Property Tax Valuation Reporting Insights

Reporting Guidelines for Real Estate Appraisal Reports

Robert F. Reilly and Robert P. Schweihs

Introduction

Appraisal reports become important documents in property tax assessments, negotiations, appeals, and litigation where the value of real estate is at issue. In these property tax dispute instances, many parties (not only the appraiser's client) have an interest in the appraisal report. For different reasons, all parties to the property tax dispute are interested in whether the appraisal report is methodologically rigorous, comprehensively prepared, and accurately concluded.

For parties to a property tax dispute (including the property owner, the assessor, and the ultimate administrative or judicial finder of fact), this discussion will (1) describe the basic components of a real estate appraisal report, (2) illustrate the typical sections presented in such an appraisal report, and (3) summarize the factors to look for in such an appraisal report.

The Appraisal Report

The Uniform Standards of Professional Appraisal Practice (USPAP) defines an appraisal report as follows: "any communication, written or oral, of an appraisal, appraisal review, or appraisal consulting service that is transmitted to the client upon completion of an assignment."[1]

USPAP also presents the following definitions that are relevant to real estate appraisal reports:

> Self-Contained Appraisal Report: a written report prepared under Standards Rule 2-2(a).
>
> Summary Appraisal Report: a written report prepared under Standards Rule 2-2(b).
>
> Restricted Use Appraisal Report: a written report prepared under Standards Rule 2-2(c).[2]

The selection of the appropriate type of report to prepare in any particular property tax appraisal assignment is influenced by (1) the specific instructions of the appraiser's client, (2) the relevant statutory authority, judicial precedent, or administrative rules, and (3) the experience and judgment of the individual appraiser. For purposes of this discussion, we assume (1) that the appraisal subject is real estate and (2) that the appraisal subject is a fee simple ownership interest in the subject property. Fee simple interest is the absolute ownership of a property unencumbered by any other interest or estate and subject only to the powers of the government. This discussion also assumes that the appraiser prepares a narrative written appraisal report.

Real Estate Appraisal Report Summary

Exhibit 1 presents an illustrative table of contents (or report outline) for a typical narrative real estate appraisal report. This table of contents is consistent with the USPAP requirements for a self-contained appraisal report, i.e., a report prepared under Standards Rule 2-2(a).

Real Estate Appraisal Report Content

The following discussion summarizes the typical contents of a narrative real estate appraisal report.

Title Page

The title page should clearly identify the subject of the appraisal report. The title page typically identifies (1) the property address, (2) the definition of value, and (3) the "as of" valuation date.

Letter of Transmittal

The letter of transmittal typically includes the following information:

- date of letter and salutation,
- street address of the property and a brief description of the property,
- identification of the subject property ownership interest,
- statement that a property inspection and other necessary investigations and analyses were made by the appraiser,
- reference that the transmittal letter is an integral component of an accompanying appraisal report,
- identification of the type of appraisal and type of appraisal report,
- standard of value (or definition of value) concluded in the appraisal report,
- date of the appraisal,
- opinion of value,

Exhibit 1
Typical Narrative Real Estate Appraisal Report
Illustrative Table of Contents

Item	Topic
General Introduction	
1.	Title Page
2.	Letter of Transmittal
3.	Table of Contents
4.	Certification
5.	Summary of Important Conclusions
6.	Photographs
7.	Location Map
8.	Plot Plan
9.	Floor Plan
Purpose and Objective of the Appraisal	
10.	Type of Appraisal and Type of Appraisal Report
11.	Extraordinary Assumptions and Hypothetical Conditions
12.	General Assumptions and Limiting Conditions
13.	Purpose and Intended Use of the Appraisal
14.	Scope of the Appraisal
15.	Definition of Value and Date of Value Opinion
16.	Property Rights Appraised
Appraisal Data	
17.	Identification of the Property and Legal Description
18.	Identification of Personal Property, Intangible Property, or Other Nonrealty
19.	Ownership and History
20.	Market Area, City, Neighborhood, and Location Data
21.	Land Description
22.	Improvement Description
23.	Assessed Value and Annual Property Taxes
24.	Zoning
Analysis of Appraisal Data and Value Conclusion	
25.	Analysis of Highest and Best Use of Land as if Vacant
26.	Land Value of Highest and Best Use of Property as Improved
27.	Land Value
28.	Cost Approach
29.	Income Capitalization Approach
30.	Sales Comparison Approach
31.	Reconciliation and Opinion of Value
32.	Estimate of Exposure Time
33.	Professional Qualifications of Appraiser
34.	Addendum and Secondary Exhibits

Exhibit 2
USPAP Standards Rule 2-3
Real Estate Appraisal Report Certification

I certify that, to the best of my knowledge and belief:

—The statements of fact contained in this report are true and correct.

