Considering Foreclosed Sales

By: Michael Barnett

Our topic is on foreclosed properties and how we are to consider them in the appraisal process. Let's take a moment to clarify our understanding of what is a foreclosure sale. Black's Law Dictionary defines foreclosure as:

> *A legal proceeding to terminate a mortgagor's interest in property, instituted by the lender (the mortgagee) either to gain title or to force a sale in order to satisfy the unpaid debt secured by the property.*

Identifying these properties often proves to be challenging. Our metro communities typically will have reporting agencies such as Realty Trac, etc. that can provide resources. Multiple listing services likewise will incorporate notes that flag the transaction as distressed or foreclosed. In districts where these services are not available a review of the transfer instrument proves to be a good source for identification.

While we are at it, let's clarify a few other terms:

> *REO – property owned by a lender, usually a bank, after an unsuccessful sale at a foreclosure auction. The bank will then go through the process of trying to sell the property on its own. It will try to remove some of the liens and other expenses on the home, and then try to sell it on the market. Real estate investors will often go after these properties as banks are not in the business of owning homes and, in some cases, the house can be bought at a discount to its market value.*
>
> *Short Sale – occurs when the lender agrees to take less than the full loan payoff of an owner's property. The homeowner is most likely behind on payments and owing more than the home is worth.*

Software tracking and identification of these properties is critical. Keep in mind that the code provides consideration of these properties for the three years preceding the tax year in which the residential homestead is being appraised.

The Texas Legislation in its regular session in 2009 amended Section 23.01 of the Texas Property Tax Code.

> **§ 23.01. Appraisals Generally**
> (c) Notwithstanding Section 1.04(7)(C), in determining the market value of a residence homestead, the chief appraiser may not exclude from consideration the value of other residential property that is in the same neighborhood as the residence homestead being appraised and would otherwise be considered in appraising the residence homestead because the other residential property:

> (1) was sold at a foreclosure sale conducted in any of the three years preceding the tax year in which the residence homestead is being appraised and was comparable at the time of sale based on relevant characteristics with other residence homesteads in the same neighborhood.

Needless to say, this provision has necessitated a different consideration of foreclosed properties that had been previously viewed from the absolute standard of market value. Sec 1.04 of the Texas Property Tax Code provides this standard definition.

> **§ 1.04. Definitions**
> (7) ''Market value'' means the price at which a property would transfer for cash or its equivalent under prevailing market conditions if:
>
> (A) exposed for sale in the open market with a reasonable time for the seller to find a purchaser
>
> (B) both the seller and the purchaser know of all the uses and purposes to which the property is adapted and for which it is capable of being used and of the enforceable restrictions on its use; and
>
> (C) both the seller and purchaser seek to maximize their gains and neither is in a position to take advantage of the exigencies of the other

This definitive explanation of the criteria for market value had appeared to exclude foreclosed properties. Typically conflict arises from A) being exposed for sale in the open market for a reasonable time to find a purchaser and C) that the seller and purchaser seek to maximize their gains and neither is in a position to take advantage of the other.

IAAO in an executive summary titled “A Guide to Foreclosure-Related Sales and Verification Procedures” states that:

> *“Any foreclosure-related sale that passes the market value test is a candidate for appraisal modeling, valuation, and ratio studies. The commonly accepted definition of market value precludes the use of any sales subject to ‘undue stimulus’.”*

Section 23.01 of the Texas Property Tax Code refers to “appraisals generally.” The mass appraisal standards used by the appraisal districts must comply with Uniform Standards of Professional Appraisal Practices.

Section 23.01 further states, “each property shall be appraised based upon individual characteristics that affect market value." All available evidence specific to the value of the property shall be taken into account. Section 23.01(1) requires the Chief Appraiser to consider foreclosure sales in any of the three preceding years that are in the same neighborhood.

The important point is that foreclosures are not automatically excluded nor are they automatically included for appraisal models. Thus, foreclosures need to be reviewed as to meeting the definition of market value.

With this in mind let's expand on some of the issues that are involved in these sales.

These are:

Sec 1.04(7)(a) – A fact determination would be the time the properties were, "exposed for sale in the open market with reasonable time for the seller to find a purchaser". What we have found is that the holding period for foreclosed properties does not have a meaningful average number of days on the market. The majority of these properties often go straight to auction. Likewise, we find that there will be certain realtors that will specialize in the marketing of foreclosed properties. We have not been able to discern as to why some properties are placed in a market listing opportunity or go directly to auction.

It has been observed that often times properties that are government backed (i.e. Fannie Mae or Freddie Mac) are transferred to HUD and put on the market. Other properties that are maintained by the original lender will move straight to auction because the lender needs to liquidate their debt to meet capital requirements and risk-weighted asset regulations. If the auction is unsuccessful in meeting a minimum bid for the property it will become an REO property and move back to the banks control, which is in turn also listed on the market.

The selling and disposition of REO properties by financial institutions usually results in two approaches. The first being to sell the property as soon as possible in "as is" condition to satisfy a potential need to monetize its illiquid assets or to satisfy the before mentioned requirements and regulations imposed by the government. And secondly, holding the property and investing significant additional capital necessary to stabilize the asset to facilitate its sale. Often with residential property it is not practical to hold the asset and invest more capital into it to stabilize its value. This approach is usually done with commercial real estate or valuable income producing properties in large metropolitan areas.

Sec 1.04(7)(c) – Another primary consideration is to what extent the seller was under duress to complete a sale. The previous comments were recognition of considerations for open market opportunity. Equally important is the premise that both seller and purchaser seek to maximize their gains and neither is in a position to take advantage of the exigencies of the other. Part of the answer to this issue may be explained by private mortgage insurance (PMI).

PMI could also be a factor that influences the position for a seller. This past year a feature article titled “The Next Mortgage Bombshell” was printed in Barron’s (June 25, 2011).

> *‘The next domino likely to topple is the so-called private –mortgage-insurance industry, which permits buyers to purchase homes without making a full 20% down payment. Private mortgage insurance covers the first 25% of a mortgage’s value against default, plus accrued interest. Some $700 billion of U.S. mortgages carry such insurance, with most of it owned by Fannie Mae and Freddie Mac and backed by the federal government.’*

A property with PMI offers less exposure to the seller. PMI reduces the loss and facilitates the transfer of the property. This might explain why property with PMI markets out for less per square foot than others.

Though statistical data is available confirming percentages of properties financed with PMI, it is another matter to confirm disclosure of PMI on a single property.

The article cited that the 3 biggest insurers comprise 60% of the industry and appear undercapitalized to meet the claims over the next couple of years. Our experience from a practical standpoint has been that the mortgage holder or party selling the property typically will be either inaccessible or reluctant to provide information. On the other hand, the purchaser will be willing to provide information. This inquiry needs to be made as soon as the transfer occurs.

The purchasers of foreclosed properties fit a certain niche. They compete with other buyers who are acquiring these properties as investment opportunities. We find very few purchases that ultimately become owner occupied.

These buyers are sophisticated in their understanding of the market and the cost associated with making the property viable. Most of these properties are purchased cash up front. Some may be acquired with financing but usually require substantial down payments, 20% or more, and a short window for closing. The typical home purchaser is excluded due to these constraints.

Now that we’ve provided a backdrop for foreclosures we can talk a little about considering these types of properties. We will move forward with the assumption that a database has been created to identify those properties that have been foreclosed. We will also assume that those properties that have some unique cost to cure associated with them have been separated from the sample.

To comply with IAAO standards each property should receive a physical inspection. These inspections are typically limited to exterior observation and as a consequence may not recognize interior vandalism or other depreciation. A data confirmation letter to confirm any issues that the property may have had at time of sale is also a helpful tool.

Our next step would be to complete a ratio study. Each appraisal district has its own guidelines for establishing market neighborhoods. The tax code refers to residential property that is in the same neighborhood. We will assume that this will be equivalent to a market neighborhood. There are several situations that may arise when completing the market analysis. These are:

1. The market neighborhood shows a significant concentration of foreclosure sales. In many ways this simplifies the issue as the foreclosures are the rule and not the exception. IAAO advises a substantial concentration (IAAO 4.3.3 – Guide to Foreclosure-Related Sales and Verification Procedures) would justify using foreclosures in valuation modeling. This is important to keep in mind as we are required to utilize sales in any of the 3 preceding years.

