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THE TAXATION OF RESTRICTED-USE PROPERTY: A THEORETICAL FRAMEWORK

JERRY A. MENIKOFF*

INTRODUCTION

"[I]ncome must be taxed to him who earns it."[1] This rule, first announced in the landmark case of *Lucas v. Earl*,[2] has properly been described as "the first principle of income taxation."[3] In the wake of *Lucas v. Earl,* countless courts and commentators quickly moved to the task of refining that proposition into a workable rule of law. In the words of the very metaphor that became a catch-word to the initiated, the law relating to assignments of income was the very ample fruit produced by *Lucas'* tree.

The student of property tax is not hard pressed to improvise a similar aphorism for that field. Such a "first principle" might be phrased as follows: "The value of property must be taxed to him who owns it." Unfortunately, this naked statement is not of itself very useful. Like the rule of *Lucas v. Earl,* it requires further evolution to develop its applicability. Only then could it be of use in serving its proper function: one of determining *who* is to be taxed on the basis of the ownership of *what* property rights.

Perhaps because of the lack of a *Lucas v. Earl* for the property tax field, first principles have received little attention. Thus, it has been observed:

> Statutory regulation of a unitary taxing system begins in most states with the fundamental provision that "real property" shall be taxed to its "owner." Unfortunately, as a guide to those concerned with the assessment process, the term "owner" is a highly ambiguous one. . . .
>
> The ambiguities of the ownership idea are compounded by statutory definitions of real property. A common definition is:
>
> " 'Real property' includes the land itself . . . and all rights and privileges belonging or appertaining thereto."
>
> If, then, "real property" is to be assessed to its "owner," should not the "owner" of "rights and privileges" be taxed in proportion to the value of his "rights and privileges"? And is it not clear that a wide

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1. Commissioner v. Culbertson, 337 U.S. 733, 739-40 (1949).
2. 281 U.S. 111 (1930).
3. Commissioner v. Culbertson, 337 U.S. 733, 739-40 (1949).

> variety of persons may own some "right" or some "privilege"? . . . Obviously these statutes can be used to justify virtually any action taken by an assessor . . . .[4]

Answers to the questions posed do exist; they do not, however, appear directly on the surface of the existing case law. What is needed is a deeper examination into the fundamental rules that underlie property taxation, rules that are more specific than the general proposition outlined above. The approach taken here toward determining those rules centers upon two aspects of the subject that might at first seem self-evident: one is the concept of a *tax* on property, while the other is the definition of property itself.

That a property tax should be influenced by the underlying system of property rights is not very surprising. What is surprising is that little has been done toward developing this relationship. Much of this article, therefore, will be centered around various property concepts and the manner in which they shape the field of property taxation. At the same time, it is also important to keep in mind that the ultimate subject matter is a tax. Its purpose is to raise revenue, not to define the relationship of rights between two claimants to a piece of land. This consequence suggests that a blind adherence to the rules laid down in real property treatises would be inappropriate. The only sensible approach to this area must involve a blend of concepts from both tax and property law, with each appropriately modified so as to achieve a workable union.

While the ultimate goal of this presentation is to develop a theoretical foundation for analysis of property tax issues, too theoretical a presentation risks losing touch with reality. Consequently, discussion will concentrate upon a relatively concrete problem: the appropriate method for taxing properties that are burdened or benefitted by private restrictive agreements. While this particular problem will remain the focus throughout, it will nevertheless permit the elucidation of a more general concept that it is hoped will be of use in many aspects of property taxation.

I. The Problem and a Proposal

No property owner is totally free in the exercise of his property rights. Nuisance laws assure that use of the property will not invade certain protected interests of neighboring property owners. Similarly,

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4. Nichols, *Real Property Taxation of Divided Interests in Land,* 11 KAN. L. REV. 309. 310-11 (1963) (citations omitted).

zoning laws limit property use in a manner designed to ensure harmonious uses of property in a particular area. Both of these types of restraints are *public* restrictions upon private property. They represent a public determination that public welfare will be substantially advanced by prohibiting the unrestricted use of an individual's property.

For the purposes of property taxation, it seems quite proper to recognize public restrictions in the valuation process. Both the restrictions and the tax are imposed in the name of the state.[5] It defies notions of fundamental fairness to imagine that the state can on the one hand take away the exercise of a property right, and on the other, assess and tax the owner as if he still possessed it. In a legal proceeding challenging such an assessment, the state should properly be estopped from maintaining that the restricted use still exists in the hands of the property owner.[6]

Property can also be subject to *private* restrictions: agreements among landowners that impose restrictions on use over and above any public regulations. For example, a neighborhood association may require its members to maintain their homes in a certain manner. Or, a developer of a new community may set aside some land for open space, and invest residents of that community with the right to ensure the land is so maintained. Perhaps the most simple example is an easement allowing a property owner to travel over his neighbor's property.

The proper tax consequences of a private restriction are far less clear than those relating to public restrictions. To the extent that it has been recognized for tax valuation purposes, the private restriction has permitted private action to reduce the taxable value of a piece of property. Of course, such a reduction may be accompanied by an increase in the taxable value of some other person's property; the increase, however, will not necessarily equal the reduction. Consequently, the problem confronting taxing authorities may be similar to that caused by an assignment of income: a loss in total revenue.

What is needed then is an "assignment of income" doctrine for property taxation, one that answers the following array of questions suggested by the private restriction:

> How should a restrictive agreement affect the assessment of a piece of real property?

5. The "state" is used here in the sense of the ultimate authority responsible for the actions of its political subdivisions.

6. *See generally* Heller, *The Theory of Property Taxation and Land Use Restrictions,* 1974 Wis. L. Rev. 751.

> Would it be proper for an assessor to ignore the existence of a restrictive covenant, and assess the property as if it were unencumbered?
> Does it matter whether another piece of property is benefitted by the encumbrance?
> If so, is it also important whether the full value lost by one piece of property as a result of the encumbrance is added to another piece?
> Does that other "benefitted" piece of property have to be improved solely as a result of the owner's contractual rights? Or are contractual rights irrelevant?
> May a property owner oppose an assessment on the ground that rights attributed to him are being taxed to someone else?
> To what extent should the property tax system ordinarily take account of the interaction between pieces of property?

The ultimate conclusion reached herein is that private restrictive agreements can and should be ignored in the valuation of burdened property. Every unit of real property should be valued as if the rights appurtaining to it could be freely exercised. To do otherwise would allow erosion of the tax base. While this result might seem inequitable, in that it taxes a property owner on rights that he has surrendered, it is in fact fully consistent with more general themes in the property tax arena that run counter to principles of equity.[7] Indeed, what is suggested here is the recognition of the following as a "first principle" of property taxation:

> The basic legal unit for valuation purposes is the fee simple. Every property right is part of exactly one fee simple, and should be taxed as part of that fee simple.

The use of the fee simple as a compartmentalization device serves a number of purposes in addition to preserving the tax base. It both allows for the consistent valuation of property rights, and greatly increases the administrative efficiency of the system.

A counterpart of the rule just announced should also be noted at the outset: nothing in the above analysis requires that agreements among landowners be ignored in assessing properties whose values are *increased* by the existence of the agreement. Admittedly, taxing property rights according to fee simple interests does mean that the owner

7. For example, in striving for an objective measure of value, property tax systems will usually ignore circumstances personal to a property owner. Thus, a person who uses his property poorly, leases it at a rate less than what the market will support, or sells it below market value, will end up paying a property tax disproportionate to the value he obtains from the property.

of a benefitted property cannot be taxed on the value of rights that have been imputed to the owner of a burdened property. It is quite another matter, however, to recognize that a restrictive agreement may alter the use of burdened property in such a way as to increase the *value* of rights that are a part of the benefitted property owner's fee simple. The failure to perceive this distinction—that there is a conceptual difference between *A's* being taxed on *B's* right, and *A's* being taxed on the increase in value of his own rights resulting from the restriction on *B's* right—is a frequent source of confusion in the property tax area.[8]

An understanding of the following valuation rule, which is an extension of the "first principle" categorization concept suggested above, should minimize confusion:

> The value of the rights contained within any fee simple cannot be measured without reference to the manner in which rights attached to neighboring properties are used. More simply, property can only be valued in the context of its surrounding environment. How that environment came to be the way it is, whether by the voluntary actions of neighboring landowners, or by the use of incentives created by the owner of the fee simple to be assessed, is irrelevant.

Again, much of this article is intended to explain this statement, and to demonstrate its place in the structure of the property tax system.

II. A Case Study: The New York Rule for The Taxation of Easements

An easement is a property right that permits its possessor to restrict the uses to which a piece of property may otherwise be put.[9] It may be negative in nature, such as prohibiting any construction on the encumbered land, or it may be affirmative, such as granting the easement owner the right to travel upon the land. In either instance, it effectively limits the property owner's exercise of his rights and thus provides a typical example of a restrictive agreement.

One easement in particular—the easement appurtenant—deserves singular treatment. The benefits of such an easement accrue not to an individual, but rather to a specific piece of property.[10] When that benefitted property is sold, the adjunct easement rights accompany

8. *See* text accompanying notes 9-49 *infra.*

9. 2 American Law of Property § 8.5 (A.J. Casner ed. 1952).

10. *See id.* § 8.71 (citing 1 Restatement of Property § 487, comment a (1944)).

it. Under these circumstances, the easement interest itself can be envisioned as a real property interest—one attaching to the benefitted estate. As a result, the creation of an easement presumably does not remove any interest from the scope of a property tax imposed upon all real property; it merely transfers a right from one property to another. This outcome contrasts markedly with the treatment accorded to leasehold interests, which are personal property and thus exempt from a tax on real property.[11]

These characteristics of easements appurtenant have caused them to receive unique treatment for property tax valuation purposes.[12] Unlike other restrictions on the use of property, the legal treatment of which is often subject to confusion,[13] it is uniformly recognized that an easement can be taken into consideration in valuing a servient tenement.[14] While the thesis of this article is that easements have generally been treated incorrectly, an examination of that treatment may nevertheless prove fruitful.

The present construction of easement interests is founded upon New York case law. The general New York rule with respect to restrictions on the fee holder's use of his property is best stated in the

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11. For example, in Fort Hamilton Manor, Inc. v. Boyland, 4 N.Y.2d 192, 149 N.E.2d 856, 173 N.Y.S.2d 560 (1958), the taxpayer leased portions of the Fort Hamilton Military Reservation from the federal government. Under applicable federal law, and the terms of the lease, the United States waived its exemption from local property taxes, and the lessee assumed an obligation to pay those taxes. Nonetheless, the New York Court of Appeals determined that no taxes were owing on the leasehold interest, for it was personal property, and thus not encompassed by the state's tax on real property.