—The reported analyses, opinions, and conclusions are limited only by the reported assumptions and limiting conditions and are my personal, impartial, and unbiased professional analyses, opinions, and conclusions.

—I have no (or the specified) present or prospective interest in the property that is the subject of this report and no (or the specified) personal interest with respect to the parties involved.

—I have no bias with respect to the property that is the subject of this report or to the parties involved with this assignment.

—My engagement in this assignment was not contingent upon developing or reporting predetermined results.

—My compensation for completing this assignment is not contingent upon the development or reporting of a predetermined value or direction in value that favors the cause of the client, the amount of the value opinion, the attainment of a stipulated result, or the occurrence of a subsequent event directly related to the intended use of this appraisal.

—My analyses, opinions, and conclusions were developed, and this report has been prepared, in conformity with the Uniform Standards of Professional Appraisal Practice.

—I have (or have not) made a personal inspection of the property that is the subject of this report. (If more than one person signs this certification, the certification must clearly specify which individuals did and which individuals did not make a personal inspection of the appraised property.)

—No one provided significant real property appraisal assistance to the person signing this certification. (If there are exceptions, the name of each individual providing significant real property appraisal assistance must be stated.)[3]

- identification of any extraordinary assumptions and hypothetical conditions, and
- appraiser's signature.

Table of Contents

The table of contents typically lists all of the sections of the appraisal report in the order in which they are presented. If there are major divisions with the report, they may also be presented in the table of contents.

Certification

The certification is typically presented as a separate page in the introduction section of the appraisal report. However, the certification may be combined with the final value conclusion. In any event, the appraiser(s) will sign and date the certification. The certification will indicate whether the appraiser personally conducted the appraisal in accordance with USPAP.

According to USPAP Standards Rule 2-3, each written real estate appraisal report should contain a signed certification similar in content to the certification presented in Exhibit 2.

Summary of Important Conclusions

The summary of important conclusions page, sometimes called the executive summary page, typically includes the following items:

- a brief identification of the subject property,
- estimate of the highest and best use of the land as if vacant,
- estimate of the highest and best use of the property as improved,
- age of the improvements,
- abbreviated site description,
- land value opinion,
- value indication from the cost approach,
- value indication from the income capitalization approach,
- value indication from the sales comparison approach,
- final estimate of the defined value, and
- description of any extraordinary assumptions or hypothetical conditions.

The summary of important conclusions may be the most important page in the property tax appraisal report. This page allows the parties to the property tax dispute to focus on (1) the summary description of the subject property and (2) the appraiser's value conclusion regarding the subject property.

Photographs

As a general rule, there cannot be too many photographs in a property tax appraisal report. One of the appraiser's responsibilities is to adequately acquaint the reader with the subject property. Photographs help this process of acquainting the reader with the subject property. The more informed the reader is regarding the subject property, the more likely the reader is to accept the report value conclusion.

Location Maps

Location maps continue the process of familiarizing the reader with the subject property. It is not uncommon for the property tax appraisal report to present two or three location maps. In this case, each successive map presents a more localized location. Ideally, the reader will be able to look at the most localized location map and know exactly where the subject property is located.

Plot Plan

A plot plan is a plan showing the layout of the improvements on the subject property site. A plot plan typically shows improvement locations (on the site), improvement dimensions, landscaping, parking areas, and other physical features. *The Dictionary of Real Estate Appraisal* defines a plot as follows:

1. A plan, map, or chart of a city, town, section, or subdivision indicating the location and boundaries of individual properties.
2. A map or sketch of an individual property that shows property lines and may include features such as soils, building locations, vegetation, and topography.[4]

Floor Plan

A floor plan is the architectural drawing that shows the floor layout of a building including (1) the exact room sizes and (2) the special relationships of the rooms. A poorly designed floor plan (or room layout) could be an important factor in the appraisal. This is because a poorly designed floor plan may indicate the existence of functional obsolescence.

Type of Appraisal and Type of Appraisal Report

USPAP defines two alternative types of real estate appraisals: (1) complete appraisal and (2) limited appraisal. These two types of appraisals are defined as follows:

> Complete Appraisal: the act or process of developing an opinion of value or an opinion of value developed without invoking the departure rule.
>
> Limited Appraisal: the act or process of developing an opinion of value or an opinion of value developed under and resulting from invoking the departure rule.[5]

USPAP also defines the following three types of real estate appraisal reports:

> Self-Contained Appraisal Report: a written report prepared under Standards Rule 2-2(a).
>
> Summary Appraisal Report: a written report prepared under Standards Rule 2-2(b).
>
> Restricted Use Appraisal Report: a written report prepared under Standards Rule 2-2(c).[6]

The appraisal report should clearly identify: (1) the type of appraisal performed and (2) the type of appraisal report presented.