2. A market neighborhood is designated that historically has few transactions. The review should include consideration as to whether the foreclosed properties are impacting market prices and are foreclosed properties the only ones selling. It may be helpful to review the annual number of transfers historically and determine if this pattern is confirmed in the current database. This would provide an opportunity to consider expanding the market neighborhood.

The consideration of foreclosed properties is challenging. Numerous criticisms have been raised that the appraisal districts are not complying with the tax code. I think much of the criticism arises out of a lack of clarity on both the part of the Chief Appraiser and the property owner.

Most recently an Attorney General's opinion (GA-0943) was released on foreclosures. The summary states:

> *'Pursuant to Tax Code section 23.01(c), a chief appraiser, in appraising a residence homestead, may not exclude from consideration the value of neighboring properties simply because they were subject to a foreclosure sale.'*

It appears as we close the year that most markets have improved. A recent article in the Dallas Morning News stated that 2012 foreclosures had dropped for the 2nd year in a row (to 48,653). That's the lowest since 2007 (home foreclosures peaked in 2010 with approximately 64,000) and now appears to confirm a downturn in foreclosures that is being witnessed nationwide. The old adage location, location, location is as true today as it was in the past. Therefore it is even more important in our market model to consider adjustments for time. Obviously this will pose a greater challenge to those districts that have limited sales. For this reason we look first at total sales and then we review sales by market neighborhood.

It would be nice to say that our review is complete and comes to a close. However the fact remains that there will be individuals who have purchased their properties through foreclosure and will argue that their foreclosed purchase price is market value. If this were the case it would suggest that the remaining properties should be selling at the foreclosed purchase price.

To address this issue regression modeling can provide an alternative method of analysis. It is common to use a regression model for a neighborhood to predict market value. However, it can also be used to compare a property to other foreclosures in the county. An example of a regression model using other foreclosed properties is Exhibit E. We use this model to compare properties to their predicted sale price based on other foreclosures in the county. If the actual sale price is comparable to the predicted sale price, we then use valid sales in the neighborhood to determine if it is market value. If the sale price is not comparable to the predicted sale price in the regression model then the subject property is considered an outlier and is not a market value transaction. This process adheres to the tax code requirement to consider other foreclosure sale prices when determining the market value of a property.

Likewise, many of the purchasers are successful at quickly getting their property leased up. For this reason it’s important to develop GRM's that will confirm a projected market value using the income approach as a comparative to the purchase price.

In closing I think the Attorney General said it best, “a chief appraiser in appraising a residence homestead may not exclude from consideration the value of neighboring properties simply because they were subject to a foreclosure sale”.

Exhibit A

Standard on Verification and Adjustment of Sales

Approved November 2010

International Association of Assessing Officers

Contents

formation subsequent to the sale, there are several disadvantages, as follows:

- Response is not immediate.
- Additional contact may be needed.
- Information is limited to what is stated on the sales verification questionnaire.
- Printing and mailing costs are incurred.

Mailed sales verification questionnaires should be as concise as possible and should include the following:

- Postage-paid return envelope
- Official stationery
- Purpose of the sales verification questionnaire
- Contact person (name, telephone number and e-mail address for additional information)
- Authorized signature (of person completing the questionnaire)

Specialized questionnaires may be designed for a specific type of property or situation such as an income producing property or a property that sells with atypical financing. Specialized questionnaires can be developed for numerous situations; however, all should follow the guidelines for the regular questionnaire suggested above.

5.2.2 Telephone Interviews

Telephone interviews provide quick responses and the opportunity for immediate clarification. Disadvantages are as follows:

- Inability to prove caller's identity
- Need for trained staff
- Difficulty in reaching the party to the sale.

An opening script should be written for telephone interviews. Always state your name, the office you represent, and the purpose of the telephone call. If the individual is unable to talk, ask for a specific time that would be more convenient. It is extremely important to use simple conversational words and avoid slang and industry jargon. Interviews should be short, courteous, and to the point.

5.2.3 Personal Interviews

The disadvantages of the in-person interview are they are the most costly and qualified analysts or appraisers should perform this task. However, they are most effective for the following reasons:

- Refusals less frequent
- Information more reliable
- More unusual or special considerations revealed.

For personal interviews it is critical to be on time. An identification badge or business card should be presented upon introduction. All paperwork and forms should be available and in order before the interview begins. The style and tone of the conversation should be geared to the interview setting. It can sometimes be helpful to establish rapport through brief small talk. Maintain eye contact, smile, and be friendly and respectful throughout the conversation.

5.3 Sales Generally Considered Invalid

The following types of sales are often found to be invalid and can be excluded unless a larger sample size is needed. If a larger sample size is needed, these sales require verification.

- Sales involving government agencies
- Sales involving charitable, religious, or educational institutions
- Sales involving financial institutions as buyer or seller
- Sales between relatives or between corporate affiliates
- Sales settling an estate
- Forced sales resulting from a judicial order
- Sales of doubtful title

5.3.1 Sales Involving Government Agencies

Sales to government agencies can involve an element of compulsion and often occur at prices higher than would otherwise be expected. When the governmental agency is the seller, values typically fall on the low end of the value range. The latter should not be considered in model calibration or ratio studies unless an analysis indicates governmental sales have affected the market in specific market areas or neighborhoods. Each sale in this category should be thoroughly researched prior to use. See Appendix C for a listing of some of the government agencies in this category.

5.3.2 Sales Involving Charitable, Religious or Educational Institutions

A sale to such an organization can involve an element of philanthropy, and a sale by such an organization can involve a nominal consideration or restrictive covenants. These sales often involve partial gifts and therefore are generally not representative of market value.

5.3.3 Sales Involving Financial Institution as Buyer

These sales are often made in lieu of foreclosure and are not exposed to the open market. However, open-market sales in which a financial institution is a willing buyer, such as the purchase of vacant land for a branch bank, may be considered potentially valid transactions.

5.3.4 Sales Involving Financial Institution as Seller

A foreclosure is not a sale but the legal process by which a lien on a property is enforced. The majority of the sales in which the financial institution is the seller are properties that were formerly foreclosed on by the financial institution. Also, they are easily identified because the seller is the financial institution. These sales typically are on the low side of the value range because the financial institution is highly motivated to sell and may be required by banking regulations to remove the property from its books. The longer the property is carried on the books by the financial institution, the lower the asking price is likely to be. If the financial institution was ordered by banking regulators to dispose of the property regardless of the sale price, the sale should not be included as a valid transaction.

Sales in which a financial institution is the seller typically should be considered as potentially valid for model calibration and ratio studies if they comprise more than 20 percent of sales in a specific market area. Care should be taken in validating this type of sale to account for changes in property characteristics (see Section 5.10). Any properties that have been vandalized should be excluded.

5.3.5 Sales between Relatives or Corporate Affiliates

Sales between close relatives (parents, children, aunts, uncles, nephews, nieces, grandparents) or corporate affiliates are usually non-open-market transactions. If the following factors apply during the follow-up verification, the sale may be considered a valid transaction.

- The property was exposed on the open market.
- The asking and selling price was within the range that any party purchasing the property would be expected to pay.
- The sale meets all other criteria of being an open-market, arm's-length transaction.

5.3.6 Sales Settling an Estate

A conveyance by an executor or trustee under powers granted in a will may not represent fair market value, particularly if the sale takes place soon after the will has been filed and admitted to probate in order to satisfy the decedent's debts or the wishes of an heir.

5.3.7 Forced Sales Resulting from a Judicial Order

These sales should never be considered for model calibration or ratio studies. The seller in these sales is usually a sheriff, receiver, or other court officer.

5.3.8 Sales of Doubtful Title

Sales in which title is in doubt tend to be below market value. When a sale is made on other than a warranty deed, there is a question of whether the title is merchantable. A quitclaim deed is an example.

5.4 Sales with Special Conditions

Sales with special conditions can be open-market transactions; however, they should be verified thoroughly. The following are types of sales with special conditions.

- Trades
- Partial interests
- Land contracts
- Incomplete or unbuilt common property
- Auctions

5.4.1 Trades

In a trade, the buyer gives the seller one or more items of real or personal property as all or part of the full consideration. If the sale is a pure trade with the seller receiving no money or securities, the sale should be excluded from analysis. If the sale involves both money and traded property, it may be possible to include the sale in the analysis if the value of the traded property is stipulated, can be estimated with accuracy, or is small in comparison to the total consideration. However, transactions involving trades should be excluded from the analysis whenever possible, particularly when the value of the traded property is substantial.

