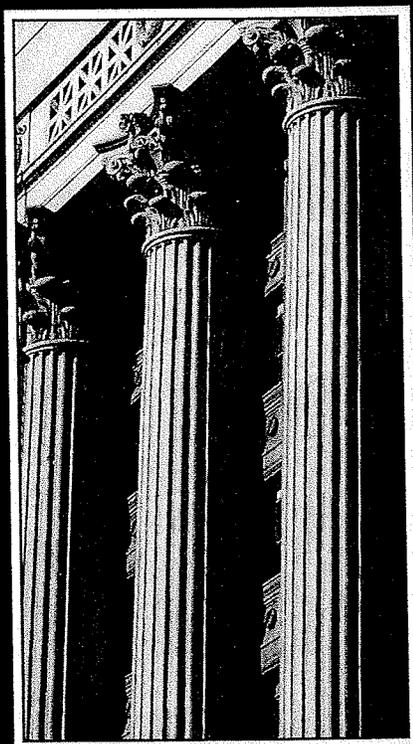


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**REAL ESTATE VALUATION
IN LITIGATION**

SECOND EDITION



J. D. Eaton, M.A., C.R.A.

APPRAISAL INSTITUTE

Highest and Best Use

“**W**hen the purpose of an appraisal is to estimate market value, highest and best use analysis identifies the most profitable, competitive use to which the property can be put.”¹ This statement holds true in condemnation appraisal. The courts have universally held that property acquired under the sovereign’s power of eminent domain is to be valued in recognition of its highest and best use.² A number of different definitions of highest and best use have been developed. Two of these definitions follow:

The reasonably probable and legal use of vacant land or an improved property, which is physically possible, appropriately supported, financially feasible, and that results in the highest value. The four criteria the highest and best use must meet are legal permissibility, physical possibility, financial feasibility, and maximum profitability.³

In real estate valuation (e.g., in condemnation proceedings) the use of land or buildings which will bring the greatest economic return over a given time. This method of valuation requires the expert to determine what the condemned property’s fair market value would realistically be if the owner were hypothetically allowed to adapt his property to its most advantageous and valuable use.⁴

In the early 1980s one definition of highest and best use that was advocated, and published, asserted that “[i]mplied within these definitions is recognition of the contribution of that specific use to community environment or to community

1. *The Appraisal of Real Estate*, 10th ed. (Chicago: Appraisal Institute, 1992), 275.

2. *Mississippi and Rum River Boom Co. v. Patterson*, 98 U.S. 405 (1879).

3. *The Dictionary of Real Estate Appraisal*, 5d ed. (Chicago: Appraisal Institute, 1995), 171.

4. *Black’s Law Dictionary*, abr. 6th ed., s.v. “highest and best use.”

development goals in addition to wealth maximization of individual property owners.⁵ This provision was immediately recognized as inappropriate for eminent domain valuations. It is now recognized, in all forms of highest and best use analysis, that "[t]he benefit a real estate development produces for a community or the amenity contribution provided by a planned project (i.e., the public space in a park-like area) are not considered in the appraiser's analysis of highest and best use."⁶

When an appraisal involves a partial acquisition, the appraiser must make two separate and distinct highest and best use estimates. In determining a property's highest and best use in the before situation, any special influences of the proposed project are generally disregarded. To estimate the highest and best use of a property in the after situation is often more difficult because it is necessary to study the impacts of the proposed project—e.g., zone changes to be made by reason of the project, the conformance of the remainder property to existing zoning and setback requirements, and general changes in the neighborhood. The appraiser must realize that, in the after situation, an entirely new real estate environment has been created by reason of the project.

The analysis of the property's highest and best use in the after situation is a totally independent study of the property, not a modification of the study of the property's highest and best use in the before situation. If the appraiser does not estimate the property's highest and best use correctly in both the before and after situations, it will be impossible to estimate the property's value correctly.

In condemnation appraisal there is a presumption that the existing use of a property is its highest and best use.⁷ Therefore, when the highest and best use of a property is determined to be other than its existing use, the burden of proof falls on the party who claims the different use.⁸

Elements affecting value that depend upon events or combinations of occurrences which, while within the realm of possibility, are not fairly shown to be reasonably probable, should be excluded from consideration, for that would be to allow mere speculation and conjecture to become a guide for the ascertainment of value—a thing to be condemned in business transactions as well as in judicial ascertainment of truth.⁹

This is not to say that a highest and best use "to hold for a speculative rise in market value" is not a proper determination of highest and best use; the courts have allowed testimony of such use. In the words of the court, such a use "... is a matter of such common knowledge that argument to the contrary is unrealistic."¹⁰ The appraiser who uses the word *speculative* or *speculation* in the description of highest and best use should exercise great care to ensure that the court or the trier of fact does not misunderstand the term. For instance, when two witnesses testified that

5. American Institute of Real Estate Appraisers and the Society of Real Estate Appraisers, *Real Estate Appraisal Terminology*, rev. ed., Byrd N. Boyce, ed. (Cambridge, Mass.: Ballinger Publishing Company, 1981), 127.

6. *The Appraisal of Real Estate*, 10th ed., 276, n.1.

7. *United States v. 8.41 Acres of Land, Etc.*, 680 F.2d 588, 594 (5th Cir. 1982).

8. *Ibid.*

9. *Olson v. United States*, 292 U.S. 246, 257 (1954).

10. *State v. Whitlow*, 52 Cal. Rptr. 556, 542 (Cal. 1966).

the highest and best use of a property was "holding for future development" an Illinois court said: "In our opinion this was an improper element—it was not a use at all and was highly speculative."¹¹

Use of the term *reasonably probable* in regard to highest and best use has been widely accepted by the courts. "[T]he fact that the property is merely adaptable to a different use is not in itself a sufficient showing in law to consider such different use as a basis for compensation. It must be shown that such use of the property is so reasonably probable as to have an effect on the present value of the land."¹² [Citations omitted]

THE FOUR TESTS OF HIGHEST AND BEST USE

There are four tests that a property must meet before its highest and best use can be determined. The use must be physically possible, legally permissible, financially feasible, and maximally profitable (i.e., create the highest economic value). The appraiser must apply each of these tests and discuss each in the appraisal report to justify the ultimate opinion of highest and best use.

While the four criteria are interrelated, the tests are often applied sequentially. The tests of physical possibility and legal permissibility *must* be applied before the tests of financial feasibility and maximum profitability. There is little to be learned from analyzing the financial feasibility of an illegal, or physically impossible, use.

Land use regulations play an important role in the appraiser's determination of a highest and best use. The appraiser cannot, of course, conclude a highest and best use that is illegal under applicable land use regulations unless there is a reasonable probability that the regulations will be changed to allow this use within the foreseeable future. The effect of land use regulations on highest and best use, and on the value of property, is discussed in detail in Chapter 7.

The physical factors to be considered by an appraiser in determining the highest and best use of a parcel being appraised for eminent domain purposes are no different than those that would be considered in any other appraisal assignment. Size, shape, the availability of utilities, topography, soils, access, and environmental influences (e.g., floodplain areas, frost damage in agricultural areas) all must be studied to assess the physical adaptability of a property to its legally allowable uses.

Once the appraiser has identified those uses of the land that are legally permissible and physically possible, the test of financial feasibility is applied. First supply and demand in the general location of the subject property must be analyzed. Often the appraiser needs to estimate the cost of various types of improvements and the amount of net income that could be generated from each. The appraiser then determines the amount of net income needed to provide an adequate return on the improvement cost so as to determine if there remains ad-

11. *Dept. of Transportation v. Janssen*, 559 N.E.2d 359, 361 (Ill. 1975).

12. *Dep't of Transportation v. Great Southern Enterprises*, 225 S.E.2d 80, 85 (Ga. 1976).

equate net income to support a reasonable land value. If the remaining income is sufficient, the use is considered financially feasible.