Extraordinary Assumptions and Hypothetical Conditions

The Dictionary of Real Estate Appraisal defines an extraordinary assumption as follows:

> An assumption, directly related to a specific assignment, which, if found to be false, could alter the appraiser's opinions or conclusions. Extraordinary assumptions presume as fact otherwise uncertain information about physical, legal, or economic characteristics of the subject property; or about conditions external to the property such as market conditions or trends; or about the integrity of data used in an analysis. An extraordinary assumption may be used in an assignment only if:
>
> - It is required to properly develop credible opinions and conclusions,
> - The appraiser has a reasonable basis for the extraordinary assumption,
> - Use of the extraordinary assumption results in a credible analysis, and
> - The appraiser complies with the disclosure requirements set forth in USPAP for extraordinary assumptions.[7]

The Dictionary of Real Estate Appraisal defines a hypothetical condition as follows:

> That which is contrary to what exists but is supposed for the purpose of analysis. Hypothetical conditions assume conditions contrary to known facts about physical, legal, or economic characteristics of the subject property; or about conditions external to the property, such as market conditions or trends; or about the integrity of data used in an analysis. A hypothetical condition may be used in an assignment only if:
>
> - Use of the hypothetical condition is clearly required for legal purposes, for purposes of reasonable analysis, or for purposes of comparison,
> - Use of the hypothetical condition results in a credible analysis, and
> - The appraiser complies with the disclosure requirements set forth in USPAP for hypothetical conditions.[8]

Hypothetical conditions or extraordinary assumptions that affect the value conclusion may be an important part of the appraisal report. Accordingly, such extraordinary assumptions and hypothetical conditions should be clearly stated.

When a value conclusion is subject to an extraordinary assumption or hypothetical condition (such as a pending lease agreement, atypical financing, or a known but not yet quantified environmental issue), the appraisal report should describe the condition so that its effect on the value conclusion is clear.

General Assumptions and Limiting Conditions

General assumptions and limiting conditions are sometimes stated in the appraisal report letter of transmittal. However, they are more commonly included as a separate page in the appraisal report. This is because, technically, the letter of transmittal is not part of the appraisal report.

The statement of assumptions and limiting conditions is used both (1) to help protect the appraiser and (2) to inform the client and other parties to the property tax dispute. The general assumptions related to the appraisal report often encompasses issues such as: (1) legal and title considerations, (2) liens and encumbrances, (3) property management, (4) information furnished by others (e.g., engineering studies, surveys), (5) concealment of hazardous substances on the subject property, (6) compliance with zoning regulations, and (7) compliance with local, state, and federal laws.

General assumptions and limiting conditions should not be considered a "boilerplate" section. Each assumption or limiting condition should be reasonable and supportable in the context of the particular property tax appraisal. And, the statement of general assumptions and limiting conditions should not conflict with the appraiser's other professional responsibilities, such as the identification of extraordinary assumptions or hypothetical conditions.

Purpose and Intended Use of the Appraisal

The purpose of the appraisal is the question that the client and the appraiser seek to answer. To avoid an unintended (and inappropriate) use of the appraisal report, the intended use and the intended user of the appraisal should be specified in the report. *USPAP* defines both terms "intended use" and "intended user" as follows:

> INTENDED USE: the use or uses of an appraiser's reported appraisal, appraisal review, or appraisal consulting assignment opinions and conclusions, as identified by the appraiser based on communication with the client at the time of the assignment.
>
> INTENDED USER: the client and any other party as identified, by name or type, as users of the appraisal, appraisal review, or appraisal consulting report by the appraiser on the basis of communication with the client at the time of the assignment.[9]

Scope of the Appraisal

A clear and accurate description of the scope of the appraisal is useful to all parties to the property tax dispute. The scope of the appraisal refers to (1) the amount and type of information researched and (2) the analyses performed in the appraisal assignment. Professional standards impose a responsibility on

the appraiser to determine the appropriate scope of work in order to (1) conclude the value opinion and (2) prepare the appraisal report. By describing the scope of the appraisal, the appraiser effectively accepts this responsibility.

Definition of Value and Date of Value Opinion

The definition of value (also called the standard of value) is the type of value that is estimated in an appraisal report. The date of the value opinion (also called the effective date of the appraisal) is the "as of" date to which the value opinion applies.

Market value is a common definition of value. However, not all property tax appraisals relate to market value. In some taxing jurisdictions, other definitions of value apply, such as true value, true cash value, full cash value, real market value, and others. Most of these alternative definitions of value are quite similar to market value. However, the appraiser should be aware of, and should consider, any subtle differences.

