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# VALUATION OF PROPERTY ECONOMIC AND LEGAL STANDARDS

By

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The valuation man is called on to appraise real and personal property for a variety of purposes. (a) determination of prices in connection with transfers of title, (b) description of the security and determination of its amount when property is pledged to insure the performance of an agreement, (c) the determination of fair compensation, (d) the examination of the soundness of a program of property utilization, (e) the assessment of property as a basis for taxation, and (f) discovery of facts or the determination of approximate facts for use in connection with the management or operation of property<sup>1</sup> All these appraisals seek, in the language of the Constitution of Kentucky the "value, estimated at the price it would bring at a fair voluntary sale."<sup>2</sup> That is, all valuations with rare exceptions, are in the nature of the case *estimates*. (Perhaps indeed

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<sup>1</sup> FREDERICK M. BABCOCK, *THE VALUATION OF REAL ESTATE* 161-4. This classic breakdown shows about 40 specific purposes under these six general headings, including of course such tax appraisals as those for property taxation, special assessments, income taxation, and gift, inheritance, and estate taxation.

<sup>2</sup> Ky. CONST. sec. 172. Sometimes the courts accord undue emphasis to the constitutional language "the price it would bring at a fair voluntary sale" and not enough to the direction in the constitution that the value shall be *estimated*. Thus, there are such expressions as "there is no market price" because the particular item of property has not been sold. An unsupported opinion as to value is of course less useful than the development of basic evidence on the basis of which the value can be estimated. But in *Carr's Fork Coal Co. v. Perry County Board of Supervisors*, 263 Ky. 642, 93 S.W. 2d 359 (1936) the court ignored capitalized earnings even though such evidence would give a "more satisfactory as well as a more accurate" valuation.

the only exception involves sales on organized stock or produce exchanges—and then only when the market is stable.) Also, the criterion is a “fair voluntary sale” and not an abstruse fiction distinguishable from market price as of a specified time.<sup>3</sup>

Recognizing that an appraisal is necessarily an estimate—analagous to an attorney’s estimate of a court’s probable decision on a hitherto unlitigated legal question—appraisers in their profession are continually *estimating the value* of property. Whether such approximations are developed for purposes of sale, establishment of rentals, determination of a basis for computing capital gain, or property tax assessment, the appraiser recognizes that he must bring to bear on every estimate *all* the available, relevant evidence. That is, he must employ any method that will help him ascertain the best possible estimate of value.

Also, the modern appraiser accepts the idea that a curbstone opinion is worthless. The valuation man accumulates a wealth of factual material<sup>4</sup> and arrives at his result as an inference from the accumulated data. He reaches a wise conclusion or a foolish one—accident aside—dependent on whether he is or is not professionally competent. Just as a layman may look at clinical data respecting an abdominal difficulty and arrive at the conclusion that the patient has eaten too many green apples whereas a skilled physician would diagnose the ailment as appendicitis, the appraiser will reach an estimate of the value of an office building or a railroad which his dentist might well have missed despite the latter’s skill in his own profession. As a valuation is rested fundamentally on inference from objective data, it is a “scientific” process.

Again, the appraiser must conduct his work within the limitations of the law for the purpose involved. The concept of value is a technicality of economics which the law borrows for

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<sup>3</sup> “What are normal costs?

“Cost levels of 1940 are normal for 1940. Cost levels of 1948 are normal for 1948.”

This expression respecting costs, applicable equally to other evidences of value, is that of the senior member of one of the most prominent, private valuation concerns. E. H. Boeckh, *What Adjustments Should Assessors Make on Account of Current Prices?* ASSESSMENT ADMINISTRATION: 1948 (Chicago: National Association of Assessing Officers, 1949) 150-153.

<sup>4</sup> As to the background facts alone, see James W. Martin, *Tax Valuation of Public Utility Property: The Preliminary Analysis*, 19 TAXES—THE TAX MAGAZINE 7 (1941).

certain purposes. Doubtless, therefore, the skilled appraiser—by definition, a person competent in this application of economics—would weigh evidence and arrive at his estimate properly if not circumscribed in any way. Indeed, this is the usual private appraisal practice—and of course most elaborate appraisals are made for private purposes. When, however, an appraisal is made for public use, as in the instance of fixing tort damages, ascertaining the value of property to be condemned, or making assessments for ad valorem taxation, the valuation man must observe the restrictions imposed by law in the jurisdiction within which he works.

If this paper is to examine appraisal standards for tax purposes—or for condemnation or tort purposes or any other objective that involves or may involve legal proceedings—the authors will have to take account of not only the valuation problem as such—the economics—but also the relevant legal institutions. Although the text which follows makes frequent reference to standards employed elsewhere, attention is centered on those appropriate to Kentucky. Also, the appraisal purpose in the forefront is valuation for property tax assessment, but other purposes involving market valuations<sup>5</sup> are alluded to from time to time.

#### APPROACHES TO VALUATION

In valuation practice it is essential in making accurate estimates that, as far as considerations of expenses will permit, the appraiser bring to bear on each problem all the available evidence that is relevant. There are three classes of evidence (a) analysis of market data, (b) some measure or measures of cost, and (c) capitalization of income. In some situations one

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A market value or appraisal—estimation of the amount a willing buyer would pay a willing seller in an arm's-length transaction—is to be distinguished from a public utility rate base, which is sometimes referred to as a "value."

The authors have failed to find any legal or other technical sanction for expressions suggesting a difference between tax and condemnation valuations found occasionally in respectable appraisal literature such as is exemplified in the following quotation: "The courts base condemnation values on presumed 'highest and best use.' Manifestly then one setting a condemnation value would *add* to the basic value an amount he deemed correct to represent all the facts and conditions. One desiring an assessment value for taxes would probably *subtract* from the basic value." D. HOWARD DOANE, *Rural Appraising*, DOANE RURAL APPRAISAL HANDBOOK 2.

or two but not all three of these approaches can appropriately be employed, especially for inexpensive valuations such as those for property tax purposes must perforce be. Vacant land values in cities can usually be established by examination of the record of recently consummated sales and leases and reduction to a front-footage basis in the light of surrounding circumstances. Certainly cost of construction is irrelevant, and the systematic examination of leasehold transactions actually reflects some consideration of capitalized income. As will be shown subsequently, cost of replacement is heavily emphasized in the appraisal of dwellings in areas in which similar structures are in process of erection. Capitalization of income or of estimated potential income is almost always a possible approach to estimation of values, but the method is too expensive for practical application to some problems, especially to the appraisal of small properties.<sup>6</sup> It would appear that the appraiser—and specifically the property tax assessor—is bound by constitutional mandate to consider as evidence of value all classes of facts leading to a correct estimate of the “fair cash value.” Only by considering all the evidence available can the assessor presume to establish the value

