Appraising Legally Nonconforming Uses – The Allocation Problem

With the trend toward stricter land use regulations, existing properties are becoming legally nonconforming at such a rate that new properties—and even properties under construction—may be nonconforming. The trend toward greater control with regard to specificity of land use has gained momentum due to environmental concerns, decay of inner cities and urban sprawl. The valuation of legally nonconforming properties presents certain problems, especially in the arena of eminent domain.

By J. L. Craft, Ph.D., MAI

The following definitions are typical clarifications of the term, *legally nonconforming*.

1. A legally nonconforming use is a use that was lawfully established and maintained, but no longer conforms to the use regulations or the yard and bulk regulations of the zone in which it is located. (*The Appraisal of Real Estate,* Eleventh Edition)

2. A use which was lawfully established and maintained, but which, because of a subsequent change of a zoning ordinance, no longer conforms to the use regulations of the zone in which it is located. A nonconforming building or nonconforming portion of the building shall be deemed to constitute a nonconforming use of the land upon which it is located. Such uses preclude additions or changes without municipal approval. (Byrl N. Boyce, *Real Estate Appraisal Terminology*)

3. A structure the size, dimension or location of which was lawful prior to the adoption, revision or amendment of a zoning ordinance, but now fails to conform to the requirements of the zoning district in which it is located by reasons of such adoption, revision or amendment. A use which does not comply with present zoning provisions, but which existed lawfully and was created in good faith prior to the enactment of the zoning provision.

> Uses permitted by zoning statutes or ordinances to continue notwithstanding that similar uses are no longer permitted in the area in which they are located. (*Black's Law Dictionary*, Sixth Edition)

The expression, "nonconforming use," covers the *particular* use of the land and the building, i.e., the use of the property as well as the *kind* of use of the land and building. The second definition includes the expressions "a nonconforming building" and "nonconforming use of the land." A building could be conforming on a tract in its particular location, yet an identical building could be nonconforming on a tract in another location. Therefore, it is the relationship of the building-to-use, that is, its

physical characteristics to the legally possible uses of the land *as though vacant,* that determine a nonconforming use. The *kind* of use is nonconforming in the case of a warehouse on a residential lot or a residence on a retail lot. The *particular* use itself is nonconforming in the case a warehouse, which violates the building-to-land ratio on an industrial lot. The third definition indicates that "a structure" may be nonconforming due to some characteristic or characteristics that have become illegal, although the *kind* of use might conform to the zoning district.

Thus, the expression, "legally nonconforming use," covers two kinds of situations: an incompatibility of *kind* of use, such as a warehouse in a single-family zoning district, and an incompatibility of the *particular* characteristics, such as impervious cover, building-to-land ratio, setbacks, parking, height, landscaping, curb cuts or signs. Accordingly, the expression, "legally nonconforming use," is generally applied to improved properties and not to vacant land. Vacant land, which does not conform to minimum lot requirements, such as minimum size or width, is not a nonconforming *use,* as it is vacant.

The question of potential use begins with the question of whether it can be used at all, for example, if noncomplying with respect to minimum size. The potential use of a substandard, vacant lot or tract generally depends on its *legal lot status*, such that a lot or tract, which has not been changed in configuration since a certain date, may be developed without regard to whether or not it meets current minimal standards.

The distinction between *nonconforming* and *noncomplying* is useful for the present discussion.

> The term *nonconforming* refers to the kind of use of a property and its zoning district, i.e., the relationship between the kind of improvements and the potential use of the land. If the kind of use is not permitted in the zoning district, it is nonconforming. If the kind of use was legally permitted when it began, but subsequent zoning made it nonconforming, it is a *legally nonconforming use*. A retail center in a residential district and a single-family residence in an industrial district are examples of nonconforming uses.[1]
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> The term *noncomplying* refers to some characteristic of the property that does not meet the specific requirements of the land use regulations. A retail building in a retail district is conforming with respect to use, but may be noncomplying, if it does not have the required number of parking spaces or does not have a sufficient area of landscaping or has more impervious cover than allowed. If the property was legally permitted when it began, but subsequent regulations made it noncomplying, it is *legally noncomplying*.