Finally the appraiser performs a comparative analysis of the financially feasible uses of the property to determine which use will be maximally profitable—i.e., produce the highest economic land value. This last step is typically accomplished through the use of a land residual technique.¹³ Appraisers must recognize that this procedure is used merely to determine highest and best use; it is not generally considered an acceptable method for estimating land value for eminent domain purposes. Although the land residual technique is recognized as a proper land valuation method in the appraisal industry,¹⁴ it is generally rejected by the courts as too speculative. As a New York court in the *Blackwell's Island* case stated:

In regard to the vacant lots, parcel No. 31, a witness was asked what would be the best use to which these lots could be put. He replied: "The erection of three apartment houses, 33 front each." He was then allowed to testify, over objections and exceptions, that the cost of constructing three such buildings would be \$75,000, and that the rental value of such buildings would be between \$14,000 and \$15,000 a year. This is clear error. It involved so much of the elements of uncertainty and speculation as to be inadmissible as proof of any fact. As said in the case of *Tallman v. Met. El. R. R. Co.* (121 N.Y. 119): "There can be no certainty that the plaintiff would ever have erected dwelling houses upon the lot, and there could be no certainty as to the rents which could have been obtained from them."¹⁵ [Citations omitted]

Because of rulings such as this, the appraiser is generally well advised to testify under direct examination only as to the analytical methodology used in determining highest and best use, without specificity. Specific details are typically not admitted on direct examination. If the appraiser's estimate of highest and best use is questioned under cross-examination, however, the appraiser is often allowed to explain, in detail and with specificity, the process employed to arrive at the highest and best use conclusion.

In cases in which the question of highest and best use is crucial and/or complex, the appraiser may find it necessary, or advisable, to retain the services of a consultant such as a contractor or marketing consultant.

HIGHEST AND BEST USE AS IMPROVED

The original concept of highest and best use called only for an estimate of the highest and best use of the land as though vacant. The concept of highest and best use as improved "was developed to answer an important question that the original concept does not address. How should the property as improved be used?"¹⁶ Recognition of this concept is extremely important in eminent domain

13. *The Appraisal of Real Estate*, 10th ed., 474-475.

14. *Ibid.*, 307-308.

15. *Matter of City of New York (Blackwell's Island Bridge)*, 105 N.Y.S. 441, 443-444 (N.Y. 1907).

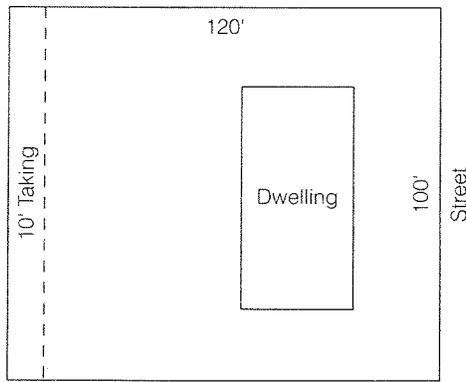
16. *The Appraisal of Real Estate*, 10th ed., 277.

valuation; if it is ignored, the appraiser may very well analyze himself into an extremely uncomfortable position on the witness stand.

A tract of land considered as though vacant may have a highest and best use different than that of the whole property as improved. Classic appraisal theory requires that "[t]he value of land is generally estimated as though vacant."¹⁷ Adoption of this procedure in eminent domain valuation would result in an accurate conclusion, but one that may be totally unbelievable to the court because of the procedure used to develop it. Figure 6.1 illustrates a situation in which the appraiser may be well advised to deviate from standard appraisal procedure.

Assume that the appraiser has developed the following conclusions after investigating and analyzing the property depicted in Figure 6.1.

FIGURE 6.1 HIGHEST AND BEST USE AS IF VACANT



Highest and best use of site, as if vacant	multifamily
Before value of site as if vacant: \$5.00/sq. ft.	\$ 56,000
After value of site as if vacant: \$5.00/sq. ft.	\$ 55,000
Highest and best use of property, as improved	single-family
Before value of property, as improved	\$119,000
After value of property, as improved	\$118,000
Before value of site for single-family purposes: \$1.00/sq. ft.	\$ 12,000
After value of site for single-family purposes: \$1.00/sq. ft.	\$ 11,000

If the appraiser were allowed to report and testify only on the value conclusions before and after, no problems would arise. The conclusions would be simply:

Before value	\$119,000
After value	<u>-118,000</u>
Difference between before and after values	\$ 1,000

¹⁷ *The Appraisal of Real Estate*, 10th ed., 279; see also *The Appraisal Foundation, Uniform Standards of Pro-*

fessional Appraisal Practice (USPAP), 1994 ed., Standards Rule 1-3(b), p. 11.

However, the appraiser is seldom allowed to report on or testify to only the conclusions, particularly when an experienced and knowledgeable attorney is conducting the appraiser's cross-examination. As one court said:

When a witness, having qualified, gives his opinion as to the value of the land sought to be condemned, he may properly give his reasons upon direct examination for his conclusions. As the element of highest and best use is an important factor to be considered in reaching a conclusion in respect to value it would seem clear that one who is entitled to give an opinion as to the value of real property should necessarily be in a position to give an opinion also with respect to its highest and best use.¹⁸ [Citations omitted]

Using classic appraisal methodology, the appraiser's before value computations, or allocation of component values, might look like this:

Land value (12,000 sq. ft. @ \$5.00)	\$ 36,000
Value of dwelling	81,500
On-site improvements	<u>1,500</u>
Total before value	\$119,000

Using the cost approach, the appraiser's value computations in the before situation might take this form:

Reproduction cost of dwelling (2,200 sq. ft. @ \$60.00)	\$152,000
Less depreciation:	
Physical deterioration	\$26,500
External obsolescence (misplaced improvement)	<u>24,000</u>
Total depreciation	- 50,500
Value of dwelling	\$ 81,500
Contributory value of on-site improvements	<u>1,500</u>
Total improvement value	\$ 83,000
Land value (12,000 sq. ft. @ \$5.00)	<u>36,000</u>
Total property value	\$119,000

The appraiser's after value computations would be:

Land value (11,000 sq. ft. @ \$5.00)	\$ 35,000
Value of dwelling	85,500
On-site improvements	<u>1,500</u>
Total	\$118,000

The appraiser's cost approach computations of value in the after situation follow:

Reproduction cost of dwelling (2,200 sq. ft. @ \$60.00)	\$152,000
Less depreciation:	
Physical deterioration	\$26,500
External obsolescence (misplaced improvement)	<u>22,000</u>
Total depreciation	- 48,500

18. *People v. Alexander*, 27 Cal. Rptr. 720, 725 (Cal. 1965).

HIGHEST AND BEST USE

Value of dwelling	\$ 83,500
Contributory value of on-site improvements	<u>1,500</u>
Total improvement value	\$ 85,000
Land value (12,000 sq. ft. @ \$5.00)	<u>33,000</u>
Total property value	\$118,000

In these calculations the external obsolescence of the dwelling is reduced by \$2,000 in the after situation because the ratio of land to building value has been redistributed. However, it would take an unusually persuasive appraiser to convince a client, or a jury, that the value of the dwelling has increased \$2,000 due to the taking of a 10-foot strip from the rear of the site. The appraiser could, of course, protect himself by including in the appraisal report a statement such as:

Where the value of the land and improvements are shown separately, the value of each is segregated as only an aid to better estimating the value of the whole; and the value shown for either may, or may not, be its fair market value.

Unfortunately, such a statement is usually forgotten or ignored by the reader of the appraisal report and the trier of fact.

Under the circumstances shown in Figure 6.1, the appraiser should consider the advisability of abandoning standard appraisal methodology and appraising the land at the highest and best use of the property as improved, rather than as though vacant. The propriety of using such a procedure under certain circumstances is acknowledged in current professional appraisal standards. The "guideline [that land is appraised as though vacant and available for development to its highest and best use] may be modified to reflect the fact that, in various legal and practical situations, a site may have a contributory value that differs from the value as if vacant."¹⁹

Application of this modified procedure would result in the following before value computations:

Land value (12,000 sq. ft. @ \$1.00)	\$ 12,000
Value of dwelling	105,500
On-site improvements	<u>1,500</u>
Total	\$119,000

If the cost approach is applied, the before value would be calculated:

Reproduction cost of dwelling (2,200 sq. ft. @ \$60.00)	\$152,000
Depreciation (physical deterioration)	<u>-26,500</u>
Value of dwelling	\$105,500
Contributory value of on-site improvements	<u>1,500</u>
Total improvement value	\$107,000
Land value	<u>12,000</u>
Total	\$119,000

¹⁹ USPAP, 1994 ed., Comment to Standards Rule 1-3(b), p. 11. See also *The Appraisal of Real Estate*, 279, n. 2.