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<sup>6</sup> As to this whole problem, see, e.g., H. G. Atkinson, *The Three Approaches*, 1 AMERICAN INSTITUTE OF REAL ESTATE APPRAISERS OF THE NATIONAL ASSOCIATION OF REAL ESTATE BOARDS, REAL ESTATE APPRAISAL (This work is cited hereafter as AM. INST. OF R. E. APPRAISERS. As the material is not paged, no paged citation is shown. The handbook of the same authority is cited by title only.), H. F. CLARK, APPRAISING THE HOME c. 10, 11, and 13; HANDBOOK FOR APPRAISERS 3; K. L. Hider, *The Appraisal Process*, 2 AM. INST. OF R. E. APPRAISERS; S. L. McMICHAEL, APPRAISING MANUAL, MARTIN, RESEARCH REPORT TO THE PUBLIC SERVICE TAX STUDY COMMITTEE (Richmond: Commonwealth of Virginia, 1947) 34 *et seq.*, ARTHUR A. MAY, THE VALUATION OF RESIDENTIAL REAL ESTATE 172-238; GEORGE L. SCHMUTZ, CONDEMNATION APPRAISERS HANDBOOK 7-10; J. J. Wagner, *Correlation and Final Estimate*, AM. INST. OF R. E. APPRAISERS; Atkinson, *The Process of Appraising Single Family Homes*, 4 JOURNAL OF THE AMERICAN INSTITUTE OF REAL ESTATE APPRAISERS 146-152 (1936), A. J. duBois, *Techniques in Value Estimation*, 5 JOURNAL OF THE AMERICAN INSTITUTE OF REAL ESTATE APPRAISERS 149-154 (1937), Alan C. Gardner, *Present Day Appraisal Techniques*, 13 APPRAISAL JOURNAL 365-370 (1945), W. E. Mosley, *Appraising Single Family Residences*, 3 JOURNAL OF THE AMERICAN INSTITUTE OF REAL ESTATE APPRAISERS 253-258 (1935), McMichael, *Appraisal—Method and Policies*, 3 FEDERAL HOME LOAN BANK REVIEW 35 (1936 and 1937), David Neiswonger, *Appraising the Small Home*, 5 JOURNAL OF THE AMERICAN INSTITUTE OF REAL ESTATE APPRAISERS 124-129 (1937), Neiswonger, *Appraising Residential Real Estate in 1947*, 15 APPRAISAL JOURNAL 79-86 (1947), Donald D. Reed, *Real Estate Analysis and Value*, 13 APPRAISAL JOURNAL 256-262 (1945), and Albert G. Towers, *The Validity of an Appraisal*, 17 APPRAISAL JOURNAL 36-38 (1949).

of a given piece of property "estimated at the price it would bring at a fair voluntary sale." The prospective purchaser and the owner consider all such evidence during negotiations for a sale, and "it is proper to consider all those elements which an owner or a prospective purchaser could reasonably urge as affecting the fair price of the land."<sup>7</sup> A careful reading of the Kentucky constitutional requirement indicates that the words used were not intended to be declaratory of any particular method of determining value, rather, they include all applicable methods which will aid the assessor in estimating the price which a given piece of property would bring at a fair voluntary sale. This recognition of the necessity for utilizing *all* the relevant evidence available for the *estimation* of fair market value has in recent years moved along at a rapid pace.

"With the growth of cities, valuations became more complicated and a branch of engineering science gradually developed so that it required some engineering science as well as an understanding of the factors entering into an appraisal in order to determine correct values. The valuation of real estate and improvements has always been difficult and presents many problems, and even with the applied science for valuation and appraisal, the true value cannot be obtained with mathematical exactitude, but by the application of these modern rules as developed, a much fairer degree of accuracy is arrived at than existed theretofore."<sup>8</sup>

"It is clear that there are some states which are beginning to recognize the need for better methods of appraisal of real estate for taxation purposes. The Michigan Supreme Court has clearly indicated that it will through judicial interpretation, assist by recognizing such methods. But decisions such as this can never afford a complete remedy."<sup>9</sup>

Perhaps it should be explained that the three independent approaches to an estimation of the value of property are not really *separate* from each other. Obviously, if a property, say a farm, has sold immediately prior to the date of appraisal the price fixed in the transaction is evidence of value.<sup>10</sup> As dollars

<sup>7</sup> *Andrews v. Cox*, 127 Conn. 455, 458, 17 A. 507, 509 (1941).

<sup>8</sup> *Conroy v. City of Battle Creek*, 314 Mich. 210, 22 N.W. 2d 275, 277 (1946).

<sup>9</sup> John J. Donahue, *The Use of Scientific Valuation Procedure in Real Property Tax Assessment*, 30 MARQUETTE L. REV. 125, 129 (1946).

<sup>10</sup> It is equally obvious, however, that, although such a transaction is good evidence, it is far from conclusive. Even the uninformed among farmers know that sometimes a buyer, sometimes a seller, is able to drive a "good bargain." The statistician would mean the same

per acre represent a customary value unit in the agricultural land market, the logical step to saying that similar land is worth as much for an acre as the land actually sold is not an unduly long one. In fact, if there are several current sales of such similar acreage, the average selling price per acre will usually indicate more accurately the unit value of such land that has not sold than will the sale price of an individual parcel. It will indeed typically give a better figure than that established by the sale of the parcel to be appraised. Thus, market data analysis affords more than one isolated type of evidence of the value of a property. On the other hand, the *cost* of a farm recently purchased is merely a sale value (such as that previously referred to). But cost after the lapse of time becomes relatively meaningless, especially in the case of buildings and chattels, because (a) the value of money or of the materials or of the labor employed in producing the property changes, (b) the property depreciates by reason of wear and tear, or (c) the property becomes obsolete, that is, less fitted to serve its purpose than when it was originally acquired. Thus, an architect, or an appraiser who uses an architect's techniques, by estimating the cost of replacement can come closer to probable selling price than will the figure for historical cost. This replacement cost estimate, though not derived from a sale of the particular property, is based directly on the market experience incident to the construction of similar property. In other words, on the basis of actual current building cost (that is, market value) experience, the appraiser "figures" the money it will require for each class of labor and each class of materials.<sup>11</sup> The approach to appraisal estimates through capitalization of income is less obviously a resort to actual market experience, but it is no less truly so. A property acquired for the purpose of producing income to the owner is more or less valuable depending on the amount of income produced, the amount of that income currently available to the owner, and the duration and stability of the income. In short, an investor pays for capital what he thinks the discounted income prospects

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thing if he said simply that any one statistical fact is subject to too great a probable error to be reliable. Cf. *Ray v. Armstrong*, 140 Ky. 800, 131 S.W. 1039 (1910).

<sup>11</sup> Following well-established real estate practice, assessors customarily make such building estimates on the more economical—and perhaps more equal—basis of reducing such figures, derived from experience, to a cost per square foot of floor space, per square foot of area occupied, or per cubic foot of cubical content.

are worth. Now certain important transactions—especially in downtown real estate—are regularly made in terms of leasehold rather than fee simple titles. That is, the purchaser pays a specified amount for the income to be produced for a specified period. Thus, “No intelligent valuation of property constructed and used for commercial purposes, and as an investment—and that is the only reason for building or operating a railroad—can properly be arrived at without considering the income derived from the property”<sup>12</sup> In good appraisal practice, this is true, as the court notes, of commercial properties generally. A railroad, such as was involved in the case cited, is merely an example of a general truth. Thus, regardless of which of the presently established approaches to valuation is being used, it is appropriate because it is actually tied in with market experience. It is a significant valuation tool because it is often available independently of significant information of other sorts.