In the explanation above, it is clear that a property over a *period of time* is changed from conforming to legally nonconforming or from complying to legally noncomplying due to a change in zoning or land use regulations. There is also the situation in which a property is complying, but after a taking, i.e., the after property, becomes noncomplying. It does not appear that a conforming property, using the above distinction, becomes nonconforming due to a taking. If the same zoning controls the after property, it cannot change to a new *kind* of use[2]. (Of course, if the question involves whether a downzoning involves a compensable loss, then there could be a change from a conforming use to a nonconforming use.)

There has been an evolution of the concept of legally nonconforming use, as is shown in the various editions of *The Appraisal of Real Estate*. The primary valuation question of legally nonconforming properties concerns the Cost Approach and the allocation of value between land and improvements. For many appraisals of legally nonconforming properties, one might argue that, since a legally nonconforming cannot be replicated, i.e., one cannot buy a vacant site similar to the subject site and construct the subject improvements, the Cost Approach is inapplicable. However, in eminent domain appraisals, dealing with partial takings, it is often assumed that an allocation of land value and improvement value requires application of the Cost Approach. This is not so. Estimating the market value of the site and deducting it from the value of the property from the other applicable approaches can serve for the basis of the allocation.

Some simple cases may serve to bring out the considerations and how the various allocations might affect an analysis in eminent domain appraisals.

The subject property is a corner site with a single-tenant retail building, the Zip-In Convenience store, located at 766 North Main Street. The site is zoned Single Family Residential; research indicates that the zoning cannot be changed. The site is 100 feet x 120 feet or 12,000 square feet and the building is 40 feet x 60 feet or 2,400 square feet. From the Income Approach and Sales Comparison Approach, the reconciled

value of the property is $200,000.

Let us say that the site, considered as though vacant with a highest and best use for a residential use, has a value of $20,000; if it had the appropriate retail zoning for its improvements, the site would have a value of $5.00 per square foot or $60,000. If the improvements were on a retail site, they would have a depreciated value of $140,000.

There are three, perhaps four, possible allocations.

Allocation A. Following standard methodology of valuing the land as though vacant, the indication by the Cost Approach is $160,000. By being legally nonconforming (and can, let us assume, continue indefinitely and be restored if it were to be destroyed[3]) there is a $40,000 added value. According to one argument, the added value should be allocated to the improvements, since there would be no added value without the improvements. Considered to accrue to the improvements, it conceptually has been called "positive economic obsolescence."[4] It would be better to call it "non-entrepreneurial profit," based on the idea that profit is the difference between basic cost and market value. The term "non-entrepreneurial" applies, because no one could buy a vacant site (similar to the one in the nonconforming use), duplicate the nonconforming improvements and achieve it. If the non-entrepreneurial profit goes to the improvements and there was a taking of 5 feet off the rear for 500 square feet, the taking land has a value of 500 square feet x $1.67 per square foot or $835 (derived from the residential land value).

Allocation B. Here the land is valued as it contributes or functions to the property as a whole. That is, the land is serving as retail land, supporting the retail building, parking, signage, etc. and functioning with the improvements to form an economic property. As a legally nonconforming use, the property can continue in its use, which means the land can continue to serve as a retail use. In this argument, the land was serving for a retail use before the imposition of the residential zoning and the land can continue in that use. In this interpretation, it is not the case that merely the building is the cause of the nonconformance (with land having a residential value only), but it is the land that is nonconforming in its use. Therefore, the land, functioning as retail land, has a value of $60,000; the taking land, then, has a value of 500 square feet x $5.00 per square foot or $2,500.

Allocation C. Here the property as a *whole* is functioning as a nonconforming property, with the nonconformance being neither solely a function of the improvements nor solely a function of the land. If the property were typical, its land value would be $60,000 and the value of its improvements would be $140,00. The non-entrepreneurial profit is apportioned based on the contribution of each. Of the $200,000 combined value, the land is 30 percent and the building is 70 percent of the property value. Therefore, 30 percent of the non-entrepreneurial profit or $12,000 is attributable to the land and 70 percent or $28,000 to the improvements. Therefore, the land has a value of $32,000 ($2.67 per square foot) and the improvements a value of $168,000. (see chart below)

Is one of those allocations right and the others wrong? Let consider some passages from various editions of *The Appraisal of Real Estate*.