To mitigate controversy in the property tax dispute, the appraiser should use the definition of value appropriate to the subject jurisdiction. If the appraiser is not sure of the applicable definition of value, then he or she should consult with the client or with the client's legal counsel.

Property Rights Appraised

In addition to identifying the subject property, the appraisal report should state and define the particular property rights or ownership interests being appraised. Typically, most property tax appraisals involve the valuation of a fee simple estate.

However, a thorough discussion of the property rights appraised is appropriate in an appraisal of partial interests in property, limited ownership rights such as surface rights or mineral rights, fee simple estates subject to long-term leases, and leasehold interests. In addition, such other encumbrances as easements, mortgages, and special occupancy or use requirements should be identified and explained in relation to the definition of value concluded.

Identification of the Property and Legal Description

When real estate is sold, leased, or borrowed against, legal documents describe the transaction. In each case, the subject property is identified in these documents by its legal description. There are three basic types of legal description: (1) the recorded lot, block, and tract (also known as the recorded map or subdivision map) description, (2) the metes and bounds description, and (3) the government (or rectangular) survey description. Some valid legal descriptions may use combinations of these three types.

Identification of Personal Property, Intangible Property, and Other Nonrealty

It is particularly important for the property tax appraisal report to identify (1) the nonrealty items included in the appraisal and (2) the nonrealty items excluded in the appraisal. This is because some nonrealty items (e.g., intangible assets) should not be included for the subject purpose. There are three common types of nonrealty items that are often identified in an appraisal: (1) personal property, (2) business value, and (3) tax incentives.

Ownership and History

The appraisal report should discuss both (1) the current ownership of the property and (2) the history of recent sales of the property. Such a discussion is not only a common appraisal procedure, it is also a USPAP requirement. USPAP Standards Rule 1-5 states the following:

> In developing a real property appraisal, when the value opinion to be developed is market value, an appraiser must, if such information is available to the appraiser in the normal course of business:
>
> (a) analyze all agreements of sale, options, or listings of the subject property current as of the effective date of the appraisal; and
>
> (b) analyze all sales of the subject property that occurred within the three (3) years prior to the effective date of the appraisal.[10]

Market Area, City, Neighborhood, and Location Data

Arguably, no other aspect of the property tax appraisal is as important as the market area, city, neighborhood, and location analysis. In particular, defining the subject neighborhood may be difficult in the appraisal of an industrial or commercial property. The term neighborhood may be defined as follows:

> A neighborhood is a cluster of properties (most of which are) of relatively similar land use and value.[11]

Neighborhood boundaries are influenced by a wide variety of factors, usually economic, physical, or legal in character. Economically, such boundaries are determined by where the benefits of the location seem to change. Evidence of such a boundary can be seen in (1) the changes in the types of buildings or land uses, or (2) the changes in the shared characteristics of the occupants. Physical features often define the boundaries of a neighborhood. Examples include rivers, lakes, and mountains, as well as freeways, railroads, and other human-made structures. City, school district, and/or zoning boundaries are commonly noted by property tax appraisers as legal

factors establishing neighborhood boundaries. Neighborhood boundaries are influenced by (1) economic factors, physical features, or legal boundaries or by (2) changes in the characteristics of occupants, buildings, and/or uses.

The market area, city, neighborhood, and location analysis should begin with a factual description of the significant characteristics of the subject area. The following characteristics are typically considered in the appraisal:

1. Location: Classified as urban, suburban, or rural.
2. Development and growth rate: The percentage of available land that has been built up or developed. Growth rate may be described as rapid, static, or slow.
3. Trend of property values: Whether values are increasing, stable, or declining.
4. Demand/supply: Whether subject property type supply is short, in balance, or in oversupply compared with current demand.
5. Marketing time: The average time needed to sell a reasonably priced property in the relevant market area.
6. Predominant occupancy: Whether owner or tenant occupancy predominates—show approximate vacancy percentage.
7. Typical property price and age: The range of property prices in the relevant market area and the predominant price; also the age range and typical age of existing competitive properties.
8. Present land use percentage: The relative percentage of residential, commercial, or industrial buildings and vacant land in the defined market area.
9. Land-use change: Whether change in land use in the near future is not likely, likely, or in process.

Generally, four categories of factors affect the market area analysis: physical factors, economic factors, social factors, and political factors.

Exhibit 3 presents a listing of data that the appraisal report typically considers in a market area, city, neighborhood, and location analysis.