The relevance of each type of evidence of value and the weight to be given each type in the event two or more approaches are employed is a problem that involves technical appraisal “know-how.” In general, this problem is one to be examined further after consideration of the three avenues to a dependable value estimate.

#### MARKET DATA ANALYSIS

One basic approach to the valuation of property requires a detailed examination of data respecting market environment and transactions.<sup>13</sup> Some of the necessary information concerns the market setting. Included in this category are economic background, population facts, and information respecting street or other transportation and communication facilities, land use pat-

<sup>12</sup> *People ex rel. Lehigh Valley Railway Co. v Harris*, 6 N. Y. Supp. 2d 794, 799 (1938)

<sup>13</sup> duBois, *The Comparison Approach—Data Assembly*, 1 AM. INST. OF R. E. APPRAISERS; duBois, *The Comparison Approach—Data Analysis and Classification*, 1 AM. INST. OF R. E. APPRAISERS; duBois, *The Comparison Approach—Data Interpretation*, 1 AM. INST. OF R. E. APPRAISERS; Ralph V. Field, *Comparison Approach—Market Price Estimates*, 1 AM. INST. OF R. E. APPRAISERS; Field, *Preliminary Market Data Approach Estimate*, 3 AM. INST. OF R. E. APPRAISERS; H. R. Moore, *Analysis of Recent Sales*, 3 AM. INST. OF R. E. APPRAISERS; Neiswonger, *The Process of Comparison*, 2 AM. INST. OF R. E. APPRAISERS; Neiswonger, *Data Sources and Assembly*, 2 AM. INST. OF R. E. APPRAISERS; Neiswonger, *Application of the Market Data Approach*, 2 AM. INST. OF R. E. APPRAISERS; Wagner, *Correlation of Final Estimate*, 3 AM. INST. OF R. E. APPRAISERS.



terns, cultural surroundings, geographical and topographical features, governmental policies, the public utility arrangements and possibilities, and the like. Numerous neighborhood items of fact will be essential in the case of dwellings and certain other properties.

The most directly important market data are those bearing on actual property transfer facts. Included in the case of dwellings are sales, offers to sell, bids, listings, and financing and insurance facts. In the case of commercial property appraisals all these and data as to recent lease transactions will need to be assembled and analyzed. In all cases the accumulation of such market data will need to be handled in such a manner as to assure a basis of comparison. For example, if the price of vacant land sold is to help in appraising other unoccupied land, the two parcels must have some sort of similarity<sup>14</sup> It will be kept in mind, too, that price data must be quite extensive in order to be reliable. Information regarding one or two sales is usually of little or no significance for estimating the market value of a particular item of property. Factual information regarding hundreds of sales, or of lease transactions, or of both showing clear elements of comparability will render the market data approach to valuation distinctly convincing.<sup>15</sup>

Not only must sales be *comparable* and sufficient in number in order to constitute good evidence of value, but they must also have been timely. The length of time elapsing between sales and the date as of which a valuation is made directly affects the utility of the transactions as evidence of value. In fact, the transactions in order to be acceptable at all for this purpose must have been consummated within a reasonable time prior to valuation date.<sup>16</sup> "Events subsequent to date of valuation may sometimes be considered, but only as bearing on what the property

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<sup>14</sup> 18 AMER. JUR. 994.

<sup>15</sup> Even in such a case, of course, the careful appraiser will, if relevant to the particular problem, examine replacement cost estimates and capitalized income as equally pertinent—though in the particular instance, less weighty—evidence. By the same token, if good income capitalization data are at hand and a timely record of only one or two sales can be found, then the market data analysis is of relatively secondary importance in arriving at a value estimate. This is doubly true if the completely arm's-length character of the transactions cannot be positively established.

<sup>16</sup> *Thaw v. Town of Fairfield*, 132 Conn. 173, 43 A. 2d 65 (1945), *Pumphrey v. Tabler, et al., State Roads Comm.*, 175 Md. 498, 2 A. 2d 668 (1938), *Commonwealth, by State Highway Comm. v. Begley*, 261 Ky. 812, 88 S.W. 2d 920 (1935), 18 AMER. JUR. 994.

has subsequently come to be worth. These same statements, with variations, are found in eminent domain, in damages, in estate taxation, etc.’<sup>17</sup>

Although a practical-minded appraiser will emphasize the danger of depending on one sale, even the sale of the property to be valued,<sup>18</sup> he will also stress the value of market experience for any valuation—and especially for the appraisal of a property essentially similar to properties of which numerous sales have occurred.<sup>19</sup> This is true whether the market involves shares of stock in the Chrysler Corporation, 1939 Chevrolet coaches, acres of a given quality of farm land, front feet in a particular block of city land, cubic feet of office building property of a specified sort, or any other clearly defined value unit. This type of evidence is almost invariably recognized in the courts, but sometimes with undue emphasis<sup>20</sup> from an appraisal angle on a single transaction.<sup>21</sup> Not only in the interest of a good valuation, but

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<sup>17</sup> 2 BONBRIGHT, *THE VALUATION OF PROPERTY* 1015 (1937). See also U. S. TREAS. DEPT. REG. 105, Sec. 81.10(c).

<sup>18</sup> “Value cannot be fixed solely by sales made for a particular purpose not subsequently carried out; nor does any one individual sale establish value.” *People ex rel. Schwitzer v. Miller*, N.Y.L.J. 2/21/40, Sup. Ct. N.Y. Co., special term, Part VII.

“No one sale will make a market or market price.” *People ex rel. Cavanaugh v. Sexton*, N.Y.L.J. 6/30/38, Sup. Ct. N.Y. Co., special term, Part VII.

<sup>19</sup> Usually the number of *items* sold is of no importance. It is the number of *sales* that is statistically significant. There are a few exceptions, however, due mainly to the fact that a sale may involve so large or so small a number of units as to be extraordinary—and hence nonrepresentative of the general market situation. For example, occasionally a sale of five or six front feet of downtown land occurs, but this sale constitutes less convincing evidence of the value of land than does another sale involving 50 or 100 front feet. Again a sale of 3 shares of stock in certain markets would be less persuasive of value than would a sale of 100 shares, especially so if the market is an exchange ordered to accommodate sales in multiples of 100.

<sup>20</sup> In *Ray v. Armstrong*, 140 Ky. 800, 131 S.W. 1039 (1910), for example, the court said that when a property has been sold at a fair voluntary sale the market value “is no longer a matter of opinion, but is a settled fact.” The court went on to say that what is sold “fixes” the fair cash value of all comparable property. The court’s emphasis on the significance of a single sale as a basis for “estimating” the fair cash value of the property obviously overlooks the possibility that one party to the transaction may have “come off second best” in the bargaining.

<sup>21</sup> Consider, for example, two dwellings situated on parallel streets a block apart, each built from the same plans by the same builder at a cost of about \$20,000. Each was finished and occupied in 1948. One of them was transferred at a forced sale in the fall of the same year at \$16,500. In May, 1949 it was purchased for \$17,000. The other building turned over twice in 1948 under favorable conditions

also as a matter of law, the assessor must give consideration to actual transactions as evidence of the approximate price a property would command in a fair voluntary sale.<sup>22</sup>

#### COST AND COST ESTIMATES

Sales of the property to be appraised or of comparable property, as previously noted, are not the only evidence of value. Even when sales data are available, other evidence may be given weight.<sup>23</sup> A second approach to the estimation of market value is through the use of cost data. Of course, if the property to be valued has been transferred shortly before the date as of which the valuation is made, the cost figure is a sale of comparable property—or of the identical property. In practice the situation is likely to be more complicated. The identical or comparable sales may largely involve transactions in which a part of the property or more than the whole of it was involved. Or the transactions may lack direct comparability for some other reason. In such an event some flexibility of approach is essential.

