



# **Guideline**

## **Property Tax Valuation Concepts - Residential and Commercial Property**

*July 2011*

### **True and Full Value**

The starting point of the assessment of real property is true and full value. For property classified as residential or commercial, true and full value means its market value. Market value is the price a property would bring if it were offered for sale in the open market for a reasonable length of time and purchased by a willing buyer from a willing seller, both parties being prudent and having reasonable knowledge of the property and neither being under undue pressure to complete the transaction.

The true and full value which the assessor believes to be correct should be used even though the property owner may not agree that it is correct.

### **Valuation by the Assessor**

It is the duty of the assessor to value all taxable tracts and lots listed in the assessment books and all taxable buildings and improvements. True and full value or market value is the standard of value to be used by the assessor for residential and commercial property.

Lots and tracts are valued separately from buildings and improvements, and the values are entered into the assessment book in the appropriate column opposite the description of the property. The value of buildings and improvements must be entered into the assessment book in the appropriate column opposite the description of the property.

It is important for the assessor to complete a thorough inspection of the interior and exterior of buildings in order to make an accurate valuation. The assessor should request the property owner's permission to enter and view the interior of the premises.

### **Residential Buildings versus Commercial Buildings**

A building classified as residential is one which is used as a dwelling by an individual or group of individuals and provides separate family living quarters for less than four separate family units.

Garages, barns and storage buildings located on a parcel with a residence and used in connection with the residential use are classified as residential.

A dwelling used for seasonal recreation and having living quarters for less than four separate family units is classified as residential property.

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Buildings not located on the same parcel as a residence and not used in connection with a residence should be classified as commercial property.

An apartment building or other building with four or more family living units is classified as commercial property.

Hotels and motels subject to license are classified as commercial property.

Any building that is not exempt as a farm building or does not fit within the residential classification must be classified as a commercial building. A reasonable amount of land on which a commercial building is located must be classified as commercial.

In the case of a property used partly for residential and partly for commercial purposes, the valuation of both land and structures must be prorated between residential and commercial and entered into the assessment book accordingly. A reasonable amount of land on which a taxable residence is located must be classified as residential.

Care should be taken to enter the assessment of buildings into the correct column of the assessment sheet. County and state boards equalize commercial and residential property separately, and an improper entry may result in an unjust equalization.

## **Incomplete Buildings**

A building under construction on February 1 is subject to assessment at its actual value on that date.

## **Vacant Lots**

\* The location of a vacant lot is probably the most important factor to take into consideration in estimating value for assessment purposes. Value will be affected by the location of the street and the location of property on the street. Due consideration must be given to the general prosperity or lack of it in the neighborhood and the city. Are all suitable buildings occupied? Are the people generally prosperous? Does the area have modern improvements? Is it well equipped with school facilities? These factors influence value.

The governing body of a city or township may establish valuations that recognize the supply of vacant lots available for sale. All vacant lots must be classified commercial. Only property used as a dwelling is classified residential.

## **Tax Maps**

It has been said that “to make a fair assessment without a tax map is either impossible or the work of a superlative genius.” This is particularly true in cities. It is important that city assessors have tax maps showing the dimensions of every assessed parcel of property. Tax maps show the valuation estimated for each lot either on the basis of a front foot valuation or a lump sum valuation.

## **Cost as a Basis of Valuation**

The cost approach to value is one of the three approaches to value used in the appraisal process. The other methods are sales comparison and income capitalization. The value obtained by use of the cost approach may be reconciled with the values indicated by the other two approaches.

The procedures in the cost approach are as follows: (1) estimate the value of the site or land as if vacant; (2) estimate current replacement cost new of the structures; (3) estimate the amount of accrued depreciation on the structures; (4) deduct the estimated accrued depreciation from the replacement cost new of the structures; and (5) add the estimated site value to the total depreciated replacement cost of all of the improvements to provide an indicated value of the appraised property.