12. Henceforth, following the spirit of the case law, "easement" will be used as shorthand for appurtenant easements. An easement "in gross," which does not benefit specific property, receives very different tax treatment. *See, e.g.*, Supervisor of Assessments v. Bay Ridge Prop., Inc., 270 Md. 216, 225-26, 310 A.2d 773, 778 (1973).

13. *Compare* Bensalem Township School Dist. v. County Comm'rs 8 Pa. Commw. Ct. 411, 303 A.2d 258 (1973) *with* Knickerbocker Village, Inc. v. Boyland, 16 A.D.2d 223, 226 N.Y.S.2d 982 (1962), *aff'd*, 12 N.Y.2d 1044, 190 N.E.2d 239, 239 N.Y.S.2d 878 (1963). In *Bensalem Township*, the Pennsylvania legislature had passed a statute allowing counties to contract with landowners to preserve properties in their undeveloped state; land governed by such covenants would thereafter be assessed at the lower value representing its restricted status. The court rejected the contention of a school district that the tax statute was unconstitutional, and instead determined that the law merely recognized that the restrictive agreements were proper elements in determining the value of land.

A very different attitude was exhibited in *Knickerbocker Village*, where a public housing company argued that statutory restrictions on the saleability of a particular project should be taken into account by the assessing authorities. The court there determined that since the regulation applied only to the housing company, and not to subsequent owners of the property, it was "personal" to the owner, and should not be included in the valuation process.

14. *See* 5 RESTATEMENT OF PROPERTY § 509, comment d (1944).

1962 case of *People ex rel. Gale v. Tax Commission*,[15] where the Appellate Division observed:

> Except in cases of easement interests, a division of ownership or the independent holding of separate legal interests in taxable property will not affect the mode of assessment. For instance, mortgagor and mortgagee interests, vendor and vendee interests, landlord and tenant interests, life tenant and remainder interests and co-tenant interests are not separately assessed. . . . Thus, in any case, a single assessment of the property, at its full value, as if not subject to a mortgage, a vendor interest, a lease, a remainder or co-tenancy, is all that is required.[16]

Given this remarkably broad rule, the introductory phrase, "[e]xcept in cases of easement interests," is rather intriguing. Why have New York courts singled out the easement as the only type of interest worthy of exceptional treatment? Is it because of its nature as a "real" property interest? Professor Bonbright attempted to answer this question and was able to conclude only that "[w]hy the easement should have received exceptional treatment we are unable to say."[17] The *Gale* court, although quite aware of Professor Bonbright's mystification, could answer only that

> it is the settled rule that, where real property is subject to an easement, the value of the property for tax purposes is to be fixed bearing in mind the outstanding easement interest. The market value of the servient estate is lessened by virtue of its being subject to the easement and the value of the dominant estate is to be increased by virtue of having the benefit of the easement.[18]

The court then justified this rule on the ground that the purpose of the tax law was to value property at its full value.[19] Exactly how this statement led to a treatment of easements different from that accorded a wide array of other split interests, which the court had just concluded were to be ignored in fixing values, was left to conjecture.

The rule stated in *Gale* had its beginning in *People ex rel. Poor v. Wells*,[20] a 1910 Appellate Division case adopting per curium the Special Term opinion. In *Poor*, the court addressed the question of

15. 17 A.D.2d 225, 233 N.Y.S.2d 501 (1962).
16. *Id.* at 228-29, 233 N.Y.S.2d at 504-05 (footnote omitted).
17. 1 J. BONBRIGHT, THE VALUATION OF PROPERTY 497 (1937).
18. 17 A.D.2d at 228 n.*, 233 N.Y.S.2d at 504-05 n.*.
19. *Id.*
20. 139 A.D. 83, 124 N.Y.S. 36, *aff'd per curiam*, 200 N.Y. 519, 93 N.E. 1129 (1910).

whether the land on which Gramercy Park was located had any value for tax purposes. The original landowner, wishing to donate a park to the residents of his neighborhood, had voluntarily subjected his land to easements on the part of all landowners in that neighborhood, each of whom he granted a legally enforceable right to demand that the land remain as a park.[21]

The court initially observed that the tax commissioners had, since the creation of the park, included the full value of the park privileges which accompanied the easements, in the value of the lots surrounding the park. This treatment had the effect of raising the value of these benefitted lots above the value of similar lots not enjoying park privileges. Furthermore, the aggregate of the "excess" valuation of the benefitted lots "amount[ed] to more than what would be the full value of the land embraced within the limits of the park if the same could be sold free and unencumbered."[22]

Having thus determined that, in its view, the city was not losing tax revenue as a result of the arrangement—to the contrary, its tax base had increased somewhat—the court then evaluated the park-owner's contention that:

> when an easement is carved out of one property for the benefit of another the market value of the servient estate is thereby lessened and that of the dominant increased practically by just the value of the easement; the respective tenements should thereafter be assessed accordingly; the determinate question of the assessable value of each of the properties affected being its market value or the amount for which it would sell under ordinary circumstances.[23]

The court concluded that since the assessing authorities had already chosen to recognize the benefit accruing to the dominant tenements, they were effectively estopped from not adhering to the rest of plaintiffs' syllogism. Thus, it required that the assessed value of the servient estate, in this case the park, be calculated subject to the restrictions.

The main emphasis of the opinion centers around the single fact that the court no doubt found conclusive; the *market value* of the property had decreased as a result of the easement. Nevertheless, the court did note the consequences of the arrangement as they affected the city's tax base. Unfortunately, nothing in the opinion gives any indication of the significance of this factor. Had the arrangement

21. *Id.* at 84-85, 124 N.Y.S. at 37.
22. *Id.* at 86, 124 N.Y.S. at 37-38.
23. *Id.* at 87, 124 N.Y.S. at 38.

caused the city to lose revenue, would the court have allowed the assessors to tax the park as if it were totally unrestricted? If so, under what general principle?

The relevance of the actions of the authorities is also left unclear. Would the outcome have differed if the assessors had chosen not to tax the surrounding homes on the increases in value stemming from the easements? Or, alternatively, would the outcome have differed had the homes been taxed on an amount insufficient to offset the revenue lost as a result of the decrease in market value of the park?

Ultimately, the factors relating to the possible loss of revenue and the choice made by the assessors appear to have been treated by the court as giving rise to an *equitable* estoppel: the city chose to view the easement interest as having been transferred to another property. Moreover, it benefitted from that choice, and therefore could not complain about it. While this argument seems superficially plausible, it in fact rests upon an unstated premise of questionable validity, namely, that in complaining about the overassessment of his own property, the taxpayer can bring into issue the assessments of other properties.[24] In what sense is the assessment of one piece of property to be related to that of another? What is there about the nature of the property tax system that requires—or even allows—a property owner to benefit, by having his assessment reduced, from the positive effects the use of his own property has had on other pieces of property? These questions underlie the argument that was accepted in *Poor:* the park was not to be assessed precisely because its "value" was being assessed to other property owners.

The argument might appear to be one merely about *who* should be paying a tax; as such, the problem would not be terribly serious. From the taxpayer's point of view contractual agreements could settle who would ultimately be liable for the tax. And, from point of view of the taxing jurisdiction, there is no reason to suspect that owners of dominant tenements are any more or less financially solvent than owners of servient tenements. The *Poor* court itself seems to treat the issue as one of choosing the taxpayer. Its treatment of the easement as something that is "carved" out of one property, and transferable to another, suggests that the easement is some sort of physical entity, with a corresponding market value.

24. This, of course, is not to say that it is improper for a taxpayer to use the assessments of other properties as evidence of the proper assessment ratio to be applied to his own property.

In fact, much more is at stake. An easement is not a physical unit, and it is imprecise to speak of it as such. Hohfeld has more accurately characterized easements as

> aggregates of right (or claims), privileges, powers and immunities vested in the "owner" of the interest . . . . For this reason it is a serious obstacle to close analysis and clear thinking that courts and writers habitually deal with the easement (as they do with all other legal interests) as if it were a simple unity to be described adequately by a few loose and ambiguous terms . . . .[25]

Once one overcomes the fiction of treating the easement as a physical entity, it is easy to recognize the flaws in treating the easement as having "a value," and in assuming that value to be transferred from one unit of property to another.

It is not difficult to hypothesize cases in which the value lost by a servient tenement is not offset by the increase in value of the dominant tenement. Consider, for example, a situation in which a hypersensitive property owner is willing to pay his neighbor to discontinue some productive activity he finds irritating. Under the objective standard of valuation subscribed to by all taxing jurisdictions, the value of the sensitive neighbor's land will increase minimally, if at all, as a result of the easement. On the other hand, the value of the burdened land could easily be reduced to zero.[26]

Admittedly, this hypothesis does not present the most common type of easement. In most instances, an easement will be purchased

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25. HOHFELD, *Faulty Analysis in Easement and License Cases*, in FUNDAMENTAL LEGAL CONCEPTIONS 162-63 (1923).

26. Most commentators in the property tax area have been quick to recognize the error in equating the gains and losses resulting from the creation of an easement. Professor Bonbright's comments are typical:

> One should note that there is no necessary equivalence between the damage a landowner suffers by being subjected to an easement and the benefit other land obtains from that easement. An easement of passage over *A*'s forest land to the road may greatly enhance the value of *B*'s hotel property without correspondingly depreciating *A*'s land; while on the other hand an easement of light over *C*'s lot may merely make *D*'s backyard slightly pleasanter while preventing *C* from building an apartment house.

1 J. BONBRIGHT, *supra* note 17, at 497. Indeed, even strong advocates of the recognition of easements (and other restrictions) for valuation purposes have admitted that the non-equivalence of the benefits and burdens of an easement presents serious problems:

> While it is generally true that the sum of the values of separate interests, as measured by their market price, will be equivalent to the value of the entire fee, there are some notable exceptions. . . .
>
> The assessment difficulties . . . cannot reasonably be avoided by assessing each owner only in accordance with the market value of his interest . . . .