One way of dealing with such a situation is to estimate *costs of reproduction* (of a building, for example) by resort to the summation approach. In other words the appraiser may follow the same method as would a contractor desiring to bid on a construction job. That means that he would estimate the expense

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for the seller. It was again sold in May, 1949 at \$25,000. Obviously, the two properties should each be valued for tax purposes in the interest of equality at about the same figure, not one at \$17,000 and the other at \$25,000—that is, at a difference in value in excess of \$8,000.

<sup>22</sup> John A. Zangerle, *Assessing Real Estate on Its Income*, 15 PUBLIC MANAGEMENT 206 at 209 (1933) This is generally true for all tax purposes. *May Rogers v Helvering*, 107 F. 2d 394 (C.C.A. 2d 1939), (estate tax), *Evans v Allen*, 305 Ky. 728, 205 S.W. 2d 514 (1947) (ad valorem tax), *City of Paducah v. Allen*, 111 Ky. 361, 63 S.W. 981 (1901), (eminent domain). It should be noted, however, that in cases involving valuation for eminent domain purposes it may be exceedingly difficult, or even impossible, to find that any similarity exists; for an illustration see *Ky Hydro-Electric Company v. Woodard*, 216 Ky. 618, 287 S.W. 985 (1926).

<sup>23</sup> *Tracy v. Commissioner of Int. Rev.*, 53 F. 2d 575 (C.C.A. 6th 1931), *Wood v. United States*, 29 F. Supp. 853 (Ct. Cl. 1939), *Exrs. of the Estate of W Lippincott*, 27 B.T.A. 735 (1933), *Thaw v. Town of Fairfield*, note 16, *supra*; *Carr's Fork Coal Company v. Perry County Board of Supervisors*, note 2, *supra*; H. M. POWELL and L. P. JACOBS, *REDUCING REALTY TAXES* (3d ed. 1947) 56; James A. E. Wood, *Valuation of Real Property for Tax Purposes in Metropolitan New York*, 2 INTRAMURAL LAW REV. 136 (1947)

of capital and labor involved in excavation, the cost of steel, concrete, and labor required to do the masonry work, and so on until the entire building is provided for in keeping with local market practices. This is a procedure for estimating current actual cost of erecting a structure similar to the one to be appraised. If the property concerned is substantially new, this attack is a reasonable employment of cost analysis.

In tax and other appraisals for which money is scarce, short cuts to cost estimates are usual. So it is, for example, in the construction market. An architect in going over his alternative sketches with clients often estimates costs by reference to the number of square feet of floor space because he knows the approximate cost per square foot for a residence of a particular class. If the structure is more complicated, he is likely to make his estimate in terms of the number of cubic feet enclosed.<sup>24</sup>

Although such a cost of reproduction analysis will occasionally be used in making a building valuation, most situations require an even more developed methodology for the employment of the cost approach. The established attack is based on a computation of *replacement costs*. In this estimate allowance can be made on a systematic basis for loss of value due (a) to wear and tear or aging and (b) to loss of appropriateness for the purpose for which the property was constructed. The former and sometimes the former plus the latter are referred to as *depreciation*, the latter is called *obsolescence*. Otherwise, the ideas of reproduction cost new and of replacement cost are similar. Always in appraising old buildings or chattels it is essential to allow for loss of value due to normal aging, usually spoken of as *wear and tear*. If, in fact, such buildings or tangible personal properties are no longer entirely appropriate for use, obsolescence is provided for, otherwise, not. If, for example, a section of a city is occupied by bungalows 30 or 40 years old but essentially similar to new dwellings, then depreciation, but nothing for obsolescence, would be deducted from the estimated cost of reproduction new. Of course this is true

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<sup>24</sup>The new Dayton, Ohio, building appraisers' manual presents an entire system for residence properties using only the number of square feet of ground covered as a basis for estimating the value of buildings of each class. The older and better known ILLINOIS REAL ESTATE APPRAISAL MANUAL 78-86 and A-1 to A-92 employs the same plan.

whether or not reproduction cost is estimated by resort to one of the standard short cuts.

Generally valuation of residence structures is estimated on the basis of a replacement cost approximation.<sup>25</sup> For several reasons such estimates are heavily emphasized, especially for tax valuations (that is, appraisals on a "mass" basis which must perforce be done at low cost) If other buildings for the same or for closely related uses are being constructed, this practice is merely a recognition that the supply of such buildings is directly dependent on cost. This emphasis on replacement cost as an approach to the valuation of buildings, especially ordinary residence and business structures, is almost universal among appraisers.<sup>26</sup> Replacement cost is even more heavily stressed by practicing valuation engineers who have prepared manuals<sup>27</sup> and especially by writers concerned specifically with tax valuations.<sup>28</sup> The reliance on replacement costs for valuation of run-of-the-mine residence and business structures in the better guides

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<sup>25</sup> *Texas-Empire Pipe Line Co. v. Commissioner of Int. Rev.*, 141 F. 2d 326 (C.C.A. 10th 1944), *In re Board of Supervisors v. Chenango County*, 6 N.Y.S. 2d 732 (1938), 1 CUMULATIVE BULLETIN OF THE BUREAU OF INTERNAL REVENUE, Advisory Tax Board recommendation 57; 3 COOLEY, *THE LAW OF TAXATION* 2307 (4th ed. 1924).

<sup>26</sup> BABCOCK, *THE VALUATION OF REAL ESTATE* especially c. 31 and 32; 1 BONBRIGHT, *THE VALUATION OF PROPERTY* especially c. 7-10; Hyder, *Cost Approach—Building Cost Estimate* (single-family home), 1 AM. INST. OF R. E. APPRAISERS; Hyder, *Cost Approach—Building Inspection*, 1 AM. INST. OF R. E. APPRAISERS; Hyder, *Cost Approach—Cost Approach Estimate*, 1 AM. INST. OF R. E. APPRAISERS; POWELL and JACOBS, *REDUCING REALTY TAXES*, especially c. 4, 8-12 (although this last work—unlike the others cited, a legal treatise—concerns primarily New York State, the valuation principles developed appear to be general), SCHMUTZ, *THE APPRAISAL PROCESS*, especially c. 15-19.

<sup>27</sup> Among the most popular are BOECK'S *MANUAL OF APPRAISALS*; J. M. CLEMINSHAW, *APPRAISERS' MANUAL* (1937), DOANE *RURAL APPRAISAL HANDBOOK*; McMICHAEL, *op. cit. supra* note 6 (1938), W. L. PROUTY, CLEM W. COLLINS, and FRANK H. PROUTY, *APPRAISERS AND ASSESSORS MANUAL* (1937), CUTHBERT E. REEVES, *THE APPRAISAL OF URBAN LAND AND BUILDINGS* (1929).