The after value computations would then be:

	\$ 11,000
Land value (11,000 sq. ft. @ \$1.00)	105,500
Value of dwelling	<u>1,500</u>
On-site improvements	\$118,000
Total	

Computations of value in the after situation using the cost approach would be:

	\$132,000
Reproduction cost of dwelling (2,200 sq. ft. @ \$60.00)	- 26,500
Depreciation (physical deterioration)	\$105,500
Value of dwelling	<u>1,500</u>
Contributory value of on-site improvements	\$107,000
Total improvement value	<u>11,000</u>
Land value	\$118,000
Total	

Adopting this modified procedure does not alter the appraiser's conclusion. It merely presents a computational process that is more persuasive and believable to those not familiar with real estate valuation techniques. Nevertheless, use of this procedure leaves the appraiser open to questions about multifamily residential land sales in the area transacted at \$5.00 per square foot. This argument can be derailed with a simple explanation of the consistent use theory, which is described later in this chapter.

It is advisable for the appraiser to include both the classic appraisal computations and the computations based on the highest and best use as improved in the report. This serves two purposes. First, if the appraisal report is reviewed by a person who is knowledgeable in real estate valuation (e.g., the condemnor's review appraiser), he or she cannot criticize the appraiser for abandoning the classic appraisal methodology. Second, providing both sets of computations demonstrates that the results are identical and shows legal counsel how and why the appraiser has deviated from classic appraisal methodology. This will enable the attorney to better prepare for trial.

ALL AVAILABLE USES

As previously mentioned, the courts have universally acknowledged the concept of highest and best use. An appraiser may take the position that the property has been appraised for a specific use (i.e., the appraiser's estimate of highest and best use), but the courts have rejected this position. Most of the courts that have addressed this question have ruled that a property is not to be valued for a specific use, but rather in light of all available uses to which the property might, in reason, be applied.

A Tennessee court clearly defined its position on this matter:

In this State we have adopted the view that "value in view of all available uses" is the proper phrase to use in valuation as against the phrase "value for the best use" as is used by the minority of the States. We are bound by the majority view, that is that we consider the "value in view of all available uses." It is well said that we use this phrase to warn the jury against awarding the "value for a particular use."²⁰ [Citations omitted]

A Massachusetts court used the same reasoning when it ruled:

The sum to be awarded for real estate taken is the fair market value of the property, having reference to all the uses to which it is adapted. Its value for any special purpose is not the test, although it may be considered, with a view of ascertaining what the property is worth in the market for any use for which it would bring the most.²¹

At first glance, these rulings may appear to contradict the appraiser's concept of highest and best use. This is not the case, however, because the courts recognize the concept of highest and best use and its importance in determining market value. The courts have adopted the *all available uses* concept in an attempt to avoid receiving testimony from various witnesses as to the value of the property for different specific uses,

for such evidence opens wide the door to unlimited vagaries and speculations concerning problematical prices which might under possible contingencies be paid for the land, and distracts the mind of the jury from the single question—that of market value—the highest sum which the property is worth to persons generally, purchasing in the open market in consideration of the land's adaptability for any proven use.²²

The distinction between highest and best use and all allowable uses may appear to be merely a question of semantics and of little concern to appraisers, but this distinction may ultimately determine whether an appraiser's testimony is ruled to be admissible or excluded from consideration by the courts. As stated by a Nebraska court:

The power company also asserts that the trial court erred in permitting, over objection, the testimony of witnesses as to their opinions as to the value of the property for use as a filling station. In this respect one witness was permitted to testify that the corner was worth \$14,000 as a filling station site. Sump [another witness] was permitted to state that the corner was worth \$15,000 as a filling station site. The evidence was erroneously admitted. The rule is: Witnesses should not be allowed to give their opinion as to the value of property for a particular purpose, but should state its market value in view of any purpose to which it is adapted. The condition of the property and all its surroundings may be shown as well as its availability for any particular use. If it has a peculiar adaptation for certain uses, this may likewise be shown, and if such peculiar adaptation adds to its value the owner is entitled to the benefit of it. Where these facts and circum-

20. *Davidson County Bd. of Ed. v. First American Nat. Bank*, 301 S.W.2d 905, 907 (Tenn. 1957).

22. *Sacramento Southern R. Co. v. Heilbron*, 104 P. 979, 981 (Cal. 1909).

21. *Comness v. Commonwealth*, 69 N.E. 541, 541 (Mass. 1904).

stances are shown, the only question as to value that is properly in issue is the reasonable market value at the time the property is taken or damaged. We conclude that the trial court erred in admitting the evidence as to the value of the property for use as a filling station.²³ [Citations omitted]

It can be seen that there is no conceptual conflict between the appraiser's highest and best use and the court's all available uses. The appraiser who concludes that the highest and best use of a site is for a service station site, and values the property being condemned using sales of comparable service station sites, is not in conflict with the all available uses concept. Such a valuation procedure automatically incorporates the fact that all of the sites analyzed, the one being appraised as well as any comparable sale sites, have potential for uses other than their highest and best use as service station sites. Thus, appraisers must simply be cautious in their use of terminology when testifying in jurisdictions that have adopted the concept of all available uses.

The all available uses concept does not generally include the use for which the property is being condemned. In other words, it is the value of the land taken which is to be estimated, not the value of the land to the *taker*. This distinction is illustrated by a case in which the government condemned land to improve and maintain a natural earthen dam. The property owner did not prevail when he claimed that his land was worth a substantial sum because it dammed a lake created by the eruption of Mt. St. Helens, thereby preventing the flooding of communities downstream.

Following this same logic, it has recently been suggested that lands being acquired by the government and conservation groups must have a highest and best use for preservation purposes; if not, why would the government acquire them? There are a number of problems with this logic. First, the term *value*, as used in eminent domain context, must be capable of quantification in money. Second, the preservation of land falls outside the scope of the definition of highest and best use used by the courts which require an economic use.²⁴ The U.S. Supreme Court has defined highest and best use for eminent domain valuation purposes as "the highest and *most profitable* use for which the property is adaptable and needed or likely to be needed in the reasonably near future."²⁵

The market for lands acquired for purposes of preservation "involves public agencies (federal, state, or municipal), environmental or conservation organizations like The Nature Conservancy and The Trust for Public Lands, and numerous smaller land trusts as acquirers."²⁶ However, any sale to a government agency with the power of eminent domain must be viewed with skepticism because such transactions are in the nature of compromises made to avoid litigation. There is no actual *competitive* market for lands for preservation purposes. The Nature Conservancy, The Trust for Public Lands, and the U.S. Fish and Wildlife Service are not out in the open market bidding against one another. "These are not competitors;

23. *Petition of Omaha Public Power Dist.*, 95 N.W.2d 209, 213-214 (Neb. 1959).

24. The concept of preservation or conservation as a use and its relevance to value was recently studied and debated by various interested appraisal bodies.

25. *Olson v. United States*, 292 U.S. 246, 255 (1954) (emphasis added).

26. Victoria Adams and Bill Mundy, "The Valuation of High-Amenity Natural Land," *The Appraisal Journal* (January 1991), 48, 49.

they are acting with a common purpose.²⁷ In fact, conservation groups would prefer a government acquisition of the lands and many groups actually acquire these lands for the sole purpose of holding them until a governmental agency can procure funding and buy the lands from the conservation group at its cost. Such transactions clearly do not meet the criteria for an open-market transaction reflecting market value.

Neither government agencies nor conservation groups base their purchase price of a property on its value for preservation purposes. The price is based on the highest and best *economic* use of the property. Therefore, although the property was purchased for preservation purposes, the price paid was based on the *economic* value of the property, not some esoteric noneconomic or non-use value, which the courts have shown no inclination to accept in the context of eminent domain.

The very purpose of reserving in the people the power of eminent domain is to prevent an owner of a site especially available for a public work [*e.g.*, preservation], but not of great value for other purposes, from trading upon the necessities of the public when it is sought to acquire his land for public use, and from compelling the public to pay for his land whatever figure he may name, and it seems clear that the owner has no such power.²⁸

For these reasons, appraisers must reject a highest and best use for preservation or conservation unless, or until, there is clear evidence that a competitive private market for such lands exist.

This prohibition does not preclude a highest and best use of "mitigation lands," which are typically lands that have suffered from environmental degradation and are purchased and environmentally restored in return for "mitigation credits" on other lands to be developed. In some parts of the country, most notably California, an active, private market exists for such lands. Nor does this prohibition exclude a highest and best use as a private hunting preserve, a duck club, or the like because, again, an active private market for such lands exists in some regions.