Nichols, *supra* note 4, at 328.

only when the buyer's potential economic gain exceeds the cost of purchase; presumably that gain will be reflected in the market value of his property. Note, however, that even if this were true at the easement's creation, a change in conditions might eventually lower the value of the easement. Should a taxing jurisdiction be forced to take that risk? Or, should it be allowed to continue to assess the dominant tenement at its value as of the time of the easement's creation?

Even if there is no change in conditions, an easement that is "efficient" from the viewpoint of the private parties may ultimately lower the county or city's overall tax base. In *Poor,* for instance, there was a possibility that the city's tax base had deteriorated as a result of the arrangement. In that case the increased valuations of neighboring properties more than equaled the value of the parkland if used most efficiently. The restrictions on the parkland, however, did not merely deprive the city of the taxable value of the land itself; they also ensured that there would never be any development of that land, and thus deprived the city of potentially *taxable* improvements.

While it might have been hoped that future decisions would show an increasingly sophisticated approach toward valuation of easements, such was not to be the case. Within a year of *Poor* the New York courts decided a second easement case, *People ex rel. Topping v. Purdy,*[27] where the property in question was subject to an easement that created a private road running across it. The court suggested that in the event of condemnation, nothing would have had to be paid to the property owner. Unlike *Poor,* this case did not involve "double taxation." The court observed that "[i]t is not shown that the property on both sides of this discontinued private road . . . has had added to it the value of the easements therein."[28] In fact, the tenor of the opinion suggested the opposite: that the dominant estate had virtually no use for the private road. Nevertheless, there appeared to be little doubt that the existence of the road completely destroyed any value of the burdened property.[29]

Despite such distinguishing factors, the court concluded that the case came "squarely" within the reasoning of *Poor.* The opinion ignored the overall change in the city's tax base and concentrated instead on the market value of the estate under consideration: "[T]he

27. 143 A.D. 389, 128 N.Y.S. 569, *aff'd per curiam,* 202 N.Y. 550, 95 N.E. 1137 (1911).

28. *Id.* at 393, 128 N.Y.S. at 572.

29. The court suggested that in the event of condemnation nothing would have had to be paid to the property owner. *Id.*

fact is that a piece of real estate which had been deprived of all its valuable attributes, so far as the owner was concerned, was treated by the tax commissioners as if still possessing them."[30]

Topping, then, seems to clarify *Poor* by indicating that only the market value is relevant in these cases. Presumably, the "equitable" factors in *Poor* were solely that—factors that made the decision easier, but which were not vital to the outcome. Even under this interpretation, however, some of the nuances of the *Topping* opinion remain unexplained. For example, the court was not totally willing to ignore the assessments of properties other than the plaintiff's. Although it felt that the plaintiff's property had lost its valuable attributes, the court did not go quite so far as to say that those valuable attributes had vanished into thin air, so to speak. To the contrary, *Topping* concluded that the land's "valuable qualities have been attached to the adjoining properties which, by the acquisition of easements appurtenant thereto, have been increased in value and should be assessed accordingly."[31]

What can this observation really mean? As noted, the court was quite clear in suggesting the easement was of no practical use to the dominant estate. Presumably, then this factor did not matter: even though the easement may be quite valuable, in the sense that the owner of the servient estate might be willing to purchase it at a high price, it should be taxed at the value it has to the owner of the dominant estate—however minimal that may be. Such a proposition would be consistent with the fairly narrow market value test that the *Topping* court had set up in evaluating the servient estate, and moreover, would conform with a not irrational theory of property taxation, the goal of which would be to preserve not the *value* of taxable rights, but merely the *taxability* of all possible rights. So long as the creation of an easement transfers a right from one taxable entity to another, there has been no "erosion" of the property tax base.

Alternatively, the court might have been suggesting something more, namely, that the easement rights did have an independent value, and that they should be taxed at that value to whomever owns them. This interpretation would be the more practical since preserving the taxability of rights would be pointless when the values of those rights can totally disappear as the result of transfers. Attaching a minimum value to the easement interest at least preserves something important

30. *Id.*
31. *Id.* at 394, 128 N.Y.S. at 573.

to the taxing jurisdiction. This type of system, however, implicitly takes the incorrect approach of treating the easement as a fictional physical entity, with a value of its own. Furthermore, it is untrue to the market value principle espoused by the court. If it is inequitable to tax the servient estate on rights it does not possess, is it not equally inequitable to tax the dominant estate on a market value that bears no real relation to the rights it does possess?

Although *Topping* and *Poor* raise numerous questions, the subsequent opinions have consistently refused to answer them. In part this is because the cases in which these questions arose usually involved challenges to the assessments of servient estates only.[32] Courts in such cases could easily ignore the taxation of the dominant estate and concentrate instead on doing justice to the owners of burdened tenements. Treating an easement as a physical entity, something "carved out," ensured that it would eventually show up and be taxed to someone. Indeed, the language from *Poor* and *Topping* became almost a litany that was parroted by each succeeding court.

A 1914 New York Court of Appeals case, *Tax Lien Company v. Schultze*,[33] clearly illustrates this phenomenon. The case was not really about the assessment of easements, but rather the effect of a tax lien upon them. The question addressed was whether the tax sale of the servient estate would destroy the existence of the easement upon it. The court felt compelled to examine first the general treatment of easements for property tax purposes: "When an easement is carved out of one property for the benefit of another, the market value of the servient estate is thereby lessened, and that of the dominant increased, practically by just the value of the easement; the respective tenements should therefore be assessed accordingly."[34] This is virtually identical to the plaintiffs' contention in *Poor*.[35] Here, the court has treated it not merely as a suggestive guide to a just outcome, however, but rather as a statement of the law itself. In doing so, it has explicitly suggested (even concluded, one might fairly say) that an easement has a single value, and that this value is transferred from servient to dominant estate. Unfortunately, the court did not have to apply this proposition to the owner of the dominant estate, or it might have discovered the complexities discussed above.

32. Bonbright had noted in 1937 that there was extremely little law on how an easement was to be valued. 1 J. BONBRIGHT, *supra* note 17, at 497 n.103. That comment is equally true today.

33. 213 N.Y. 9, 106 N.E. 751 (1914).

34. *Id.* at 11, 106 N.E. at 752.

35. *See* text accompanying note 23 *supra*.

Indeed, for its purposes, all that the court needed was to be able to demonstrate that whatever its value, the easement was not being taxed to the owner of the servient estate. If nothing else, this issue *was* resolved in *Topping*. Thus, since the easement was not an element of the unpaid tax liability of the servient estate, the *Schultze* court concluded that it was not destroyed on a tax sale of that estate.[36] This came as "a necessary consequence" of the fact that easements were taxed to the dominant estate.

Easement taxation was next discussed in *Crane Berkley Corporation v. Lavis*,[37] where a developer was taxed on the value of a park that he had been required to create in order to obtain approval of his development plan. He resisted the assessment, claiming that he no longer had any interest in the "value" of the park land. Since the park was for the benefit of homeowners in the development, he argued the value of the park had been attached to those homes.

Interestingly, the tax assessors had *not* assessed the value of the park to the surrounding homes. Thus, as in *Topping*, there was no question of double taxation. Presumably the jurisdiction simply wanted to employ a method of assessment that avoided needless complexity. Only one taxpayer would have to be billed, and there would be no need to allocate the park's value among the individual landowners. Indeed, it might be expected that the assessment of the park land to its owner would lead to the eventual reallocation of the tax burden among the homeowners. Even if the developer in this particular instance were unable to so distribute the tax burden, future developers would certainly be able to include in their plans appropriate contractual provisions, similar to those used for allocating tax liability between lessors and lessees.[38]

As might be expected from the prior case law, the court concluded that the assessor did not have the option of deciding whom to assess; the land could be assessed only to the homeowners.[39] This result was mandated even though there was no actual easement belonging to the homeowners. The court found it sufficient that the structure of the development established a situation "equivalent" to the creation of an easement. The result was

> to destroy, and as a fact it has destroyed, the taxable value of the

36. 213 N.Y. at 12, 106 N.E. at 752.
37. 238 A.D. 124, 263 N.Y.S. 556 (1933).
38. *See, e.g.*, Clark-Kunzl Co. v. Williams, 78 Wash. 2d 59, 469 P.2d 874 (1970) (en banc).
39. 238 A.D. at 127, 263 N.Y.S. at 560.

> park lands in the owner of the fee of those lands, or it may be, stating it better, it has shifted the taxable value from the park lands to the other lands of the development, to the owners of which the use and enjoyment of the park lands for park purposes for all time is assured . . . .[40]

The opinion is unclear as to how this result will affect the tax base of the community. The above language does suggest, however, that the court felt there would be little, if any, revenue loss.[41] In this sense, then, *Crane Berkley* is a much easier case than *Topping* was, for it did not require the court to apply a rule whose application would lead to a decrease in the tax base.

One of the more thorough discussions of this subject appeared twenty years later in *Beach Bungalows v. Bushwick Savings Bank,*[42] a decision by a New York trial court. As in *Schultze,* the major issue in the case was whether a pre-existing easement could survive a tax lien. In reaching that issue, the court made its own determination of why the rules as to easements existed, apparently relying on pure "market value" considerations:

> Upon the creation of (an appurtenant) easement the dominant tenement experiences an enhancement in value for sale purposes by reason of the existence of the easement. When the land constituting the dominant tenement is sold . . . the purchaser gets the benefit of the easement. It follows that the value of the land for sale purposes, and hence for tax purposes, is enhanced because of the existence of the easement. . . . This interest having been taxed to the owner of the dominant tenement, the value of this interest ought not to be taxed again to the owner of the servient tenement.[43]

The argument made here that taxable value is equivalent to the sales price is curious, since the *general* treatment of split interests in New York is contrary to the market value assessment rule: a buyer will pay less for property as a result of the existence of lessees, mortgagees, and remainder interests, and yet none of these is deemed to affect the value of the interest for property tax purposes.[44] The court in *Beach Bungalows* failed to explain the reason for distinguishing easements from

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40. *Id.*

41. The court's implicit test, of course, was whether the taxing jurisdiction would recoup the taxable value of the park land. This ignores the fact that the jurisdiction has also lost the tax on future improvements on the property.

42. 133 N.Y.S.2d 712 (Sup. Ct. 1954), *aff'd,* 285 A.D. 1069 141 N.Y.S.2d 503 (1955).

43. *Id.* at 716.

44. *See* text accompanying note 16 *supra.*

other similar interests. Moreover, had it not considered the easement interest as belonging to the dominant estate for tax purposes, the double taxation problem about which it worried would have vanished.

