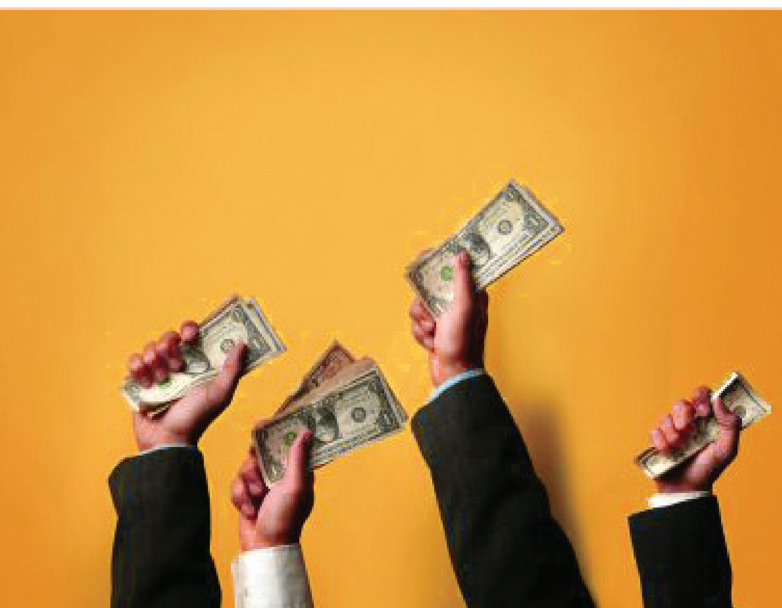
OFFERS AS A MARKET VALUE INDICATOR

Can offers to purchase real estate be used as the primary indicator to derive market value in a court of law?



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When property is up for sale, the offers represent the property's worth from the buyer's perspective, which, depending on the marketplace, will commonly set the lower limit of value.

In many litigation situations, offers are inadmissible as evidence. In a condemnation, for example, the condemnee could disingenuously present insincere offers by parties (friends or relatives of the owner-condemnee) who have no intention of buying, in an effort to demonstrate the appearance of demand and boost property value. Rather than rely on false or mistrusted indicators of value, courts often rule that offers are inadmissible.

So what consideration, if any, should be given if there are multiple offers from credible, knowledgeable potential buyers who are ready, willing, and able to buy the subject property at the offered price?

IRS VALUATION STANDARDS

The valuation standard required by the Internal Revenue Service is fair market value, which it defines 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 to sell and both having reasonable knowledge of relevant facts."

According to USPAP Standards Rule 1-5, offers are not required to be analyzed as part of the appraisal process. USPAP states, "When the value opinion to be developed is market value, an appraiser must, if such information is available to the appraiser in the normal course of business, analyze all agreements of sale, options, and listings of the subject property current as of the effective date of appraisal…"

Under this rule, offers to buy are not required to be analyzed. However, in the Frequently Asked Questions section that accompanies USPAP's 2010-2011 edition, it states that an appraiser must not commit a substantial error of omission or commission that significantly affects an appraisal.

A RECENT CASE

I served as an expert witness in Texas for the Department of Justice in a case that was recently decided and upheld on appeal. The case was *Michael R. Levy, as Independent Executor of the Estate of Meyer Levy, Deceased, v. United States of America,* United States Court of Appeals, Fifth Circuit.

The case centered around property owned by Meyer Levy, who died on March 25, 2001. He owned a valuable parcel of real estate in Plano, Texas, an affluent suburb of Dallas. At the time of his death, his tract of land, which he had owned for more than 40 years, was roughly 93 acres in size. While the surrounding areas of Plano experienced enormous physical and economic growth, his property had become the last large tract that remained undeveloped.

As indicated in Figure 1, the subject tract is the dark shaded area in the center. An adjoining 300-foot tract that separates the subject property from Preston Road is also undeveloped. The subject property extends from Parker Road south to Tulane, and it is plainly visible that nearly all of this part of Plano is built out except for the subject and the adjoining tract.