Land Description

Land that has been graded and prepared for a specific purpose is typically referred to as a site. A site has features that are classified as physical, locational, legal, and economic. Land is immobile and, therefore, it is significantly influenced by its surroundings. The value of land is a function of its ability to satisfy a market need. Land value is determined by its highest and best use under current market conditions. The most common factors in the land description are listed below:

Exhibit 3
Typical City, Neighborhood, and Location Data

Typical Types of Information

- Area topography
- Regional natural resources
- Regional climate
- Available public transportation:
  - Air
  - Rail
  - Bus
  - Subway
  - Route maps
- Area expressways
- Area traffic patterns
- Regional population trends
- Typical family size
- Zoning types
- Typical building codes
- Regional employment level
- Area level of business activity and growth
- Area average family income
- Typical rents and lease features
- Typical percentage of vacancies
- Neighborhood new buildings (amount and kind)
- Number building permits issued
- Property tax structure and rates
- Typical utilities or improvements available (streets, curbs, sidewalks, water, electricity, telephone, gas, sewers)
- Neighborhood percent built up
- Neighborhood boundaries
- Predominant type of building
- Typical age of buildings
- Typical condition of buildings
- Price range of typical neighborhood properties
- Typical marketability
- Neighborhood land value trends
- Location of facilities: churches, schools, shopping, recreational, cultural
- Neighborhood avenues of approach
- Area availability of personnel
- Neighborhood employee amenities (shopping, eating, and banking facilities)
- Neighborhood competition for subject property
- Typical types of industry (light, heavy)
- Sources of raw materials
- Neighborhood hazards and nuisances
- Deed restrictions
- Changing use of area

1. size and shape,
2. topography, and
3. frontage.

Other land description factors commonly include: drainage and water runoff, soil conditions, environmental conditions, site access and transportation patterns, visibility, and neighboring property uses.

Improvement Description

The next section of the appraisal is a description of the subject physical improvements. These improvements include any structure on the site as well as any improvements added to the site, such as parking lots, utility lines, storm drainage, and landscaping. Each improvement has its own specific characteristics that should be analyzed by the appraiser. Structural improvements consist of a combination of physical components designed to serve a specific purpose. The typical factors included in the improvements description are listed below:

1. use;
2. size;
3. architectural style;
4. construction type;
5. site preparation and foundation;
6. frame;
7. floor structure;
8. floor covering;
9. ceiling;
10. interior constructions;
11. plumbing;
12. sprinkler system;
13. heating, ventilation, and air-conditioning;
14. electrical system;
15. exterior walls;
16. roof;
17. insulation;
18. special building features;
19. building additions; and
20. site improvements.

Assessed Value and Annual Property Taxes

The property tax appraisal report will typically describe both (1) the property's assessed value and (2) the property's annual property tax expenses. In addition to ad valorem taxes, direct (or "special") assessments can also affect the property's total tax burden. Often collected with regular property taxes, direct assessments are imposed by local government entities. Municipal street lighting, water supply systems, sewage treatment plants, and public landfills may be financed by special assessments, as may flood and water runoff control services. Also, direct assessments are sometimes imposed to reimburse developers of new subdivisions for the cost of streets, curbs, and utilities.

Zoning

Virtually all communities have zoning ordinances that control land use in their jurisdictions. Zoning ordinances vary widely from one community to another both (1) in land-use classifications and (2) in methods of implementation. The appraiser may be faced with a situation in which the subject property is not zoned to allow for what appears to be its highest and best use. The appraiser who makes a zoning change assumption in a property tax appraisal should be able to support the conclusion (1) by presenting evidence of land-use changes in the area, (2) by citing comparable successful zoning petitions, or (3) by quoting support for a zoning change from appropriate public officials.

Analysis of Highest and Best Use as if Vacant

The analysis and conclusion of the subject property highest and best use is a standard procedure in any real estate appraisal. Concluding highest and best use is not only a generally accepted procedure, it is a USPAP requirement. USPAP Standards Rule 1-3 provides the following instruction with regard to highest and best use:

> When the value opinion to be developed is market value, and given the scope of work identified in accordance with Standards Rule 1-2(f), an appraiser must:
>
> (a) identify and analyze the effect on use and value of existing land use regulations, reasonably probable modifications of such land use regulations, economic supply and demand, the physical adaptability of the real estate, and market area trends; and
>
> (b) develop an opinion of the highest and best use of the real estate.[12]

In a highest and best use analysis, the appraiser determines the property use that fulfills the following four tests:

1. physically possible,
2. legally permitted,
3. economically feasible, and
4. maximally productive.

Each of these four analyses is affected by the others. The amount of income that a particular use could generate is meaningless if legal approval for the use cannot be obtained. Likewise, not every legally permitted use will warrant the expenditure of funds required to bring it about. The appropriate combination of all four factors results in the single use that can be identified as the subject property highest and best use.