5.4.2 Partial Interest

A sale involving a conveyance of less than the full interest in a property should be excluded as a valid transaction. Sometimes all the partial interest owners of a property may agree to syndication and sell their portions of the estate to a buyer (typically on the same day). However, the sum of all the sale prices may not necessarily indicate the market value of the whole property. These transfers should not be used as valid sales without thorough testing, analysis, and documentation.

5.4.3 Land Contracts

Land contracts (also known as contracts for deeds) and other installment purchase agreements in which title is not transferred until the contract is fulfilled require careful analysis. Deeds in fulfillment of a land contract often reflect market conditions several years in the past, and such dated information should not be considered. Sales data from land contracts also can reflect the value of the financing arrangements. In such instances, if the transaction is recent, the sale price should be adjusted for financing, if warranted, and included as a valid transaction (see Section 7.4.4). Because the contract itself often is not recorded, discovery of these sales is difficult until the deed is finally recorded. The sale then is likely to be too old to be used.

5.4.4 Incomplete or Unbuilt Common Property

Sales of condominium units and of units in planned unit developments or vacation resorts often include an interest in common elements (e.g., golf courses, clubhouses, or swimming pools) that may not exist or be usable on the date of sale or on the assessment date. Sales of such properties should be examined to determine whether prices might be influenced by promises to add or complete common elements at some later date. Sales whose prices are influenced by such promises should be excluded or the sales price should be adjusted to reflect only the value of the improvements or amenities in existence on the assessment date.

5.4.5 Auction Sales

In general, auction sales of real property tend to be at the lower end of the price spectrum and are more prevalent in rural areas. Absolute auctions do not have a low bid clause or right of refusal and typically are advertised as absolute auctions. The property is sold to the highest bidder whatever that bid may be. All absolute auctions should be considered invalid. Before auction sales should be considered as valid transactions, the following criteria should be met.

- Was the auction well-advertised?
- Was the auction well-attended?
- Did the seller have a minimum bid or the right of refusal on all bids (with reserve)?

5.5 Acquisitions or Divestments by Large Property Owners

Acquisitions or divestments by large corporations, pension funds, or real estate investment trust (REITs) that involve multiple parcels typically should not be considered for analysis.

5.6 Multiple-Parcel Sales

A multiple-parcel sale is a transaction involving more than one parcel of real property. These transactions present special considerations and should be researched and analyzed prior to being used for valuation or ratio studies.

If the appraiser needs to include multiple-parcel sales, it should be determined whether the parcels are contiguous and whether the sale is a single economic unit or multiple economic units. Regardless of whether the parcels are contiguous, any multiple-parcel sale that involves multiple economic units generally should not be used in valuation or ratio studies.

The sum of the appraised values for the parcels involved in the transaction should be compared to the total sale price (see Appendix D for a copy of a multiple-parcel form.)

For example,

Parcel No.	Appraised Value	Sale Price
001	$ 150,000	
002	50,000	
003	100,000	
Total	$ 300,000	$315,000

5.7 IRS Section 1031 Exchanges

Internal Revenue Service (IRS) Code Section 1031 stipulates that investment properties can be sold on a tax-deferred basis if certain requirements are met. These transactions enable the taxpayer to defer capital gains tax on the sale of a business use or investment property. All net equity must be reinvested in a certain time period. A certain amount of undue stimuli may be present as this time period lapses. Sale transactions that represent Section 1031 exchanges should be analyzed like any other commercial transaction and, absent conditions that would make the sale price unrepresentative of market value, should be considered valid sales.

5.8 Adjoining Property Owners

Sales in which the buyer already owns adjoining property should be examined carefully to determine whether or not the buyer possibly paid more or less than the property is worth on the open market. In some cases because of the neighbor relationship, the buyer may even receive a *deal* on the property. These sales should not be excluded solely because the buyer owns adjoining property unless one or more of the following reasons exists:

- Buyer is willing to pay more than the asking price.
- Buyer is willing to pay more than the fee appraisal.
- Selling price is substantially less than the asking price.
- Buyer is under undue stimuli to purchase the adjoining property.

5.9 Leasebacks

A leaseback is defined as the sale of a building, land, or other property to a buyer under special arrangements for simultaneously leasing it on a long-term basis to the original seller, usually with an option to renew the lease. These transactions are also referred to as *sale and leaseback* and *sale-leaseback*. Leasebacks occur in the commercial and industrial class of property. Sales involving leasebacks are generally invalid because the sale price is unlikely to represent the market value of the property. This can be determined only by further verification of the sale (see Appendix B for questions involving leasebacks).

Appendix A. Sales Validation Guidelines

A.1 Sources of Sales Data

The best sources of sales data are copies of deeds or real estate transfer affidavits containing the full consideration and other particulars of the sale. Assessing officers in jurisdictions without laws mandating full disclosure of sales data to assessing officials work under a severe handicap and should seek legislation that provides for such disclosure.

1. *Real estate transfer documents*. These documents are (1) copies of deeds and land contracts, (2) copies of real estate transfer affidavits, and (3) closing statements.
2. *Buyers and sellers*. Buyers and sellers of real property can be contacted directly to secure or confirm sales data. Means of contact include sales questionnaires, telephone interviews, and personal interviews.
3. *Third-party sources*. Third-party sources include multiple listing agencies, real estate brokers and agencies, government and private fee appraisers, attorneys, appraisal organizations, and others. Of particular value are those individuals or agencies that publish lists of sales or provide sales in an electronic format.

A.2 Information Required

The following data are needed to make any necessary adjustments to sales prices, compute sales ratios, and update ownership information.

1. *Full consideration involved.* This is the total amount paid for the property, including the cash down payment and amounts financed. The sale price is the most essential item of information concerning the sale, and its accuracy must be carefully scrutinized. In many jurisdictions it is common practice in deeds of conveyance to state considerations in such terms as "one dollar plus other due and just consideration." These amounts are rarely the actual selling price and should be ignored in favor of information from the buyer and seller or other reliable source.
2. *Names of buyer and seller.* This information permits the assessor to maintain a current record of the owners of all property in the jurisdiction. Transfer documents often refer to the buyer as the grantee or transferee and to the seller as the grantor or transferor.
3. *Addresses, phone numbers, and other contact information of buyer and seller or their legal designee*. This information helps to identify more positively the parties to the sale. If the buyer will not reside at the property, the buyer's address may be needed for future correspondence. If the seller has established a new address, this information will aid the assessor in contacting the seller regarding the sale.
4. *Relationship of buyer and seller.* It is important to know whether the buyer and seller are related individuals or corporate affiliates because such sales often do not reflect market value.
5. *Legal description, address, and parcel identifier.* If each parcel is assigned a unique parcel identifier and if this number is noted on the document at the time it is recorded, then the assessor can locate the parcel in the files directly. If not, the legal description or street address is essential to locate the parcel.
6. *Type of transfer.* It is crucial to identify whether or not a sale is an "arm's-length" transfer. Therefore, if the sources of sales data do not include copies of deeds, the type of deed should be specifically required.
7. *Time on the market*. Sales that have been exposed to the open market too long, not long enough, or not at all may not represent market value.
8. *Interest transferred*. The appraiser must identify whether or not the entire bundle of rights (fee simple) to the property has transferred. For example, in some transactions, only a life tenancy ("life estate") may be conveyed, or the seller may retain mineral or other rights to the property. Similarly, the sale price of a property encumbered by a long-term lease may not reflect the market value of the fee simple estate in the property.
9. *Type of financing*. In analyzing the sale, it is helpful to know the amount of down payment; the type, remaining amount, and interest rates of notes secured by mortgages or deeds of trust assumed by the buyer; and the value of any stocks, bonds, notes, or other property passed to the seller. It is also important to know whether the sale conveys title to the property or that it is a land contract, in which title is not conveyed until some time in the future, typically several years.
10. *Personal property*. A sales ratio study requires knowledge of the amount paid for the real

property. The sale document ideally would note the type and value of any significant personal property items included in the transaction.

11. *Date of transfer.* This is the date on which the sale was closed or completed. The date the deed or other transfer document was recorded can be used as a surrogate, provided there was no undue delay in the recording. If there has been a delay in recording, the date of the deed or transfer instrument should be used.
12. *Instrument number.* This number, as well as the record or deed book and page, indicates where the deed is located in the official records and thus can be important in researching sales or leases and identifying duplication.