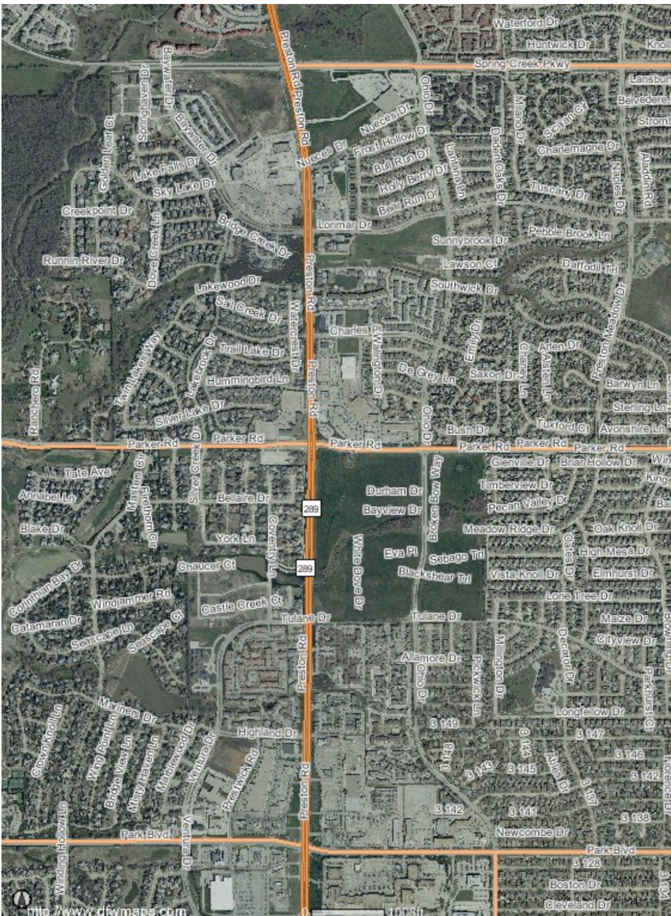

FIGURE 1

On its land use plan, the city of Plano included Mr. Levy's land as residential, although it was zoned for agricultural, which is a holding classification. He had tried unsuccessfully to get the land rezoned for commercial or industrial use. At the time of his death, his lawsuit appeal which attempted to remove his property from Plano's zoning, was pending. The suit was ultimately decided in Plano's favor.

Under these circumstances, the highest and best use of Mr. Levy's land was seemingly residential, a category that would provide an acceptable use to the community, though bringing a lower valuation than expected from the commercial or industrial use zoning he was seeking. At the time, it was well known by the City's planning staff that there was inadequate land available for retirement housing. Plano's desire to have more land available for retirement housing was known prior to the date of value and could be accommodated by a special-use permit within a residential zoning category.

Before his death, Mr. Levy had been entertaining offers to buy his property. After he died, the offers continued. From 2001 through 2003, the estate received multiple offers from several real estate developers in the range of \$20 to 25 million. Generally, they had rezoning requirements, most of them requiring residential use.

In late October 2003, an investor agreed to purchase the property subject to rezoning, and the estate agreed to sell it. In May 2004, the property was rezoned and the sale closed in June 2004 at \$25 million, less 50% of the total tax rollback. On the same day as closing, the buyer resold the property to another development partnership for \$26.5 million.

The alternative date of value, which was six months after Mr. Levy's death, was selected by the estate. This date of value was two weeks after the terrorist attacks of September 11, 2001, and the estate argued that a weak economy at the time, combined with the agricultural zoning and the negative effect of the terrorist attack depressed the property value. Immediately following the 9/11 terrorist attacks, an offer came in at \$15 million. However, this offer was made by the same party who had offered \$23.5 million before 9/11. This huge reduction formed an important basis for the estate's assertion that 9/11 brought a loss in value.