Finally, in the 1962 case of *People ex rel. Gale v. Tax Commission,*[45] the Appellate Division attempted to justify the rule of *Poor* and *Topping.* After again repeating the by-then-standard litany about the value of the easement being transferred to the dominant estate, the court stated:

> This method of assessment, where there are easement interests, is fully in accord with the purpose and policy of the tax laws to subject real property to taxation upon its full value. The easement interest is thereby viewed in a proper perspective to achieve full and proper valuation for assessment purposes. This method is clearly justified on the basis that it places the easement where it belongs for tax lien and tax sale purposes, namely, severed from the servient estate and attached to the dominant estate.[46]

Although the *Gale* court properly emphasized the need for "full value" taxation, a goal which has in fact been strongly supported by the New York case law,[47] nothing in the opinion indicates how the court's rule will aid in achieving that goal. In fact, the opposite will probably occur because values change as property interests are transferred among owners. Thus, this rule more likely hinders the taxation of the "full value." Even if that were not the case, however, it should at least be recognized that "full value" is a concept that is ambiguous at best. Until that concept is more precisely defined no clear answer to the easement problem can be obtained.

Given its ringing defense of the concept of full value taxation, the *Gale* court may be forgiven its misapplication of that concept. It cannot be forgiven, however, for its mystifying comment on the relationship between the taxation of easements and the tax sale rule, quoted above. It was in 1914, in *Schultze,* that the tax sale rule first emerged. As noted, the court developed the rule *as a result of* the existing treatment of easements for tax purposes.[48] Thus, it is certainly odd to find the *Gale* court reversing the process and supporting the easement tax rule because it is in conformity with the tax sale rule.[49] A neat trick indeed.

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45. 17 A.D.2d 225, 233 N.Y.S.2d 501 (1962).

46. *Id.* at 228 n.*, 233 N.Y.S.2d at 505 n.*.

47. *See, e.g.,* Knickerbocker Village, Inc. v. Boyland, 16 A.D.2d 223, 226 N.Y.S.2d 982 (1962), *aff'd,* 12 N.Y.2d 1044, 190 N.E.2d 239, 239 N.Y.S.2d 878 (1963).

48. *See* text accompanying notes 33-35 *supra.*

49. It is, of course, open to argument whether the proper place for the easement

III. Taxation of Restricted-Use Property

The preceding section examined the existing tax treatment of easement interests in an effort to illustrate some of the considerations that are relevant to the taxation of property subject to private restrictions. The goal of this section is to organize those considerations into a coherent framework, and then to develop fairly specific rules for taxing restricted-use property. The approach taken here leads ultimately to a suggested definition of ownership for property tax purposes, that is, a formula for determining which person, in relation to the special needs of the property tax system, is to be considered the owner of a particular property right. In developing this formula, burdened and benefitted properties are treated as analytically distinguishable.

A landowner who makes an enforceable restrictive-use agreement for the benefit of his neighbor reduces the scope of property rights he can exercise with respect to his own land; this reduction in rights will probably also diminish the market value of his property. Nevertheless, an argument can be made for taxing the transferred rights as if they still belonged to the original owner. As shall be shown, any other system would be contrary to basic themes of property taxation.

A. *Full Value Taxation*

Since the measuring rod for the property tax is ultimately not property alone, but rather the value of property, it is appropriate to begin this investigation with an examination of the concept of value. There is certainly a great deal of diversity in the terminologies used by taxing jurisdictions for the purpose of defining exactly what value it is that they are seeking to tax. Given the various formulations—

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in a tax sale is with the dominant or servient estate; and, if the easement is deemed to be attached to the dominant estate, it would not be irrational to apply a similar rule then for taxation purposes. That decision would require a determination that uniformity between the two rules is of greater importance than whatever other concerns might militate toward attaching the easement to the servient estate for taxation purposes.

In any event, the argument presupposes some justification for treating the easement as part of the dominant estate for tax sale purposes. One possible reason was given in Jackson v. Smith, 153 A.D. 724, 138 N.Y.S. 654 (1912), where the court felt it would be unfair for the easement owner to have to protect his interest by paying taxes not just on the increase in value of his own estate, but also on the servient estate's value. This argument, however, is of no force if the dominant estate is *not* taxed on the easement interest, and thus assumes away its conclusion. In reality, the position of the dominant estate owner is no worse than that of a lessee.

"fair and reasonable market value,"[50] "full cash value,"[51] "true market value,"[52] "present true and actual value,"[53] and so forth—one wonders whether the differences in phraseology actually correspond to differences in the substantive legal standards to be applied. At the least, it is clear that this array of statutes, all disdaining the taxation of mere "value," must reflect some basic undercurrent common to property taxation generally. Surely qualifiers such as "true," "full," and "actual" are directed toward some special concept of value for property tax purposes.

At the outset, one observation can be made about these sundry qualifiers: they serve to *objectify* the standard of value that is to be applied.[54] The great majority of the value standards appear to seek ultimately an ideal market value, meaning the price at which a willing buyer would buy from a willing seller in an open market.[55] The need for an objective standard of this nature should be self-evident. Just as in the realm of income taxation it would be administratively impractical to tax imputed income, so it would be equally if not more impractical to tax property owners on the personal satisfaction they get from owning property.

The need for objectivity, however, does not fully justify assessing property for tax purposes at its ideal market value. Presumably an objective measure of real value to the owner would not be much more difficult to determine than a hypothetical "ideal" value. Moreover, the property tax is essentially a wealth tax and, while there is no single theoretical foundation for it, one frequent justification is that it is grounded to some degree on the owner's ability to pay, as measured by the property that is subject to the tax.[56] Faithful adherence to a doctrine that a property owner should be taxed according to his ability to pay would require that taxation be based on an objective meas-

50. ALA. CODE tit. 51, § 46 (1958).

51. ARIZ. REV. STAT. § 42-221 (West Supp. 1975-1976).

52. ARK. STAT. ANN. § 84-428 (1960).

53. CONN. GEN. STAT. ANN. § 12-63 (1958).

54. *See, e.g.,* De Luz Homes, Inc. v. County of San Diego, 45 Cal. 2d 546, 290 P.2d 544 (1955).

55. *See, e.g.,* O. OLDMAN & F. SCHOETTLE, STATE AND LOCAL TAXES AND FINANCE 138-39 (1974).

56. *See* R. MUSGRAVE & P. MUSGRAVE, PUBLIC FINANCE IN THEORY AND PRACTICE 344-46 (2d ed. 1976). Ability to pay is a criterion that reflects considerations of equity. These were probably foremost in the minds of the New York judges when they emphasized a market value standard in reducing the taxable value of the plaintiffs' property in the easement cases. *See* text accompanying notes 16-49 *supra.*

ure of the value of the property to its *current* owner, not of its value to a willing buyer.[57]

Nevertheless, most statutes and court decisions provide for assessment at the "ideal" market value. Thus, restrictions "personal" to the owner of real property are ignored for valuation purposes. For example, in *Knickerbocker Village, Inc. v. Boyland*,[58] the court considered the problem of assessing a housing project that was subject to a number of statutory provisions restricting its saleability. Since the restrictions were clear and indisputably binding,[59] there was no difficulty in measuring the resale value of the property to its current owner, which was significantly below what a willing buyer would have paid. Nonetheless, the court concluded that they were personal to the current owner.[60] As a result, the project was valued as if it were unrestricted, a proposition clearly contrary to the actual legal state of affairs.

A somewhat different case illustrating a similar principle is *R.L.K. & Co. v. State Tax Commission*,[61] where the taxpayer possessed a "use permit" which gave him essentially unlimited use of certain government-owned land for fifteen years, after which the land would revert to the government. The taxpayer claimed, and the lower court agreed, that his interest would be decreasing in value over the 15 years, and that he should be taxed accordingly. On appeal, the Oregon Supreme Court acknowledged that the decreasing payment schedule did reflect the true market value of the interest, but held that he was nevertheless taxable on the full value of the fee simple. The court explicitly noted that no constitutional violation occurred as a result. In essence, then, the taxpayer was deemed to be the owner of the government's remainder interest, which thus became taxable to him. While this result might be described as unwise, it nevertheless is a remarkable demonstration of the extent to which a taxpayer can be taxed according to a value he never sees.

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57. Otherwise, many owners would be required to sell their property or change its use. For example, the expanding borders of many cities produce skyrocketing values for neighboring farmland. The resulting increases in property taxes can make farming unprofitable and force farmers to sell their land to developers. *See* text accompanying notes 113-115 *infra*.

58. 16 A.D.2d 223, 226 N.Y.S.2d 982 (1962), *aff'd*, 12 N.Y.2d 1044, 190 N.E.2d 239, 239 N.Y.S.2d 878 (1963).

59. This case is thus distinguishable from those wherein the decrease in value is the result of poor business judgment on the part of the taxpayer. *See, e.g.*, Clayton v. County of Los Angeles, 26 Cal. App. 3d 390, 102 Cal. Rptr. 687 (1972); Lodge v. Swampscott, 216 Mass. 260, 103 N.E. 635 (1913).

60. 16 A.D.2d at 228, 226 N.Y.S.2d at 987.

61. 249 Ore. 603, 438 P.2d 985 (1968).

The true nature of taxable market value is a frequent question in cases involving unfavorable leases. The law on this issue differs greatly among various jurisdictions. Of those states which will take into account the existence of an unfavorable lease in valuing property, Michigan has the most explicit case law. In *C.A.F. Investment Co. v. Michigan State Tax Commission,*[62] for example, the Michigan Supreme Court had to construe a statute using the term "economic income." The court stated:

> [T]he taxing authorities have contended that [economic income] creates a new concept of taking into account hypothetical income which is different than the actual income from the property. . . . They thus in effect define "economic income" as the possible income absent a lease, rather than the actual income in the face of a pre-existing lease.[63]

The court rejected the arguments of the taxing authorities and held that "economic income" means actual income.[64] This holding is in fact consistent with earlier Michigan cases that had interpreted the statute prior to the introduction of the phrase "economic income." For example, in *Lochmoor Club v. City of Grosse Point Woods,*[65] which involved a private park, a lower court rejected the State Tax Commission's argument that the restrictive covenant at issue did not warrant a reduction in assessment. The court concluded that "[t]o ignore such a restriction constitutes fraud on the taxpayer . . . ."[66]

Other jurisdictions, no doubt marching to the beat of a very different drummer, have had little trouble ignoring the circumstances of a particular owner. Consider the language in *De Luz Homes, Inc. v. County of San Diego,*[67] a 1955 *en banc* decision of the California Supreme Court:

> The present owner may have invested well or poorly, may have contracted to pay very high or very low rent, and may have built very expensive improvements or none at all. . . . [S]ince, however, the legislative standard is "full cash value," it is clear that whatever may be the rationale of the property tax, it is not the profitableness of the property to the present owner.[68]

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62. 392 Mich. 442, 221 N.W.2d 588 (1974).
63. *Id.* at 454 n.3, 221 N.W.2d at 594 n.3 (quoting MICHIGAN LAW REVISION COMMISSION, 1972 ANNUAL REPORT).
64. *Id.* at 454, 221 N.W.2d at 594.
65. 10 Mich. App. 394, 159 N.W.2d 756 (1968).
66. *Id.* at 398, 159 N.W.2d at 758.
67. 45 Cal. 2d 546, 290 P.2d 544 (1955).
68. *Id.* at 566, 290 P.2d at 557.