Sometimes, however, the highest and best use of the property is, in fact, the use to which the condemnor will put the land. This type of situation often arises in the acquisition of recreational properties such as golf courses. When the property's highest and best use and the use for which the property is being taken are identical, the appraiser could properly estimate property value for this use. This practice is not inconsistent with court rulings that land should not be valued for the use to which the condemnor will put it. As explained by the court:

[I]t is the "no value attributable to Government demand" principle that informs those decisions which hold that in determining the fair market value of condemned property, the use to which the Government proposes to devote the property should not be considered *unless private owners could also reasonably devote the property to that use.*²⁹

27. Parker Reynolds, "Letters to the Editor," *The Appraisal Journal* (July 1992), 438.

28. Nichols' *The Law of Eminent Domain*, rev. 5d ed. (New York: Mathew Bender Co., Inc., 1990), vol. 4, §12B.16.

29. *United States v. 320.0 Acres of Land*, 605 F.2d 762, 785 n.26 (5th Cir. 1979) (emphasis added).

CONSISTENT USE THEORY

Consistent use is "[t]he concept that land cannot be valued on the basis of one use while the improvements are valued on the basis of another."⁵⁰ The consistent use theory was discussed in relation to the valuation of mineral deposits and timberland in Chapter 3.

The consistent use theory seems straightforward, but a review of appraisal reports, appraisal testimony, and court rulings indicates otherwise. The consistent use theory is often misapplied when the cost approach is used. Consider once again the property shown in Figure 6.1. In this situation it would be a violation of the consistent use theory for the appraiser to value the land for multifamily purposes, and then value the improvements for single-family purposes, without deducting the external obsolescence present in the dwelling.

This error can be carried through to the sales comparison approach by analyzing comparable sales improperly. For instance, assume the appraiser has valued the subject land for multifamily purposes at \$56,000 and then makes the following analysis of the sale of a comparable dwelling on a residential site:

Sale price	\$150,000
Land value (12,000 sq. ft. @ \$1.00)	- 12,000
Value of improvements	\$118,000
Value of on-site improvements	<u>3,500</u>
Value of dwelling	\$114,500

The appraiser then compares the subject property to the sale property as follows:

Land—subject is superior (\$56,000 - \$12,000)	\$ 24,000
On-site improvements—subject property is inferior (\$3,500 - \$1,500)	- 2,000
Dwelling—properties are physically equal	<u>0</u>
Net adjustment	\$ 22,000
Sale price of comparable	<u>150,000</u>
Indicated value of subject property	\$152,000

Note that a substantial error results when the consistent use theory is misapplied by valuing land for multifamily purposes and improvements for single-family purposes. The New York court addressed a similar situation when it said:

The claimant was awarded \$55,500 for the entire taking of her property. It was conceded that the highest and best use for this property was commercial. At the time of the appropriation there was a dwelling house and combination garage and work shop on the property. The trial court awarded \$40,850 as the market value of the land and \$14,700 for the value of the buildings. The expert for the claimant as well as the State testified the buildings would of necessity have to be removed from the property to permit its use for commercial purposes. It was error, therefore, to award anything for the value of the buildings while at the same time fixing the land value for commercial usage since the two bases [sic] are

50. *The Appraisal of Real Estate*, 10th ed., 46; *The Dictionary of Real Estate Appraisal*, 3d ed., 72.

entirely inconsistent. Under the facts here the commercial value of the land was in no way enhanced by the value of the buildings.⁵¹ [Citations omitted]

Although it is relatively easy for appraisers to understand and properly apply the consistent use theory, it is often difficult to explain its application persuasively to a jury. It may be difficult for the average person to accept the fact that a large, well-kept, single-family dwelling has no value, particularly when the property owner is living in the house and had no intention of tearing it down and constructing a commercial building. In fact, the courts have, on occasion, refused to accept the consistent use theory and made erroneous rulings.⁵²

Although it is a violation of the consistent use theory to value a parcel for two uses that are mutually exclusive, it is permissible to value a parcel for two uses that are not incompatible and can take place simultaneously. A potato farm that attracts a great number of waterfowl can have a highest and best use for both farming and recreational hunting, because neither use is necessarily mutually exclusive.

INTERIM USE

An interim use, which is also referred to as a transitional use, is "[t]hat existing and relatively temporary use where the transition to highest and best use is deferred. A building or other improvement may have a number of years of remaining life yet may not enhance the value of the land which has a higher use, except as an interim-use taxpayer while the land is in transition."⁵³

One property may, in effect, have two highest and best uses—one for a relatively short period and one as a deferred highest and best use. Developing a property to its ultimate highest and best use may be inadvisable at the time of the appraisal because of market conditions or other factors, such as the unavailability of mortgage money. The property owner can choose to either let the property lie fallow until it is ripe for development to its ultimate highest and best use, or put it to an interim use and at least receive some benefit from the property until its ultimate highest and best use is realized. An example of an interim use would be the utilization of potential subdivision land for agricultural purposes. Courts have ruled that such an analysis is proper.

In the case at bar, witness Barnes substantiated his estimates with competent testimony as to the value, nature and use of the property as a dairy farm and also ...sufficiently demonstrated an increasing demand for the property as a residential development site. Certainly a future purchaser of the Wallace property might well desire to continue the interim use of the dairy operation to offset any costs and interest charges that might exist during the piece-meal process of a housing development. There is nothing incompatible about or inconsistent in these two uses of the property.⁵⁴

51. *Spano v. State of New York*, 255 N.Y.S.2d 750, 750-751 (N.Y. 1964).

52. *State, Dep't. of Highways v. Luster*, 277 So.2d 181 (La. 1973).

53. *Real Estate Appraisal Terminology*, rev. ed., 157.

54. *Arkansas State Highway Comm. v. Wallace*, 459 S.W.2d 812, 814 (Ark. 1970).

The best way to determine whether interim improvements (i.e., those incompatible with the land's ultimate highest and best use) actually contribute any value to the property as a whole is to analyze sales of comparable properties in the same economic position. Because such sales are sometimes unavailable, however, various methods of estimating an improvement's interim contributory value have been developed.

To apply one of these methods the appraiser values the income that can be realized during the interim period as if it were income from a lease and values the land as if it were a leased fee reversion. For example, assume a 50-acre farm that has an ultimate highest and best use for subdivision purposes can be leased for \$5,000 net per year for an estimated interim period of three years, at which time the land will be ready for development. Similar land currently ready for development is selling for \$6,000 per acre. Therefore, the subject property would have a value of \$300,000 if it were ready for development. The proper discount rate applicable to this type of investment is 10%. The value of the property can be estimated by computing the present value of the income stream and the present value of the reversion as follows:

Value of income stream:	
\$5,000 income x 2.486852*	\$ 12,434
Value of reversion:	<u>225,395</u>
\$300,000 x 0.751515†	\$237,829
Present value of property	\$238,000
Rounded	

* Present worth of \$1 per period for 3 years discounted at 10%.

† Present value of \$1 in 3 years discounted at 10%.

Another way to estimate the contributory value of interim improvements is to use the building residual technique of capitalization. Consider a lot improved with a single-family dwelling that has commercial potential and a current value of \$30,000 in light of this potential. The property will rent for \$500 net per month, or \$3,600 per year. Recognizing the lot's commercial potential, the appraiser estimates that the improvements have a remaining economic life of only five years. An appropriate return rate is 8%. With this information, the contributory value of the improvements can be computed:

Annual net income	\$ 3,600
Income imputable to land (\$30,000 x 0.08)	- 2,400
Income residual to improvements	<u>\$ 1,200</u>
Value of improvements (\$1,200 ÷ 0.28)*	\$ 4,286
Land value	<u>30,000</u>
Total indicated property value	\$34,286
Rounded	\$34,300

* 8% interest rate plus 20% recapture rate to reflect 5-year life.