<sup>28</sup> ROGER BALDWIN, *THE MARKET VALUE CONCEPT AS APPLIED TO THE ASSESSMENT OF CONNECTICUT REAL PROPERTY* (Storrs: University of Connecticut, 1944), BOECKH, *supra* note 3, at 153; Albert E. Champney, *Unit Building Costs*, *PROCEEDINGS OF A SHORT COURSE FOR MUNICIPAL ASSESSING OFFICERS* (Ann Arbor: University of Michigan, 1947) at 59 (also same author's *Evaluating Residences*, *id.* at 75), Thomas S. Holden, *Construction Cost Outlook*, *ASSESSMENT ADMINISTRATION* (1947) at 11, NATIONAL ASSOCIATION OF ASSESSING OFFICERS, *ASSESSMENT PRINCIPLES* 60; F. W. Beck, *Market Value—Do We Define it Correctly?* 15 *APPRAISAL JOURNAL* 197 (1947).

prepared specifically for the use of local assessors is almost complete.<sup>29</sup>

Replacement cost as evidence of the value of property for Kentucky tax purposes has been accorded scant attention—doubtless because modern valuation practices have been so rare in Kentucky counties and cities. It would seem, however, from a comparison of the evidence discussed in *Kenmont Coal Co. v Perry County Board of Supervisors*<sup>30</sup> with the final figure adopted by the Court that original cost less depreciation will be given consideration in the absence of sales values. Other evidence was introduced in that case in the form of opinions of persons claiming to be familiar with similar properties and their values, but this evidence was discounted in favor of original cost less depreciation. In an earlier case<sup>31</sup> the Court stated that, in the absence of sales data

“ the assessors, as well as all other persons having taxing authority, in arriving at the fair cash value of the property, must necessarily take into consideration

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<sup>29</sup> JOHN C. DONEHOO AND ASSOCIATES, REAL ESTATE APPRAISAL MANUAL, JEFFERSON COUNTY, ALABAMA (1941), CALIFORNIA STATE BOARD OF EQUALIZATION, ASSESSORS HANDBOOK: APPRAISAL OF BUILDINGS, REPLACEMENT COST APPROACH (1945), ASSESSOR'S OFFICE OF THE CITY AND COUNTY OF DENVER, REAL ESTATE APPRAISAL MANUAL (1941), TERRITORY OF HAWAII, APPRAISAL MANUAL FOR ASSESSORS AND APPRAISERS OF REAL PROPERTY (1942), ROY D. LEONARDSON, MANUAL OF APPRAISALS (1945), STATE BOARD OF TAX COMMISSIONERS, REAL ESTATE APPRAISAL MANUAL (1948), DEPARTMENT OF REVENUE, RAILROAD AND PROPERTY TAX DIVISION, ILLINOIS ASSESSORS' MANUAL (1944), ILLINOIS TAX COMMISSION (now Department of Revenue), ILLINOIS REAL ESTATE APPRAISAL MANUAL (1942), MICHIGAN STATE TAX COMMISSION, ADMINISTRATIVE SERVICE DIVISION, ASSESSORS' MANUAL (1938), BOARD OF ASSESSORS, DETROIT ASSESSORS' MANUAL (1943), DEPARTMENT OF TAXATION, MINNESOTA ASSESSORS' MANUAL (1944), CUTHBERT E. REEVES, J. H. THAYER MARTIN, and FRANK A. O'CONNOR, A MANUAL OF PRACTICE IN APPRAISING REAL ESTATE (1933), ASSESSORS' MANUAL, BUNCOMBE COUNTY, NORTH CAROLINA, 1933 (1933), REAL ESTATE DIVISION OF THE TAX COMMISSION OF OHIO, OHIO APPRAISEMENT MANUAL. REAL PROPERTY (1937), ZANGERLE, PRINCIPLES OF LAND AND BUILDING APPRAISALS AS SCIENTIFICALLY APPLIED IN CUYAHOGA COUNTY, 1946-1947 (n.d.), SCHEDULES AND SPECIFICATIONS, MONTGOMERY COUNTY, OHIO (n.d. but evidently 1949), FARM BUILDING APPRAISER'S MANUAL (1948), PENNSYLVANIA GOVERNMENT ADMINISTRATION SERVICE, HANDBOOK FOR PENNSYLVANIA ASSESSORS (1949), GEORGE P. ALDERSON, WEST VIRGINIA ASSESSORS' MANUAL (1943), WISCONSIN TAX COMMISSION, MANUAL FOR SUPERVISORS OF ASSESSMENTS, FIELD STATISTICIAN AND PROPERTY TAX EMPLOYEES OF CENTRAL OFFICE (1931), WISCONSIN TAX COMMISSION, ASSESSORS' MANUAL (1935).

<sup>30</sup> 262 Ky 764, 91 S.W. 2d 47 (1936).

<sup>31</sup> *Eminence Distillery Co. v Henry County Board of Supervisors*, 178 Ky. 811, 816, 200 S.W. 347 (1918)

the conditions and circumstances, which surround each particular case, including the extent and location of the property, its accessibility to market, transportation facilities, *cost of equipment and construction, if recent, its adaptability for its purpose, and every element which will have influence in appreciating or depreciating its value*, and thus with the best light attainable determine its fair cash value as contemplated by the Constitution and statutes."<sup>32</sup>

Obviously, in the light of market practice, the appraiser must take account of construction costs if he is to give weight to "every element" that influences buyers and sellers in arriving at price in an arm's-length transaction. It is equally apparent that, if a property is old, allowance must be made for depreciation.<sup>33</sup> This has been generally recognized by the courts where the issue has arisen.<sup>34</sup>

In short, "Appraisers generally agree that the most reliable method for determining the structural value of a building is to compute the cost of replacing the building—and then depreciate this cost for past use. This brings values up to the present time."<sup>35</sup> This is applicable to both farms and city residences and to most classes of city business property. It is equally true of many classes of tangible personal property, such as machines, vehicles, equipment, and the like.

#### CAPITALIZATION OF INCOME

The third fundamental approach to the valuation of property for tax and other general purposes is capitalization of earnings. This method is particularly useful in appraising property held for investment purposes where the value depends on the

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<sup>32</sup> Italics supplied.

<sup>33</sup> UNITED STATES TREAS. DEPT., BUREAU OF INT. REV., BULLETIN "F" INCOME TAX, DEPRECIATION AND OBSOLESCENCE, ESTIMATED USEFUL LIVES AND DEPRECIATION RATES, 1942 1. ACCORD COMMONWEALTH OF KENTUCKY, DEPT. OF REV., INCOME TAX LAW AND REGULATIONS, 1946, arts. 80-32 and 80-33.

<sup>34</sup> See, for example, POWELL and JACOBS, *op. cit. supra* note 23 at 81-84 and the authorities there cited. Observe especially that this eminent tax attorney quotes as adequate authority CITY OF ROCHESTER, ASSESSMENT MANUAL.

<sup>35</sup> J. P. Wooley and R. P. Beasley, *The Appraisal of Farm Buildings*, DOANE RURAL APPRAISAL HANDBOOK 613.

capacity to produce income and not on the labor of the owner.<sup>36</sup>  
This approach

“ is now recognized as one of the practical methods of unlisted stock valuation for taxation. If in theory the concept of value embraces all the future benefits arising from the ownership of property, the potential earnings are a dominant factor in measuring its present worth or value. This proposition has the sanction of both law and logic. The Supreme Court and text writers have consistently affirmed it in general terms.”<sup>37</sup>

The value of real estate may likewise be established by capitalizing the earnings.<sup>38</sup>

<sup>36</sup> 7 A.L.R. 171.