Oregon takes a similar view of the goals of the property tax system. In *Swan Lake Moulding Co. v. Department of Revenue*,[69] the land at issue was subject to leases running for over 30 years. The court analyzed the issue in this manner:

> The appraisers testifying for the taxpayer stated that these leases had to be taken into account as they control the income potential and what the highest and best possible use would be if the land were unencumbered is only hypothetical. . . . In fixing the true cash value of land for property tax purposes the effect of existing leases on the value to the owner is disregarded. The basis for such a principle is that the tax is levied upon the land and is a tax upon all interests into which the land might be divided. Admittedly, a lease might decrease the price which the owner might receive; however, the tax is not merely upon the owner's interest; the tax is upon all the interests in the land, including the leasehold interest.[70]

The comments in the *Swan Lake* opinion with regard to taxing all of the interests are particularly interesting. The court suggests that ignoring the lease is required because otherwise a property interest will not be taxed. Yet the court is clearly wrong in this conclusion. The taxpayer was *not* claiming that he could not be taxed on the stream of payments he was receiving from the lessee. This stream, therefore, would have represented one possible method of taxing the lease interest. Thus, the real dispute was not whether the lease resulted in a property right becoming tax-exempt; rather, it was whether the lease altered the value of that property right. The court's decision is therefore one in support not merely of preserving the *taxability* of all property rights, but also of preserving the *value* of those rights for tax purposes. The distinction is a crucial one, and bears directly upon the proper taxation of the easement.

A word should also be said about the notion of "best use" mentioned in *Swan Lake*. The argument that property rights should be valued as if they were applied to their best use stems directly from the concept of ideal market value. Presumably, a buyer who wanted to use the property for its best use would pay more than anyone else, and thus the seller would sell to him. This aspect of the valuation rule is a further reflection of the extent to which the tax system strives for some ideal value to tax. In addition, since it applies even to unrestricted property, the best use concept is extremely potent. For ex-

69. 257 Ore. 622, 478 P.2d 393 (1970).
70. *Id.* at 625, 478 P.2d at 395.

ample, in *Sabin v. Department of Revenue*,[71] the Oregon Supreme Court approved an assessment based upon a non-existing division of the property into sub-units:

> The principal contention is that the subject property should have been assessed as one piece, and therefore it was erroneous to value the property on the basis of a hypothetical division of the property into smaller units. We find no error. . . . There is no reason why a large parcel should not be hypothetically subdivided for the purpose of assessment when the evidence indicates, as it does here, that such subdivision is required to effectuate the highest and best use of the property.[72]

As a number of the cases discussed above have indicated, it is not easy to establish exactly where the "full value" concept comes from. As noted earlier, it is not mandated by the needs of efficient administration. Moreover, it exists in spite of being in direct conflict with principles of equitable taxation. Most likely its source is simply the need for the taxing jurisdiction to maintain its major source of revenue. While the power to tax may be the power to destroy, it is equally true that the absence of taxing power would put an end to many local governments.[73] Moving from this basic premise to the rule of "full

71. 270 Ore. 422, 528 P.2d 69 (1974).

72. *Id.* at 425-26, 528 P.2d at 70-71.

73. A striking example of how little concern is often shown for local tax bases is given by Bensalem Township School Dist. v. County Comm'rs, 8 Pa. Commw. Ct. 411, 303 A.2d 258 (1973). In that case, a state statute was passed allowing counties to contract with landowners to have their land preserved as open-space land, with the result that property taxes would be lowered in accordance with this restricted use. A school district then brought suit, claiming that the statute unconstitutionally deprived it of its tax base by requiring the valuation of property at something other than the full value demanded by the state constitution. The court rather summarily rejected these claims:

> Act 515 merely provides that a county may covenant that a tax assessment will reflect the fair market value of the land as restricted by the covenant. No exemptions from taxation are awarded. It is merely agreed to recognize the actual value of the land as its use has been restricted. Land must be assessed according to its actual value, and actual value means market value . . . . As courts in the past have recognized, especially in eminent domain cases, everything which affects the value of the land is a proper element [of valuation] . . . . [I]n arriving at market value, it is proper to consider any restrictions placed on the land.

Id. at 417, 303 A.2d at 262-63 (footnote omitted).

As the analysis in the body of this paper attempts to demonstrate, a municipality need not respect private restrictive covenants; to force it to do so would destroy the protection given its tax base by the full value principle. In the facts of this case, of course, the restrictions are not wholly private; and, in most circumstances, it is quite appropriate that a restriction enacted at the express consent of the government should be recognized for valuation purposes. The unique factor in this case is that two governmental bodies are disagreeing on the extent to which the restrictions should be recognized—and it is the unit which relies on the tax revenue which is unwilling to

value" taxation requires no great leap. To the extent that private actions are allowed to decrease the tax base below a certain fixed minimum, an undesirable element of uncertainty enters the system. Taxpayers could easily take advantage of this uncertainty to create arrangements leading to the reduction of their property taxes.[74]

The "full value" rule stands as an inviolable wall preventing any such intrusions upon the tax base. Its force lies not so much in that it guarantees a particular tax base, but rather that it acts as an obstacle to a variety of arrangements that would otherwise wreak havoc with the system. The concept of "full value" thus can be understood less as a substantive theory regarding the proper definition of value than as a corollary of the following principle: no private action should be permitted to reduce the taxable base of any particular property below a fixed minimum.

B. *The Fee Simple Bundle*

> [T]o achieve the essential indiscriminate and full measure of taxation of real property as a whole, it is not generally proper or necessary that separate legal interests in a piece of property be independently assessed.[75]

The preceding section has provided only a partial answer to the problem of taxing restricted property. Assuming that a "full value" standard requires that certain types of private agreements restricting the use of property be ignored for valuation purposes, it remains to

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accept the restriction. Certainly, forcing it to accept the restriction for valuation purposes might cause serious revenue consequences. The question of who "wins out" in this instance is a complex one, and no doubt must be answered by resort to the provisions of the state constitution detailing the respective powers of the two governmental units. The court's answer—that the restriction is enforceable, and thus prima facie affects assessed value—is wholly inadequate.

74. This possibility is examined and rejected in Arizona R.C.I.A. Lands, Inc. v. Ainsworth, 21 Ariz. App. 38, 515 P.2d 335 (1973), where the court held that easement interests did affect the taxable value of property:

> Plaintiff argues that if the Superior Court decision is upheld it would have a statewide detrimental effect upon tax revenues by creating a perfectly valid means of escape from real property taxes. The authorities cited above indicate, however, that the holder of an easement . . . is presumed to have paid a tax on the value of the easement inasmuch as that value was added to the value of the easement holder's dominant estate for tax assessment purposes. Thus, the easement holder is not escaping taxation on the value of the easement, but rather is paying a full tax on that value.

Id. at 41, 515 P.2d at 339. The court has made the error of assuming the easement, like a physical entity, has a "value" which is transferred from one property to another. *See* text accompanying notes 25-26 *supra.*

75. People *ex rel.* Gale v. Tax Comm'n, 17 A.D.2d 225, 228, 233 N.Y.S.2d 501, 504 (1962).

be determined what constitutes an agreement conflicting with the full value standard. It is not always self-evident that a particular arrangement has led to a restriction on the use of property rights. An affirmative easement, for example, may be viewed either as restricting the rights of the owner of the servient estate, or as having merely transferred those rights to the owner of the dominant estate. If it is viewed as a mere transfer, and not as a restriction, then the easement need not be ignored to achieve full value taxation. The purpose of this section is to demonstrate that the property tax system has in fact chosen between these two alternatives.

In order to tax property at its full value, it is necessary to identify every property right. Given that an infinite number of such rights can be imagined, it is unreasonable to expect any tax system to identify and tax each of them separately. There must of necessity be a device for categorizing these rights, for mapping them into a manageable number of "clusters." To anyone familiar with property law, the fee simple should immediately suggest itself as a likely candidate for this role. Every property right is a part of some fee simple interest; moreover, it is a part of only one such fee simple. Consequently, using the fee simple as the basic unit for categorizing rights would produce a complete and non-duplicative structure. More important, since the fee simple is the most complete set of rights that can be possessed with respect to a piece of real property,[76] its choice as a basic unit for assessment would minimize the number of necessary separate assessments, a result of no small importance given the possible administrative concerns.

It is therefore not surprising to find considerable support for the use of the fee simple as a fundamental unit in the property tax area. As stated by Professor Bonbright:

> Real estate is commonly split up into separate legal interests held by different persons—mortgagor and mortgagee, landlord, tenant, and subtenant, holders of various easements over the land, and so forth.

76. The fee simple interest has been described thusly:

> It is elementary that a property interest is one or more of the rights, powers, privileges and immunities over and concerning land which exist in a particular person. The totality of these rights, powers, privileges and immunities which it is legally possible for an owner to have with regard to a given piece of land constitutes complete property in the land. Land thus owned is held in fee simple, which is *the largest estate known to the law* and which constitutes ownership in the fullest sense in, since complete dominion, possession and enjoyment are in the owner.