Although this methodology is widely applied, it contains a flaw. Assume that the current value of the land, recognizing its commercial potential, is \$60,000, not \$50,000. The contributory improvement value would then be calculated as follows:

Annual net income	\$ 3,600
Income imputable to land ($\$60,000 \times 0.08$)	<u>- 4,800</u>
Income residual to improvements	\$ <u>0</u>
Contributory value of improvements	\$ 0
Land value	<u>60,000</u>
Total property value	\$60,000

It is quite probable that the land, if it were vacant, could not be rented during the interim period. In this case the property is capable of producing \$300 per month in net income because of the existing dwelling. However, the above computations indicate that the improvements add nothing to the value of the property as a whole.

To correct this type of error, another method of estimating the contributory value of interim improvements has been developed.⁵⁵ To apply this procedure the appraiser adds the present value of the interim income stream created by the improvements to the current land value. The computations follow:

Annual net income from property, as is	\$ 3,600
Annual net income from property, as if vacant	<u>0</u>
Income imputable to improvements	\$ <u>3,600</u>
Indicated present worth of improvements ($\$3,600 \times 3.992710$)*	\$14,374
Land value	<u>60,000</u>
Total property value	\$74,374
Rounded	\$74,500

* Present worth of \$1 per period for 5 years discounted at 8%.

In estimating the net income imputable to the improvements on the site, the appraiser should determine what portion of the real estate tax burden and other expenses are attributable to the improvements and deduct that portion of the tax from the gross income attributable to the improvement. If the land if vacant could be rented to produce a net income, that income would be deducted from the net income produced by the property as improved. In the above example, assume that the land if it were vacant could be leased as a parking lot during the interim period for a net rental of \$1,000 per year. Then the income imputable to the improvements would be \$2,600 ($\$3,600 - \$1,000$) and the indicated contributory value of the interim improvements would be \$10,381 ($\$2,600 \times 3.992710$).

Appraisers who estimate the contributory value of interim improvements must remember to consider the demolition cost of any improvements that will have to be removed from the site before it can be put to its ultimate highest and

55. Laurence Sando, "Theories of Valuation for Interim Use," *The Appraisal Journal* (January 1964), 29-54.

best use. This can be a substantial amount, especially if the improvements are contaminated with asbestos or other hazardous materials. If demolition is anticipated at the end of the interim life of the improvements, it is appropriate to discount the anticipated cost of demolition to its present worth.

Lengthening the estimated interim time period diminishes the validity of this estimating procedure. To estimate an interim use period longer than five years can be considered speculation and conjecture. Because the property owner is not receiving any return on the land, this valuation method should be applied only when the interim period is relatively short and, perhaps, when the land is appreciating relatively rapidly. The appraiser should not use this valuation procedure if comparable sales exist; the procedure is not intended to eliminate the need for market research. Moreover, the results of this procedure should not be accepted blindly, but must be correlated with the realities of the marketplace. Due to the simplicity of this procedure, it is often misused by uninitiated appraisers and advocates.

At times, interim improvements can have a contributory value beyond the value created by their income-producing capabilities. Many real estate lenders will not make loans on unimproved properties as a matter of policy, but they will lend on improved properties regardless of the ratio of land-to-building value. This fact can sometimes affect market value, as can the fact that the existence of the improvements may produce an income-tax advantage.

In arriving at an estimate of highest and best use, the appraiser must remember the doctrine of reasonable probability. If the amount of time between the effective date of the appraisal and the time when the property is expected to reach its ultimate highest and best use is too great, the appraiser's conclusion of highest and best use becomes remote and speculative and will be rejected by the courts.

ENHANCEMENT AND BLIGHT

Condemnation blight is a diminution in the market value of a property due to pending condemnation action; *project enhancement* is an increase in a property's market value in anticipation of a public project requiring condemnation action. As a general rule, the appraiser cannot properly consider either of these factors in the before situation when estimating highest and best use or value. "The United States cannot be charged in condemnation proceedings for values which it has created in constructing the project for which the property is taken; nor can the owner be charged for any diminution in value attributable to the project."⁵⁶ The appraiser "shall disregard any decrease or increase in the fair market value of real property, prior to the date of valuation, caused by the project for which the property is to be acquired, or by the likelihood that the property would be acquired for the project other than that due to physical deterioration within the reasonable control of the owner."⁵⁷

56. *Uniform Appraisal Standards for Federal Land Acquisitions* (Washington, D.C.: U.S. Government Printing Office, 1992), §A-10, pp. 26-27.

57. Uniform Relocation Assistance and Real Property Acquisition Policy Act of 1970 (P.L. 91-646) §42.11(c)(1).

There are exceptions to this rule however.

In 1966, the Georgia legislature enacted a statute providing that any increase or decrease in the value of the property caused by the knowledge of the public project could not be considered in assessing just and adequate compensation [Ga. Code Ann., §§ 36-617a, 36-1117, 36-1312]. The [State] Supreme Court declared this statute unconstitutional on the grounds that the legislature was attempting to interpret the constitutional requirement of just and adequate compensation in violation of the separation of powers doctrine [*Calhoun v. State Hwy. Dep't* 153 S.E.2d 418 (Ga. 1967)].³⁸

Thus, in Georgia, both increases and decreases in value that have occurred prior to the date of taking are properly considered. There appear to be other jurisdictions that also allow consideration of value enhancement and/or diminution by reason of the government's project.³⁹ Therefore, appraisers should consult legal counsel as to the applicable rule in the jurisdiction.

Condemnation blight, which decreases property values, most often occurs when public projects are announced long before property acquisition begins or when the acquisition program is not completed in a timely manner. Urban renewal projects are a classic example. Once an urban renewal project is announced, tenants tend to vacate buildings, vacancy rates escalate, property maintenance is often ignored, and vandalism tends to increase; these factors have a depressing effect on property values within the area. All of these conditions, except for physical deterioration within the reasonable control of the owner, must be disregarded by the appraiser in estimating the property's highest and best use and its market value.

The owner of a property located within a designated urban renewal area is well advised to retain the services of an appraiser well before the actual appraisal will be required. If this is done, the appraiser can analyze and inspect the property and neighborhood before the negative impact of the urban renewal designation has had a chance to distort the actual before situation. Condemnation blight can be so severe at times that property owners may claim a *de facto taking*.

The distinction between condemnation blight and a *de facto taking* has been described as follows:

The concept of a *de facto* appropriation is limited to situations in which there has been a *direct* invasion by the condemning authority upon the property of the condemnee or some *direct* legal restraint upon the use of such property. Condemnation blight, on the other hand, properly refers to the diminution in value of the property of the condemnee, caused by acts of the condemning authority between the time of the announcement of the projected taking and the *de jure* vesting of title.⁴⁰ [Citations omitted]

38. Charles N. Pursley, Jr., *Georgia Eminent Domain* (Norcross, Georgia: The Harrison Company, 1982), §6-4, 151.

39. *Anderson v. State Road Dept.*, 204 So. 2d 899 (Fla. 1967); *Prudential Insurance v. Central Neb. Pub. P.&I. Dist.*, 296 N.W. 752 (Neb. 1941).

40. *Beaux Arts Prop., Inc. v. United Nations Dev. Corp.*, 528 N.Y.S.2d 16, 22 (N.Y. 1972).

The distinction between these terms is important to appraisers because the date of value is affected. If a de facto taking has occurred, the date of value is the date of the de facto taking and interest must usually be paid on the condemnation award from the date of the de facto taking to the date the award is received by the condemnee. If only condemnation blight has occurred, the valuation date usually is the date of actual vesting of title in the condemnor, and the appraiser does not consider any diminution in value by reason of the proposed taking. To assume a de facto taking, the appraiser must have adequately supported written legal instructions from legal counsel. Because of the complex distinction between a condemnation blight case and a de facto taking case, and the significant implications involved, legal counsel will often request a dual-premise appraisal, one assuming a de facto taking and one assuming condemnation blight.

Project enhancement can also have a dramatic effect on property values. Zoning may be changed to accommodate a pending public project, which will require all or part of the rezoned property to be acquired. The appraiser must decide whether the property in question was rezoned because of the pending project or not. This determination will have a substantial impact on the appraiser's estimate of highest and best use and market value in the before and/or after situations.

If the rezoning is a result of the proposed public project, under the premise of project enhancement the appraiser must ignore the rezoning in the before situation. On the other hand, if the appraiser concludes that the property would have been rezoned anyway, the conclusion of highest and best use in both the before and after situations should be made in light of the rezoning. The proper treatment of this appraisal problem is demonstrated in the next chapter.

