Department of Revenue

OVERVIEW OF REAL PROPERTY APPRAISAL PRACTICES

Pertinent tasks of the Real Property Appraiser in the Assessor's Office:

1. Discovering: Locate and identify all real property in the jurisdiction

2. Listing: Create and maintain an inventory of quantity, quality, and important characteristics of each property.

3. Valuing: Use appropriate appraisal techniques
- a. Cost Approach
- b. Sales Comparison Approach (Market Data Approach)
- c. Income Approach

4. Revaluing: Perform mass valuation updates on all real property within the jurisdiction.
- a. Statistical Ratio Analysis
- b. Mass Update

5. Defending: Review and support valuations appealed by the taxpayer
- a. County Board of Equalization
- b. State Board of Tax Appeals
- c. Court System

Market Value

By law, county assessors are to determine the fair market value of taxable property in their respective counties. RCW 84.40.030 governs the approaches an assessor shall use to value various types of property, which states:

> "All personal property shall be valued at one hundred percent of its true and fair value in money and assessed on the same basis unless specifically provided otherwise by law.
>
> *All real property shall be appraised at one hundred percent of its true and fair value in money and assessed as provided in RCW 84.40.0305 unless specifically provided otherwise by law.*
>
> Taxable leasehold estates shall be valued at such price as they would bring at a fair, voluntary sale for cash without any deductions for any indebtedness owed including rentals to be paid.
>
> The true and fair value of real property for taxation purposes (including property upon which there is a coal or other mine, or stone or other quarry) shall be based upon the following criteria:
>
> (1) Any sales of the property being appraised or similar properties with respect to sales made within the past five years. The appraisal shall be consistent with the comprehensive land use plan, development regulations under chapter 36.70A RCW, zoning, and any other governmental policies or practices in effect at the time of appraisal that affect the use of property, as well as physical and environmental influences. An assessment may not be determined by a method that assumes a land usage not permitted, for that property being appraised, under existing zoning or land use planning ordinances or statutes. The appraisal shall also take into account: (a) In the use of sales by real estate contract as similar sales, the extent, if any, to which the stated selling price has been increased by reason of the down payment, interest rate, or other financing terms; and (b) the extent to which the sale of a similar property actually represents the general effective market demand for property of such type, in the geographical area in which such property is located. Sales involving deed releases or similar seller-developer financing arrangements shall not be used as sales of similar property.
>
> (2) In addition to sales as defined in subsection (1) of this section, consideration may be given to cost, cost less depreciation, reconstruction cost less depreciation, or capitalization of income that would be derived from prudent use of the property. In the case of property of a complex nature, or being used under terms of a franchise from a public agency, or operating as a public utility, or property not having a record of sale within five years and not having a significant number of sales of similar property in the general area, the provisions of this subsection shall be the dominant factors in valuation. When provisions of this subsection are relied upon for establishing values the property owner shall be advised upon request of the factors used in arriving at such value.
>
> (3) In valuing any tract or parcel of real property, the true and fair value of the land, exclusive of structures thereon shall be determined; also the true and fair value of structures thereon, but the appraised valuation shall not exceed the true and fair value of the total property as it exists. In valuing agricultural land, growing crops shall be excluded." [Emphasis added.]

The Definition of Market Value is:

- the most probable price which a property should bring
- in a competitive and open market
- under conditions requisite to a fair sale
- the buyer and seller each acting prudently and knowledgeably
- assuming the price is not affected by undue stimulus.

Important to note!

Implicit in the definition of Market Value is the consummation of a sale as of a specified date and the passing of title from the seller to buyer under conditions whereby:

1. buyer and seller are typically motivated;
2. both parties are well informed or well advised, and acting in what they consider their best interest;
3. a reasonable time is allowed for exposure in the open market;
4. payment is made in terms of cash in United States dollars or in terms of financial arrangements comparable thereto;
5. the price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.

Subject Property Data

SITE

(a) location
(b) access
(c) size
(d) shape
(e) topography
(f) utilities
(g) amenities

SITE IMPROVEMENTS

(a) utility hook-ups
(b) driveway, landscaping, retaining walls, bulkheads,
etc.

IMPROVEMENTS

(a) Dwelling (qualitative/quantitative)

1. number of stories
2. exterior walls
3. roof material
4. size in square footage
5. basement (size/finish)
6. number of bedrooms
7. number of bathrooms
8. type of heating system / air conditioning
9. age (any remodeling) effective age
10. condition
11. quality
12. garages, carports, porches, decks
13. other (built-ins, fireplace, saunas, pools, hot tubs, etc.)