The traditional procedure for determining highest and best use is to analyze the site as if vacant. In the "as if vacant" analysis, the present structures are disregarded in the highest and best use analysis. However, the feasibility and cost of demolition and removal of existing structures should be noted. In this "as if vacant" analysis, the appraiser is following the "theory of consistent use." In other words, the site and the improvements will be valued based on the same use.

Analysis of Highest and Best Use as Improved

The first procedure in this analysis is to list all possible uses for the property. Generally, this list is relatively small and includes the current use plus several closely related alternatives. In some instances, however, there may be conversion or rehabilitation potential that can complicate the analysis. For example, the subject building may be used for low-quality offices. However, its location on major thoroughfare may suggest that rehabilitation into retail space would generate higher net operating income.

In this case, additional considerations in the highest and best use analysis include (1) the cost to rehabilitate the space plus (2) any costs needed to attract the appropriate tenants. Another possibility may be to rehabilitate the current building while maintaining the same general use. In that case, the rehabilitation costs should be considered, as well as rent-up of the rehabilitated space.

Land Value

The land valuation directly relates to highest and best use analysis. The relationship between (1) the highest and best use and (2) the land (or site) value may indicate whether the existing use is the highest and best use of the land. Land value can be a major component of total property value. Appraisers typically estimate land value separately, even when valuing properties with extensive improvements. Over time, land value and building value may change at different rates. This is because improvements are almost always subject to depreciation.

The appraiser can use several methods to estimate land value, including:

- sales comparison method,
- extraction method,
- allocation method,
- subdivision development method,
- land residual method, or
- ground rent capitalization method.

The most common method to estimate land value is the sales comparison method. However, (1) when few sales are available or (2) when the value indications of the sales comparison method need additional support, the other land valuation methods may be used.

Cost Approach

The principal procedures in a cost approach analysis are outlined as follows:

1. Estimate the highest and best use of the site. This initial procedure provides a basis for selecting comparable site sales. In addition, this procedure provides a basis for setting a benchmark against which accrued deprecation of the improvements is measured.
2. Estimate current dollar cost of either reproducing or replacing the subject improvements. In addition to direct costs and indirect costs, a current cost estimate typically includes both a developer's profit and an entrepreneurial incentive based on local market evidence.
3. Estimate the total dollar amount of accrued depreciation from all causes. This total accrued depreciation typically includes three categories of depreciation: (1) physical deterioration, (2) functional obsolescence, and (3) external obsolescence.
4. Subtract the dollar amount of total accrued depreciation from the estimate of the current reproduction or replacement cost new. This difference, if computed accurately, approximates the current value of the subject major improvements.
5. Estimate the replacement (or reproduction) cost new less depreciation for any minor buildings and other on-site improvements, such as landscaping, fencing, and driveways. The key to this procedure is to estimate the value (rather than the cost) that these improvements add to the overall value of the property.
6. Add the site value to the depreciated cost of (1) the building major improvements and (2) the other on-site improvements. The resulting sum is the estimated value of the subject property via the cost approach.

In the estimation of current cost, it is important that all cost components be considered. Total current construction costs (either reproduction or replacement) are often identified as direct and indirect costs. Direct costs are labor and materials (sometimes called "hard costs") and typically include:

1. labor hired by the general contractors and subcontractors;
2. materials used, beginning with site clearance to the final cleanup;
3. equipment, leased or owned;
4. temporary electric service; and
5. developer's overhead and profit.

Indirect costs (sometimes called "soft costs") typically include:

1. professional service fees, including legal, appraisal, financial feasibility, engineering, architectural, and surveying;
2. construction and possibly permanent loan charges;
3. property management commissions;
4. project management fees;
5. land lease rent, if appropriate;
6. real estate taxes;
7. project promotion charges; and
8. any other interim carrying costs.

The common construction cost estimation methods include:

1. quantity survey method,
2. unit-in-place construction method,
3. comparative unit method, and
4. historical cost indexing method.

The appraisal report should also describe the analyses related to estimating depreciation. Accrued depreciation is typically defined as a loss in value from any cause. The three types of accrued depreciation follow:

1. physical deterioration,
2. functional obsolescence, and
3. external obsolescence.

Income Capitalization Approach

The income approach converts the property's expected income or cash flow into a present value. There are two categories of income capitalization methods: (1) direct capitalization and (2) yield capitalization. Direct capitalization methods rely on direct capitalization rates typically extracted from comparable sales. And, yield capitalization methods rely on yield capitalization rates that are typically derived as the internal rate of return required by the typical investor. The yield capitalization method is typically applied as the more general discounted cash flow procedure. The appraisal report should adequately explain the relationship between the discounted cash flow procedure and the yield capitalization method. And, the appraisal report should adequately explain the relationship between yield rates and capitalization rates.