If the highest and best use of the property changes to a more valuable use immediately before the announcement of a public project and the date of valuation, project enhancement may be indicated. In such a case it is the responsibility of the appraiser to investigate the possibility and determine whether project enhancement has actually occurred. One of the most difficult determinations to be made in such an investigation is the *scope of the project*.

As a classic example of project enhancement, consider a property that contains a gravel deposit. Before the announcement of a road project requiring acquisition of the property for right-of-way purposes, there was no foreseeable market demand for the gravel. However, the pending project will create a demand for the material and the condemnor's contractor may, in fact, use the gravel for construction of the new roadway. Nevertheless, the appraiser must not consider the demand for the gravel in the before situation because the demand was created by the project itself and is therefore project enhancement.

SCOPE OF THE PROJECT RULE

In addressing enhancement and blight, as well as highest and best use and value, the appraiser must adhere to the scope of the project rule. The scope of the project

rule essentially holds that the effects of a proposed project *cannot* be considered in valuing a property to be acquired for the project when it was clear that the parcel under appraisal would, or probably would, be acquired in whole or in part for the project. Conversely, the effects of a project on a parcel under appraisal must be considered when the parcel was not included in the area to be acquired for the initial project, but the project is later expanded to include acquisition of the parcel in whole or in part for the expanded project. The scope of the project rule can best be demonstrated by analysis of an actual case.

*United States v. Miller*⁴¹ concerned the construction of the Shasta Dam and Reservoir in northern California. Congress authorized the project in 1937 and property values escalated in proximity of the proposed project. Alternative routes for the relocation of a railroad right-of-way that would be flooded by construction of the dam and reservoir were surveyed and staked in 1936. One of these routes passed through the Miller property. The federal district court ruled that the appraisers had to estimate the value of the property excluding any enhancement in value from the proposed project after its date of authorization in 1937. The Supreme Court upheld the lower court, stating:

If a distinct tract is condemned, in whole or in part, other lands in the neighborhood may increase in market value due to the proximity of the public improvement erected on the land taken. Should the Government, at a later date, determine to take these other lands, it must pay their market value as enhanced by this factor of proximity. If however, the public project from the beginning included the taking of certain tracts but only one of them is taken in the first instance, the owner of the other tracts should not be allowed an increased value for his lands which are ultimately to be taken....

The question then is whether the respondent's lands were probably within the scope of the project from the time the Government was committed to it. If they were not, but were merely adjacent lands, the subsequent enlargement of the project to include them ought not to deprive the respondents of the value added in the meantime by the proximity of the improvement. If, on the other hand, they were, the Government ought not to pay any increase in value arising from the known fact that the lands probably would be condemned....

If [the lands] were within the area where they were likely to be taken for the project, but might not be, the owners were not entitled, if [the lands] were ultimately taken, to an increment of value calculated on the theory that if they had not been taken they would have been more valuable by reason of their proximity to the land taken.⁴²

Application of the scope of the project rule can be difficult. The two most problematic questions that arise are: When was the government committed to the project? Was it probable that the parcel under appraisal would be acquired, in whole or in part, for the project? As one court stated:

41. *United States v. Miller*, 317 U.S. 369 (1945).

42. *Ibid.*, at 376-377, 379.

As with any test that deals in probabilities, its application to any particular set of facts requires discriminating judgment. The rule does not require a showing that the land ultimately taken was actually specified in the original plans for the project. It need only be shown that during the course of the planning or original construction it became evident that land so situated would probably be needed for the public use.⁴³

In the same case it was noted at page 18 that in the federal courts "it is for the judge and not the jury to decide whether the property condemned was probably within the project's original scope." Thus it may be advisable to obtain a ruling from the court in this regard prior to trial. "If there is any real question whether the property under appraisal meets the 'scope of the project' test, the appraiser should confer...with the responsible trial attorney."⁴⁴

It is also possible that a property under appraisal could be subject to two takings at, or near, the same time for two different projects or for different elements of a joint project. For example, consider the situation depicted in Figure 6.2. Taking A is for the construction of a dam and reservoir, which will flood the state highway that serves much of the remainder property. This acquisition is being funded by the state. Taking B is for the construction of a new highway. The acquisition of property for this new highway right-of-way is being funded by the federal government. The acquisitions for both projects will be made by the state. From an appraiser's standpoint, the most logical approach to this valuation problem would be to treat the two projects as one. This, however, would require agreement between the condemnee and the condemnor, which is not always possible. Even if such an agreement can be reached, it may be necessary for the appraisers, or at least the condemnor's appraiser, to allocate the total compensation between the two projects because of their different funding.

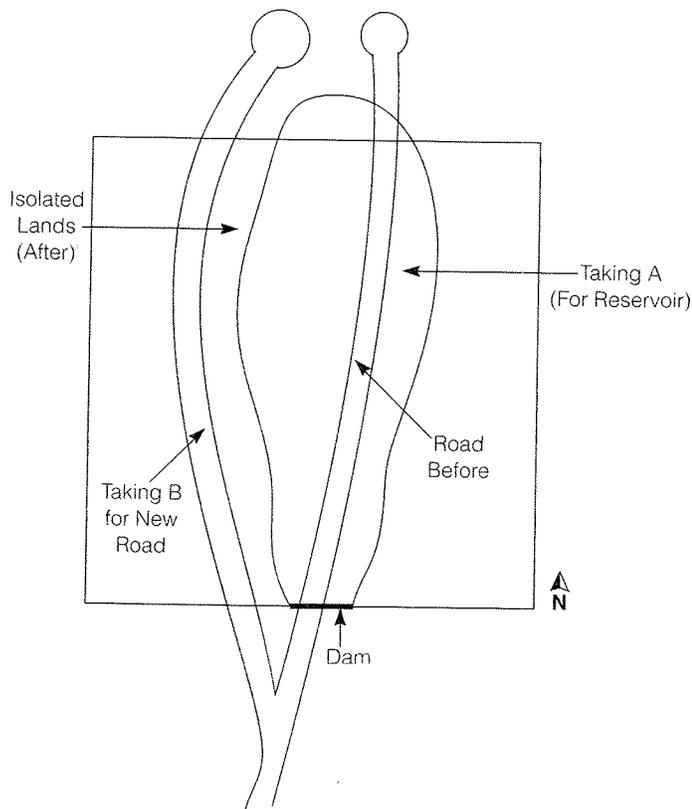
Even if the two projects must be viewed independently, the appraiser's approach to the appraisal problem must not be unreasonable. In this case it would not be reasonable to estimate the value of the property remaining after Taking A as if the remainder would be without access forever. Nor would it be reasonable to claim that the value of the taking and damages caused by Taking B would be totally offset by the benefits of the new highway because, without it, the property would have inadequate access. The only reasonable approach would be for the appraiser, when valuing the property in conjunction with Taking A, to estimate the property's after value in light of the *probability* that Taking B will occur and that the new highway will be constructed. In appraising the property in conjunction with Taking B, the appraiser would estimate the after value of the remainder in light of the *probability* of Taking A and the probable construction of the dam and reservoir. If the probability of both projects coming to fruition is at, or near, 100%, there would be little or no difference in the total compensation due the owner if the projects were treated as one consolidated project or two separate projects.

43. *United States v. Reynolds*, 397 U.S. 14, 18 (1970).

44. *Uniform Appraisal Standards for Federal Land Acquisitions*, SA-10, pp. 27-28.

In such a situation, a determination must be made as to which of the two takings will occur first. The dates of takings for the two projects, if they differ, will decide this matter. If the two takings are simultaneous, the appraiser will have to determine which is to be considered first. When the appraiser has been retained by the condemnor, it is probable that the condemnor will instruct the appraiser as to which taking to consider first; in that way the condemnor can have some control over the attribution of damages. For instance, if it is found that the remainder area identified in Figure 6.2 as "isolated lands" is damaged due to the isolation, the condemnor (the state) would probably instruct its appraiser to treat Taking B as the second taking. Then the damages attributable to the isolation would be chargeable against Taking B, which is being funded by the federal government, rather than against the acquisition cost of Taking A, which is state funded.