(b) Auxiliary structures

Valuation of the Property

Cost Approach:

Data needed

(a) quantified subject characteristics

(b) construction cost figures

(c) depreciation factors

(d) land value

Basic process

(a) enter subject data into format

(b) determine appropriate cost figures

(c) mathematics

(d) determine accrued depreciation

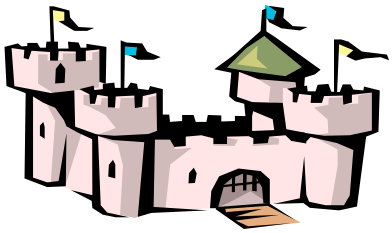
(e) subtract depreciation

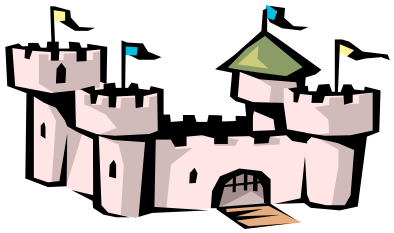
(f) add land value (some or all site improvements often included)

(g) arrive at estimate of value

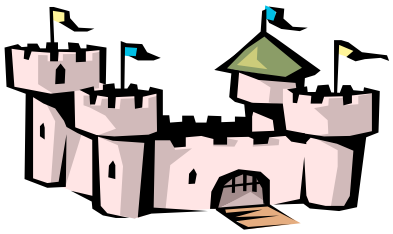
Reproduction Cost vs. Replacement Cost

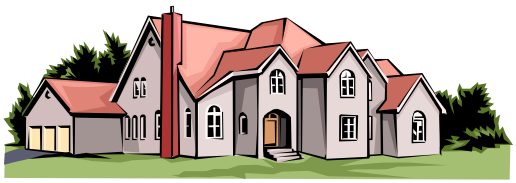
Reproduction Cost (defined) is the cost, including material, labor, and overhead, that would be incurred in constructing an improvement having **EXACTLY** the same characteristics as the improvement in question.





Replacement Cost (defined) is the cost including material, labor and overhead, that would be incurred in constructing an improvement having the same utility to its owner as the improvement in question, without necessarily reproducing exactly, any particular characteristic of the property.





Sales Comparison Approach:

(Market Data Approach)

Data needed

(a) subject characteristics

(b) comparable sales data and characteristics

1. valid sales
2. invalid sales

Basic process

(a) subject data into format

(b) select most similar comparables

(c) enter data from comparables

(d) adjust comps TO THE SUBJECT

(e) correlate indicated values into a single estimate of value

Additional process

(a) Gross rent multiplier

1. monthly rent
2. residential properties

(b) Gross income multiplier

1. annual gross income
2. commercial properties

SEE *HOMEWORK PROBLEM* HANDOUT
FOR SALES COMPARISON APPROACH EXAMPLE

INCOME APPROACH:

The Income Approach is the third approach to value. This material is a high-level overview of the Income Approach as it applies to typical commercial properties. For those that want to learn in more detail the International Association of Assessing Officers, or IAAO for short, has a 30-hour, 4-day course on the Income Approach.

The Income Approach is based on the concept that the value of a property can be estimated based upon the income that the property achieves from rent combined with the expected future sale price of the property.

Investors have a wide variety of investment choices that are available to them. They can buy stocks, bonds, real estate, other alternative investments, or they can put their money in a savings account. No matter what investment they choose, what the investors have in common is that at some point when they exit the investment and cash out, they want to get their initial investment back, plus some profit as well. Investors getting their initial investment back is known as "return of" investment, and investors earning a profit on their investment is know as "return on" investment. Investors considering different options evaluate the risk versus reward of different investments, meaning they weight the risk of losing the invested funds as compared to the reward of the potential profit.

In many ways, savings accounts and real estate are at opposite ends of the "risk/reward" spectrum and the characteristics of each investment can be compared and contrasted. In terms of the pros of savings accounts, savings accounts are very safe and low risk; the money deposit is usually insured against loss by the FDIC. A savings account can be opened with a small amount of money, and it's very liquid, meaning that the money in the account can be quickly and easily withdrawn. Savings accounts are also very passive investments since an investor can just deposit money and receive interest without any additional effort. The cons of savings accounts are that investors don't earn typically very much interest, in the sense that these accounts usually earn less than other investments and over periods of time don't even keep up with inflation. In addition, savings accounts do not have any income tax advantages, and there is no ability to leverage.