The data noted above should be maintained in a separate data file or the sale history file component of a CAMA system. In addition, the file should include additional information useful for stratification and other analytical purposes. Sales data files should reflect the physical characteristics of the property when sold. If significant legal, physical, or economic changes have occurred between the sale date and the assessment date, the sale should not be used for ratio studies. (The sale may still be valid for mass appraisal modeling by matching the sale price against the characteristics that existed on the date of sale.)

A.3 Confirmation of Sales

A.3.1 Importance of Confirmation

The usefulness of sales data is directly related to the completeness and accuracy of the data. Sales data should be routinely confirmed or verified by contacting buyers, sellers, or other knowledgeable participants in the transaction. In general, the fewer the sales in a stratum, the less common or more complex the type of property, and the more atypical the sale price, the greater the effort should be to confirm the particulars of the sale. With larger sample sizes, It may be sufficient to confirm single-family residential sales by audit or exception.

A.3.2 Methods of Confirmation

In general, the completeness and accuracy of sales data are best confirmed by requesting the particulars of a sale from parties to the sale. If a transfer document is not required, questionnaires after the sale can be used. A sales questionnaire, which requests the type of information listed in Section A.2, is one practical means of confirming sales. Telephone or personal interviews can be more comprehensive than mailed questionnaires. Forms with space to record the same types of information should be used for such interviews. Appendix G contains a model sale confirmation questionnaire (additional sample sales questionnaires and interview forms can be found in *Improving Real Property Assessment* [IAAO 1978, 95–104]).

Mailed sales questionnaires should be as concise as possible and should include

- a postage-paid return envelope
- official stationery
- purpose of the questionnaire
- contact person
- authorized signature

Forms designed for telephone interviews should include the name and phone number of the contact person. Such forms also should include the date and name of the person conducting the interview along with the number of attempts made to contact a party to the sale.

A.4 Screening Sales

Sales used in a ratio study must be screened to determine whether they reflect the market value of the real property transferred. Specific objectives of sales screening are as follows:

- to ensure that sales prices reflect to the maximum extent possible only the market value of the real property transferred and not the value of personal property, financing, or leases
- to ensure that sales that occurred only during the period of analysis are used
- to ensure that sales are excluded from the ratio study only with good cause (e.g., when they compromise the validity of the study)

Every arm's-length, open-market sale that appears to meet the conditions of a market value transaction should be included in the ratio study unless one of the following occurs:

- Data for the sale are incomplete, unverifiable, or suspect.
- The sale fails to pass one or more specific tests of acceptability.
- A sufficiently representative sample of sales that occurred during the study period can be randomly selected to provide sufficiently reliable statistical measures.

The sales reviewer should take the position that all sales are candidates as valid sales for the ratio study unless sufficient and compelling information can be documented to show otherwise. If sales are excluded without substantiation, the study may appear to be subjective. Reason codes can be established for invalid sales.

No single set of sales screening rules or recommendations can be universally applicable for all uses of sales data or under all conditions. Sales screening guidelines and procedures should be consistent with the provisions of the value definition applicable to the jurisdiction. Appraisers must use their judgment, but should not be arbitrary. To help analysts make wise and uniform judgments, screening procedures should be in writing. Each sales analyst should be thoroughly familiar with these procedures as well as with underlying real estate principles (Tomberlin 2001).

A.4.1 Sales Generally Invalid for Ratio Studies

The following types of sales are often found to be invalid for ratio studies and can be automatically excluded unless a larger sample size is needed and further research is conducted to determine that sales are open-market transactions.

1. *Sales involving government agencies and public utilities*. Such sales can involve an element of compulsion and often occur at prices higher than would otherwise be expected.
2. *Sales involving charitable, religious, or educational institutions*. A sale to such an organization can involve an element of philanthropy, and a sale by such an organization can involve a nominal consideration or restrictive covenants.
3. *Sales involving financial institutions*. A sale in which the lienholder is the buyer can be in lieu of a foreclosure or a judgment and the sale price can equal the loan balance only.
4. *Sales between relatives or corporate affiliates*. Sales between relatives are usually non-open-market transactions and tend to occur at prices lower than would otherwise be expected.
5. *Sales settling an estate*. A conveyance by an executor or trustee under powers granted in a will may not represent fair market value, particularly if the sale takes place soon after the will has been filed and admitted to probate in order to satisfy the decedent's debts or the wishes of an heir.
6. *Forced sales*. Such sales include those resulting from a judicial order. The seller in such cases is usually a sheriff, receiver, or other court officer.
7. *Sales of doubtful title*. Sales in which title is in doubt tend to be below market value. When a sale is made on other than a warranty deed, there is a question of whether the title is merchantable. Quit claim deeds and trustees' deeds are examples.

A.4.2 Sales with Special Conditions

Sales with special conditions can be open-market sales but must be verified thoroughly and used with caution in ratio studies.

1. *Trades*. In a trade, the buyer gives the seller one or more items of real or personal property as all or part of the full consideration. If the sale is a pure trade with the seller receiving no money or securities, the sale should be excluded from analysis. If the sale involves both money and traded property, it may be possible to include the sale in the analysis if the value of the traded property is stipulated, can be estimated with accuracy, or is small in comparison to the total consideration. However, transactions involving trades should be excluded from the analysis whenever possible, particularly when the value of the traded property appears substantial.
2. *Partial interests*. A sale involving the conveyance of less than the full interest in a property should be excluded from the analysis unless several sales of partial interests in a single property take place at the same time and the sum of the partial interests equals the fee-simple interest. Then the sum of the sales prices of the partial interests can sometimes be assumed to indicate the sale price of the total property. At other times, however, the purchase of such partial interests is analogous to plottage value in which a premium may have been paid.
3. *Land contracts*. Land contracts and other installment purchase arrangements in which title is not transferred until the contract is fulfilled require careful analysis. Deeds in fulfillment of a land contract often reflect market conditions several years in the past, and such dated information should be excluded from analysis. Sales data from land contracts also can reflect the value of the financing arrangements. In such instances, if the transaction is recent, the sale price should be adjusted for financing (see section A.5.2).
4. *Incomplete or unbuilt common property*. Sales of condominium units and of units in planned unit developments or vacation resorts often include an interest in common elements (for example, golf courses, clubhouses, or swimming pools) that may not exist or be usable on the date of sale or on the assessment date. Sales of such properties should be examined to determine whether prices might be influenced by promises to add or complete common elements at some later date. Sales whose prices are influenced by such promises should be excluded from the analysis, or the sales prices should be adjusted to reflect only the value of the improvements or amenities in existence on the assessment date.

5. *Auctions*. In general, auction sales of real property tend to be at the lower end of the price spectrum. Auction sales that have been well-advertised and well-attended may be valid for consideration in ratio studies. The seller also must have the option to set a minimum bid on the property or the right of refusal on all bids *(with reserve)* in order for the sale to be considered valid.

A.4.3 Multiple-Parcel Sales

A multiple-parcel sale is a transaction involving more than one parcel of real property. These transactions present special considerations and should be researched and analyzed before being used in ratio studies.

If the appraiser needs to include multiple-parcel sales, he or she should first determine whether the parcels are contiguous and whether the sale comprises a single economic unit or multiple economic units. Regardless of whether the parcels are contiguous, any multiple-parcel sale that also involves multiple economic units generally should not be used in ratio studies because of the likelihood that these sales include some plottage value or some discount for economies of scale, unless adequate adjustments for these factors can be made to the sale price.

A.4.4 Acquisitions or Divestments by Large Property Owners

Acquisitions or divestments by large corporations, pension funds, or real estate investment trusts (REITs) that involve multiple parcels typically should be rejected for ratio study purposes.

A.4.5 IRS 1031 Exchanges

Internal Revenue Service (IRS) Regulation 1031 stipulates that investment properties can be sold on a tax-deferred basis if certain requirements are met. Sale transactions that represent Section 1031 exchanges should be analyzed like any other commercial transaction and, absent conditions that would make the sale price unrepresentative of market value, should be regarded as valid.

A.4.6 Internet Marketing

Property that sells on the Internet and meets the criteria of being an open-market, arm's-length transaction should be included as a valid transaction in a ratio study. Brokerage and realty firms are using the Internet as an additional method to advertise and market their inventory of property.