3 AMERICAN LAW OF PROPERTY § 11.1 (A.J. Casner ed. 1952) (emphasis added).

> Here, too, one would think, an allocation problem is presented; for if these legal interests are regarded as so many separate properties, must not the unitary value of the physically undivided land be apportioned among them? Contrary to expectation, the answer is that the general property tax ordinarily pays no attention to these divisions of interest and assesses the property as if it were owned in fee simple.[77]

Despite his feeling that this result is an odd one, Bonbright nevertheless finds a simple explanation. Observing that it is "immaterial" whether the result is explainable on "historical or on other grounds," he concludes that it "can be justified practically on the ground that the number of assessments is reduced to a fraction of what they would otherwise be, and also that difficult problems of allocation of values are avoided."[78]

The use of the fee simple unit in property taxation dates at least as far back as 1906. In *Hill v. Williams*,[79] the Maryland Court of Appeals approved the assessors' decision to ignore a restrictive easement in valuing an estate:

> As the fee-simple title remained in the . . . estate, the land was properly assessed to that estate. It was no part of the duty of the appeal tax court to inquire into or separately value the interest or easement . . . . And there is nothing in our general tax system which compels the collector to examine what title a party has to land with which he is assessed. . . . It is not compatible with public convenience and the prompt collection of revenue for the state to trace out all the subdivided or qualified interests that may be held in real estate and seek to hold various owners responsible. Its policy is to assess the fee-simple value of the land to the holder of the possession.[80]

Several years later, in one of its rare comments on the property tax, the United States Supreme Court stated simply: "In ordinary cases the whole property is taxed and which party shall bear the burden is not a matter of public concern."[81]

A review of the case law and commentary on this point reveals two separate themes that justify the use of the fee simple. One of these, as noted earlier, is administrative convenience.[82] But surely, con-

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77. 1 J. Bonbright, *supra* note 17, at 495-96.
78. *Id.* at 497.
79. 104 Md. 595, 65 A. 413 (1906).
80. *Id.* at 603, 65 A. at 414.
81. Trimble v. Seattle, 231 U.S. 683, 689 (1914).
82. *See* text accompanying note 76 *supra*. *See also* Doughty v. Loomis, 9 A.D.2d 574, 575, 189 N.Y.S.2d 413, 415 (1959), *aff'd*, 8 N.Y.2d 722, 167 N.E.2d 643, 201

venience alone could not support the taxation of interests to people who no longer own them. Indeed, it would not be difficult to establish a system whereby owners of property interests could petition for special assessments at their own expense; these special assessments could serve to verify the splitting of the fee simple interest among a number of owners.[83] The owner of the fee simple would remain primarily liable, but the assessing jurisdiction would initially attempt to collect the appropriate share of the taxes from the holders of the sub-interests. Such a system is not very complicated and has been proposed by at least one opponent of the existing system.[84] It would constitute a definite move toward greater equity in the property tax, a goal that should be fundamental to the design of any type of tax.[85]

Given the possible benefits, it may appear somewhat surprising that no such special systems for assessing split interests have yet been enacted. The surprise vanishes, however, when one recognizes that there is a second justification for the use of the fee simple for tax purposes: it is a key factor in assuring full value taxation.[86] Specifically, the fee simple unit provides a generally applicable standard by which "full value" can be determined. In a world free of transaction costs, such a standard would not be needed. As suggested by the Coase Theorem, property rights could be valued on the assumption that they

N.Y.S.2d 100 (1960) ("No requirement of any statute compels the assessor to trace and follow internal arrangements between lessors and lessees as to who should pay the tax; and it would be an unfair burden to make them do this.").

83. Such a system would be somewhat similar to what is done under the special schemes used for the reduction of assessments on open-space property. *See, e.g.,* Mix, *Restricted Use Assessment in California: Can it Fulfill its Objectives?,* 11 SANTA CLARA LAW. 259 (1971).

84. *See* Nichols, *supra* note 4.

85. *See* R. MUSGRAVE & P. MUSGRAVE, *supra* note 56, at 210.

86. The language of courts and commentators suggests that the fee simple plays a role in the preservation of value. *See, e.g.,* Hill v. Williams, 104 Md. 595, 596, 65 A. 413, 414 (1906) (the goal is to assess the "fee-simple value"); People *ex rel.* Gale v. Tax Comm'n, 17 A.D.2d 225, 228, 233 N.Y.S.2d 501, 504 (1962) (one value is assigned to property in order to achieve the "essential indiscriminate and full measure . . . of real property as a whole"); 1 J. BONBRIGHT, *supra* note 17, at 495 (there is a "unitary value of the physically undivided land").

In addition, consider the following comments:

> [T]he dominant theme of the real property tax statutes remains unitary assessment—assigning one value and computing one tax. No matter how the ownership of the property is broken down in fact, the values of all separate elements are distilled into a single figure. Separate consideration of individual interests is given only to the extent required in valuing the whole. . . .
>
> Viewing each piece of property *as a unified whole,* lumping together all interests for valuation purposes, and emphasizing the payment of the full tax results in the frequently adopted approach of giving highly particularized statutory directions as to which of several interests is to bear the entire tax.

Nichols, *supra* note 4, at 309 (footnotes omitted).

were being employed in the most efficient arrangement possible.[87] Transaction costs exist, however, and the allocation of property rights affects their values. As was shown earlier, for example, the transfer of an easement interest to a dominant estate will not necessarily create equal changes in value on both sides of the transaction.[88] Thus, in a system that seeks to preserve a minimum value for all rights, it is extremely important to develop a consistent and meaningful valuation standard.

The fee simple, as a compartment containing the full set of rights connected with a particular piece of property, provides a meaningful standard.[89] Although achieving the most efficient use of property sometimes requires going beyond the borders of a particular parcel and acquiring additional rights, in most circumstances, the fee simple allows its owner to make full use of his property without acquiring such "external" rights—or incurring any additional transaction costs. Thus, in general, grouping all the rights into a single fee simple bundle for the purposes of taxation is likely to lead to their most efficient use, and, concomitantly, the *greatest* valuation of those rights. Given the need for administrative convenience in taxation, it is then surely reasonable for the property tax system to value all property as if it were owned in fee simple.

C. *A Rule of Ownership*

Now that the parallel concepts of full value taxation and fee simple categorization have been developed, the resulting valuation rule can be stated:

> Every property right should be valued as a part of the fee simple interest of which it is properly a part. The owner of that fee simple should be taxed according to the value of all rights that are a part of the fee simple, whether or not he possesses all such rights.

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87. *See* Coase, *The Problem of Social Costs*, 3 J. LAW & ECON. 1 (1960). Coase argued that in a completely unrestricted market, property would eventually be used in the most efficient manner possible. To illustrate this conclusion, imagine that farmer *A*'s property adjoins that of *B*, who raises livestock. *B*'s animals often escape and destroy portions of *A*'s crops. One can imagine two alternative initial allocations of rights in this situation: *A* may be given an absolute right to prevent his neighbors from raising livestock, or *B* may be given an absolute right to raise as many animals as he desires. Coase demonstrated that, as long as *A* and *B* can come together and resolve their conflicting rights in a costless manner, it does not matter which initial allocation of rights is chosen. In both instances, the negotiations between *A* and *B* will ultimately result in the outcome that maximizes overall efficiency. *See generally* R. POSNER, ECONOMIC ANALYSIS OF LAW 16-17 (1972).

88. *See* text accompanying notes 25-27 *supra*.

89. *See* note 76 *supra*.

Under the proposed valuation system, the fee simple owner is *presumed* to own all property rights that are a part of the fee simple. Of course, he will often not really own every such right; the interests of lessees, remaindermen, and owners of easements, to name but a few, will restrict his use of the land. Nonetheless, in order to satisfy the needs of the property tax system, the fee simple owner will be taxed on the value of these rights.

An example of how this rule might apply in practice is appropriate at this stage. In *Twin Lakes Golf & Country Club v. King County*,[90] the assessment of a privately owned golf course was at issue. The golf course was part of a planned unit development; it had been intended from the start to be an integral part of the newly created housing arrangement. After completion of the development, the developer conveyed the golf course land to a corporation entrusted with its operation. To each of the homeowners in the new development, he gave the right to ensure that the land be maintained as a golf course for a twenty-year period. Furthermore, this restriction was to be automatically renewed for ten-year periods unless seventy-five per cent of the owners requested otherwise.[91]

Even though it attempted to attract players from beyond the group of homeowners, the golf course consistently lost money. Despite those losses, however, the county assessor valued the land at $660,000, which was its market value without the restriction. The fee owner resisted this assessment, arguing that the land was restricted to use as a golf course and that the golf course as operated was losing money. Furthermore, he argued, the taxable value of homes in the development had increased by $1,141,108 as a result of their proximity to the golf course, producing, in effect, a net gain of at least $481,108 to the total taxable value of the development.[92]

In the face of these arguments, it is not surprising that the Washington Supreme Court decided in favor of the golf course owner. It concluded that where "the use of land is so restricted that its ownership is of no benefit or value, the assessment for tax purposes should be nothing." By "failing to take into account the restrictions," the assessor had so overvalued the property as to produce a "constructive fraud" on the owner.[93]

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90. 87 Wash. 2d 1, 548 P.2d 538 (1976).
91. *Id.* at 3, 548 P.2d at 539.
92. Brief for Respondent at 22, Twin Lakes Golf & Country Club v. King County, 87 Wash. 2d 1, 548 P.2d 538 (1976).
93. 87 Wash. 2d at 5, 548 P.2d at 540.

The court's conclusion was of course incorrect; the property should have been valued in its unrestricted state. As this article has attempted to prove, the argument that the county had lost nothing from its tax base is a fallacious one. The proper value from which to measure the loss to the tax base is *not* the $660,000 undeveloped value of the golf course land, but rather the likely value of that land in its developed state, with improvements included. Presumably, had the land not been restricted, homes would have been built on it, and the value of these homes would easily have been in the millions of dollars. As a result, the restrictive agreement created not a tax benefit of $481,108, but rather a decrease in the tax base on the order of over a million dollars.