The theory of the cost approach to value, like the sales comparison and income capitalization approaches, is based on the principle of substitution. That states that no prudent person would pay more for a property than the cost to acquire the site and construct improvements of equal desirability and utility, assuming that there are no costly delays encountered in making the substitution. Consequently, replacement cost new (RCN) of the structures prior to any deduction for accrued depreciation, plus land value, tends to set the upper limits of value. However, cost does not necessarily equal value. Cost may equal market value if the structure is new and the land is being put to its highest and best use.

In order for the cost approach to produce a valid indication of market value, one must consider accrued depreciation, which is the loss in value to the structures from all causes. The amount of accrued depreciation can be determined by using sales of comparable property and allocating the sale price between the land and the structures, then deducting the contributory value of the structures from the RCN of the structures sold. If the price allocation is less than the RCN, there is accrued depreciation. By applying the cost approach to similar properties that have sold, depreciation can be calculated as a percentage factor, which may then be used to calculate the accrued depreciation for the subject property or the property being appraised. For example:

RCN of structures sold			\$ 57,500
Sale price of property sold	\$ 45,000		
Land value of property sold	<u>15,000</u>		
Contributory value of structures			<u>30,000</u>
Accrued depreciation			\$ 27,500
Accrued depreciation as a percentage			
<u>Accrued Depreciation</u>	=	<u>\$27,500</u>	=
RCN		\$57,500	47.8%

If the structures on the subject property have an RCN of \$60,000, then RCN times the accrued depreciation percentage equals the dollar amount of accrued depreciation:

$$\$60,000 \times .478 = \$28,680 \text{ depreciation}$$

This method does not produce a breakdown or allocation of depreciation among the different categories. However, it is probably the most reliable method for determining accrued depreciation and it is a relatively fast method.

The causes of accrued depreciation fall into three general categories: physical deterioration, functional obsolescence and external obsolescence. Accrued depreciation is the loss in value from all causes. Physical deterioration and functional obsolescence relate to deficiencies within the property. External obsolescence is the loss in value due to factors outside the property itself.

Physical deterioration is the loss in value due to wear and tear and disintegration of the structures from the forces of nature and man. The two most common methods of estimating physical deterioration are depreciation tables and observed conditions. Generally, assessment officials prefer the use of depreciation tables that can be obtained from professional cost services.

Functional obsolescence is a loss in value as a result of defects in design or of changes which have taken place over the years which have made some aspects of the structure, materials or design obsolete by current standards. Examples of functional obsolescence include very high ceilings in residential structures or low-hanging pipes in commercial or industrial structures. One method of measuring functional obsolescence is to determine the difference between reproduction cost new and replacement cost new. Reproduction cost new is the current cost of producing an exact replica of a building or improvement using the same or very similar materials, design and workmanship. Replacement cost new is the current cost of producing a building or improvement having the same utility but using modern materials, design and workmanship. Generally, if the cost approach is based upon a replacement cost estimate instead of reproduction cost estimate, costs of excesses or deficiencies of construction are not included.

External obsolescence (EO) is the loss in value resulting from adverse influences outside the property itself. These include changing neighborhoods, shifting business districts and adverse economic conditions. Since EO is caused by factors external to the property, its adverse effect upon value may offset the land value, the structure value, or both. EO is sometimes referred to as location or community depreciation. It may be determined by market comparisons of similar properties that have recently sold. The RCN of the comparable property minus the contributory value of the structures (sale price minus land value) equals the accrued depreciation. Accrued depreciation minus depreciation due to physical deterioration and functional obsolescence results in depreciation attributable to external obsolescence of the comparable property and should be expressed as a percentage of the structure value after physical and functional depreciation. For example:

RCN of structures sold		\$ 57,500	
Sale price of property sold	\$ 45,000		
Land value of property sold	<u>- 15,000</u>		
Contributory value of structures		<u>30,000</u>	
Accrued depreciation		\$ 27,500	
Physical deterioration			
30% from table (30% x \$57,500)		<u>- 17,250</u>	
Remaining depreciation		\$ 10,250	
Structure value after physical deterioration			\$40,250
Functional obsolescence			
Reproduction cost new of deficiency			
or superadequacy	\$ 3,000		
30% physical deterioration	- 900		
Plus cost to remove/replace	+ 1,000		
Net functional obsolescence		<u>3,100</u>	
Structure value after physical deterioration and			
functional obsolescence			\$37,150
Remainder attributable to external obsolescence or			
19.2% of \$37,150 structure value after physical and			
functional depreciation		\$ 7,150	
Value of structures after physical, functional and external			
depreciation = contributory value of structure (above)			\$30,000

If the assessor has determined from sales analysis that certain property types have been affected by EO or community depreciation, it is appropriate to apply the same percentage factor for EO, in addition to physical and functional depreciation, to all property of the same type in the community.

