SPECIAL NOTE

THE INFORMATION WHICH FOLLOWS IS NOT TO BE VIEWED AS AN OFFICIAL STATEMENT OR POSITION OF THE IRS. WHILE TAKEN FROM TREASURY REGULATION AND CODE IT IS NOT MEANT TO BE AN INTERPRETATION AND PROVIDED AS COMMENTS AND SUGGESTIONS ONLY.

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VALUATION EXPECTATIONS FOR THE IRS

- A – Market Analysis
- B – Highest and Best Use
- C – Estate and Gift
- D – Fractional Interests
- E – Casualty Loss
- F – Fair Market Rent

EXPECTATIONS FOR MARKET ANALYSIS

- **MARKET ANALYIS - THE PRIMARY CONSIDERATION IN ALL VALUATION ASSIGNMENTS!**

MARKET ANALYSIS --THE FOUNDATION UPON WHICH ALL VALUATION CONSIDERATION RESTS IS DEPENDENT UPON THE ACCURATE AND REASONABLE ANALYSIS OF THE MARKET IN WHICH A PROPERTY FUNCTIONS (COMPETES).

ONLY THROUGH MARKET ANALYSIS CAN THE RELATIONSHIP BETWEEN REAL ESTATE AND VALUE BE IDENTIFIED

Thorough examination of the productive attributes of a property establishes:

1. Delineation of the subject's COMPETITIVE market, a fact finding exercise.
2. Explains the relationship between SUPPLY, DEMAND, and ABSORPTION, an analysis exercise.
3. Fundamental analysis to prepare a fully supported conclusion of Highest and Best Use.
4. Identifies the key factors of value that will be measured through application of the appropriate approaches to value (sales comparison, income capitalization, and cost).

THE BASIC DRIVERS OF VALUE

ABSORPTION: The rate at which the market satisfies its desire with its effective purchasing power (demand) for commodities of utility until there are none left or the few remaining are priced out of the purchaser's reach.

BALANCE: Rarely are supply and demand in balance. We review and analyze the volume of components and the constant state of change in markets. The cost of money and whims of market participants creates a state of chaos the appraiser tries to explain in terms of property value!

THE SIX BASIC STEPS OF MARKET ANALYSIS

Step 1, Define the potential products by property type.

Step 2, Quantify elements of market delineation (linkages, physical limitations, availability of resources).

Step 3, Demand analysis.

Step 4, Supply analysis.

Step 5, Analysis of the interaction between supply, demand and absorption.

Step 6, Forecast or projection of the subject’s capture rate potential and reconciliation.

EXPECTATIONS OF HIGHEST AND BEST USE ANALYSIS

- MUST be addressed and explained in every assignment
- Analysis of vacant land, or AS IF vacant when already improved
  - ❖ Legally permissible (zoning and potential for change, covenants, open space)
  - ❖ Physically possible (topography, flood plain, open space)
  - ❖ Financially feasible (uses that create value > vacant land)
  - ❖ Maximally productive (use that generates highest land value)

EXPECTATIONS OF HIGHEST AND BEST USE ANALYSIS

- Which land use alternatives satisfy the four tests
  - Agricultural
  - Industrial
  - Commercial
  - Residential
  - Special use
- When the assignment dictates, an ideal improvement analysis may be required (e.g., within residential, what type of housing is the maximally productive use)

EXPECTATIONS OF HIGHEST AND BEST USE ANALYSIS

- Analysis as improved (critical for historic preservation)
  - ❖ Legally permissible (zoning, covenants, TDR’s, size restricted)
  - ❖ Physically possible (does it fit, possibility to expand)
  - ❖ Financially feasible (existing use, alternative use, alter current)
  - ❖ Maximally productive (ideal improvement)

EXPECTATIONS OF HIGHEST AND BEST USE ANALYSIS

- What kind of improvement satisfies the four tests.
  - ❖ If not improved to the ideal what next
    - ❖ Leave it as an interim use
    - ❖ Alter the existing improvement to approach or match ideal
    - ❖ Demolish and start over

- The current use would not change until it is economically feasible to do so.

- The answer to HIGHEST AND BEST USE is always financial in scope, and must always be based on the analysis of MARKET CONDITIONS!

- At the end, does the conclusion make sense?

AS AN EXAMPLE . . .