From *The Seventh Edition* (1978):

> Land is valued as if vacant and available for its highest and best use. (Page 43).

> Sometimes zoning changes, in creating a condition of monopoly, allow the older, nonconforming properties a land utilization with which new buildings cannot compete. Over the past half-century there has been a trend to reduce the percentage of the lot that the building is permitted to occupy. Thus properties with buildings constructed in the past, under more liberal land coverage provisions, *may give the land a monopoly value* for the life of the existing improvements. [author's italics] (Page 119).

The second passage states that the land may gain a monopoly value. The term "monopoly value" does not appear in later editions and is not explained; however, it is given to the land and in our example, the amount of the "monopoly

COMPARISON OF ALLOCATIONS

Allocation	A		B		C	
	$/SF		$/SF		$/SF	
Land Value	$1.67	$20,000	$5.00	$60,000	$2.67	$32,000
Improvement Value	$75.00	$180,000	$58.33	$140,000	$70.00	$168,000
Property Value	$83.33	$200,000	$83.33	$200,000	$83.33	$200,00
Taking Land		$835		$2,500		$1,335

value" is $40,000. This would be Allocation B. The idea of the monopoly, presumably, is based on the fact that in our case no vacant, residential land would be available on which the same improvements as the subject could be constructed. Therefore, in comparison to similar residential land, the subject land has a monopoly on retail improvements; however, it is not a monopoly in comparison to vacant retail land.

From *The Eighth Edition* (1983):

> The value of land is always estimated as though vacant. [One exception to this rule concerns legally nonconforming improvements …] (Page 247).
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> Occasionally, parcels of land have been developed to an intensity that is higher than would be allowed under current zoning. For example, an apartment project might have more units per acre than allowed under a new land use plan and zoning regulations. If 25 percent more land would be needed to accommodate the same number of apartments, *the land under existing improvements use may be worth more than if it were vacant*. This type of situation is the one exception to the rule that land must be considered as vacant when estimating its highest and best use and value. [author's italics] (Page 262).

The Eighth Edition, concurring with the *Seventh*, favors attributing the nonentrepreneurial profit to the land. Again this is Allocation B. It is important to note that the exception of the rule extends to estimating highest and best use of the land. If the land under the existing improvements has a higher value than as though vacant, that is its highest and best use. This is a confusion, which the author will address shortly.

From *The Ninth Edition* (1987):

> The value of land is generally estimated as though vacant. [Land with legally nonconforming improvements is an exception to this rule]. (Page 273).

In most nonconforming use situations, the property value estimate reflects the nonconforming use. Land value, however, is based on the legally permissible use, assuming the land is vacant and its value can be deducted from the total property value. The remaining value reflects the contributions of the existing improvements and a possible bonus for nonconforming use. The appraiser may find it helpful to allocate value separately to the nonconforming improvements and the bonus created by the nonconforming use.

Usually, any bonus resulting from a nonconforming improvement and use is directly related to the existing improvements. Therefore, the extra income or benefit should be capital-

ized over a time period that is consistent with the economic life of the improvements. Page 287.

The Ninth Edition seems to agree with the *Seventh and Eighth Editions* insofar as the second sentence allows that land with legally nonconforming improvements may be an exception to the rule of valuing land as though vacant. The "always estimated as though vacant" in the *Eighth Edition* is replaced with "generally estimated as though vacant." However, in the second passage it is stated that with respect to nonconforming properties land is valued as though vacant and put to a legally permissible use. The land value as though vacant is deducted from the total property value to derive the value of the improvements. This would be Allocation A. The sentence, "The appraiser may find it helpful to allocate value separately to the nonconforming improvements and the bonus created by the nonconforming use," is not clear with respect to the criteria for the allocation, whether it is to land, improvements, both or neither. In our example, does this mean a possible allocation is the following?

Allocation D	
Land Value	$ 20,000
Improvement Value	$140,000
Non-entrepreneurial profit	$ 40,000
Property Value	$200,000
Taking Land	$835

On the other hand, does it mean to allow for Allocations A and B and C at the appraiser's discretion? If "helpful" means to select an allocation that suits a particular need, then the text is not helpful at all. One way to understand Allocation D is that the value land as though vacant and the cost of the improvements do not have the non-entrepreneurial profit, except as an inseparable unit, which does not permit allocation by either Allocation A or B or C.