The necessity for heavy emphasis on income capitalization as a prerequisite of accurate valuations is urged by appraisal and legal authorities such as BABCOCK, *op. cit. supra* note 1, at 129; BOECKH, *op. cit. supra* note 27, at 322; 1 BONBRIGHT, *op. cit. supra* note 17, at 216; HERMAN H. CHAPMAN, FOREST VALUATION; W. D. DAVIS, *Net Income Estimates and Capitalization*, 3 AM. INST. OF R. E. APPRAISERS; DOANE RURAL APPRAISAL HANDBOOK; MAY, *op. cit. supra* note 6, at 182; McMICHAEL, *op. cit. supra* note 6, at 90; WILLIAM G. MURRAY, FARM APPRAISAL 156; POWELL and JACOBS, *op. cit. supra* note 23, at 84; Charles B. Shattuck, *Income Approach—Data Assembly*, 1 AM. INST. OF R. E. APPRAISERS; Shattuck, *Income Approach—Capitalization Process*, 1 AM. INST. OF R. E. APPRAISERS; Schmutz, *THE APPRAISAL PROCESS* 139; J. C. Tredwell, *Income Approach—Selection of Rates*, 1 AM. INST. OF R. E. APPRAISERS; H. O. Walther, *Income Approach—Data Analysis*, 1 AM. INST. OF R. E. APPRAISERS; Walther, *Operating Statements—Data and Analysis*, 2 AM. INST. OF R. E. APPRAISERS; R. H. Armstrong, *Capitalization*, 7 APPRAISAL JOURNAL 134 (1939), duBois, *The Capitalization Process*, 3 JOURNAL OF THE AMERICAN INSTITUTE OF REAL ESTATE APPRAISERS 109 (1935), W. D. DAVIS, *Rural Appraisal Procedures*, 14 APPRAISAL JOURNAL 349 (1946), Thomas A. Dolan, *The Case History of an Apartment House*, 15 APPRAISAL JOURNAL 487 (1947), R. M. Fisher, *Economic Background of the Capitalization Process*, 5 JOURNAL OF THE AMERICAN INSTITUTE OF REAL ESTATE APPRAISERS 329 (1937), George Goldstein, *Capitalization Rates in Today's Market*, 15 APPRAISAL JOURNAL 492 (1947), James M. Kern, *The Valuation of Real Estate*, 15 APPRAISAL JOURNAL (1947), John A. Linnett, *Value Through Capitalization of Income*, 14 APPRAISAL JOURNAL 361 (1946), McMichael, *Appraising Leasehold Estates*, 15 APPRAISAL JOURNAL 495 (1947), McMichael, *Appraisal Methods and Policies*, 3 FEDERAL HOME LOAN BANK REVIEW 196 (1936-1937), Neiswonger, *Appraising Residential Real Estate in 1947*, 15 APPRAISAL JOURNAL 79 (1947), Reeves, *The Capitalization Method in the Valuation of Homes*, 2 JOURNAL OF THE AMERICAN INSTITUTE OF REAL ESTATE APPRAISERS 87 (1934), Louis Roth, *Bases of Common Stock Valuation*, 15 APPRAISAL JOURNAL 119 (1947).

<sup>37</sup> Alex M. Hamburg, *Tax Valuation of Real Estate, Stock and Goodwill*, SIXTH ANNUAL INSTITUTE ON FEDERAL TAXATION 145 (1948). See also Thomas Tarleau, *Tax Problems in the Valuation of Property*, 25 TAXES 520 (1947).

<sup>38</sup> *Welch et ux. v. Tennessee Valley Authority*, 108 F. 2d 95 (C.C. A. 6th 1939), *Exrs. of Estate of W. Lippincott*, 27 B.T.A. 735 (1933), *Somers v. Meriden*, 119 Conn. 5, 174 A. 184 (1934), *Department of Public Works and Buildings v. Diggins*, 374 Ill. 11, 27 N.E. 2d 826



As stated in the "appraisal principles" laid down by the American Society of Farm Managers and Rural Appraisers

"Income capitalization is a direct and primary approach. Comparison is an indirect but equally important approach. The use of both income capitalization and comparative approaches to value is necessary in every appraisal, and one should not be emphasized to the minimization or exclusion of the other.

"Reproduction cost is useful primarily in reporting and analyzing the value of improvements."<sup>39</sup>

Although this statement has reference to farm valuations, the generalization is equally applicable to the careful appraisal of other business real property

Two means of defining the unit to be used in valuation of property are often available. The land can be appraised on the basis of market data analysis, then, the building and its contents may be valued in terms of replacement cost, afterward, the summation of these estimates will provide a reasonable approximation of the price the property would command at a fair voluntary sale. This attack assumes that land values are defined in terms of front footage (or occasionally an area unit) and building values in terms of cubage (or of square feet of floor space or of space occupied depending on the system in use)<sup>40</sup> But the appraiser may define the business unit as such as the valuation unit. Under this plan capitalization of income will usually prove to be the means of providing primary valuation data. That is, income capitalization will be the basic approach. In some cases this basic evidence can be supplemented by market data analysis. For example, occasionally comparable business properties, land and building and equipment together, may have sold recently in sufficient numbers to provide a means of checking on the income capitalization. More often, to cite only one other illustration, the securities of the owner corporation will be transferred in an open market in such manner that a summation of stock and debt of the corporation can be made. In such a

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(1940), *Housing Authority of New Orleans v Persson*, 203 La. 255, 13 So. 2d 853 (1943), *People ex rel. Parklin Operating Corp. v. Miller*, 287 N.Y. 126, 38 N.E. 2d 465 (1941), *Skyline Swannanoa, Inc. v Nelson County*, 186 Va. 878, 44 S.E. 2d 437 (1947) See also note 36.

<sup>39</sup> DOANE RURAL APPRAISAL HANDBOOK 11.

<sup>40</sup> This definition of the unit, obviously emphasizing equality, is usually the one exclusively used in modern property tax appraisals. The money available for doing the assessment job will rarely permit the employment of both attacks even when both can be used.

case, since the equity represented by the stock and debt is the plant, the appraiser can employ the facts as evidence of the value of the combined land and the building with its contents.<sup>41</sup>

Obviously, if the facts of a situation permit the appraiser to employ both definitions of the appraisal unit, he can make a more accurate estimate of value than if the circumstances are such that only one of these attacks is feasible or if one of them can be employed only by making extensive adjustments.<sup>42</sup> As already indicated, the business unit—farm, factory, warehouse, or railroad—offers the most realistic of the two possible valuation units, and, if the unit is so conceived, capitalization of income is the direct and primary attack.<sup>43</sup> Even in the case of residence property capitalization of rents is a standard commercial approach to the valuation problem.

The Kentucky Court of Appeals seems to have had difficulty with capitalized income as evidence of value. In *Commonwealth v J B. Clay and Company*<sup>44</sup> the court regarded the net income from land as “a circumstance that might be considered.” In a later case the court employed capitalization of earnings in conjunction with comparable sales to show that the fair cash value of the property in question was above the figure at which the property had been assessed.