Assessing the land as if it were unrestricted creates no "fraud" upon the taxpayer, any more than does assessing the fee owner on land subject to an unfavorable lease. In both instances, the fee owner has voluntarily come into possession of property that should properly produce a minimum amount of taxable value. Owners should be perfectly free to participate in arrangements which alter the value of their rights, but should not be entitled to deprive the taxing jurisdiction of some share of its proper tax base. Failure to assess property as if unrestricted ultimately results in a loss to the taxing jurisdiction. Under existing valuation rules, restrictions on property will result in reduced assessments only when those restrictions significantly reduce the value of the property. Concomitantly, a restriction will significantly reduce the value of property only when it prevents the property from being put to its best use, which in most cases would involve development. As a result, in virtually all important cases involving restrictive agreements, the taxing jurisdiction, if it accepts a reduced assessment, will be foregoing a sizable amount of tax on development that will never take place.[94] Nothing in the system of property taxation mandates that a jurisdiction be forced to recognize private agreements that virtually ensure reductions in its base.[95]

94. Another example of this phenomenon, apart from the planned unit development, is the effort to give farmers property tax relief so as to assure that farmland does not quickly succumb to pressures for development emanating from the cities. *See, e.g.*, INTERNATIONAL ASS'N OF ASSESSING OFFICERS, USE-VALUE FARMLAND ASSESSMENT (1974).

95. On the other hand, it is equally true that nothing *forces* the jurisdiction to ignore the restriction. As will be noted in the final section of this paper, legitimate reasons may support a voluntary recognition of a restrictive agreement.

IV. Taxation of Benefitted Property

> The economic phenomenon that has occurred here is that of a dominant estate absorbing the value of the servient estate. As a result, the value of the servient estate is being taxed in the dominant estate.[96]
>
> Each parcel must be valued in its own right, and it may often turn out . . . that a servient estate gives substantial value while still retaining value. In short, a parcel's value is fixed with reference to its *own* characteristics and burdens, and is not automatically reduced by whatever collateral benefit it may give to neighboring lots.[97]

Thus far, the discussion has centered on only half of the restricted use puzzle. Presumably, a restriction on one piece of property will result in a benefit to another.[98] The appropriate tax consequences to the owner of the benefitted property must now be examined.

The two quotations above, taken from the briefs of the parties in the *Twin Lakes* case, are helpful in initially framing the issue to be confronted. Both discuss primarily the subject of the previous section of this article—the proper tax treatment to be accorded a burdened property. In so doing, however, they of necessity make reference to the valuation of the dominant property, emphasizing that the *interaction* of benefitted and burdened properties is a crucial factor in establishing a coherent tax structure.

Indeed, the fact that the proper tax consequences for the restricted property have been resolved is highly relevant here. If a jurisdiction taxes the fee owner on all rights normally encompassed within the fee simple, it cannot at the same time tax those rights to someone else. Otherwise the jurisdiction would be guilty of "double taxation."[99] This leads to the initial rule relating to the taxation of benefitted property: The owner of a benefitted property cannot be taxed on the rights that are deemed, for purposes of satisfying the full value principle, to remain in the hands of the owner of the servient tenement.

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96. Brief for Respondent at 22, Twin Lakes Golf & Country Club v. King County, 87 Wash. 2d 1, 548 P.2d 538 (1976).

97. Brief for Appellant at 28-29, Twin Lakes Golf & Country Club v. King County, 87 Wash. 2d 1, 548 P.2d 538 (1976).

98. As noted earlier, the treatment of easements in gross is somewhat special. *See* note 12 *supra.*

99. A similar rule is specifically provided for under the federal income tax, where section 1311 allows for the correction of errors in cases involving the IRS' maintenance of "an inconsistent position." I.R.C. § 1311. Moreover, that inconsistency can involve consideration of the circumstances of persons other than the taxpayer himself. *See, e.g.,* Treas. Reg. § 1.1312-1(b), Example 2 (1978) (wife allowed refund where income assigned to her by husband is ultimately taxed to husband in later year).

It is important to note that this rule does not require the assessing authority to ignore the existence of the restrictive agreement from the point of view of the benefitted tenement. For while the owner of that tenement cannot be taxed on *rights* he has acquired as a result of the agreement, he is nevertheless taxable on the rights he has owned all along; and, most importantly, it is quite possible that the existence of the restrictive agreement has increased the *value* of these "old" rights. The distinction being made here is a fine but vital one, and was completely ignored in *People ex rel. Poor v. O'Donnell*,[100] where the court concluded that since the assessors had taxed the value of a private park to the homes surrounding it, they could no longer tax that value to the park owner.[101] The *Poor* court made the mistake of confusing "value," which is not a transferable entity, with "rights," which can be preserved when they are transferred.

That it is foolish to ignore an agreement's effect on the dominant property is indicated by the *Twin Lakes* case. There, as a result of the existence of the golf course, which itself was worth $660,000 in an undeveloped but unrestricted state, surrounding homes increased in value by $1,141,108. The proper taxable value of the golf course should be its unrestricted value, $660,000. But if the result of assuming the golf course to be unrestricted would be that the benefitted properties must be taxed as if no restrictive agreement benefitted them, then the jurisdiction would be forced to forego an extra $1,141,108 of taxable value. In that case none of the $480,000 increase in total value resulting from the creation of the easements would be taxable. This loss to the tax base is above and beyond the foregone taxes on any development of the golf course land which, but for the restrictions, might have occurred.

This example demonstrates quite clearly that ignoring the agreement from the point of view of the benefitted property would be unwise. In terms of economic reality, parties usually enter into a restrictive agreement only when some benefit, sufficient to outweigh transaction costs, is likely to be generated. The jurisdiction should be able to tax that benefit, without at the same time defeating the principle that the burdened property should be taxed at its unrestricted value.

The solution to this seeming paradox is suggested by observing

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100. 139 A.D. 83, 124 N.Y.S. 36, *aff'd. per curiam*, 200 N.Y. 519, 93 N.E. 1129 (1910).

101. *See* text accompanying notes 20-24 *supra*.

that owners often use their properties in ways that affect the value of the property of others, without actually involving any transfer of rights. Such effects on the property of others are normally referred to as externalities. One variety of externality is that which imposes costs upon the public generally, such as a landowner's discharge of pollutants.[102] Other types of externalities may affect a smaller segment of the general population. For example, a particular use of a piece of property may be simply incompatible with neighboring uses. Of course, not all externalities are negative. The private park in *Poor* and the golf course in *Twin Lakes* are both examples of property uses that generated highly desirable externalities.

Several branches of property law have evolved in response to problems created by externalities. Zoning law, for example, allows municipalities to categorize and thereby restrict the location of various externalities, in order to avoid the efficiency losses that might result from allowing owners complete freedom in the use of their properties.[103] Nuisance law is similar, although its general purpose is not so much to restrict location as to eliminate certain externalities entirely.[104]

Given the existence of externalities, the question naturally arises as to how they are to be incorporated into the property tax valuation process. Where a piece of property generates favorable externalities which increase the values of neighboring properties, should it be entitled to a reduction in its own taxable value as a result? Or should the neighboring properties be taxed as if their value had not been increased? Alternatively, where property owner *A* uses his land in such a way as to lower the market value of *B*'s property, should *A*'s tax assessment be increased as a result? Or should *B*'s property be assessed as if *A*'s interfering use did not exist? The answer to all of these questions should be no; the reason lies in an understanding of how property law deals with externalities.

In general, externalities are not "property" under the existing legal system. The person "producing" a positive externality has no property right allowing him to take advantage of the beneficial effects generated. And in most cases, the landowner who finds himself sub-

102. *See generally* R. MUSGRAVE & P. MUSGRAVE, *supra* note 56, at 56-61; Mishan, *The Postwar Literature on Externalities: An Interpretive Essay*, 9 J. ECON. LIT. 1 (1971).

103. *See* Heller, *supra* note 6.

104. *See generally* W. PROSSER, HANDBOOK ON THE LAW OF TORTS § 89 (4th ed. 1971).

jected to a negative externality has no right to terminate it.[105] In both instances, the changes in value take place via interactions "external" to the property law.[106]

The vigor of this concept is best indicated by the zeal with which it is sometimes attacked. In a landmark article, Professor Joseph Sax has attempted to develop a new framework for analyzing the law of just compensation for takings of property.[107] His theory is that in many instances where governmental regulation causes a reduction in the value of a piece of property, part or all of that reduction may be considered a direct result of externalities produced by other pieces of property.[108] Irrespective of the conclusions that Professor Sax ulti-

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105. For example, to the owner who wants to build a swimming pool on his property, his neighbor's refusal to cut down a tree so as to increase the available sunlight would not be actionable. In some cases, however, zoning and nuisance law provide such rights. *See* text accompanying notes 103-04 *supra*.

106. The classic view of property rights would appear to suggest that externalities cannot even exist: "[*C*]*ujus est solum, ejus est usque ad coelum et ad inferos*," meaning, "to whomsoever the soil belongs, he owns also to the sky and to the depths." Macht v. Department of Assessment, 266 Md. 602, 604 n.1, 296 A.2d 162, 164 n.1 (1972). The phrase suggests that a piece of property is surrounded by walls extending infinitely high into the air and infinitely low into the crust of the earth, permanently and unalterably separating the property from surrounding units.

107. Sax, *Takings, Private Property and Public Rights,* 81 YALE L.J. 149 (1971).

108.

> The inadequacy of the view of property rights embodied in takings law can be demonstrated by reference to governmental regulation of strip mining. Assume that the government has prohibited all strip mining on land having a slope of more than twenty degrees, because it has been determined that, given present technology, mining on such lands exposes lower lying land, owned by others, to ruinous erosion. Under present practice, the question posed by a court would be whether the governmental regulation, however justified, so reduced the value of the restricted owner's land as to deprive it of all present economic productivity. If the effect of prohibiting strip mining were to make the mining land utterly worthless to the holder, who might own only coal mining rights, most courts today would award compensation to him. From the limited perspective of the mineral owner claimant, who asks that the general public bear the cost of thus advancing the social welfare, such a result might seem appropriate.
>
> It is more accurate, however, to identify the problem in quite another way. The mineral owner demands that the lower land serve to carry mining wastes while the lower owner demands that the upper lands be preserved in such a way as to protect his desired uses. Neither owner is merely using his own property, nor is either entitled a priori to have his demand met, for neither of the conflicting uses is, in some theoretical sense, superior to the other. Traditional legal analysis has looked only to the effects of government action on the complainant's land, and has thus attended to only one fraction of the problem, for the property interest in controversy is not simply the land circumscribed within the boundaries of the mine owner's tract, but the totality of property the mine owner is using, which includes the land owned by those lower down. Is there any reason in theory why the lower owner ought not to be equally entitled to recover from the government for failing to protect his property right to use his land for residential purposes by prohibiting mining above him? Surely there

mately draws regarding the proper measure of compensation to be paid when governmental regulation decreases the value of a piece of property, his analysis underscores a characteristic of the existing system, namely, that property law often refuses to take cognizance of externalities. This refusal has obvious consequences for a system of taxation of property rights;[109] specifically, it produces answers for the questions posed at the start of this analysis.

