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Hogan Lovells: Fair Market Value and Uncertainty Regarding Highest and Best Use.

In this article, Montague argues that the Tax Court's valuation in Palmer Ranch Holdings did not reflect the property's true fair market value because it failed to account for uncertainty regarding the property's highest and best use.

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The central valuation issue in the recent Tax Court case Palmer Ranch Holdings Ltd. v. Commissioner1 was the question of the property's highest and best use. The partnership claimed a charitable contribution deduction of nearly $24 million for the donation of a conservation easement on 82.19 acres of undeveloped land in Sarasota County, Florida. In valuing the property, the partnership's appraiser relied on a land use analysis that concluded the highest and best use for the property was a 360-unit multifamily development. However, the property's zoning on the valuation date did not permit such a use.2 For that reason, the IRS insisted that the property's highest and best use was for low-density residential development as permitted by the property's then-current zoning, resulting in a substantially lower valuation.3 As in many conservation easement cases, the Tax Court was asked to decide the valuation dispute. Unfortunately, because the court considered the question of highest and best use separately from its analysis of the fair market value, it arrived at a value that exceeded the property's true fair market value.
Background on Valuing Conservation Easements

In general, when a taxpayer makes a charitable contribution of property other than money, the contribution amount is the fair market value of the property at the time of the contribution.4 The regulations under section 170 define fair market value as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having a reasonable knowledge of relevant facts."5

The regulations provide specific guidance on valuing conservation easements: If a substantial record of sales of comparable easements exists, the fair market value of the donated easement should be based on the sales prices of those comparable easements; otherwise, it is acceptable to use what is known as the before-and-after method,6 which is often used for conservation easements because there is rarely a record of sales of comparable easements.7 As its name suggests, the before-an--after method considers "the difference between the fair market value of the property it encumbers before the granting of the restriction and the fair market value of the encumbered property after the granting of the restriction."8 Using language closely modeled on the legislative history,9 the regulations provide:

If before and after valuation is used, the fair market value of the property before contribution of the conservation restriction must take into account not only the current use of the property but also an objective assessment of how immediate or remote the likelihood is that the property, absent the restriction, would in fact be developed, as well as any effect from zoning, conservation, or historic preservation laws that already restrict the property's potential highest and best use.10

In Hilborn v. Commissioner[11] — one of the earliest and most frequently cited cases applying the before-and-after method — the Tax Court explained that the before value:

is arrived at by first determining the highest and best use of the property in its current condition unrestricted by the easement. At this stage the suitability of the property's current use under existing zoning and market conditions and realistic alternative uses are examined. Any suggested use higher than current use requires both "closeness in time" and "reasonable probability." Next, to the extent possible, the three commonly recognized methods of valuing property (capitalized net operating income, replacement cost, and comparable sales) are used, but are modified to take into account any peculiarities of the property which impact on the relative weight to be afforded each respective method.[12]

Hilborn seems to require that the court apply a two-step approach to valuation: First, it must determine the highest and best use of the property, and second, it must determine the fair market value of the property given the highest and best use determined in the first step. However, that two-step approach is inconsistent with the requirement that the property be valued at its fair market value. To understand that inconsistency, it is helpful to consider the application of the two-step approach in Palmer Ranch Holdings.

The Valuation in Palmer Ranch Holdings

When the conservation easement was donated on December 19, 2006, the 82.19 acres designated parcel B-10 was zoned RE-1, permitting residential development no denser than one house for every two acres.[13] Nevertheless, the partnership's appraiser determined that the highest and best use of the land was for a multifamily development, which would have necessitated rezoning to moderate density residential, permitting development of up to 5 units per acre.[14] The IRS pointed to several facts that it contended made rezoning unlikely.

First, and most significantly, only two years before the valuation date, the board of county commissioners (BOCC) denied an application to develop and rezone part of parcel B-10 and an adjacent parcel B-9. In 2003 the partnership agreed to sell 86.9 acres in parcels B-9 and B-10 to a developer contingent on the BOCC's approval of applications for development and rezoning the land to residential single family, which would have permitted development of 3.5 units per acre. In June 2004 the BOCC denied the development application by a 3-2 vote. Although the separate rezoning application was not voted on at that time, the BOCC presumably would not have approved it. In August 2004 the developer revised and resubmitted its applications, seeking to develop only parcel B-9 and to rezone it to residential multifamily, permitting up to six units per acre. In October 2004 the BOCC denied both the revised development plan and the rezoning application, again by a 3-2 vote. The ordinance issued by the BOCC in conjunction with its denial instructed the developer to resubmit its application including parcel B-10 that showed a plan "to keep Parcel B-10 intact as it related to the Eagle Preservation Area, the wetlands, and the wildlife corridor."[15]

Second, the IRS pointed to several environmental concerns that might have prevented rezoning. Those concerns included the BOCC's directive that future development plans keep parcel B-10 intact, as well as a comprehensive plan adopted by Sarasota County designating an eagle nest zone and a wildlife corridor, which included part of parcel B-10.[16] The Eagle Preservation Area referred to in the 2004 ordinance included an eagle nest on parcel B-10 with a U.S. Fish and Wildlife Service-designated primary protection zone of 750 feet, and a secondary protection zone of 1,500 feet. In June 2006 the protection zone was reduced to 660 feet.[17]