In cities experiencing a normal rate of growth, the RCN minus physical and functional depreciation plus land value will conform very closely to the usual selling price of property because all of the buildings are in demand for use or rental purposes and do not have any EO. In cities with a declining population, property generally sells for less than the RCN minus physical and functional depreciation plus land value because of the number of vacant residential or commercial structures. In those cities where the supply of residential or commercial buildings exceeds the demand, the effect is a reduction in the value of those types of buildings. In order to estimate market value properly, it is necessary to make a reduction in value to account for the unfavorable local condition, sometimes described as community depreciation or external obsolescence.

Another example of EO is found if a residential structure is located in, or at the edge of, a business district. Such a situation is common in growing cities where the expansion of the business district has resulted in making what was once a desirable residential section now an undesirable location for a residence. Residences once considered to be valuable have, because of city growth, lost much of their former value. The lots upon which they are located have, as a rule, increased in value. While it is proper to increase the lot values, it is necessary to reduce the valuation of the residential structures to reflect the decrease in their value because of location or external obsolescence.

To derive a final value indication of a subject property, the assessor subtracts the total estimated amount of each form of depreciation from the current replacement cost new of the structures. The assessor adds the value of land to this amount to estimate the market value of the property.

## **Sales as a Basis of Valuation**

The sales comparison method is one of the more accurate methods of estimating market value. This method involves comparing the property being appraised to similar properties that have recently sold and reflects the actions of buyers and sellers in the real estate market. A buyer or seller usually examines other available properties before negotiating a final purchase price.

To use the sales comparison method to estimate market value, the assessor must have information about an adequate number of properties that have recently sold. The properties must be reasonably similar in physical characteristics and location. The county director of tax equalization can help the assessor obtain information about sales transactions from Statements of Real Estate Full Consideration completed for the sales ratio study. The assessor is cautioned to comply with the secrecy provisions which require that the names of the grantee (buyer) and grantor (seller) be kept confidential.

The assessor must consider and adjust for differences that exist between the property that sold (the comparable) and the property that is being valued (the subject). The three main comparison points to adjust are: (1) time (How recent is the sale?); (2) location (How close is the comparable to the subject property?); and (3) physical characteristics (How similar is the comparable to the subject property in size, shape and components?). After the assessor makes adjustments to the price paid for the comparable property to reflect those differences, the adjusted price is an indication of the value of the subject property.

## **Rentals as a Basis of Valuation**

The monthly or annual rental of real property, if properly used, is a guide to market value. In considering rental value, the assessor should be careful that rental value does not become the only measure of value. Rental value is the economic or income value and, under normal conditions, the rental value of improved property should be reasonably close to the cost or sales comparison value, provided the property is being used properly. It is essential that the assessor consider the potential or prospective earnings of the property when using rental information.

One method of estimating value is use of a gross rent multiplier (GRM). The GRM is calculated by dividing the sale price of a property that sold recently by the monthly rent. It is important to examine a number of similar properties that have sold recently to determine a valid GRM. The assessor estimates the value of the subject property by multiplying the monthly rent by the GRM.

A similar method is use of a gross income multiplier (GIM). The GIM is calculated by dividing the sale price of a property that sold recently by the annual gross income. The assessor estimates the value of the subject property by multiplying the annual gross income by the GIM.

Both the GRM and GIM allow for a reasonable return on the investment and make allowance for ordinary tax, depreciation, maintenance and management charges and all other proper charges connected with ownership of buildings and improvements.

The assessor should consider all other elements, as well as rental value, that will result in determination of true market value.