis went as follows:

> The County argues that reducing replacement cost for external obsolescence without proof of the specific cause of the obsolescence and proof that it affects the subject property contravenes standard appraisal methods. Eurofresh counters that under standard appraisal methods, it is not necessary to identify a cause of external obsolescence when such obsolescence is market-wide.
>
> Thus, we are asked to decide whether a party seeking an adjustment in property value for *ad valorem* tax purposes based on external obsolescence must prove the cause, effect, and quantity of such obsolescence. We hold that it must.
>
> … Our conclusion is based not only on the authorities cited above but also on the appraisal treatise relied upon by both sides' experts. *The Appraisal of Real Estate* permits the use of the market extraction method to calculate depreciation, including

external obsolescence. Appraisal Institute, *supra* at 389-92 (describing the market extraction method as a means of calculating depreciation) and 363 ("depreciation" includes external obsolescence). But the treatise warns that the market extraction method should be used only when the comparable properties relied upon "have incurred similar amounts and types of depreciation" as the subject property.

> ... It seems to us that the treatise's warning that market extraction requires that the subject property have similar "amounts and types" of obsolescence as the comparables use to calculate obsolescence is a reflection of the concern that underlies the rule applied by court in Indiana and the other jurisdictions discussed above. It is not sufficient, these authorities teach, to simply assert that a property's value should be reduced because of external obsolescence observed elsewhere. Particularly when, as here, a taxpayer calculates obsolescence based on other "comparable" properties, the taxpayer must prove that the subject property actually is affected by the obsolescence seen in the other properties.

Ibid., 533, 538.

Thus, it is not appropriate to claim obsolescence merely based upon other sales when no indication of obsolescence exists specifically as to the subject property.

Marketability study

Another angle to consider the issue from involves a marketability study.

> "... (A)ll appraisals must include what is more precisely labeled a *marketability study*. A marketability study includes a critique of the subject property, a study of the economic environment in which it is and will be functioning, and an estimate of the subject property's proportional capture of market demand.
>
> In the appraisal of a specific property, the purpose of market analysis is to show how the interaction of supply and demand affects the property's value.
>
> Market analysis also provides a basis for determining the highest and best use of a property. In short, the market determines the use, and the use affects the value. An existing or proposed improvement under a specified use may be put to the test of maximum productivity in highest and best use analysis only after it has been demonstrated that an appropriate level of market support exists for that use.
>
> ... In market analysis for real estate, demand analysis focuses on identifying the potential users of a subject property – i.e., the buyers, renters, clientele, or customers it will attract. For each particular type of property, demand analysis focuses on the end product or service that the real estate provides. For example, a demand analysis for retail space would attempt to determine the demand for retail services generated by potential customers in the market area.
>
> A marketability study can also be used to analyze an existing property. Appraisers regularly forecast income and occupancy, e.g., whether the market expects the subject property to maintain or lose tenants and how much rent the owners can expect in the future.
>
> — *The Appraisal of Real Estate*, 14th ed. p. 299-300, 303, The Appraisal Institute, 2013.

In a marketability study of an existing property, the appraiser must analyze the demand for the subject property. In that analysis, *the appraiser does not ignore the current demand for the services provided by the subject property – which includes the current user.*

To ignore the current user is to pretend that the current user is not a part of the market demand for the property. Thus, another way to view the issue is that *the current user is part of the market of hypothetical buyers of the property.* If the current user did not occupy the property, would that user consider purchasing the property, and if so, for what price?

Case law

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.
>
> — *Ibid.*, 588-589.

Often, owners of elaborate buildings argue that the property is affected 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.

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 interests 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 value 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.
>
> — *Ibid.*, 551-52.

One common application 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 numerous states addressing the issue.

Thus, 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 rather than its fair market value. However, every one of the cases cited herein are from states that require a valuation based on fair market value.

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.
>
> — *Ibid.*, 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.
>
> — *Ibid.*, 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 also 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 subdivision lots are being valued, 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).

In 2016, the Iowa Supreme Court embraced the hypothetical buyer issue in a case involving a 600,000-square-foot corporate office headquarter building located in downtown Des Moines, Iowa. In *Wellmark, Inc. v. Polk Cnty. Bd. of Review*, 875 N.W.2d 667 (Ia. 2016), the court set forth the problem as follows:

> Does such an expensive property, for property tax purposes, have zero value because there are no willing buyers? In this case, the question is whether, for property tax purposes, the value of a building with all its fine amenities should be based upon the taxpayer's current use as an owner-occupied headquarters building, even though there may not be a local market for such a property?
>
> — *Ibid.*, 672.

After analyzing appraisal theory and other case law, the court arrived at a conclusion and stated,

> It is true, of course, that the market for the Wellmark property for use as a single-tenant office building may be limited. But we think the fact that the property is currently being successfully used as a single-tenant corporate headquarters cannot go unnoticed. Current use is an indicator that there is demand for such a structure. While no specific potential buyer has been identified, we do not think there has been a showing of no market, but only of no *active* market. We adopt the view of other jurisdictions that under the circumstances, value should be based on the presumed existence of a hypothetical buyer at its current use.

In conclusion, analyzing a unique property from the viewpoint of a hypothetical buyer applies the concept of fair market value in a manner that is fair and equitable.

WILLIAM D. SHEPHERD is General Counsel for the Hillsborough County, Florida, Property Appraiser, in Tampa, Florida.