- If you are going to suggest this should be a 35 acre subdivision -
  - Document current supply
  - Document current demand
  - Document absorption
  - Support DCF assumptions
  - Reconcile to bulk value
  - No LOF's or TMB's

EXPECTATIONS OF ESTATE APPRAISALS

- **Must cite the correct definition of Fair Market Value**
  - **Estate Tax – §20.2031-1(b)**
  - "The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. The fair market value of a particular item of property includible in the decedent's gross estate is not to be determined by a forced sale price. Nor is the fair market value of an item of property the sale price in a market other than that in which such item is most commonly sold to the public, taking into account the location of the item wherever appropriate."
  - **Must establish date of value. Date of Death or 6 months past DOD depending on tax strategy (client, attorney, and/or accountant decision, not the appraiser).**

EXPECTATIONS OF ESTATE APPRAISALS

- **No specific form or format for reports**
  - **Form 1004 typically not recommended.**
  - **Narrative or a general purpose form is preferred.**

- **Must follow Generally Accepted Appraisal Standards**
  - **USPAP compliance is the minimum standard.**
  - **Know and understand supplemental standards (IRS Code and Regulations).**

EXPECTATIONS OF ESTATE APPRAISALS

- **Must not allow taxpayer objectives to influence analysis and conclusions.**
  - **Complying with a request to reach conclusions higher or lower than FAIR MARKET VALUE intended to better the tax position of the client is unethical.**
  - **There are no high or low safe harbor margins.**

- **Must include all applicable and necessary approaches to value.**
  - **Direct Sales Comparison approach must be used.**
  - **Residential and commercial income producing properties should include an appropriate and supported income approach.**
  - **Cost approach may be a coin toss depending on land sales and accrued depreciation.**
  - **Discuss the exclusion of an approach not included in the appraisal.**

EXPECTATIONS OF GIFT APPRAISALS

- **Must cite the correct definition of Fair Market Value**
  - **Gift Tax -- §25.2512-1**

  - “The value of the property is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell, and both having reasonable knowledge of relevant facts. The value of a particular item of property is not the price that a forced sale of the property would produce. Nor is the fair market value an item of property the sale price in a market other than that in which such item is most commonly sold to the public, taking into account the location of the item wherever appropriate.”

EXPECTATIONS OF GIFT APPRAISALS

- No specific form or format for reports
  - Form 1004 typically not recommended.
  - Narrative or a general purpose form is preferred.

- Must follow Generally Accepted Appraisal Standards
  - USPAP compliance is the minimum standard.
  - Know and understand supplemental standards (IRS Code and Regulations).

EXPECTATIONS OF GIFT APPRAISALS

- **Must not allow taxpayer objectives to influence analysis and conclusions.**
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EXPECTATIONS OF PARTIAL INTEREST DISCOUNTING

- Real property rights may be subject to discounts in cases of partial interest ownership.
- Revenue Ruling 59-60 is the guideline.
- Real property rights are discounted for the fractional interest, this is <u>not</u> the sum of Lack of Control and Lack of Marketability.

  Lack of Control and Lack of Marketability are used in the valuation of shares of stock, a business valuation function and not appropriate for real property rights.

EXPECTATIONS OF PARTIAL INTEREST DISCOUNTING

- Comparison to partial interests are preferred.
- Partitioning costs generally the best alternative.
- Fractional interest method may be appropriate, but very complex.
- If none of these approaches are adequate, then fully discuss and support the alternatives used.
- Each case and data set is unique and must be analyzed as such.
- There is NO SUCH THING as a “safe harbor” discount rate.
- Discounting may be beyond the scope of work in the appraisal assignment and become an accounting and/or legal function.

EXPECTATIONS OF CASUALTY LOSS APPRAISALS

- IRC §165 – Primary legal guide

  Losses. (a) General Rule.

  > *There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.*

- PUB 547 is available and provides a basis for casualty loss analyses.
- Regulation locks IRS to Fair Market Value, no alternatives!
  - Value is measured immediately before the loss and immediately after the loss.
  - Value opinions are based on comparable sales when possible, but . . .
- Post casualty undepreciated value is Investment Value, not Fair Market Value.
  - Analyze sales data carefully (if you find any).

EXPECTATIONS OF CASUALTY LOSS APPRAISALS

- Fair Market Value after the loss is not inclusive of entrepreneurial profit for tax purposes.
- The value after repairs cannot be greater than the value of property before the repairs (must depreciate after repair value).
- Unreasonable repair costs must be adjusted to reflect market conditions.
- New or updated repair cost must be depreciated to property condition before the casualty.
- Loss deductions may be tied to “basis”.
  - This is an accounting or tax preparer consideration not an appraisal function.