FIGURE 6.2 SIMULTANEOUS TAKINGS



There is some precedence for this approach. In 1978 the Washington Metropolitan Area Transit Authority (WMATA), as part of its expansion of the Washington area subway system, decided that it would acquire land from Old Georgetown for the construction of a parking lot to serve transit system users. As a part of that decision, Montgomery County agreed to extend roads into the parking lot; these road extensions required the acquisition of a portion of Old Georgetown's property. The county acquired the new right-of-way from Old Georgetown by negotiation. The remainder of Old Georgetown's property was split into three tracts by the county's acquisitions. When WMATA condemned 2.52 acres of Old Georgetown's property, it claimed that compensation for the taking was nominal because the remainder of Old Georgetown's property was specially benefited by its proximity to the transit facility. Old Georgetown claimed that the 2.52 acres formed a separate larger parcel because it was severed from the balance of its ownership by the rights-of-way acquired by the county, and there was no contiguity or unity of use between the parcels. The court found that the entire ownership constituted a single larger parcel, stating:

We think that the impact of the planned road extensions should not be taken into account, and therefore that there is a potential unity of use between the taken land and the retained land. If, with no advance warning, the same governmental entity has simultaneously condemned both the 2.6 acres needed for the rights-of-way for the planned road extensions and the 2.52 acres needed for the parking lot, there would be no doubt that the compensation should be reduced by the amount of the special benefit to be conferred, and increased by the amount of the damage to be inflicted, by the taking on the land retained by the landowner. We think for practical purposes that this is that case. Both takings—the taking of land for the rights-of-way, achieved by purchase rather than condemnation, and the taking for the parking lot—were for the same basic purpose—the extension of the Washington mass transit system into the surrounding area in Maryland. The final decisions to take both were reached contemporaneously, if not simultaneously, in 1978. Both takings were contemporaneous with each other. The only distinction between this case and that posited is that in the instant case, the acquiring authorities were two separate governmental entities. Yet they were working in a cooperative effort to accomplish a single objective so that we think the distinction is without real difference. Stated otherwise, we do not think that there should be a different result in the present case simply because it was necessary that the mass transit project be undertaken by an alliance of various governmental entities formulating, announcing and carrying out their plans at different speeds.⁴⁵

As with the scope of the project rule, the appraiser is well advised to seek legal advice if the property under appraisal is subject to contemporaneous takings.

45. *Washington Metropolitan Area v. One Parcel of Land*, 691 F.2d 702, 705 (4th Cir. 1982).

ADVANCED PROBLEMS

ASSEMBLAGE

At times appraisers conclude that the highest and best use of a specific parcel of land is to assemble it with other ownerships. Historically, definitions of highest and best use have included the provision that "if the intended use is dependent on an uncertain act of another person, the intention cannot be considered."⁴⁶ This provision is considered overly restrictive in some jurisdictions. The courts have generally reverted back to *reasonable probability* in such instances. One court stated:

Proof of use of lands in combination with other lands [not owned by the condemnee] is not excluded from [consideration in] a condemnation case, "if the possibility of such connection is reasonably sufficient to affect market value."

This is part of the question of the highest and best use. "Value may be determined in light of the special or higher use of the land when combined with other parcels."

It is elemental that the burden of proof of the highest and best use contended by the defendant-landowners, as well as the burden of proof of fair market value is upon the defendant-landowners. Accordingly, if they contend for a use involving utilization or combination with other lands they have the burden of showing "the reasonable probability" of such use.⁴⁷ [Citations omitted]

When assemblage is considered, the appraiser must be cautious in writing the appraisal report and in testifying because the question of *reasonable probability* is generally considered a preliminary question for the court, not a question for the appraiser. In the case quoted above, the court went on to say:

In determining the question of law as to whether a sufficient showing is made of the "reasonable probability" the court will want to hear *facts* and not some expert's ultimate opinion about the very problem the court is to decide. An expert, of course, may be used to present factual matters. Nor are we stating that expert testimony may not be offered on technical problems such as the adequacy of a sewer line. What we are stating is that we will not hear experts give their opinion that there is or is not the required "reasonable probability."⁴⁸

The fact that the appraiser can consider the probability of assemblage in estimating highest and best use introduces some interesting valuation problems. First, the appraiser cannot assume that the assemblage has occurred in estimating the value of the property under appraisal. Only the *probability* of such an assemblage can be considered. Therefore, the estimated value of the property has to be something less than it would be if it were part of an assembled tract. Second, the appraiser must address which property is to be the beneficiary of the plottage factor.

46. *Appraisal Terminology and Handbook*, 4th ed. (Chicago: American Institute of Real Estate Appraisers, 1962), 92.

47. *United States v. 70.39 Acres of Land*, 164 F.Supp. 451, 476 (S.D. Cal. 1958).

48. *Ibid.*

For example, consider two parcels (A and B), each with 12,000 square feet of area. Each parcel would have a value of \$5.00 per square foot individually, but if they were assembled under one ownership they would have a higher and better use and a value of \$8.00 per square foot.

Forgetting for a moment the discount in value that must be applied because the tracts are not, in fact, assembled, there are several arguments that can be made regarding how Parcel A and Parcel B should be valued. From the condemnor's viewpoint it could be argued that Parcel A is not, in fact, assembled and that if the owner of Parcel B wanted to acquire Parcel A for purposes of assemblage he or she would pay no more than the market value of Parcel A as a separate entity. On the other hand, the condemnee might take the position that if Parcel B has a value of only \$5.00 per square foot, or \$60,000 (12,000 x \$5.00) as a separate entity and the total value of the tracts if assembled would be \$192,000 (24,000 sq. ft. x \$8.00), Parcel A must be worth \$132,000 (\$192,000 - \$60,000). Of course, neither of these positions is reasonable.

To value the parcels accurately the appraiser would probably have to know, or assume, who the assembler would be—the owner of Parcel A or the owner of Parcel B? Of course, working in the hypothetical field of eminent domain valuation, the answer to this question can never be determined with any degree of certainty. Therefore, the only practical solution is for the appraiser to allocate the beneficial effect of the plottage over both of the tracts that are to be assembled on a pro rata basis. To do otherwise would indicate appraiser advocacy and result in an unjust award for either the condemnor or condemnee.

To illustrate the condemnor's and the condemnee's positions, assume that both Parcels A and B are being condemned. If the condemnor's argument were accepted by the trier of fact, total compensation for both parcels would be \$120,000. If the condemnee's argument were accepted, the total compensation paid would be \$264,000. Neither of these results is reasonable. The only reasonable solution is for the condemnor to pay total compensation of \$192,000, less a discount for the fact that the two tracts are not, in fact, assembled.

To make and support an adjustment for the probability of an assemblage is most difficult. As the number of parcels in the anticipated assemblage increases, the amount of risk, and thus the amount of discount, tends to increase. The appraiser can ask the owner of Parcel A, "If this condemnation action had not been pending for 3 years, do you think that you and the owner of Parcel B would have assembled your ownerships?" but an objective response cannot be expected. The property owner has been negotiating with the government for the sale of his land for 3 years. With substantial money at stake, his answer is obviously going to be the one that is to his economic advantage.

An appraiser can attempt to develop some indication of an appropriate probability of assemblage discount by thoroughly investigating similar land assemblages and interviewing the parties involved. If other parcels of land have been assembled and resold, the price differential between the assembler's cost of the assemblage and the resale price of the assembled parcel can give some indication

of the profit such land assemblers demand in the marketplace. Interviews with the assembler are essential. What the assembler wanted, or anticipated, as a profit before the assemblage began may be entirely different from the profit actually realized. It is the former that is important to the appraiser. Because land assemblages are seldom similar in the types of land, the number of parcels to be assembled, and the value increment created by the plottage, however, the proper adjustment is often up to the judgment of the appraiser. In any case, the adjustment must be well reasoned and thoroughly explained in the appraisal report.

One other factor must be considered in the assemblage of grazing land.