Third, the IRS contended that multifamily development was not reasonably probable because Sarasota County regulations required residential developments of at least 100 units to have two fully functional access points, which parcel B-10 lacked. To achieve access, a developer would have had to obtain an easement on parcel B-9 and county approval to extend another road.18

Fourth and finally, the IRS pointed out that there had been vigorous neighborhood opposition to the 2004 rezoning attempt, which it contended would have resurfaced in response to any new rezoning application.19

The Tax Court considered each of the IRS's arguments. It rejected the first argument, weakly stating that the "rezoning history does not eliminate the reasonable probability on the valuation date of a successful zoning." As grounds for its conclusion, it reasoned that the previous rezoning attempt was of limited predictive value because it was two years before the valuation date and, although the BOCC had previously rejected a development plan that included parcel B-10, the only rezoning application considered by the BOCC was for the adjacent parcel B-9. It also noted that the initial rezoning application had been rejected by a close vote.20 The court similarly rejected the second argument because the size of the Eagle Preservation Area had shrunk since 2004 and because some development had previously been allowed in the wildlife corridor, although it did not mention the density of that development.21 The court rejected the third and fourth arguments because even though there had previously been vigorous neighborhood opposition to the development, it was not certain that the opposition would resurface or that it would be successful in preventing rezoning.22 The court concluded that "there is a reasonable probability that parcel B-10 could have been successfully rezoned to allow for the development of multifamily dwellings. Therefore, the highest and best use of the property is development for multifamily dwellings."23

The Tax Court did not attempt to assign a percentage to the probability of rezoning, but it is safe to say that the percentage was not very high — perhaps even less than 50 percent. The phrase "reasonable probability" comes directly from Hilborn; it does not appear in the regulations or the legislative history. Although the Tax Court has not defined the term "reasonable probability," it is generally considered to be less than "more likely than not."24 In rejecting each of the IRS arguments for why rezoning would be improbable in Palmer Ranch Holdings, the court stated only that each argument did not preclude the reasonable probability of rezoning. Rezoning would not have been a sure bet. Yet because the court was applying the two-step approach articulated in Hilborn, once it decided that there was a reasonable probability of rezoning, it then concluded that the highest and best use of the property was for multifamily dwellings, and it went on to calculate the before value as if the property had been rezoned as of the valuation date.

Highest and Best Use as a Component of FMV

The problem with the two-step approach to valuation articulated in Hilborn25 and applied in Palmer Ranch Holdings is that it is not equivalent to fair market value. No willing buyer would have paid a price equal to the before value arrived at by the Tax Court. For purposes of valuation, the court's method treated what it probably considered to be a less than 50 percent chance that the property could have been rezoned as if it were a 100 percent certainty.26 Any buyer considering purchasing the property would have taken into account that there was a significant possibility that the rezoning application would have been rejected. After all, a development plan for a less-dense subdivision on the same parcel two years before had been denied, and a rezoning application for the adjacent parcel had also been denied. Those facts cast serious doubt on the probability that rezoning would have been granted, even if they do not preclude the possibility. Accordingly, any buyer with a reasonable knowledge of the relevant facts would have discounted the price to account for that uncertainty.27

Instead of considering the highest and best use of the property separately from its fair market value, the court should have considered it as a component of fair market value. In other words, the court should have considered the possibility that the property could have been used for multifamily development but discounted the value of that use to account for its uncertainty, just as a hypothetical buyer would have done. Doing so would have resulted in a fair market value between that arrived at by the partnership's appraiser, who assumed the property could be rezoned, and the IRS appraiser, who assumed that rezoning was impossible. That approach is the only one consistent with the regulations' requirement that the property be assigned its fair market value.

The two-step approach is also inconsistent with the approach to fair market value taken by other courts and by the Tax Court in some other cases. In discussing a property's highest and best use, along with Hilborn the Tax Court often cites Olson v. United States,28 a 1934 Supreme Court case. However, Olson is inconsistent with the two-step valuation approach endorsed in Hilborn. Olson was a condemnation proceeding in which the property owners insisted that the highest and most profitable use for their land was the construction of a power plant. The Supreme Court stated that the fair market value of property:

does not depend upon the uses to which [the owner] has devoted his land but is to be arrived at upon just consideration of all the uses for which it is suitable. The highest and most profitable use for which the property is adaptable and needed or likely to be needed in the reasonably near future is to be considered, not necessarily as the measure of value, but to the full extent that the prospect of demand for such use affects the market value while the property is privately held.29

In other words, the highest and best use to which the property is adaptable and likely to be used in the near future should be considered as one factor affecting fair market value — that is, to the extent it would influence demand for the property. It is not determinative of fair market value as it is in Hilborn. As the Tax Court correctly stated in Boltar LLC v. Commissioner30: "The concept of 'highest and best use' is an element in the determination of fair market value, but it does not eliminate the requirement that a hypothetical willing buyer would purchase the subject property for the indicated value."