In contrast to savings accounts, real estate can be risky, because there is no guarantee against loss. Real estate is not a liquid investment, because the invested funds cannot be easily or quickly accessed without selling the property or borrowing against its value through "cash out" refinancing. Real estate requires a larger initial investment than savings account, and it also requires property management, so it is not a passive investment. Property management refers to the need to oversee tasks such as the maintenance of the property, the payment of the taxes, insurance, etc. Other examples of managerial decisions are the type of property to be purchased; whether to make repairs, capital improvements or renovations; hold the real estate, sell it, or refinance it.

Real estate investing is risker, less liquid, and requires more work than a savings account, but there are also advantages. Even though real estate has no guarantees against loss like an FDIC insured savings account, real estate typically tends to appreciate over time and can be used as a hedge against inflation. Also, real estate usually has tax advantages as compared to other investments. Real estate investors can often reduce, defer, or eliminate income taxes.

Real estate also allows for the use of leverage. Leverage is the borrowing of money in hopes of earning a greater return than the cost of the borrowed funds. The basic process is that an investor makes a down payment and borrows the rest of the purchase price to buy a commercial property. The investor then rents out the property and hopes to generate more each month in rental income than the cost of the mortgage, thereby earning a profit.

This concept of renting out a property and generating an income stream is what ties in with the Income Approach. Real estate investors are buying the physical land and buildings, but they are also buying the legal ability to receive a periodic and/or ongoing income stream. These income streams can be analyzed and evaluated to derive the value of a property.

When we look at the income stream, we want to think in terms of quantity, quality, and duration. Quantity means the amount of rent that landlord will get. Quality in this case refers to the likelihood that the landlord will continue to get the rent every month, compared to the risk that the tenant will miss rent payments. And duration refers to how long the income stream is expected to stay in place.

The relationship between a property's income stream and the value of the property can be expressed by the acronym "IRV".

"IRV" is an acronym that stands for Income, Rate, and Value. There is a mathematic relationship between Income, Rate, and Value, wherein if you know two, you can solve for the third.

1. "I", or Income, refers to NOI or Net Operating Income. This is equal to the total amount of income from rent minus expenses (vacancy, collection, maintenance, utilities, management, etc.)

2. "R" equals the rate, known as the capitalization rate or "cap rate". In direct capitalization, the cap rate reflects the relationship between a single year's net operating income and the total property value. R can also be thought of as the annual NOI being a certain percentage of the value of the property. R is derived from the market and from published sources.

3. V= property value. This is the variable appraisers are solving for, by using the two known values of "I" and "R".

Income Approach Key Takeaways

The Income Approach is based on the concept that the value of a property can be estimated based upon the income that the property achieves from rent combined with the expected future sale price of the property.

Investors getting their initial investment back is known as "return of" investment, and investors earning a profit on their investment is known as "return on" investment.

Commercial property is attractive to investors because they can buy it using leverage (debt) and receive tax advantaged income streams.

The income streams can be analyzed and processed into a value indication using the IRV formula, where IRV means Income, Rate and Value. If we know 2 of the 3 parts of IRV, we can solve for the 3rd part.

ADVANTAGES AND DISADVANTAGES OF EACH APPROACH

The ***COST APPROACH*** has the distinct advantage of universal application to all types of real property. It is the principle and sometimes only valuation approach for special purpose properties which rarely sell on the open market. It is well adapted and easy to apply under a mass appraisal system. This approach, however, does not always include a highly reliable estimate of depreciation. Especially in older structures, a large amount of depreciation would need to be estimated and subtracted from cost new.

The ***SALES COMPARISON APPROACH*** *(Market Data Approach)* is widely recognized as a highly reliable valuation approach by nearly all who are involved with real property values including taxpayer, boards of equalization, courts, salespersons, lenders, fee appraisers, and even assessors. It gets much of its acceptance from the active market. It is a true reflection of what those buyers and sellers determine value to be, and it is easy for the general public to readily understand it. There are instances, however, when sufficient sales data may not exist or the property is so unique that no reasonable comparables would be available.

The ***INCOME APPROACH*** *is* not suitable for valuation of residential properties or some types of special use properties, but generally the most reliable approach for commercial properties. The market for commercial properties is comprised of investors who make their decisions to buy or sell primarily on a properties quantity and quality of net income capabilities. For this property type, the income approach is a direct reflection of buyers and sellers in the market.

It should be noted that most users of appraisals require that all three approaches to value be considered, and if applicable, be processed into an estimate of value for the subject property. After each estimate is determined then the appraiser reconciles those various estimates of value into a single value by considering the strengths and the weaknesses of each of the approaches used in relation to the subject property and the data available.