“The court does not find, under the proof, that appellant’s land is assessed more highly than it should be. The proof shows that each vein of coal, in its coal bearing land, will produce from 4,000 to 6,000 tons of coal to the acre. There are on most of its land 2 or 3 such veins. Under its leases it gets ten cents a ton for the coal mined. This will net it from \$400 to \$600 an acre, for each vein of coal that is worked out. Some of the veins are not workable on some of the tracts. But as a

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<sup>41</sup> The appraisal of public service properties, including railroads, is generally based on this business unit as the valuation unit. See MARTIN, *supra* note 6, at c. 3 and the cases cited, particularly at 32 *et seq.*

<sup>42</sup> Leffert Holz and Herman Schrier, *Real Estate Appraisal in Legal Proceedings*, 14 APPRAISAL JOURNAL 38 (1946).

<sup>43</sup> Employment of the business unit as the valuation unit clearly demands more appraisal skill to secure a reasonable measure of equality when, as in the case of ad valorem property assessments, mass appraisals are necessary. This fact explains why this definition of unit is not much used in property tax administration, except in the case of larger properties such as public utilities, hotels, mines, etc., even though it is admittedly appropriate.

<sup>44</sup> 215 Ky. 125, 284 S.W. 428 (1926) Cf. also Board of Supervisors of Frankfort v State National Bank of Frankfort, 300 Ky. 620, 189 S.W. 2d 942 (1945).

rule at least 2 veins are workable. The proof shows that it will take about thirty or forty years to work out the leases. But the present cash value of what appellant will in the meantime get for its coal makes the present value of its land more than \$100 an acre."<sup>45</sup>

In *Carr's Fork Coal Co. v Perry County Board of Supervisors*<sup>46</sup> it is stated that in cases where a willing purchaser might not be obtainable at the time of the assessment other facts may be looked to for the purpose of fixing a correct market valuation.

"Among such factors, either in such contingency or in its absence, are the net revenue, dividend, or profit that may be realized upon the operation of a going mine, plant, or other manufacturing concern, its prospects of continuing such operation and the prospective length of time thereof, the material at hand to be manufactured, mined, or produced in pursuing the purpose of the plant or establishment, the physical condition of the properties, including all of the different items composing the one unit of its productive plant, and many others, all of which make the processes by which a correct valuation of such properties is made both difficult and unsatisfactory

"Many states have statutes providing methods and means—such as capitalization or other provisions—whereby a more satisfactory as well as a more accurate valuation may be obtained. We have none such in this jurisdiction, and which necessitates a resort to the methods stated"<sup>47</sup>

The solicitude for statutory direction suggested by the last paragraph quoted would seem for a number of reasons to be unfounded. In the first place, the authors find no general statutory directions as to the use of *any* particular method.<sup>48</sup> There is, therefore, no more general objection on this ground as to capitalization of income than as to the use of market data or replacement cost.

In the second place, the court has experienced no difficulty in accepting nonstatutory evidence in many instances. For example, the "stock and bond method" in the case of public

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<sup>45</sup> *Kentucky River Coal Corp. v. Knott County*, 239 Ky. 18, 21, 39 S.W. 2d 190 (1931).

<sup>46</sup> See note 2 *supra* at 647.

<sup>47</sup> In a letter to one of the writers, dated Oct. 21, 1948, Judge Thomas, through whom this opinion was delivered, said, "when it was said 'and which necessitates a resort to the methods stated,' it was meant to refer to the methods provided by our then statutes"

<sup>48</sup> It is true that as to particular classes of property a method has been suggested in the statutes (e.g. sec. 4080, Carroll's Kentucky Statutes).

utilities was adopted by the court long before any method *other than* capitalization of income was expressly approved by statute. The capitalization method, again, has long been employed in the valuation of life estates even though the property tax statute does not provide for this.

Thirdly, the Court of Appeals early held that section 172 of the Constitution is self-executing.<sup>49</sup> If the section is self-executing, then the provision that property value be "estimated at the price it would bring at a fair voluntary sale" would seem to require the resort to all the types of evidence which would assist in making an accurate estimate. That is, the *Constitution* in a self-executing provision demands the use of income capitalization—admittedly a standard method of attack—among other approaches to value estimation.

The Iowa court has accepted a viewpoint which can be strongly commended to Kentucky

"The objective of this section is to fix upon the actual value of a particular tract. *The elements described therein are simply those which inhere in such valuation. They are not dependent on the statute for their influence upon such valuation.* They are somewhat in the nature of instructions to the assessors as a class, and are intended to attain uniformity of estimates on the part of assessors."<sup>50</sup>

The extremely narrow attitude assumed by the Pennsylvania court<sup>51</sup> is accounted for by one author as follows

"Such decisions can only be explained in the light of the history of real property tax valuation in this country. Sooner or later they must be removed from the law, either by judicial repudiation or by legislative repeal of market value as the guide to taxable value."<sup>52</sup>

The so-called "strict-construction" courts themselves have in some cases indirectly repudiated such decisions where the assessor has employed experts, or has himself used scientific formulas or equations, by tending to accept the assessor's valua-

<sup>49</sup> Louisville and Nashville Railroad Company v. City of Barboursville, 105 Ky. 174, 48 S.W. 985 (1898).

<sup>50</sup> Italics supplied. Davison v. Board of Review of Buchanan Tp., Page County et al., 209 Ia. 1332, 230 N.W. 304 (1931). See also 133 N.J.L. 569, 45 A. 2d 623 (1946).

<sup>51</sup> For example, Kemble's Estate, 280 Pa. 441, 445, 124 A. 694, 695 (1924).

<sup>52</sup> Kenneth K. Luce, *Assessment of Real Property for Taxation*, 35 MICH. L. REV. 1217 (1937).

tion as prima facie correct.<sup>53</sup> For example, in 1928 Chicago assessments were conducted under the supervision of a high-salaried valuation engineer and with the advice of financial experts from the universities and the real estate organizations of the city. It was made in accordance with plans and specifications evolved by scientific tax experts. The Revenue Act of the state provided

"Real property shall be valued at its fair cash value, estimated at the price it would bring at a fair voluntary sale in the course of trade, which shall be set down in another column headed 'assessed value.'"

The taxpayer, whose property had been thus reassessed, resisted a suit by the city to have the property sold for delinquent taxes on the ground that the reassessment procedure violated statutory requirements. While the court did not approve of the methods used and believed that the statute was not followed,<sup>54</sup> it passed the matter by saying that there was no evidence to show that the valuation placed upon the objector's real estate in the 1928 reassessment was too high as compared with other properties in the state.<sup>55</sup>

There are certain cautions which must be observed in the use of the income capitalization approach if it is to contribute to a truly accurate valuation. First, the rate of capitalization to be applied must represent, as nearly as may be, the element of risk for the particular property under consideration. Second, income must be stabilized over a period of years.

"A representative period must be taken so that normal earnings may be accepted as reasonable. Obviously no fixed number of years can be rigidly adopted. The Bureau formula is to average past earnings for a five-year period."<sup>56</sup>

It is generally accepted that capitalization of earnings, like the other two attacks, is not the sole criterion for estimating value of property for tax purposes, however, it should be considered, where applicable, along with other evidence of value.<sup>57</sup>

<sup>53</sup> See James Hughes, Jr. and Oscar Sheinbrood, *Taxation—Valuation of Real Estate in Wisconsin*, 12 WIS. L. REV. 540 (1935).