Although Hilborn is frequently cited in Tax Court cases considering the valuation of conservation easements, its two-step approach to valuation has not often been applied.31 Whether the court uses a two-step approach or considers highest and best use as a component of fair market value will make little difference in cases in which the proposed rezoning or other alternative use is a near certainty. As noted above, Palmer Ranch Holdings is not such a case.

In at least two cases with similar uncertainty about whether rezoning would be granted, the Tax Court has correctly used uncertainty as a factor in determining fair market value. For instance, in Mathis v. Commissioner,32 the Tax Court stated that although the prospects for zoning were uncertain, the IRS appraiser was wrong not to give any weight to such a possibility. Because the court concluded that both the IRS and the taxpayer miscalculated the chances that the property would be rezoned, it adjusted the property's fair market value accordingly. Similarly, in Hay v. Commissioner,33 the court concluded that on the valuation date, the highest and best use of the property was uncertain because of the challenge of obtaining the necessary zoning and other approvals, and it therefore adjusted the property's value to account for the uncertainty. The Tax Court should have followed a similar approach in Palmer Ranch Holdings.34

To arrive at the fair market value required by the regulations, the Tax Court should decline to follow the two-step approach of Hilborn and instead consider the highest and best use of the property as a component of its fair market value analysis.

FOOTNOTES

1 T.C. Memo. 2014-79 2014 TNT 88-14: Court Opinions.

2 Id. at *4-*7.

3 Id. at *22.

4 Reg. section 1.170A-1(c)(1).

5 Reg. section 1.170A-1(c)(2).

6 Reg. section 1.170A-14(h)(3)(i).

7 See, e.g., Hilborn v. Commissioner, 85 T.C. 677 (1985); Butler v. Commissioner, T.C. Memo. 2012-72 2012 TNT 54-13: Court Opinions; Simmons v. Commissioner, T.C. Memo. 2009-208 2009 TNT 177-17: Court Opinions, aff'd, 646 F.3d 6 (D.C. Cir. 2011) 2011 TNT 120-13: Court Opinions.

8 Reg. section 1.170A-14(h)(3)(i).

9 S. Rep. No. 96-1007, at 14-15 (1980).

10 Reg. section 1.170A-14(h)(3)(ii).

11 Hilborn v. Commissioner, 85 T.C. 677.

12 Id. at 689. Although Hilborn continues to be one of the most frequently cited cases concerning the valuation of conservation easements, it predates the issuance of the regulations quoted in supra note 10.

13 Palmer Ranch Holdings, at *22.

14 Id. at *7.

15 Id. at *8-*10.

16 Id. at *28-*29.

17 Id. at *11-*12.

18 Id. at *34-*35.

19 Id. at *35-*36.

20 Id. at *27-*28.

21 Id. at *29-*31.

22 Id. at *34-*36.

23 Id. at *36.

24 See Kyles v. Whitley, 514 U.S. 419, 434 (1995).

25 Because there was general agreement in Hilborn on the highest and best use of the property, the two-step approach did not result in a markedly different valuation in that case.

26 Even if the court in Palmer Ranch Holdings considered the chance of rezoning to be more than 50 percent, as noted above, the reasonable probability standard from Hilborn does not require even that degree of certainty.

27 More than likely, the buyer would have included a contingency in the offer for obtaining the necessary rezoning and other approvals. But the regulations require that the property be assigned a fair market value as of the valuation date. On that date a hypothetical buyer purchasing the property would have been confronted with the uncertainty of rezoning.

28 292 U.S. 246 (1934).

29 Id. at 255 (citations omitted, emphasis added).

30 136 T.C. 326, 336 (2011) 2011 TNT 66-10: Court Opinions; see also the Tax Court's extensive discussion of the relationship between highest and best use and fair market value in Whitehouse Hotel Limited Partnership v. Commissioner, 139 T.C. 304, 330-337 (2012) 2012 TNT 206-8: Court Opinions.

31 One other case in which it has been applied with similar consequences is Stanley Works v. Commissioner, 87 T.C. 389 (1986). In that case, the taxpayer contended that the highest and best use of the property before the conservation easement was a hydroelectric power plant. The court rejected IRS arguments that the use was not reasonably probable given environmental concerns and public opposition and concluded that use was a "reasonable probability." Id. at 408. As in Palmer Ranch Holdings, despite the uncertainty regarding necessary approvals for use as a power plant, the court went on to value the property as if those approvals would have been granted. Id. at 411, 413. Again, no reasonably informed buyer would have purchased the property on the valuation date without discounting the price to account for the uncertainty.

32 T.C. Memo. 1989-254.

33 T.C. Memo. 1992-409.

34 Taxpayers who are in a position similar to the partnership in Palmer Ranch Holdings but who feel confident that their property will be rezoned should obtain that rezoning before donating a conservation easement. That the partnership failed to do so suggests that it thought rezoning was unlikely.

END OF FOOTNOTES

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