A.4.7 Inaccurate Sale Data

Sale information should never be considered absolutely trustworthy. Jurisdictions can reduce the problem by requiring a sale verification questionnaire (see Appendix G). There should be statutory penalties for persons who falsify information.

A.5 Adjustments to Sale Prices

Sale prices used in ratio studies may need to be adjusted for financing, assumed long-term leases, personal property, gift programs, and date of sale. This is especially true for nonresidential properties. The real property tax is based on the market value of real property alone as of a specific date. This value may not be the same as investment value (that is, the monetary value of a property to a particular investor) and does not include the value of personal property or financing arrangements.

If adjustments for more than one purpose are to be made, they should be made in the following order:

1. adjustments that develop or isolate the price paid for taxable real property (These include adjustments for personal property received by the buyer, property taken in trade by the seller, the combination of partial interest sales, and incomplete or unbuilt common property.)
2. adjustments that convert the price to a better representation of the market value as of the date of sale (These include adjustments for financing and assumed long-term leases.)
3. adjustments for differences in market value levels between the date of sale and the date of analysis

Procedures for adjusting sales prices should be documented and the adjustment factors supported by market data. These requirements imply an ongoing study of local real estate prices, interest rates, and financing practices. Unsubstantiated or blanket adjustments can jeopardize the acceptance accorded a ratio study by making it appear subjective.

A.5.1 Adjustments for Personal Property

Sales screening includes determining the contributory value of any significant personal property included in the sale. Personal property includes such tangibles as machinery, furniture, and inventories and such intangibles as franchises, licenses, and non-compete agreements.- Ordinarily, it is not necessary to consider goodwill, going-concern value, business enterprise value, or the like, unless the value of these intangible assets has been itemized in a sales contract or a formal appraisal has been prepared by either party.

It is necessary to decide whether each item included in the sale should be classified as real or personal property. (See *Standard on Valuation of Personal Property* [IAAO 2005], which provides guidance on classification of property as real or personal.)

Sale prices should be adjusted by subtracting the contributory value of personal property received by the buyer. Ordinary window treatments, outdated models of free-standing appliances, and common-grade used furniture included with residential property do not usually influence the sale price of real property and do not require an adjustment unless the items were specifically broken out in the contract as personal property included in the sale price.

If the value of personal property appears to be substantial *(10 percent for residential, 25 percent for commercial)*, the sale should be excluded as a valid sale in statistical analysis unless the sample size is small.

A.5.2 Adjustments for Financing

When financing reflects prevailing market practices and interest rates, sales prices require no adjustment for financing. Adjustments should be considered in the following instances:

1. The seller and lender are the same party and financing is not at prevailing market rates.
2. The buyer assumes an existing mortgage at a non-market interest rate. As with personal property, the preferred means of adjusting for financing is by individual parcel. In this instance and no. 1 above, downward adjustments are warranted when (1) the loan appears to be well secured and the contract interest rate is less than the market interest rate, or (2) the loan appears not to be well secured and the contract interest rate is lower than that required by the market for a loan of equal risk. The amount of adjustment can be computed by capitalizing the difference between monthly payments based on the required market interest rate and those based on the actual interest rate. Market analysis using paired sales (sales of similar properties, some with and some without conventional financing) or statistical techniques can correct for such factors.
3. The seller pays "points" (a percentage of the loan amount). *(Points paid by the borrower are part of the down payment and do not require adjustment.)* When the seller pays points, the sale price should be adjusted downward by the value of the points.
4. The property is sold under a gift program. Gift programs are a type of creative financing for qualified buyers by certain lending institutions that provide the buyer with additional monies to use as part of a down payment or for property improvements. This program is typically associated with low-value properties and can be difficult to discover without a validation questionnaire and/or telephone interview. The gift amount is added to the actual sale price of the property; however, the seller is never in receipt of the gift amount. This gift amount must be deducted from the actual sale price of the real estate prior to statistical analysis.

Adjustments for financing require data on actual and market interest rates, the amount of the loan, and the term and amortization provisions of the loan. Obtaining and properly analyzing such data, as well as estimating the extent to which the market actually capitalizes non-market financing, are difficult and time-consuming and require specialized skills.

A.5.3 Adjustments for Assumed Leases

The sale price of a property encumbered by a long-term lease of at least three years should be adjusted as follows:

- If the contract rent differs significantly from market rent, then the sales price should be adjusted by the difference between the present worth of the two income streams.
- If the contract rent exceeds market rent, the present worth of the difference in the two income streams should be subtracted from the sale price.
- If the contract rent is less than current market rent, the present worth of the difference in the two income streams should be added to the sale price.

A.5.4 Adjustments for Time

There should be a program to track changes in price levels over time and adjust sale prices for time as required. This step is an important component of a ratio study. Time adjustments must be based on market analysis and supported with appropriate documentation.

Valid time-adjustment techniques are as follows:

- tracking sales and appraisal ratios over time
- including date-of-sale as a variable in regression or feedback models
- analyzing re-sales
- comparing per-unit values over time in homogeneous strata, such as a subdivision or condominium complex
- isolating the effect of time through paired sales analysis
- statistically supported time trend analysis studies

These techniques are discussed in Gloudemans (1990; 1999), *Property Appraisal and Assessment Administration* (IAAO 1990, Appendix 5-3), and *Improving Real Property Assessment* (IAAO 1978, section 4.6). If sales prices have generally been rising, ratios for sales that occurred after the assessment date tend to understate the overall level of appraisal. Similarly, sales ratios for sales that occurred before the assessment date tend to overstate the level of appraisal. If prices are generally declining, an opposite pattern results. When tracking ratios over time (using the inverse ratio technique) for determining time adjustments, it is important that ratios for chased sales be excluded, since there is no correlation of such sales ratios with the date of sale.

Changes in price levels should be monitored and time adjustments made by geographic area and type of property, because different segments of the market tend to change in value at different rates.

Oversight agencies can make any appropriate time adjustments after making all other adjustments.

A.5.5 Other Adjustments

Adjustments to sales prices should not be made for real estate sales and brokerage commissions; closing costs, such as attorney's fees, transfer taxes, and title insurance; and current or delinquent property taxes. Exceptions to this general rule occur when the buyer agrees to pay real estate commissions and delinquent property taxes, in which case the amounts of the payments should be added to the sale price if not already included in the sale amount. Other exceptions occur when the seller agrees to pay expenses normally paid by the buyer. Such expenses include loan origination fees and repair allowances. Loan origination fees paid by the seller should be deducted from the sale price. Repair allowances should be deducted from the sales price only if the property was in an unrepaired state on the appraisal date, but sold at a higher price reflecting the value of the repairs. If the sale occurred before the appraisal date and the repairs were made prior to that date, no adjustment should be made (Knight, Miceli, and Sirmans 2000).

A.5.6 Special Assessments

Special assessments are used to finance capital improvements or provide services adjacent to the properties they directly benefit. Typically, the property owner is obligated to make annual payments of principal and interest to a local unit of government over a specified number of years. The sale price of a property encumbered by a special assessment can require adjustment if the current balance of the defrayed amount is significant. The sale price can be adjusted upward to account for this lien. If the effect on market value is significant and can be ascertained, an adjustment should be made.

Exhibit C

Executive Summary:
A Guide to Foreclosure-Related Sales and Verification Procedures

This executive summary was developed by the IAAO Research Committee for informational purposes only and does not necessarily represent a policy position of the International Association of Assessing Officers. The paper this executive summary refers to is not a Standard. It was developed for the benefit of assessment professionals and exposed to the IAAO membership for their review. All comments received have been reviewed and in many cases incorporated into this final document. This paper was approved for distribution by the IAAO Executive Board on 07/18/2009.

"A Guide to Foreclosure-Related Sales and Verification Procedures" addresses three important issues brought on by a significant increase in the number of foreclosures and foreclosure-related sales in many assessment jurisdictions:

- If and how foreclosure-related sales can be used for computer-assisted mass appraisal (CAMA) or automated valuation model (AVM) modeling, valuation, and sales ratio studies
- Verification of foreclosure-related sales
- How assessors can provide information to tax policy officials to help them be more proactive in responding to a significant increase in foreclosure-related sales.

An understanding of foreclosure-related sales is critical to property tax and other public officials in order to respond to market conditions and trends resulting from a significant number of foreclosure-related sales. These sales must be considered in a manner that maintains the principles of fairness and equity of market-based appraisal and assessment systems.