<sup>54</sup> The present writers doubt the validity of the finding as to statutory authority—except that they recognize the narrow viewpoint traditionally adopted by the Illinois Supreme Court.

<sup>55</sup> *People ex rel. McDonough v Cesar*, 349 Ill. 372, 182 N.E. 448 (1932), *certiorari denied* 288 U.S. 603.

<sup>56</sup> See note 37, *supra*.

<sup>57</sup> *Cf.*, for example, COMMONWEALTH OF KENTUCKY, DEPT. OF REV., INCOME TAX LAW AND REGULATIONS, 1946, Article 80-41.

In some situations it may well be accepted as the most important approach.<sup>58</sup>

#### WEIGHTING THE EVIDENCE

An opinion as to the value of a share of stock, a farm, a factory, or a railroad unsupported by facts is useless. Any *conclusion* as to value—like other scientific generalizations—must rest on the accumulation and the marshalling of facts, classified as bearing on (a) market background, prices, or other data, (b) cost analysis, or (c) income or income prospects capitalized. The valuation *process*, therefore, consists in the accumulation, analysis, and synthesis of factual information of one or more of these classes and the exercise of judgment as to the value estimate which the facts justify

In one of its aspects, the valuation process calls for the exercise of judgment as to the weight to be assigned different bits of basic evidence—and especially different classes of evidence. The problem presents itself to the appraiser in numerous guises, and so generalization as to standards involves risk. The important generalization perhaps is that the exercise of judgment must be based on *facts*. Some of the variables can be sketched to indicate a sample of the weights to be assigned different classes of facts.

In the first place, the weighting of evidence will depend on the thoroughness of the appraisal. Tax valuations, especially for *ad valorem* taxation, must be made at extremely low cost. In consequence the tax assessor will have to choose the kind of evidence that can be most readily assembled. For run-of-the-mine buildings, he will usually assemble replacement cost estimates and nothing further—partly because this procedure involves equality of error in respect of competitive properties. For much the same reason land will generally be valued by analysis of actual market data and comparable land valued at the same figure per front foot or per acre as the case may be.<sup>59</sup> The sum of the two

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<sup>58</sup> United States v. 11 Acres of Land, More or Less, in Port Washington, Nassau County, New York, 54 F Supp. 89 (D.C.E.D.N.Y. 1944), 51 AMER. JUR. 654.

<sup>59</sup> The Kentucky statutes appear to contemplate this plan, as they require the separate valuation of land and buildings. This is a generally approved practice even among experts who regard the procedure in particular instances as inconsistent with the best market practice.

figures is the value of the realty roughly estimated. Income capitalization will similarly be employed in the valuation of securities which are not sold or not frequently sold or which are sold under "controlled" conditions.<sup>60</sup> The capitalization of income, too, is the most basic to public service property valuations, but because of their unit size most tax assessing officers can resort also to comparison (mainly sale prices of securities) and sometimes to cost analysis.

In the second place, the weighting depends on the type of evidence available. Data regarding sales of second-hand refrigerators or tanker cars can usually be assembled. Data regarding open market sales of whole electric power plants are rarely to be had, statistics regarding the cost of replacing a house can usually be had, but not so in the case of bare land. So the valuation man will emphasize the available data which bear most directly on the appraisal problem he confronts. Note that this criterion is involved in the preceding paragraph though from a somewhat different point of view.

Thirdly, in the case of property of different sorts, the appraiser will give weight to considerations which are most basic. For example, investment property is acquired for the income it will produce—whether it is a railroad, a farm, or a share of stock. In such cases, though other valuation data will be employed, income capitalization constitutes the basic evidence for appraisal for the simple reason that, taking account of the risk involved, this is basic to market transactions. Only when market data are exceptionally accessible, therefore, as in the case of an actively traded security, can the capitalization of income take second place in weighting the evidence of value. (In such exceptional cases, the market traders themselves have previously performed this appraisal function.)

Finally, it should be stressed that for an accurate valuation *all* available evidence must be assembled and the weightings arrived at in the light of the many factors ordinarily impinging on the valuation problem. Although the inference from the evidence of value ought to be reasonably intelligible to the physician, the lawyer, or the farmer, the professional task of actually weighing the available data is one for an appraiser. The courts recognize

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<sup>60</sup> But see *Board of Supervisors of Frankfort v. State National Bank at Frankfort*, 300 Ky 620, 189 S.W. 2d 942 (1945).

this by according special weight to the valuations made by administrators especially designated for the purpose—particularly if there is evidence of the professional competence of such appraisers.

### CONCLUSION

Careful examination of appraisal practice and of the legal authorities seems to justify several categorical conclusions.

1. A good appraisal is not based on a single approach to a value estimate, no single approach is controlling. Because adherence to this policy seems to be essential to a good approximation, it appears to be required, at least for *tax* valuations, by the Constitution of Kentucky. It is in harmony with professional appraisal practice.<sup>61</sup>

2. Whether income capitalization, cost analysis, or market data analysis should be given greatest weight depends, according to appraisers, on the circumstances surrounding the individual case. There is reason to think that the courts would be inclined to emphasize sales of the same or of comparable property if (a) there was, on or shortly prior to valuation date, a reasonable number of relevant transactions and (b) the sales were fair and voluntary.

3. It is well established that no statute calling for particular approaches to valuation estimates is essential to the employment of such evidence. This would seem to be doubly true in Kentucky where a self-executing constitutional provision requires that value of property be estimated (for tax purposes) at the price it would bring at a fair voluntary sale.

4. These generalizations apply in valuing property for *all*

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<sup>61</sup> 1 BONBRIGHT, *op. cit. supra* note 17, at 122.

The following relates specifically to real estate appraisal.

"*Appraisal* is a conclusion which results from the analysis of facts.

"*Appraisal by capitalization*: an appraisal technique in which the anticipated net income is processed to indicate the capital amount of investment which produces the net income.

"*Appraisal by comparison*: an appraisal technique in which the market value estimate is predicated upon prices paid in actual market transactions and current listings.

"*Appraisal by summation*: an appraisal technique in which the estimate is (1) the value of the land considered as vacant and available for improvement, in addition to (2) the depreciated replacement cost of the improvements."

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tax purposes (inheritance, estate, gift, income, and property taxation), for eminent domain, and for other objectives which require the establishment of estimated market value.<sup>62</sup>

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<sup>62</sup> In *Mathew's Will*, 174 Wis. 220, 182 N.W. 744 (1921), the court very realistically observed that, "We are unable to perceive, however, how there can be two widely varying valuations of the same thing at the same time upon substantially the same basis. The fact that one amount is to be used as the basis for computation of the inheritance tax and the other amount for general appraisement and administration purposes is not an element to be considered in determining the value in either case." See also Appeal of E. J. Bray, Admr. (Estate of R. Bray), 4 B.T.A. 42 (1928).

For consideration of the special problems incident to condemnation appraisals see SCHMUTZ, *op. cit. supra* note 6, especially pt. II and pt. III.