Value estimates may be calculated by applying an appropriate multiplier or capitalization rate to the subject property's expected income or cash-flow. The term direct capitalization is sometimes used to refer to the procedure of extracting income multipliers or capitalization rates from comparable sales. However, capitalization rates and income multipliers derived from comparable sales do not explicitly address profitability. Rather, they are simply observed ratios of income to value.

Common direct capitalization multipliers or rates include: (1) income multipliers such as potential gross income multiplier (PGIM), effective gross income multiplier (EGIM), and net income multiplier (NIM) and (2) several capitalization rates such as overall capitalization rate, land capitalization rate, and building capitalization rate.

The PGIM is derived by (1) extracting PGIMs from comparable property sales, (2) comparing the comparable property attributes (physical, locational, and financial) to the subject property, and (3) selecting an appropriate multiplier. When either calculating value or extracting multipliers, the appraiser should ensure that the rents (however measured) are calculated on the same basis with regard to treatment of operating expenses (gross, net, and so on).

The primary difference between the EGIM and the PGIM is that the EGIM is applied to income after subtracting vacancy and collection loss. If (1) a difference in the vacancy rate of the comparable property and that of the subject property exists and (2) the difference is expected to continue, then use of the EGIM may be more appropriate.

The NIM is derived by (1) extracting NIMs from comparable property sales, (2) comparing the comparable property attributes (physical, locational, financial) to the subject property, and (3) selecting an appropriate multiplier. An advantage of the NIM is that it is applied to income after expenses (and vacancy and credit loss) are deducted from the PGI. If there is a difference in the expense ratios of the subject property and the comparable properties, the NIM may provide a more reliable value estimate.

Real estate value may be estimated by dividing the one-period net operating income (NOI) by an overall capitalization rate. The rate is estimated by (1) extracting overall rates from comparable property sales, (2) comparing the comparable property attributes (physical, locational, financial) to the subject property, and (3) selecting an appropriate overall rate. As with the PGIM, EGIM, and NIM, an implied assumption is that the future performances of the comparable properties and the subject property will be similar.

Real estate values may also be estimated by projecting cash flow over a typical holding period and discounting the cash

flow to a present value estimate using a discount rate. This valuation method is called yield capitalization (or a discounted cash flow analysis). The discount rate directly addresses the expected profitability of the property. The projected cash flow components are: (1) NOI and (2) the net proceeds from the property resale. The discount rate is sometimes called the "property yield rate" or overall yield capitalization rate.

Yield capitalization requires a projection of the estimated future income of the project property. Value is estimated by discounting this income, including any proceeds from reversion, at an appropriate yield rate. A specific procedure of the yield capitalization method is the discounted cash flow analysis. When estimating value using yield capitalization, the first-year NOI is explicitly estimated. The property income after the first year is either (1) explicitly estimated for each year of the investment holding period or (2) projected to change according to a particular mathematical process. Several common alternative property income patterns include: level income, compound change, and straight-line change.

Sales Comparison Approach

The comparability of the selected sale transactions is typically a controversial aspect of the sales comparison approach analysis. Therefore, market sale transactions should not be used unless the sale data have been confirmed by the appraiser or by a reliable delegate. And, this confirmation process should include inquiries into the circumstances causing the sale or affecting the transaction price. Verification is often obtained either from the seller or buyer of the property or from the agent who handled its sale. Circumstances affecting the comparable sales should also be researched, especially if extraordinary terms or conditions appear likely or if lack of objective, impersonal bargaining, or forced-sale motivations are suspected. Where the comparable sale was not arm's-length, and when adjustments for conditions or terms of sale cannot be made, it may be best not to use that transaction.

Price represents the amount paid for the real estate in terms of dollars. Before accepting the price as evidence of value, the appraiser should verify the transaction for the following conditions:

1. relationship of the parties,
2. date of sale, and
3. financial terms of sale.

Another controversial issue is the adjustments to the comparable sales to account for differences between the comparable properties and the subject property. Any adjustments related to differences due to variations in age, size, and quality of comparable vs. subject building construction should be identified and quantified in the appraisal report. Appraisers typically use one of the following methods to justify these adjustments:

1. detailed property analysis method or
2. overall property rating method.

Detailed Property Analysis Method

After confirming the sale prices and terms of sale with respective buyers, sellers, or brokers, the appraiser will typically inspect comparable properties for size and details of construction. This allows the appraiser to make price adjustments to make each sale as comparable as possible to the subject property.

Overall Property Rating Method

Under this method, market comparisons are based on an overall judgment as to the percentage-value adjustment called for in order to make each sale comparable with the subject property. The overall percentage applied to each comparable property in turn is justified by the appraiser's explanation that the subject property is better, poorer, or the same in relation to its construction as to type, size, features, age, and building condition. By adjusting the comparable sale prices upward or downward in accordance with the characteristics of the subject property, a market value estimate is derived.