It is important to understand the difference between the foreclosure process and foreclosure-related sales. A foreclosure is a legal process—not a sale. *Black's Law Dictionary* (Garner 1999, 658) defines foreclosure as:

> *A legal proceeding to terminate a mortgagor's interest in property, instituted by the lender (the mortgagee) either to gain title or to force a sale in order to satisfy the unpaid debt secured by the property.*

A number of different sales transactions can occur during the foreclosure process. Taken together, these foreclosure-related sales are the focus of this paper. However, not all foreclosure-related sales are the same nor should they all be treated alike. Foreclosure-related sales that meet the market-value test can be used for CAMA or AVM modeling, as comparable sales for valuation purposes, or as part of the sales sample in ratio studies. It may also be possible to determine adjustments for foreclosure-related sales for use in CAMA or AVM market modeling, comparable sales valuation, and sales ratio studies. This paper describes many types of foreclosure-related sales and how to examine them to determine *if and how* they can be used for modeling, appraisal, or ratio studies.

In a depressed market there may be as many or more foreclosure-related sales than traditional market sales. As a result, foreclosure-related sales should be examined and, when reasonable, used or adjusted in valuation modeling and sales ratio analyses. In periods of real estate recession, foreclosure-related sales may be so numerous that the supply and demand curve is shifted and traditional sellers in a market area are forced to lower their prices in order to sell their property. If such conditions exist, the appraiser or assessor must determine whether foreclosure-related sales should be used in valuation modeling, in sales ratio analysis, and ultimately in their revaluation programs.

The textbook *Property Assessment Valuation* (IAAO 1996, 100) states,

> *Market data are essential if uniformity and equality in assessment are to be achieved, and the best evidence of market value is the actions of buyers and sellers in the market. Sales, when consummated, are of all types with all possible conditions, and reflect the attitudes and ideas of people. The imperfect nature of the real estate market makes each sold property subject to scrutiny to learn how closely the sale conditions meet the criteria in the definition of market value.*

Any foreclosure-related sale that passes the market value test is a candidate for appraisal modeling, valuation, and ratio studies. The commonly accepted definition of market value precludes the use of any sales subject to "*undue stimulus*" (IAAO

2007). However, when foreclosure-related sales are common within a market area or property group, they may represent typical market stimulus.

Sales verification, including examination of terms and conditions, and price information are the keys to evaluating foreclosure-related sales to determine if and how they can be used. A follow-up process on foreclosure-related sales should also be developed to determine whether the property condition at the time of sale was different than on the assessment date. Significant differences may exclude the sale from being used in ratio studies but still permit the sale to be used in valuation modeling. Detailed sales verification and re-inspection of foreclosure-related sales transactions may require additional resources. In order to facilitate and simplify this process, legislation mandating disclosure of sales data including information on foreclosure-related sales is desired. Where this type of legislation is already in effect, it may be necessary to modify it to disclose additional information on foreclosure-related sales.

IAAO and others are also conducting research into if and how adjustments can be developed for certain foreclosure-related sales. This is important because if this can be accomplished, adjusted foreclosure-related sales may provide necessary additional sales for modeling, valuation, and ratio studies in areas in which few traditional sales are available.

Under any market conditions, real property valuation is subject to the appraisal guidelines established by the *Uniform Standards of Professional Appraisal Practice* (USPAP, Appraisal Foundation, updated annually), as well as state or provincial legislation and regulations on assessment practices.

In market areas where foreclosure-related sales affect the sale price of other properties, they may represent prevailing market conditions and therefore can be used for modeling, valuation, and ratio studies as long as they meet the market value test. Also, case studies and research can determine if and how foreclosure-related sales can be adjusted and used for modeling, valuation, and ratio studies and provide proactive information for tax policy makers as well. However, in order to use foreclosure-related sales, additional sales verification may be needed to determine if and how they can be used. The fair and equitable assessment of all property based on market value standards must be supported by agencies at all levels of government. The integrity of assessment systems must be maintained because the property tax is a principal source of revenue for local government.

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Exhibit D

4. Guidelines for the Sales Verification Process

The main purpose of sales verification is to determine whether a sale meets the definition of a market value transaction. Implicit in the definition of market value is the consummation of a sale as of a specified date and the passing of title from seller to buyer under the following conditions:

- The buyer and seller are typically motivated.
- Both parties are well-informed or well-advised and acting in what they consider their best interests.
- A reasonable time is allowed for exposure in the open market.
- Payment is made in terms of cash or in terms of financial arrangements comparable thereto.
- The price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.

4.1 Overview of the Sales Verification Process

A sales verification process is required to determine whether to include foreclosure-related sales in modeling, valuation, or ratio studies.

Many foreclosure-related transactions can be eliminated early in the verification process. It is expedient to filter out those sales that are known to be non-market value before parties involved in the sale are contacted. This filtering can be done on a mass basis by computer or by clerical staff. Mass screening may be more practical with large sample sizes and involves review of the transfer instruments and elimination of any obvious non-arm's-length sales. Mass screening techniques include computer-assisted analyses that can distinguish sales of property in typical conditions at representative prices from sales of property in abnormally poor condition or otherwise out of the normal price range in a given market area. Mass screening can also include electronic identification of and exclusion of certain deed types. Statistical trimming of ratios is also common in larger jurisdictions. If available, MLS data in which foreclosure-related sales and property condition at the time of sale can be discerned and very useful.

According to the IAAO *Standard on Ratio Studies* (2007, 49):

> *The following types of sales are often found to be invalid for ratio studies and can be automatically excluded unless a larger sample size is needed and further research is conducted to determine that sales are open-market transactions.*
>
> 1. Sales involving government agencies and public utilities. *Such sales can involve an element of compulsion and often occur at prices higher than would otherwise be expected.*
> 2. Sales involving charitable, religious, or educational institutions. *A sale to such an organization can involve an element of philanthropy, and a sale by such an organization can involve a nominal consideration or restrictive covenants.*
> 3. Sales involving financial institutions. *A sale in which the lien holder is the buyer can be in lieu of a foreclosure or a judgment and the sale price can equal the loan balance only.*
> 4. Sales between relatives or corporate affiliates. *Sales between relatives are usually non-open-market transactions and tend to occur at prices lower than would otherwise be expected.*
> 5. Sales settling an estate. *A conveyance by an executor or trustee under powers granted in a will may not represent fair market value, particularly if the sale takes place soon after the will has been filed and admitted to probate in order to satisfy the decedent's debts or the wishes of an heir.*
> 6. Forced sales. *Such sales include those resulting from a judicial order. The seller in such cases is usually a sheriff, receiver, or other court officer.*
> 7. Sales of doubtful title. *Sales in which title is in doubt tend to be below market value. When a sale is made on other than a warranty deed, there is a question of whether the title is merchantable. Quit claim deeds and trustees' deeds are examples."*

Within distressed market areas, with a preponderance of foreclosure-related sales, a larger sample size is needed and further research should to be conducted on sales involving financial institutions to determine whether foreclosure-related sales meet the market value criteria.

Ideally, all the sales remaining after the initial filtering process should be examined through an individual sales verification process that includes contacting parties involved in the transaction, typically the buyer and broker/agent, and asking a series of questions to determine whether the sale meets the market value criteria.

Transactions during the foreclosure process that do not meet the definition of market value need to be omitted from the market modeling process, valid comparable sales lists, and sales ratio analysis. Those transfers that do meet the definition of market value should be included in the market-modeling process, valid comparable sales lists, and sales ratio analysis.

4.2 Suggestions for Other Verification Sources

Many states and provinces require real estate agents or other parties to the transaction, such as conveying attorneys, to file a sales verification form with the recordation, registration, or assessment office. This practice should be encouraged because it provides a discovery tool for sales verification. Where they are available, these forms should be carefully examined in order to determine whether a sale can be used for modeling, valuation, or sales ratio analysis.

In addition to the sales verification form, the parties to the sale transaction are a good source of information, but interviewing them is not always possible because of limited time and staff resources. Interviews can be difficult because disclosure of financial information is not always possible for the parties involved. Requesting a personal meeting and on-site inspection of the property would provide an opportunity to discuss the terms and conditions of the sale with a knowledgeable party as well as to verify physical data and is therefore recommended.

