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A Taxpayer's Brief Guide to Market Valuation

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The Texas Tax Code provides two remedies for a taxpayer who wishes to appeal a property's appraised value. A taxpayer is entitled to relief for excessive appraisal if the taxpayer proves to the court "that the appraised value of property according to the appraisal rolls exceeds the appraised value required by law." Tex. Tax Code § 42.25. A taxpayer may also claim a property was appraised unequally if "the appraised value of the property exceeds the median appraised value of a reasonable number of comparable properties appropriately adjusted." Tex. Tax Code § 42.26(a)(3). At the core of every appeal filed under Sections 42.25 and 42.26(a)(3) of the Texas Tax Code is the issue of market value.

Property tax is *ad valorem* in principle and thus requires property to be taxed in proportion to its market value. While courts typically have broad discretion, they have consistently held that market value should be determined by three generally accepted methods: (1) the sales comparison method, (2) the income method, or (3) the cost method.

Under the sales comparison method, market value is determined by comparing the subject property to a reasonable number of comparable properties that are similar to the subject property which have recently been sold or listed for sale. Market value is achieved by studying the market's reaction to comparable properties as they relate to the subject property. The points of comparison generally include location, physical characteristics (*e.g.*, age, size, style, and condition), economic characteristics (*e.g.*, operating expenses and net income), and zoning or use laws.

The subject property will always be the baseline when performing a comparative analysis. Therefore, comparable properties will always be adjusted to make them similar to the subject property. If a comparable property is superior to the subject property, a downward adjustment is made to the sales price of the comparable. If the comparable property is inferior to the subject property, an upward adjustment is made to the sales price of the comparable. The best comparable properties are ones that require little to no adjustments. Once the appropriate adjustments have been made, the indication of value is reached. The sales comparison method is most applicable when an abundance of properties similar to the subject property have recently traded hands. It is often touted as the most reliable method of appraisal because sales are primarily based on the actions of buyers and sellers in the marketplace. However, its reliability is often questioned when the availability of comparable properties is limited.

The income method is generally best suited for appraising income-producing properties. Income-producing properties typically include rental properties, hotels, office buildings, retail centers, and other properties which owners use to produce an income. The income method is based on the fundamental concept of anticipation, which states that value is created by the anticipation of future income. The rate of return or capitalization rate (calculated by dividing the annual net operating income by the subject property's current market value) is applied to the estimated future income and then converted into an indication of value or the present worth of future income. The indication of value must also account for expense forecasts and the subject property's remaining economic life. Naturally, reliability is called into question when applying the income method to properties that do not produce income such as single-family homes (that are not leased out to others), specialized industrial properties (which generally do not sell on the open market), and single tenant offices (*i.e.*, corporate headquarters).

In cases where unique, special purpose, or newly constructed properties require appraisal, the cost method is typically the recommended method. Under the cost method, market value is determined by comparing the cost to replace or rebuild the subject property with the cost of construction of similar properties with similar utility (as the subject property) plus the value of the land. Once determined, the value must be adjusted to account for the cost of depreciation and any other improvements that exist on the property. The cost method will arguably provide the most reliable estimate of value when market data such as sales or income information is unavailable as both the sales comparison and income method depend on market data to formulate an accurate value. However, reliability is weakened by subjective elements, assumptions about depreciation, and the often lack of consideration for market factors (*i.e.*, supply and demand).

A basic understanding of the three traditional methods of appraisal and their applications will better prepare any taxpayer contesting appraised value under Sections 42.25 and 42.26(a)(3) of the Texas Tax Code. **HN**

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