A ranch owner is not entitled to compensation for any value added to fee lands as a result of their actual or potential use in combination with Taylor Grazing Act permit lands, as these permits to use the public domain for grazing are revocable and create no property rights in the holder (n. 195; *United States v. Fuller*, 409 U.S. 488 (1973)). To require the United States to pay for this value would be to create private claims in the public domain. This same principle should apply to situations involving federal grazing permit lands held under permit authority other than the Taylor Grazing Act, where the permit is revocable and creates no property rights in the holder, such as permits issued by the U.S. Forest Service under 16 U.S.C. 580(L), for example.⁴⁹

However, value added to fee land as a result of their actual or potential use in combination with grazing permits issued from parties other than the federal government can be considered in valuing the fee land for federal condemnation purposes.⁵⁰

UNDIVIDED FEE RULE

In estimating highest and best use, appraisers are typically advised to consider the legal restrictions on the property being appraised, including private limitations such as deed restrictions and leases.⁵¹ Highest and best use estimation for eminent domain is different from other types of appraisal analysis in this regard because of the *undivided fee*, or *unit*, rule. (This rule was introduced in Chapter 4.) "[T]he unit rule requires valuing property as a whole rather than by the sum of the values of the various interests into which it may have been carved, such as lessor and lessee, life tenant and remainderman, etc.. This is an application of the principle that it is the property, not the various titles, which is being taken."⁵² Because the various estates in the property must be disregarded in the valuation process, they must also be disregarded in estimating the property's highest and best use.

This can lead to some rather unique results. For example, assume that a 20,000-sq. ft. site with a highest and best use for an office building would have a value of \$100 per square foot, or \$2,000,000, for this use. However, the property is under a long-term lease, with 15 years remaining, for specific and restricted use as a parking lot. The rental specified in the lease is \$40,000 per year, net to the

49. *Uniform Appraisal Standards for Federal Land Acquisitions*, §A-24, p. 62.

50. *United States v. 27,223.21 Acres of Land, Las Animas County*, 589 F. Supp. 1121 (Colo. 1984).

51. *The Appraisal of Real Estate*, 10th ed., 280-281.

52. *Uniform Appraisal Standards for Federal Land Acquisitions*, §A-13, p. 39.

lessor, which is equivalent to the economic, or market, rent for the land for parking lot purposes. Therefore, the lessee's interest in the property is neither positive nor negative. In a typical appraisal assignment, the appraiser might conclude that 10% is an appropriate rate to be applied to the lessor's interest and that the value of the leased fee could be computed as follows:

Value of income stream (\$40,000 x 7.606080)*	\$304,243
Value of reversion (\$2,000,000 x 0.239392)†	<u>478,784</u>
Total value of leased fee estate	\$783,027

* Present worth of \$1 per period for 15 years discounted at 10%.

† Present worth of \$1 in 15 years discounted at 10% per annum.

Thus, the value of the lessor's interest plus the value of the lessee's interest in the property would be \$783,027 (\$783,027 + \$0). (The value of these interests could change if there was *reasonable probability* that the lessor could buy out the lessee's interest in the property.)

Under the *unit rule* applicable in eminent domain valuation, however, the condemnor must pay the market value of the undivided fee interest in the property, which is \$2,000,000. The allocation of condemnation awards between lessors and lessees is discussed in Chapter 17.

An opposite situation could also result. Consider a parcel that is leased for \$60,000 per year, but has a market, or economic, rent of only \$40,000 per year. The value of the property under the undivided fee rule would be based on its market rent of \$40,000; the contract rent of \$60,000 would have no influence on the property's market value.

CONTAMINATED PROPERTY

Highest and best use estimation has been further complicated by the recent adoption of environmental regulations concerning hazardous waste. In the analysis of a site, the appraiser must make a reasonable effort to determine whether it is contaminated and, if so, the impact of that contamination on the property's highest and best use and value.⁵⁵

Disregarding the contamination issue, an appraiser might make the following highest and best use analysis of a property under appraisal:

Highest and best use, if vacant	Office building
Value of site as if vacant	\$300,000
Demolition cost of building	- 45,000
As is value of site for office building	\$255,000
Value as improved with industrial building	\$175,000

From these calculations, the appraiser would conclude that the highest and best use of the property would be to demolish the industrial building and convert the site to office building use.

55. *Uniform Appraisal Standards for Federal Land Acquisitions*, §B-1 - 15a, fn. 206, p. 70.

However, if the site or building were contaminated, the cost of cleaning up the site to make it suitable for office building purposes might change the highest and best use of the property. For example, assume that the industrial building is contaminated with asbestos. Then the highest and best use analysis might be:

Highest and best use, if vacant	Office building
Value of site as if vacant	\$300,000
Demolition cost of building (including asbestos removal)	<u>-190,000</u>
As is value of site for office building	\$110,000
Value as improved with contaminated industrial building	\$145,000

Under these circumstances, the highest and best use of the property would be for its continued use as improved. This situation could occur if the asbestos in the building were nonfriable and the industrial building could continue to function in its existing condition. The cost of the asbestos removal would be delayed, and therefore discounted to present value.

Some environmental agencies have established different standards of clean-up of sites, depending upon their intended use. The problem then becomes, *how clean is clean?* The existence of such regulations can also have an impact on highest and best use. A site located in an industrial area may have a highest and best use, if clean, as a day-care facility to accommodate the children of industrial workers in the area. However, the standards for cleaning up the site for day-care use may be so much stricter than the standards for use as an industrial site that the highest and best use of the site may be for industrial purposes when the comparative costs of cleanup are considered.

S U M M A R Y

Highest and best use is the most profitable, likely use to which a property can be put. The appraiser's estimate of highest and best use is an integral part of the appraisal process because, without an accurate estimate, the appraiser cannot accurately estimate the market value of the property being appraised. In appraising a property subject to a partial acquisition, two independent highest and best use estimates are made—one in the before situation and one in the after situation.

Many definitions of highest and best use have been promulgated over the years. The appraiser must take care to use the definition applicable in the specific jurisdiction where the property being appraised is located. The courts have adopted economic highest and best use definitions exclusively, rejecting noneconomic definitions and the considerations of community development goals.

The highest and best use of a site as though vacant may be different from the highest and best use of the property as improved. In such instances, the appraiser may wish to include two sets of computations: the classic appraisal computations, which reflect the obsolescence present in the improvements due to their lack of

conformity to the highest and best use of the land as though vacant, and another set computing the land value for the property's highest and best use as improved.

Most courts have held that a property should be valued for *all available uses*, rather than for a specific use. This concept is not in conflict with the appraiser's interpretation of highest and best use. Rather, it is an attempt on the part of the courts to eliminate the possibility that the trier of fact will add together the values of the property for several specific uses to arrive at a conclusion of just compensation.

It is improper to value the land for one use and the improvements for another. This practice violates the consistent use theory and has been soundly rejected by the courts. Several methods can be used to estimate the value of improvements on properties that are in transition from one use to another. The appraiser should be familiar with all applicable procedures and adopt the methodology that best reflects the actions of buyer and sellers in the market.

As a general rule, an estimate of market value should

not include an increase or decrease in value before the date of valuation that is caused by (1) the proposed improvement or project for which the property is taken; (2) the reasonable likelihood that the property would be acquired for the improvement or project; or (3) the condemnation action in which the property is taken.⁵⁴

Because there are some exceptions to this general rule, the appraiser must confirm which rule is applicable in the specific jurisdiction.

A change in the highest and best use of a property immediately before the announcement of a public project and the date of valuation may indicate that condemnation blight or project enhancement has occurred. It is sometimes difficult to make a conclusive determination in this regard. Appraisers often reach different conclusions concerning the existence of condemnation blight and/or project enhancement, and this determination can have a material impact on their value estimates.

In estimating a property's highest and best use, the appraiser may usually consider the probability of assembling the property with lands owned by others if such probability affects the current market value of the property being appraised.

The appraiser must follow the undivided fee, or unit, rule in estimating the highest and best use of property in an eminent domain valuation. Private land use restrictions, leases, and other divisions of the fee simple estate are to be disregarded.

In estimating highest of best use, appraisers must consider the impact of environmental regulations and land use regulations that affect the utility of the property. The presence of hazardous materials on a site and the regulations governing its removal may have a bearing on the property's highest and best use.

It is implicit in all definitions of highest and best use that the use must be legal. Any estimate of highest and best use must be reasonably probable on the

54. *Uniform Eminent Domain Code*, 1974. §1005, p. 10.9.

date of the appraisal or in the reasonably near future. There is a presumption in eminent domain cases that the existing use of a property is its highest and best use. The burden of proving that the highest and best use of a property is something other than its existing use is upon the party advocating the different use. An estimate of highest and best use cannot be remote, speculative, or conjectural in nature. The key to determining whether a specific highest and best use can be considered by the appraiser is whether the potential for that use has an effect on the property's market value as of the effective date of the appraisal. If the potential use of the property has a recognized effect in the marketplace, the appraiser not only may, but must, acknowledge that effect and consider it in estimating market value.