EXPECTATIONS OF FAIR MARKET RENT

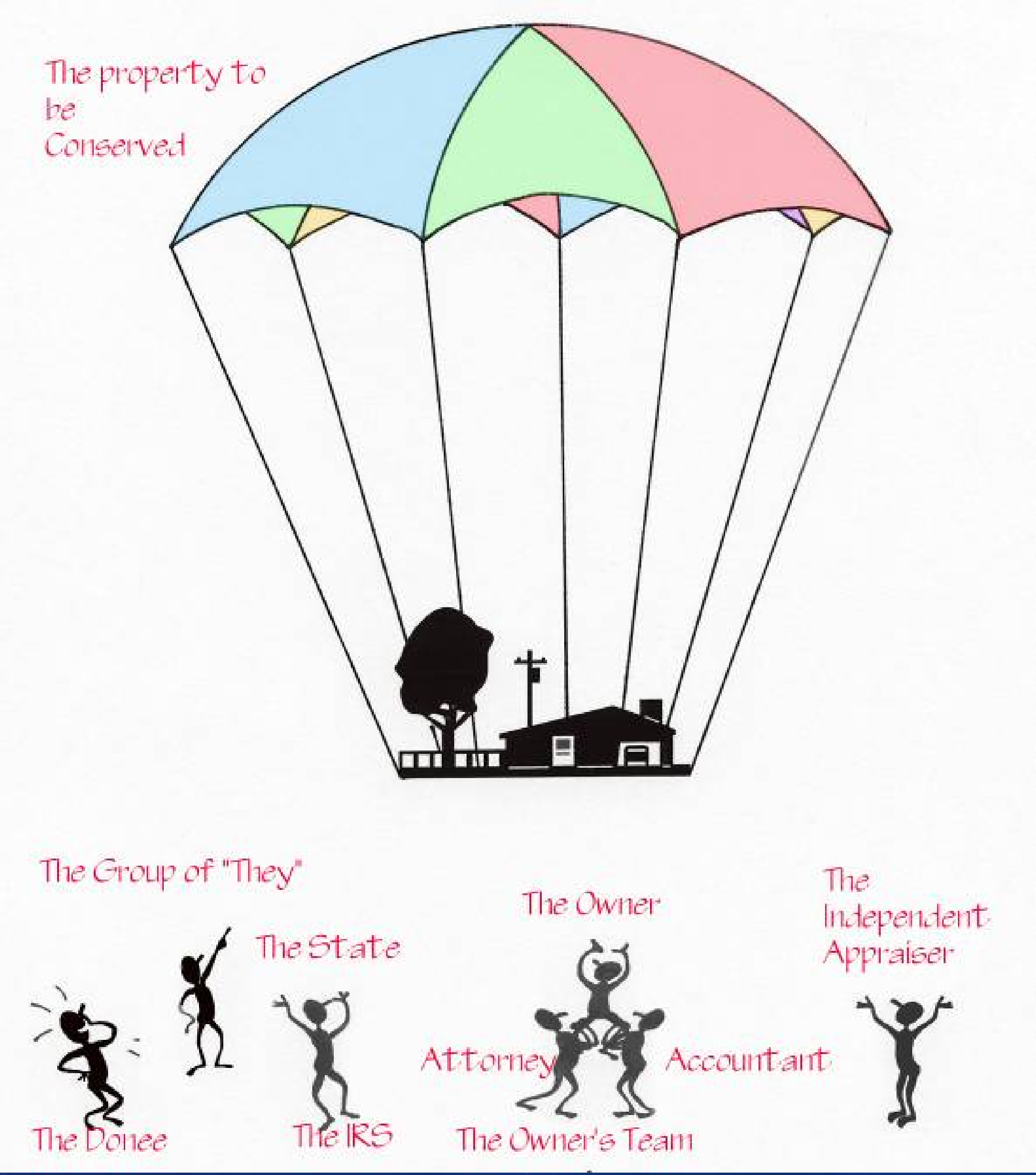
- Regulation always locks IRS to Fair Market Value therefore income analysis requires an assessment of Fair Market Rent.

- No published IRS definition of Fair Market Rent, but referenced in many tax decisions.

- The income and value relationship is a constant.
  - Fair Market Value is to Fair Market Rent as Market Value is to Market Rent.

EXPECTATIONS OF FAIR MARKET RENT

- Contractual Rent not at market indicates the leased fee value and establishes a leasehold advantage or disadvantage.
  - Is not an indication of Fair Market Rent.
  - Does not indicate Fair Market Value.
  - Not an acceptable measure.
- Financial Units of Comparison must be reflective of market norms for the property and appropriately supported.
  - Multipliers, (gross rent and gross income).
  - Capitalization Rates.
  - Internal Rate of Return and Discount Rate.
  - Assumptions in discounted cash flow must be explained and justified.



At the end of the day the goal is to have all the players on the same page regardless of assignment type. When the market is fully analyzed, highest and best use is justified, and truly comparable data is analyzed there should be little room for disagreement!

THE END

- It has been a pleasure to be here with you.
- Work for government entities is challenging and fun but dependent upon thorough knowledge and commitment to rules, law, and regulations.
- I am happy to answer your questions and available for conversation.
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