

Publications

Highest and Best Property Use: Why Does it Matter?

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Any investor wants to maximize his property's value and income-producing potential, but many fail to take this concept seriously - until they realize what they could be missing out on.

Who cares about the highest and best use of a property? Well, appraisers certainly care, and when a property ends up in litigation, the judge cares. Understanding how these authorities determine value will make it clear that commercial property owners should care about highest and best use, too.

I learned the importance of highest and best use during my first year at the Department of Justice, in a small condemnation or government taking case. The property owner had a single-family home on a prime piece of commercial real estate, and a highway expansion was bringing traffic lanes to within 12 feet of the house. The property had been rezoned commercial and was surrounded by other commercial uses.

As a residential asset, the entire property before partial condemnation had appraised at \$140,000, whereas the land as a commercial site was worth double that amount. Because the highest and best use of the property was redevelopment as a commercial site, the value for the land taken as right of way was worth more than the residential value of the entire, previously undivided property.

Not all analyses of highest and best use are so simple and obvious. This is particularly true in the context of appraising an industrial property for a property tax appeal. The standard test for determining highest and best use has four prongs, and each can be critical to the valuation of the property. That question is: What use is legally permissible, physically possible, financially feasible and maximally profitable?

The first prong, what is legally permissible, refers to zoning or other governmental restrictions, as well as the deed restrictions, and the uses that those parameters allow for the property. In a recent case, a 57-acre property was zoned industrial, which allowed for offices as an accessory use to the industrial use. Improvements included several older flex manufacturing buildings totaling close to 600,000 square feet. The condition and use of the flex buildings varied but the need to use the structures primarily for manufacturing no longer existed.

The Oregon Department of Revenue's appraisal valued the majority of the 600,000 square feet as office use. This did not meet the test for what is legally permissible, because the zoning only allowed office as an accessory to an industrial use.

What is financially feasible? In this same case, the appraiser for the Department of Revenue also failed to address if it was cost effective to reconfigure several 80,000-squarefoot two-story flex manufacturing facilities for multitenant use. The government's appraisal lacked any discussion of the basic demising costs to create smaller rentable spaces, including common areas for hallways, lobbies, and relocation of elevators and restrooms.

What is physically possible? Many of the industrial buildings in this example were interconnected. They had shared utilities, were situated on a single tax lot and offered only limited access without dedicated parking for a given building. Separation of the buildings into viable stand-alone parcels may have been prohibited by the physical location of the utilities, the placement of the buildings on the lot, or by parking, ingress and egress to the site.

The fourth prong is often the simplest to address. Of the possible uses meeting the first three facets of the highest-and-best-use test, which offers the maximum profit for the owner?

An appraiser's failure to do a highest- and-best-use analysis and appropriately support its conclusions can be fatal in a trial setting. In a 1990 decision, *Freedom Federal Savings & Loan vs. Department of Revenue*, the Oregon Supreme Court held that highest and best use of the property subject to evaluation is the first question that must be addressed in a credible appraisal. This set the critical framework for valuation, and determines what other comparable properties can be used to value the subject property.

These highest-and-best-use tests must be appropriately supported. In the context of an investment property, for example, would an investor deem the current use to be most productive from a financial or physical basis for the property, or would an alternative use be preferable?

If a careful highest-and-best-use analysis is done at the beginning, the appraiser can select credible comparable sales or leases for use in valuation. The property owner, in turn, will be treated fairly, whether in a tax assessment appeal or an eminent domain acquisition.

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[Cynthia M. Fraser](#)

[Principal \(Retired\)|Portland](#)

[503.553.3223 cynthia.fraser@foster.com](#)

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