From *The Tenth Edition* (1992):

The value of land is generally estimated as though vacant. When land is already vacant, the reasoning is obvious; an appraiser values the land as it exists. When land is not vacant, however, land value depends on how the land can be utilized. Therefore, the highest and best use of land as though vacant must be considered in relation to its existing use and all potential uses. [From a comment to Standards Rule 1-3(b): "This guideline (appraising land as though vacant) 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."] [author's italics] (Page 279).

When valuing land with a legally nonconforming use, an appraiser must recognize that the current use may be producing more income and thus have more value, than the property could produce with a conforming use. … In most nonconforming use situations, the property value estimate reflects the nonconforming use. *Land value, however, is based on the legally permissible use, assuming that the land is vacant*. The difference between the property value and the land value reflects the contribution of the existing improvements and possibly a bonus for the nonconforming use. The appraiser may find it helpful to allocate value separately to the nonconforming improvements and the bonus created by the nonconforming use. Usually any bonus resulting from a nonconforming improvement and use is directly related to the existing improvements. [author's italics] (Pages 292 and 293).

As in the *Ninth Edition*, there is the acceptance of an exception to the rule of appraising land as though vacant. There is added a footnote quoting from *USPAP*, which allows that the contributory value of land may differ from its value as though vacant. However, it is stated unequivocally in the second passage that (in nonconforming use situations) land value is based on its legally permissible use as though vacant. This again is Allocation A. No cases are given to show how the value of land as though vacant could be different from its contributory value. Nor is the expression "contributory value" explained in relation to land.

From *The Eleventh Edition* (1996):

The value of land is generally estimated as though vacant. When land is already vacant, the reasoning is obvious: an appraiser values the land as it exists. When land is not vacant, however, land value depends on how the land can be utilized. Therefore, the highest and best use of land as though vacant must be considered in relation to its existing use and all potential uses. [From the comment to Standards Rule 1-3(b): "This guideline (appraising land as though vacant) 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."][5] (Page 302).

When valuing land with a legally nonconforming use, an appraiser must recognize that the current use may be producing more income and thus have more value, than the property could produce with a conforming use … *The site should be considered as though vacant and available for development under a less intense use.*

In most nonconforming use situations, the property value estimate reflects the nonconforming use. *Land value, however, is based on the legally*

permissible use, assuming that the land is vacant. The difference between the property value and the land value reflects the contribution of the existing improvements and possibly a bonus for the nonconformance. (Note: Alternatively, some practitioners believe that the value added in a downzoning should not be attributed solely to the improvement, but should be allocated between the improvement and the land. This is commonly accomplished by applying a ratio to the overall property value, which reflects typical ratios of the contributions of land and improvements to value in similar market property not affected by downzoning.) The appraiser should recognize the separate value of the nonconforming improvements and the bonus created by the nonconforming use.

Usually any bonus resulting from a nonconforming improvement and use is directly related to the existing improvements. [author's italics] (Pages 314 and 315).

In some circumstances, the appraiser of a property may require that the site be considered in terms other than its highest and best use. In an appraisal to estimate the *use value* or legal, nonconforming *use value* of an improved site, *an appraiser may need to the value site according to its specified use or the existing improvements*, not its highest and best use. In this case, *the appraiser should value the site both in terms of its highest and best use and its conditional use.* [author's italics] (Page 324).

This differs little from the *Tenth Edition* with the exception of allowing in a footnote that some appraisers allocate the bonus value, using a ratio, between land and improvements "in a downzoning." It is not clear whether only in downzoning cases is this done or whether it applies to all legally nonconforming properties. This is the first recognition of Allocation C albeit in a footnote and apparently with respect to downzoning. Instead of the language "The appraiser may find it helpful to allocate value separately to the nonconforming improvements and the bonus created by the nonconforming use" there is this language: "The appraiser should recognize the separate value of the nonconforming improvements and the bonus created by the nonconforming use." Again, this doesn't clarify whether the bonus value should attach to the land or improvements (or both or neither).