The sales comparison approach is applicable in situations where there are an adequate number of similar properties that have recently sold. In using these sales, the appraiser will attempt to verify each sale in order to confirm the relationship of the parties, date of sale, and any financing terms. In analyzing comparable sales, it may be necessary to adjust a price if prices have changed between (1) the time the comparable property sold and (2) the subject appraisal date. Also, an adjustment is typically required if a comparable sale property's price was influenced by financing terms. The "cash equivalency" method is often used to adjust for this price influence. The purpose of this adjustment is to reveal the price that a comparable property would have brought without the influence of atypical financing.

Reconciliation and Opinion of Value

The final procedure is the reconciliation of the various value indications into a final value opinion. For appraisals performed for some purposes, it is reasonable to conclude a range of values as the final value opinion. For property tax appraisals, however, it is more common to conclude a point estimate as the final value opinion. The nature of reconciliation procedure depends on: (1) the purpose and objective of the appraisal, (2) the individual valuation approaches and methods used, and (3) the appraiser's assessment of the reliability of each value indication derived.

In addition to being a necessary procedure in any real estate appraisal, the valuation reconciliation procedure is required by USPAP. USPAP Standards Rule 1-6 indicates the following:

> In developing a real property appraisal, an appraiser must:
>
> 1. reconcile the quality and quantity of data available and analyzed within the approaches used, and
> 2. reconcile the applicability of suitability of the approaches used to arrive at the value conclusion(s).[13]

Estimate of Exposure Time

USPAP Statement on Appraisal Standards No. 6 (SMT-6) addresses the estimation of exposure time. USPAP Statements do not carry the weight of USPAP Standards Rules, so the consideration of exposure time is not a USPAP requirement. However, SMT-6 indicates that the analysis and conclusion of exposure time is a recommended procedure:

> Reasonable exposure time is one of a series of conditions in most market value definitions. Exposure time is always presumed to precede the effective date of the appraisal.
>
> Exposure time may be defined as follows: the estimated length of time the property interest being appraised would have been offered on the market prior to the hypothetical consummation of a sale at market value on the effective date of the appraisal; a retrospective opinion based on an analysis of past events assuming a competitive and open market.[14]
>
> The discussion of reasonable exposure time should appear in an appropriate section of the appraisal report, one that presents the discussion and analysis of market conditions, and also be referenced at the statement of the value definition and at the value conclusion.[15]

Professional Qualifications of the Appraiser

The statement of the professional qualifications should describe the appraiser's education and training, experience and expertise, and professional credentials and designations. This statement should emphasize the appraiser's: (1) experience in conducting appraisals for property tax purposes and (2) experience appraising properties like the subject property.

Addendum and Secondary Exhibits

This section of the appraisal report should include all maps, charts, graphs, photographs, exhibits, spreadsheets, financial statements, legal documents, and other supplemental data not included in the narrative section of the report. It is a good idea to include a table of contents at the beginning of the addendum. This table of contents should list the contents of the appraisal report addendum.

Summary and Conclusion

Real estate appraisal reports are used by all parties to a property tax dispute. In particular, real estate appraisal reports are used by the finder of fact in a property tax dispute when concluding and rendering a value decision.

All parties to the property tax dispute should be able to rely on the appraisal report to provide factual description and data, rigorous empirical research, comprehensive qualitative and quantitative analyses, and impartial conclusions. Particularly within the context of a property tax dispute, real estate appraisal reports should be clear, convincing, and cogent.

Notes:

1. *Uniform Standards of Professional Appraisal Practice (USPAP)*, 2004 edition (Washington, D.C.: The Appraisal Foundation, 2004), p. 4.
2. Ibid.
3. Ibid., p. 31.
4. *The Dictionary of Real Estate Appraisal*, 4th ed. (Chicago: The Appraisal Institute, 2002), p. 214.
5. *USPAP*, p. 1.
6. Ibid., p. 4.
7. *The Dictionary of Real Estate Appraisal*, pp. 106-107.
8. Ibid., p. 141.
9. Ibid., p. 3.
10. Ibid., p. 21.
11. D.J. McKenzie and R.M. Betts, *The Essentials of Real Estate Economics*, 3rd ed. (Upper Saddle River, N.J.: Prentice Hall, 1992).
12. *USPAP*, p. 19.
13. Ibid., p. 21.
14. Ibid., p. 94.
15. Ibid., p. 95.

Robert Reilly and Robert Schweihs are managing directors of the firm and are located in our Chicago office. Robert Reilly can be reached at (773) 399-4318 or rfreilly@willamette.com. Bob Schweihs can be reached at (773) 399-4320 or rpschweihs@willamette.com. www.willamette.com