The federal estate tax is based on the fair market value, less deductions and exemptions, of all assets one leaves upon death; or, if less, upon the alternate date which is six months after death. Mr. Levy's executor initially filed an estate tax return reporting that the land had a fair market value of \$4,250,000 as of the date of death. Later, the estate reported the land value as of the alternate date at \$3,600,000. The IRS challenged the estate tax return.

At trial, the estate's appraiser opined that the property value was \$5,260,000 as of September 25, 2001. The Estate and the IRS contested the valuation of the property. The estate paid \$3,236,377 in additional estate taxes and brought suit for a refund. The jury

in the trial court determined that the value of the property was $25 million. The jury also provided a 0% discount related to the valuation of an interest in a family limited partnership.

THE REAL ISSUE

With the likelihood of rezoning in 2001 had residential rezoning then been applied for, the multiple offers in the range of $20 to $25 million demonstrated the expectation of that price range. Refusals by the owner of written offers and other expressions of interest totaling $23 to $25 million from credible arm's-length purchasers demonstrated the owner's confidence that the expected price was a minimum of $23 to $25 million.

These offers provided an indication of the lower limit of fair market value at $23.5 million as of September 25, 2001, before certain expenses of sale. However, from the date of value in 2001 through the closing date in June 2004, the estate's expert economist claimed that there was no indication of rapid price appreciation in the area.

In my opinion, the actual offers, which set a lower limit on value, were a far better indicator of the subject property's value than the sale price of another piece of land. This was the last remaining undeveloped parcel in the area. The prospective buyers included two of the largest national homebuilders, a large Dallas-area homebuilder and a major retirement home operator, all of whom had performed extensive acquisition due diligence. These were knowledgeable, financially strong companies in 2001–2002, so it is safe to say that their offers set the lower limit on fair market value.

Some of the prospective purchasers had been willing to rezone the subject property at their own expense. As a conservative measure, a 1% amount was deducted from my opinion of fair market value as a seller's expense, for attorney and land use planner fees for rezoning ($235,000).

VALUATION CONSIDERATIONS

The tax rollback as of August 2001, if triggered then by a change from agricultural use value, was estimated at $596,412 plus $117,092 for interest. This total is $713,504. One half of this amount ($356,752) is estimated to be paid by the seller.

The value indication within the sales comparison approach using offers was appraised as follows:

Gross selling price	$23,500,000
Less: Rezoning expenses	–235,000
Less: 50% of tax rollback	–356,752
TOTAL VALUE	$22,908,248

An important consideration in my analysis was the retrospective nature of this appraisal. The rezoning of property from agricultural to residential with permission for a retirement facility on a portion was a foreseeable event providing its highest and best use. Offers to purchase that were extended prior to the date of value were supportive of a floor on fair market value.

Offers subsequent to the date of value were noted in the appraisal to confirm trends. Research into the effect of the terrorist acts of 9/11 supported the expectation that 9/11 had no effect on residential land values in Plano.

The opposing party offered local economic statistics to demonstrate that the sale in 2004 occurred in a stronger economic situation. But the same expert economist pointed out data to demonstrate that land prices had increased little between 2001 and 2004. Appropriate analysis of this data implied that the $25 million price received in 2004 (flipped for $26.5 million) was little different from what could have been received in 2001.

THE APPEAL

The estate of Meyer Levy appealed the decision. It asserted a number of issues. In particular, it claimed that the appraisal methodology of using offers was improper, as was using the assumption of a rezoning in 2001. The appeals court supported the appraisal methodology and rezoning assumption. They let the jury verdict $25 million stand stating, "We affirm the judgment and address the numerous points of error raised by the Estate."

RULINGS ON EVIDENCE

The estate argued that the trial court erred when it allowed the admission of evidence of the ongoing negotiations over the sale of the property, specifically the offers and proposals, as well as evidence of the listing price and ultimate sale price. The Estate also argued that the evidence concerning the property negotiations were not relevant to the determination of the fair market value of the property on September 25, 2001.

