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Appraisal theory and the principal of change

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Appraisal theory is a branch of general economic theory that seeks to explain and understand property value; what causes value, how value changes, and methods of analyzing value. Valuation theory is based on the economic axioms or principles, i.e. substitution, competition, contribution, supply and demand, increasing and decreasing returns, principle of change, indeterminacy, regression and progression, anticipation, and utility. Economic conditions, marketing, laws, regulations, and a myriad of human activities can cause change to existing valuation theory. Appraisal practice is the application of appraisal theory to solve specific valuation problems.

Valuation theory is seldom taught as an appraisal course. It is similarly missing from most appraisal reports. It should not be missing because economic exchange value, the basic premise under which appraisers provide opinions, is subject to change. The lack of knowledge about valuation theory is probably why many appraisers bypass such thoughts and get right into applying some routine dogma-methodology. If the only tool in your tool chest is a hammer, you are likely to see every problem as a nail.

The Uniform Standards of Professional Appraisal Practice (USPAP) guide the appraisal process requiring the first step to be the identification of the appraisal question, problem, or issue. Real estate appraisers like using the word "problem." The word "problem" means a quandary, setback, riddle, conundrum, difficulty, dilemma, predicament, and question. Immediately, we have a quandary about just what is it we are identifying. I prefer the term appraisal issue or question. Appraisers identify the appraisal issue by an analysis of the what, when, where, who, how, and why of the appraisal. Under USPAP, the elements include the intended use, intended user(s), apposite definition of value, effective date of the appraisal, etc.

I'll use two examples of recent changes that significantly affect appraisal theory. The first example is relatively straight forward. The IRS has adopted USPAP as the generally accepted appraisal standards. The IRS has made appraisers unsigning enrolled agents, meaning the appraiser is liable when giving written advice to a taxpayer for use in a tax return USPAP has forever warned about giving unsupported appraisal opinions, but under IRS Regulation Circular 230 the details and consequences of negligent performance penalties and fines are lengthy. The change affects how appraisers perform appraisals for gift tax, charitable donation, and soon-to-return decedent estate tax returns. The IRS Rules apply. Some minor examples include the IRS decedent estate value definition for personal property which involves the value of the property purchased at retail, not the liquidation value. Then there are the added issues of lack of marketability discounts and minority discounts.

The second example changed how value theory applies to an S-Corporation. In Bernier v. Bernier, 449 Mass. 774, 776 (2007), the Massachusetts Supreme Court said that tax affecting an S-Corporation was required. The Court adopted the Kessler matrix [Open MRI Radiology Assocs. v.

Kessler, 898 A.2d 290, 327 (Del. Ct. Ch. 2006)], with a rather convoluted method of arriving at the tax affecting percentage. What it basically means is that the appraiser in appraising a Real Estate S-Corporation or one that operates a business enterprise, assume a reduced cash flow based on subtracting a percentage of the cash flow for income taxes.

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