Can a property owner seek a reduced assessment when the use of his property increases the value of someone else's property? No, for that increase in value is produced by an externality, which in itself generates no property rights. Property tax is imposed on the owner's *property;* in the absence of any effect on his property rights, there should be no change in his assessment. This concept might profitably be restated as a general proposition:

> In valuing a real property interest for property tax purposes, the effects of the owner's use on the value of other property interests should be ignored. The assessment of any parcel should be independent of its effects on other parcels.

As for the second question, can the effect of an unactionable negative externality be ignored in assessing a piece of property whose value is affected by it? Again, the answer is clearly no. Since the property owner has no right to terminate the externality, it would be unjust for the tax system to treat him as if he did. Indeed, it might profitably be said that the property tax must be consistent with the common law notion that a parcel is surrounded by infinite walls. The property owner is taxed solely on his use of the rights within such walls, although what happens *outside* the walls may have a substantial influence on the value of his rights. In a sense, each property is surrounded by what might best be described by the term "environment" —the set of all other properties whose uses will influence it via externalities. Each and every property can therefore be valued only when it is examined in the context of its existing "environment."

These concepts may now be applied to the taxation of benefitted tenements. Easements are created precisely for the externalities they

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> is no theory of property rights that suggests that property owners should have an advantage in conflict resolution merely because of superior physical position, *e.g.*, being located at the top of a hill.

Id. at 52-53 (footnotes omitted).

109. One suggestion of this is Cooley's observation, over a half century ago, that it is "generally made imperative that separate and distinct parcels of land be assessed separately." COOLEY ON TAXATION § 1068 (4th ed. 1924).

produce. In other words, the increase in value of the benefitted property is the result of an externality generated by the burdened property, and hence may be taxed even though the burdened property is to be assessed as if it were unrestricted. No problem of double taxation exists, since the benefitted property is not being taxed on *rights* that are assumed to remain in the restricted estate, but rather, on an increase in value resulting from externalities produced by the use of the restricted estate. An increased valuation of the benefitted estate merely acknowledges a beneficial change in that estate's environment.

That the owner of the benefitted property *paid* for the easement should not change the analysis. Assume that *A* and *B* own identical homes bordering on the property of *C*. Consider the following two possibilities:

1. *C* turns his property into a neighborhood park, giving *A* and *B* the right to keep it as such.
2. *A* pays *C* to turn his property into a park solely for his own benefit; only *A* can enforce the agreement.

In the first example, it should be evident that *A* and *B* can be taxed on the increase in the values of their properties as a result of *C*'s beneficence. There has been a change in the environment, which has affected their properties. The situation is similar to what happens whenever a neighborhood is upgraded—*all* the properties in that neighborhood generally increase in value. Indeed, to make the analogy even more compelling, assume that the increases in value to *A*'s and *B*'s properties result solely from aesthetic considerations and that neither *A* nor *B* may use the park in any way.

In fact, a property bordering the park need not receive any "rights" at all to increase in value; the mere existence of the park is what matters. The second example clarifies this observation. That *B* has no right to insist upon the park's existence affects the value of his property only to the extent that *A* declines to exercise his right. Conversely, if it is virtually certain that *A* and his successors in interest will insist upon the park's continued existence, the value of *B*'s property will increase as much as it did in the first example. In either case, the benefit *B*'s property receives is the result of an externality, and clearly should be recognized in the valuation process.

But what of *A* in example 2? Should he be treated differently from *B* because he paid for change in the environment? Because he has a right to enforce the agreement? Is there any reason not to tax him on the increase in value of his property as a result of the agree-

ment? The answer is clearly no. The benefits to *A*'s property are at least as great as those to *B*'s.

Thus, the effects of externalities upon a piece of property should always be taken into account, even if they have been caused by an arrangement initiated by the owner of the benefitted property. This is equivalent to saying that the effects of easements upon benefitted properties can be included in the valuation process. The assessing jurisdiction would not be acting inconsistently by doing this while simultaneously assuming that the servient estate should be viewed as unrestricted; as has been noted repeatedly, taking the external effects of the easement into consideration has nothing to do with the ownership of the rights in the servient estate. As the examples have shown, a person with no rights at all can be the beneficiary of an externality. A transfer of rights—which the property tax system ignores—should not be allowed to mask the creation of externalities, which in and of themselves can be introduced into the valuation process.

Were this rule applied to the *Twin Lakes* case, the homes surrounding the golf course would have been taxed according to the full $1,141,108 increase in value. Such a result is entirely justified since the golf course will be there for the indefinite future, and its close proximity to the homes will continue to increase their value.[110] The assessing authorities should be allowed to take account of this very concrete, externality-induced increase in market value.

V. The Policy Perspective

The theme of this paper has been that for the purposes of taxing burdened property, private restrictive agreements need not be recognized by an assessing jurisdiction. There will, however, be instances in which a jurisdiction does wish to recognize particular types of restrictive agreements in order to encourage certain desired land uses. This possibility suggests two important questions: (1) What restrictive agreements should a jurisdiction recognize? (2) What conduct by the jurisdiction should be held to constitute such recognition?

The latter question is the more easily answered. The simplest case would be where the jurisdiction has prohibited a particular use of a property; to treat the landowner as if he could disregard the

110. As noted earlier, the golf course was open to persons outside of the development, but could not attract sufficient members to be profitable. Thus, the increases in value of the homes were clearly due to the nearby presence of the golf course as open space, and not as a result of any special rights to become members of the course.

prohibition would be a fraud. Consequently, zoning restrictions should not be disregarded.[111] Admittedly, such restrictions often change over time, and thus may not permanently bind a landowner. The effect of the restriction on present market value may nevertheless be determined, and should be recognized.

A second important category of restrictions that should be recognized comprises those that have been implicitly encouraged by the jurisdiction. The *Twin Lakes* case provides an example. There, the developer had set aside land for a golf course precisely because the zoning laws gave favorable treatment to developments containing open space areas.[112] Such encouragement should be sufficient to estop the government from taxing the property as if it were in an unrestricted state. In essence, favorable property tax treatment should be part of the landowner's side of the *quid pro quo* by which the agreement is created.

Finally, there may be *explicit* governmental approval of private restrictions. Jurisdictions can establish procedures under which landowners wishing to restrict land for particular purposes will be allowed to file papers describing the land and the proposed restriction. The taxing jurisdiction then "validates" the agreement, consenting to tax the property only in its restricted state. Of course, to avoid misuse of this system, it would be necessary to ensure that proposed restrictions will in fact be maintained over time; otherwise, an owner could get reduced assessments for several years and then sell the property to a third party who would not be bound by the restriction.

Actually, validation systems of this nature do exist. They have emerged primarily in open space preservation schemes, particularly in some of the western states where metropolitan areas are expanding rapidly, with the result that farm land surrounding cities is being converted to commercial and residential uses to meet the demands of growing population pressures.[113] The potential for such conversion in turn drives up the value of the remaining farmland and thus raises its tax assessment. To ease the burden on the farmers who wish to keep their land, many states have consequently instituted systems that permit restricted use assessment.

The system adopted in California is typical. The California property tax statute includes a subdivision entitled "Valuation of Open-

111. *See generally* Heller, *supra* note 6.
112. 87 Wash. 2d at 2-3, 548 P.2d at 539.
113. *See* Sullivan, *The Greening of the Taxpayer*, 9 WILLAMETTE L.J. 1 (1973).

Space Land Subject to an Enforceable Restriction," under which special "open-space" regions are set up within the state.[114] Persons owning land within these regions can, if they so desire, restrict their land by means of a number of permissible arrangements. In every case, however, the state is made a party to the agreement, and thus may enforce it.[115] In return, the restriction will be recognized for property assessment purposes.

One question remains: which types of restrictive agreements should a jurisdiction recognize? To answer this question, it is first necessary to examine the effect of recognizing a restriction. As suggested above, the better way to tax property is according to an assumption of unrestricted use, an assumption designed to maintain the tax base at a high level. To the extent that it recognizes restrictive agreements the taxing jurisdiction effectively decreases its tax base. In effect, the jurisdiction is making a *tax expenditure*—it is spending money by foregoing a given amount of tax revenue.[116]

An analysis of the merits of tax expenditures could take the space of several articles this size. For the moment, it is sufficient to observe that their efficacy is disputed, and with good reason.[117] In general, the purpose of a tax expenditure is to induce a change in someone's behavior. To the extent that its purpose is achieved an expenditure may be worthwhile, but even then one must question whether putting the tax dollars to direct use would have produced the intended result more economically.

There is one strong indication that property tax expenditures are likely to be as ineffective as those made in the income tax area. Over thirty states have open space preservation statutes, and the virtually unanimous conclusion is that these statutes are ineffective.[118] The comments of Henry Aaron are typical: "In practice, these agreements amount to preferred assessment. . . . If state governments conclude

114. CAL. REV. & TAX. CODE §§ 421-22 (West Supp. 1976). *See generally* Mix, *Restricted Use Assessment in California,* 11 SANTA CLARA LAW. 259 (1971); Comment, 13 SANTA CLARA LAW. 284 (1974).

115. *See* Comment, *supra* note 114, at 291.

116. *See generally* S. SURREY, PATHWAYS TO TAX REFORM (1974).

117. *See* Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures,* 83 HARV. L. REV. 705 (1970). Professor Surrey notes that most tax expenditures are wasteful, inefficient, and inequitable. Moreover, any benefits from the allegedly simple administrability of such measures are more than offset by the losses which result when tax legislation authorities are required to devise substantive regulations for areas they know little or nothing about.

118. *See, e.g.,* Sullivan, *supra* note 113; INTERNATIONAL ASS'N OF ASSESSING OFFICERS, *supra* note 94.

that development surrounding urban areas should be restricted, instruments of direct control are at hand."[119]

This result should at least make jurisdictions very wary of attempting tax expenditures in the property tax field. Moreover, it also stresses the importance of recognizing the proper tax treatment of restricted property. Taxing jurisdictions that needlessly take private restrictive agreements into account in the valuation process err twice. Not only do they forego tax revenue; they in effect spend that foregone money in an inefficient manner.

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119. H. Aaron, Who Pays the Property Tax? 85-86 (1975).