Offers to buy and sell property are not frequently considered admissible as evidence of fair market value, as the offers that typically come from third parties were usually unidentified. In most of these cases, there was no evidence that the party making the offer had the expertise or qualifications to give his opinion on value had he been called at trial. However, in this particular case, the proposals came from identified, sophisticated developers who could be reasonably expected to have investigated the value of the land before making a proposal. Presumably, the developers could have been called to testify had the estate desired to test their knowledge under cross-examination.

The court ruled that offers to purchase were admissible as evidence of fair market value when they were part of ongoing negotiations resulting in a contract with substantially the same terms. With one exception, which the parties agreed was unreasonable, the offers were between $20 million and $25 million. The estate held out for $25 million throughout all of the negotiations, and that was, in fact, the final sale price. The evidence of the negotiations was consistent with the actual sale and was admissible.

The estate contended that the evidence of the final sale price was inadmissible because the sale was contingent on rezoning and too remote in time. To be relevant, the eventual sale of the property must be within a reasonable time. However, a previous court ruling held that a trial court did not abuse its discretion in admitting evidence of comparable sales that took place more than three years after the valuation date. In this case, the contract was signed two years after the valuation date, but unlike the sale evidence using comparables, this case was for the actual land at issue, not comparable land. The estate's expert also testified that the real estate market in Plano was relatively flat, so the sales price would be an accurate comparator.

The estate further argued that the sale price was inadmissible because the rezoning of the land to single-family and retirement community use was not foreseeable. Levy himself had tried to have the property rezoned to no effect. They argued that the eventual sales price was unforeseeable and therefore, the land must instead be valued as agricultural. But Levy's attempted rezoning was aggressive and unrealistic. The land use plan had anticipated that the property would be rezoned to at least single-family homes. That the property would be rezoned to allow for some type of development was entirely foreseeable. It was determined that the district court did not abuse its discretion in admitting evidence of the actual sale price of the property. Nor did the court abuse its discretion in allowing testimony regarding the listing price of the property because it was not based on pure speculation.

The estate also contended that the district court erred when it denied the estate's motion to exclude my expert testimony after being retained as the government's valuation expert. It was the trial court's decision to admit expert testimony. District courts are given wide latitude in determining the admissibility of expert testimony, noting that the discretion of the trial judge will not be disturbed on appeal unless manifestly erroneous.

Admission of expert testimony is governed by Rule 702 of the Federal Rules of Evidence. The part of Rule 702 that the estate urged on appeal is the methodology I used to arrive at my valuation of the property, which the estate argued was novel and likely invalid. Specifically, the estate contended that using offers as part of my basis for valuation was an unrecognized appraisal method, and that my assumption that the property would be rezoned improperly relied on hindsight rather than on facts known to the parties at the time.

The appeals court ruling stated, "Because we have already recognized the admissibility of offers under the circumstances of this case, we cannot say that the court abused its discretion in permitting Friedman to refer to such offers, with appropriate contingencies, in his valuation analysis."

My assumption that the property would be rezoned for single-family housing was reasonable. It was determined that the trial court did not abuse its discretion in admitting Friedman's expert testimony. The estate, as a taxpayer, requested that the U.S. Supreme Court hear an appeal, but the Supreme Court declined to do so, letting prior decisions stand.

CONCLUSION

The number of sincere offers from qualified, knowledgeable and sophisticated buyers provided compelling evidence that their offers set a floor on fair market value. It was not a situation of a single insincere offer by a related party to a condemnee, which should deserve little or no weight. In this matter, with multiple qualified buyers submitting bona fide offers, it was abundantly clear that offers were the best indicator of fair market value.

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Internal Revenue Code, Regulation 20.2031-1.

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With an appraisal practice in Dallas, Texas, Jack focuses on litigation support in appraisal, appraisal review and other real estate matters. He has written or coauthored more than 20 books and 200 articles. He is currently a member of the editorial boards of The Appraisal Journal and Real Estate Issues and has served on the Appraiser Qualification Board of the Appraisal Foundation and the Real Estate Committee of the American Institute of Certified Public Accountants.