Other credible sources should be contacted, if necessary, such as the following:

- *Lenders*. Some of the information helpful in evaluating the potential use of foreclosure-related sales is best obtained from lenders. An ongoing relationship with local lenders provides not only valuable information on foreclosure-related sales but also more recent information than can be gained from published sources.
- *Utility companies or government utilities*. Utility companies and government utilities should have records of properties that have turned off their services. The physical condition of an abandoned property can deteriorate quickly, so identifying a date of vacancy could be helpful in updating assessment records.
- *Code and law enforcement agencies*. Code enforcement agencies receive complaints about many problem properties that are not being maintained. Their field staff can also be a good source of information on the physical condition of the properties. Police agency reports of vandalism may be another good source of information on property condition or the need for further verification.
- *Volunteer services*. Volunteer services may be able to provide useful information about foreclosure-related sales. These services include neighborhood watch groups, delivery services such as meals-on-wheels, religious missionary organizations, and various other local providers.

4.3 Other Verification Issues

4.3.1. Physical Condition

The physical condition and other property characteristics at the time of sale should be determined and compared to the condition on the assessment date; significant differences in physical condition between the two dates would prevent the sale from being used in ratio studies, but could still allow the sale to be considered for valuation and modeling. The IAAO *Standard on Ratio Studies* (2007, 24) states,

> *...physical characteristics of the property on the date of assessment must be the same as those on the date of sale. Properties with significant differences in these factors should be excluded from the ratio study.*

This is particularly critical in foreclosure-related transactions because of the possible change in physical condition due to vacancy of the structure at the time of sale. Properties that are significantly damaged or stripped of mechanicals and other valuables should be excluded from the market value transaction list.

4.3.2 Time on the Market

The amount of time the property is listed for sale should be considered. A sale is more likely to be market value if the time on the market is long enough to truly be exposed to all market participants. This can be determined by comparing the marketing time of the subject sale with the marketing time typical for the market area at the time of sale. Extra vigilance is necessary in this analysis. Time on the market can be misleading based on re-listings. Short market time compared to typical market exposure may be a sign of undue duress. Any review of sales must also consider that other factors, such as a reasonable asking price and the desirability of the property, can influence how long a property is on the market.

4.3.3 Number and Percentage of Foreclosure-Related Sales in the Market Area

Each market area should be analyzed to determine whether there are a substantial percentage of foreclosure-related sales. Foreclosure-related transactions can become so prevalent in some neighborhoods that they strongly influence the market. The principle of substitution states that, "A prudent buyer will pay no more for a property than the purchase price of a similar and equally desirable one" (IAAO 1990, 44). Market asking prices and sale prices are set with this principle in mind. To exclude all foreclosure-related sales from valuation models could result in assessed values that exceed asking prices of non-distressed properties.

4.4 Documentation of the Verification Process and Results

Comprehensive documentation of the process and results of the foreclosure-related sales verification effort is important to support decisions for both valuation modeling and ratio study purposes. No substantive questions should remain unanswered. Documentation of the process should take place at the time of verification, and the results should be reported as part of the mass appraisal or reassessment program. The validity of all sales used must be supported through review documentation.

A sales verification form or set of interview questions should seek to clarify a number of key foreclosure-related sale issues, such as the following:

- What was the total mortgage or loan balance?
- What was the asking price?
- What was the sale price?
- Was personal property involved, and if so, what was its value?
- Was an independent appraisal performed, and what was the value?
- What was the condition of the property at the time of sale, and have any changes in condition or other property characteristics occurred since?
- Was there any indication of fraud?
- How was the property marketed (i.e., listed with a real estate agency, word-of-mouth, newspaper, for-sale signs, Internet, auction, and so on)?
- How long was the property exposed to the open market?

Other key features on a verification form are as follows:

- Parcel identification number of the property that sold
- Sales disclosure document number
- Name, telephone number, and other contact information of parties to the transaction
- An information source code that can be queried
- A validity decision code that can be queried.

5. Written Guidelines and Training

A comprehensive set of written guidelines along with specialized training should be provided to staff in charge of validating and screening foreclosure-related sales.

For CAMA systems and ratio study programs, specific codes can be assigned to sales to clearly identify foreclosure-related sales, providing the flexibility to add or extract the data for future analysis. Assigning different codes for different types of foreclosure-related sales affords the user more flexibility in reporting and analyzing data.

6. Sales Information Disclosure

Many states and provinces currently have laws mandating sale price disclosure, that is, a sales verification form or other document must be filed with the recordation, registration, or assessment office. Currently the number of U.S. states with some type of sale price disclosure requirement is 36, and only 10 of those states use a questionnaire (Technical Standards Committee 2009). IAAO strongly encourages jurisdictions that do not currently have mandatory sale price disclosure and a requirement for a comprehensive sales verification form to actively seek such authority. Without this information, assessing officials continue to work under difficult discovery conditions.

7. Monitoring and Communication

Monitoring foreclosure trends makes it possible for jurisdictions to be more proactive in tracking and responding to changes in foreclosure activity. Assessing officers are encouraged to report increased activity to other governmental agencies in anticipation of the effects of a changing market and housing-related issues. Public relations programs may need to be prepared and initiated or current ones altered. For more information on this topic, see the *Standard on Public Relations* (IAAO 2001).

Regardless of assessed value changes made in consideration of foreclosures, property tax changes cannot be anticipated without a complete understanding of the underlying assessment and property tax systems (see *Standard on Property Tax Policy* [IAAO 2004]).

8. Measuring Dispersion

In cases in which the typical market sales have not yet responded to the influence of foreclosure-related sales, a price gap is created and the coefficient of dispersion parameters recommended by the IAAO *Standard on Ratio Studies* (2007) may not be met. As a result, jurisdictions can fall out of assessment uniformity compliance. Oversight agencies and assessors should be prepared for this possibility and may either accept less precision or change the sample size.

9. Oversight Agencies

Oversight agencies must work closely with local jurisdictions to ensure that only valid foreclosure-related sales are considered. As part of the official ratio study conducted by the oversight agency, an informal appeal process should be developed for the consideration of these sales when *verifiable* documentation is provided by the local jurisdiction that such sales are truly influencing the market in any specific area of the jurisdiction. This process is especially important when the oversight agency performs an independent validation process. (See the *Standard on Administration of Monitoring and Compliance Responsibilities*, section 10, Performance Evaluation [IAAO 2003].)

10. Conclusion

The recent large increase in foreclosures has resulted in renewed interest in evaluating foreclosure-related sales for modeling,

Exhibit E

Muiltiple Regression Analysis of Foreclosures in Smith County, Texas

Prepared by Drew Dunklin 11/05/2012

Introduction:

The subject property located at [redacted], is being protested based on grounds of being appraised over market value. Pursuant to § 1.04(7) of the Texas property tax code, market value is defined as the following: "Market value means the price at which a property would transfer for cash or its equivalent under prevailing market conditions if, (A) exposed for sale in the open market with a reasonable time for the seller to find a purchaser, (B) both the seller and the purchaser know of all the uses and purposes to which the property is adapted and for which it is capable of being used and of the enforceable restrictions on its use, and (C) both the seller and purchaser seek to maximize their gains and neither is in a position to take advantage of the exigencies of the other." Considering that the property owner purchased the subject property for $45,000 out of foreclosure from a financial institution, the purchase does not adhere to the Texas property tax code definition (C) of a "market value" transaction because the property owner was in a position to take advantage of the "exigencies of the other." The financial institution placed an original listing price of $95,100 on the subject property which is representative of true market value. After being on the market for only 115 days the seller accepted an offer of $45,000. This transaction is typical of bank-owned real estate being liquidated out of foreclosure to alleviate accumulated debt from defaulted mortgages. Furthermore, the subject property was originally purchased in April of 2009 for $114,000, which is a closer representation of market value for the subject property than $45,000.

However, according to SUBCHAPTER A, § 23.01(c)(1), "In determining the market value of a residence homestead, the chief appraiser may not exclude from consideration the value of other residential property that is in the same neighborhood as the residence homestead being appraised and would otherwise be considered in appraising the residence homestead because the other residential property: (1) was sold at a foreclosure sale conducted in any of the three years preceding the tax year in which the residence homestead is being appraised and comparable at the time of sale based on relevant characteristics with other residence homesteads in the same neighborhood." Therefore, the following analysis of foreclosures in Smith County, Texas is in compliance with the Appraisal District's responsibility to consider all sales, including foreclosures, in the analysis and determination of market value for the subject property.