The last passage indicates that the site can be valued as it contributes to the existing use; this is use is a "conditional use (of the site)." Apparently, *value of the site under its conditional use* is the same as its *contributory value* (as referred to in the USPAP]. In addition, the appraiser *should* value the site with respect to both its highest and best use (as though vacant) and its conditional use, when, presumably, the value of the conditional use is estimated. This seems to contradict the second passage, which states that land is appraised as though vacant with the bonus value accruing to the improvements (unless the possible nonconforming use specifically runs with the land). It is unclear in what circumstances ("In some circumstances") the appraiser may estimate the value of the site under its conditional use, if land is valued as though vacant and the bonus value accrues to the improvements. In the *Eighth Edition* it is implied that the highest and best use of the site could be its use under existing improvements and not as though vacant. This was based, presumably, on the recognition of the possibility that the value of the site at its highest and best use as though vacant can be *less* that its value under its (legal) conditional use. The problem through the various editions is an ambiguity with respect to the expression "land value," which vacillates in meaning between "market value of the land" and "value in use of the land."

Let us consider a typical case used in these discussions. An apartment site can legally (as of the date value) only have 20 units, but is improved (as a legally nonconforming use) with 24 units. The adjacent site is similar in all respects, but it is improved with 18 units. The market recognizes $5,000 per unit for land value. Should the value of the sites be $120,000 and $90,000, respectively, recognizing in one case an over-improvement and in the other an under-improvement? Alternatively, is the market value of each site $100,000? It is inconsistent to argue that in the case of the over-improvement the market value of the land is its contributory value, while in the case of the under-improvement its market value is as though vacant. The market value of each site is $100,000. The value in use of one site is $120,000 and the value in use of the other is $90,000.

Conclusion

The logic for appraising both under-improvements and over-improvements should be the same. The contributory value of the site to the existing use of the improvements is the site's *value in use*, which may or may not be the same as its market value.

The confusion between market value and value in use creates the problem of allocation. On the one hand, under-improvements may be demolished in order to use the site for its highest and best use. On the other hand, over-improvements may be preserved as long as possible to maintain the non-entrepreneurial profit. The non-entrepreneurial profit is attributable to the improvements and the market value of the land is based on its highest and best use as though vacant. That is the basis for recognizing the improvements as *over-improvements*.

Considering all of the arguments, if the appraiser *must* allocate a property's value between land and improvements in an eminent domain appraisal, where the type of value is market value, land should

be valued as though vacant. It would be improper to substitute the contributory value of the site in a legally nonconforming use, as that would be *value in use*. Therefore, Allocation A is the right allocation. Noting the evolution of the concept of legally nonconforming use and the resolution of allocation problem, it is no wonder that the most tangled web the appraisal community has woven and, continues to weave, centers on the Cost Approach, especially the concept of depreciation. Now with "positive economic obsolescence" someone has discovered a positive form of depreciation. Isn't that an oxymoron? ■

J. L. Craft is a commercial fee appraiser and principal of J. L. Craft & Associates in Austin, Texas. He has worked with various government agencies including the Lower Colorado River Authority and the City of Austin, Texas. An approved IRWA instructor and a member of the Appraisal Institute, Mr. Craft earned a doctorate from the University of Texas at Austin and was awarded a grant by the National Endowment for the Humanities for postdoctoral studies at Cornell University.

Notes

[1]The author is speaking in general terms here, as different municipalities have different zoning regulations; for example, with respect to the inclusion of less "dense" (or intrusive) uses in more 'dense' districts. Typically, the hierarchy of 'density' runs like this (for less to more "dense"): single-family residential, multi-family residential, office, retail and industrial.

[2]The exception might arise if there is a Condemnation Ordinance that allows for mitigation in certain cases; for instance, if a variance is permitted, because the taking caused the change of highest and best use of the After.

[3] Different municipalities have different regulations concerning the repair, restoration and even life of legally nonconforming improvements. The author has simplified the case for illustrative purposes.

[4]J. Mark Quinlivan and Vance R. Johnson, "Nonconforming–Use Properties: The Concept of Positive Economic Obsolescence," *The Appraisal Journal* (January 1981)

[5] In USPAP, effective March 31, 1999 the sentence in S.R. 1-3(b) referring to the possible difference between the land value as though vacant and the contributory value of the land is omitted.