

How Tax Assessors Use the Income Approach to Value Property

A Fair Assessments, LLC Guide

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www.fair-assessments.com



About the Author

Daniel Thomas Jones

Daniel Thomas Jones is a property tax consultant at Fair Assessments, LLC which focuses on helping real estate owners minimize their property tax burden.

Before Fair Assessments, he worked for two other property tax management firms. Prior to his work as a property tax consultant, Daniel worked as a mass appraisal specialist at two county tax assessment departments including Fulton County, GA. He is also a licensed real estate appraiser, and has appraised thousands of properties

About Fair Assessments

Fair Assessments is a full service property tax reduction firm. When you engage us we will file the appeal on your behalf, do all of the research necessary to build a case for a lower value, and represent you in negotiations with the tax assessment staff and at formal hearings.

Fair Assessments has been in valuation services for 28 years. This has included licensed fee appraisal work, mass appraisal work with two counties, and property tax consulting work for the past 15 years. We have a high value reduction success rate and always get the appeals resolved such that your taxable value is capped for three years.

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Market Value

All states base their assessed value on fair market value (also referred to as “market value”), or a defined percentage of fair market value (here in GA we are assessed at 40% of the fair market value estimate).

Market value can be defined as: The most probable price that a property would sell for on a specific date, in terms of cash, and provided that the property is exposed to the open market, and the buyer and seller are both acting in their own best interests and are not under any undue pressure. Every state can have their own market value definition, but they all have all or most of the elements of the definition above.



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The Income Approach

The income approach is one of three recognized approaches to value.

The income approach is based on the principle of anticipation: The Income Approach uses capitalization to convert the anticipated benefits of the ownership of property into an estimate of present value. The income approach is most commonly used in the valuation of commercial, income producing property. It can only be used on single family houses if there is a very active rental market in the neighborhood.



it needs to be an income producing property type to use the income approach

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Income Approach Components

The income approach has three major components. They are potential gross rent (or income), operating expenses, and a capitalization rate.

Potential gross rent is the total annual amount that would be collected if the property was 100% occupied at market rent. Operating expenses are those expenses that must be paid to maintain the income producing capability of the property.

A capitalization rate is a rate that is used to convert an income estimate into an estimate of market value.

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Income

As stated above, potential gross rent is the annual amount that would be collected if the subject property was 100% occupied at a market rent.

Once the potential gross rent of the property is determined, deductions are made for a market vacancy rate and a market collection loss rate.

Any miscellaneous income from things such as laundry rooms, parking, concessions, and storage bins, as long as they are related to the ordinary operation of the project are added. The resulting number is called effective gross income, and this is the income amount that operating expenses are deducted from.



the income approach
is all about cash flow



physical deterioration is something
we are all familiar with

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Operating Expenses

Operating expenses are those expenses that are necessary to continue the income producing capability of the property. Some common operating expenses are management, insurance, utilities, repairs and maintenance, pest control, and replacement reserves (for replacement of short-lived components such as roofs and hvac systems).

Some improper expenses that are sometimes used in the income approach are tax depreciation (IRS), debt service (principal and interest), income taxes, and capital improvements. Capital improvements are major expenditures that tend to increase income and value.

After operating expenses are deducted from effective gross income the remaining dollar amount is called net operating income (NOI).

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Capitalization Rate

The capitalization rate converts income into a value estimate. The income to be capitalized is the net operating income. A capitalization rate that converts a single year's NOI into a value estimate is called an overall capitalization rate.

The process of converting a single year's NOI into a value estimate with an overall capitalization rate is called direct capitalization. This is the method that the tax assessors use to value income producing properties.

The best way to get a direct capitalization rate is to get recent sales of similar properties in the same market area and divide the NOI by the sale price. There are other ways but they are beyond the scope of this eBook.



cap rates vary over time and
with the business cycle

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The Total Value Estimate

Dividing a single year's NOI by the appropriate capitalization rate yields the value estimate. This value estimate includes the value of both the land and building

To separate the two, you would have to develop a land value separately, using say, a sales comparison approach to value and then deduct it from the total value.

This is typically what the tax assessors do, as they generally need to have both and land and improvement value in their system.

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A Caveat

Not all tax assessors use the income approach to value. Most tax assessors in large metropolitan areas have (CAMA) systems that have an income approach built in.

Assessors in these areas also have (generally) more commercial sales data to use in implementing the income approach.

Tax assessors in smaller cities, or rural areas may not have a system with an income approach to value. They may not have a lot of commercial sales data to use. They may only use the cost approach to value all of their properties, both residential and commercial in the same year, has a quality code of "A".

A photograph of a city street at dusk. The sky is a mix of orange and grey. In the foreground, several cars are driving on the road. In the background, there are modern buildings and streetlights. A red rectangular box is overlaid on the left side of the image, containing white text.

cost to construct is used in
the cost approach to value

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An Important Point

“The main components of the income approach are the points to argue ”

I can't tell you where your tax assessor got their rental rate, their operating expense ratio (ratio of operating expenses to effective gross income), or the capitalization rate they are using. If they are using a higher rental rate than your most recent tenant is paying then they may have the market rate wrong. If they are using a lower expense ratio than your property is experiencing year after year they may have this wrong too. They may say that better management could get to the numbers they are using, but that is your point to argue.

Capitalization rate information does not come cheap, so you may have to pay for this, or use a property tax consultant.