Methodology:

In accordance with SUBCHAPTER A of the Texas property tax code, 618 foreclosures in Smith County, Texas, dating back from January 2009, through July 2012, were considered and included in a multiple regression analysis (MRA) to determine on average what the predicted sale price of the subject property would be from a sale or auction out of foreclosure. MRA was utilized to compare the subject property to other sales out of foreclosure as an alternative to the matched-paired sales method.

Exhibit E

Traditional appraisal produces a point estimate of value (the central tendency where values tend to cluster), which may or may not be accompanied by a subjectively estimated range (how values may be scattered or dispersed around the point estimate). Regression modeling produces both a point estimate of value (mean) and an objectively determined measure of dispersion (standard deviation or standard error) around the point estimate. Thus, regression is particularly useful when data elements are not homogenous, or in this case, when the sale price of foreclosed homes does not adhere to traditional market value transactions.

Predicted sale price was the dependent variable in the model and it was regressed by the independent variables building class, effective year built, condition of construction, square feet, amenities, exterior wall construction type, ISD, condition and depreciation (C&D), and number of days on market. The inclusion of 9 independent variables is considered a strength of the model because it produces a higher R^2 value. The R^2 value is expressed as a percentage of which the variability observed in the dependent variable (sale price) is explained by the independent variables included.

Results:

The regression model output (see figure 1) defines coefficients for each of the independent variables which are expressed in the same unit of measurement of the dependent variable, sale price ($). Each coefficient is a linear function of sale price independent of all other variables. Each coefficient is summed together to arrive at the predicted sale price of the subject property based on the characteristics that it exhibits. For example, one property might have a construction condition defined as “excellent”, which would give that characteristic a value of $26,740. Conversely, another property might exhibit a construction condition defined as “Average”, which would contribute $20,314 to the predicted sale price. The following equation is the sum of each applicable coefficient from the model to arrive at a predicted sale price by using the unique characteristics of the subject property.

$$Y = b_0 + b_1 + b_2 + b_3 + b_4x_4 + b_5x_5 + b_6 + b_7 + b_8x_8 + b_9x_9$$

Y = Sale price
b_0 = Intercept
b_1 = Coefficient for building class (4+)
b_2 = Coefficient for Effective Year Built (5=1975)
b_3 = Coefficient for Condition of Construction (Good)
b_4 = Coefficient for Square Feet
x_4 = Number for Square Feet (1,515 square feet)
b_5 = Coefficient for Amenities
x_5 = Amenity Value (-15%)
b_6 = Coefficient for Exterior Wall Construction (Brick)
b_7 = Coefficient for School District (TY)
b_8 = Coefficient for C&D
x_8 = C&D value (10%)
b_9 = Coefficient for Days on Market
x_9 = Days on Market value (115 days)

Therefore, application of the equation using the appropriate coefficients determined by the characteristics of the property is as follows:

$$\text{Sale Price} = 18{,}284.01 + 25{,}346.30 + (-10{,}008.06) + 22{,}570.71 + (14.42)(1{,}515) + (52{,}938.40)(-0.15) + 8{,}349.12 + (-4{,}360.64) + (40{,}349.63)(0.10) + (-32.21)(115)$$

Sale Price = $74,417.79

The regression model predicts a sale price for the subject property of $74,417.79. As stated previously, 618 sales out of foreclosure and 9 independent variables were included in the model (no valid "market value" sales were included). The MRA is significant at the 95% confidence interval and the large sample size and number of independent variables produced a strong R^2 value of 77.4%. Thus, 77.4% of the observed variability in sale price is explained by the 9 independent variables included in the model. R^2 values over 60% indicate that the model is functioning correctly. Moreover, R^2 values approaching 80% and above are indicative of a very strong explanatory relationship of the dependent variable by the independent variables.

The standard error of the MRA is ± $6,922.96. As stated in the introduction, an advantage of MRA over traditional appraisal methods is that regression modeling produces both a point estimate of value (mean) and an objectively determined measure of dispersion (standard deviation or standard error) around the point estimate. Thus, since the model is significant at the 95% confident interval, it is valid to assert that with 95% confidence the true mean of the subject property (predicted sale price) is $74,417.79, ± ($6,922.96 x 2).

Conclusion:

The multiple regression analysis outlined here, along with the traditional sales analysis included, was used to further demonstrate that the sale price of the subject property was indicative of severe liquidation by the financial institution that possessed it. Furthermore, the Appraisal District's application of the regression model, which considered sales out of foreclosure as comparables in the determination of market value for the subject property, satisfies the requirements of SUBSECTION A, § 23.01(c)(1), of the Texas property tax code. And lastly, this analysis also sustains the ARB order that reduced the subject property from its market value of $110,694 to $70,000.

Exhibit E

Appendix

Figure 1:

Model Summary

Target	Sale Price
Automatic Data Preparation	On
Model Selection Method	Forward Stepwise
Information Criterion	12,290.403

The information criterion is used to compare to models. Models with smaller information criterion values fit better.

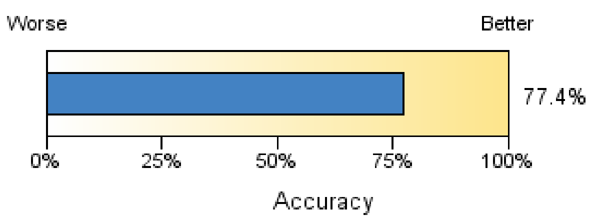

Exhibit E

Figure 2:

Coefficients (in $)
Target: Sale Price

Model Term	Coefficient	Standard Error	t statistic	Sig.	Importance
Intercept (Constant)	18,284.01	6,922.96	2.641	0.008	52.7%
Bldg Class 4-	7,346.11	4,835.25	1.519	0.029	52.7%
Bldg Class 4	11,208.87	4,479.62	2.502	0.013	52.7%
Bldg Class 4+	25,346.30	4,761.97	5.323	0.000	52.7%
Bldg Class 5-	42,095.92	5,360.51	7.853	0.000	52.7%
Bldg Class 5	52,992.25	5,599.66	9.463	0.000	52.7%
Bldg Class 5+	75,117.48	6,136.28	12.242	0.000	52.7%
Bldg Class 2,3,3-	0[a]				52.7%
Effective Yr Built 1	-33,736.84	7,231.00	-4.665	0.000	22.0%
Effective Yr Built 2	-23,419.41	7,048.55	0.332	0.001	22.0%
Effective Yr Built 3	-17,947.91	4,223.77	-4.239	0.000	22.0%
Effective Yr Built 4	-16,162.72	3,784.30	-4.271	0.000	22.0%
Effective Yr Built 5	-10,008.06	3,638.04	-2.751	0.006	22.0%
Effective Yr Built 6	-8,378.62	2,898.51	-2.891	0.004	22.0%
Effective Yr Built 7	84,273.22	10,415.50	8.091	0.000	22.0%
Effective Yr Built 8	0[a]				22.0%
Condition - Fair	11,199.21	4,880.56	2.295	0.022	8.9%
Condition - Average	20,314.12	4,465.56	4.549	0.000	8.9%
Condition - Good	22,570.71	4,526.61	4.986	0.000	8.9%
Condition - Very Good	30,235.04	5,024.51	6.018	0.000	8.9%
Condition - Excellent	26,740.71	4,929.66	5.424	0.000	8.9%
Condition - Poor	0[a]				8.9%
Square Feet (per square ft.)	14.42	2.43	5.931	0.000	6.5%
Amenities	52,938.40	11,591.25	4.567	0.000	3.9%
Brick or Stucco	8,349.12	2,529.99	3.300	0.001	2.2%
Wood Frame	0[a]				2.2%
ISD - TR, Van, WI	-13,356.25	4,295.25	-3.110	0.002	2.0%
ISD - AR, CH, TY, GL	-4,360.64	2,039.50	-2.138	0.033	2.0%
ISD - BU, LI, WH	0[a]				2.0%

C&D	40,349.63	17,301.07	2.332	0.020	1.0%
Days on Market (per day)	-32.21	15.98	-2.016	0.044	1.0%

[a] This coefficient is set to zero because it is redundant.

Figure 3:

Effects

Target: Sale Price

Source	Sum of Squares	df	Mean Square	F	Sig.	Importance
Corrected Model ▼	854,717,255,094.584	29	29,473,008,796.365	73.984	.000	
BldgClass_transformed	112,684,564,829.645	8	14,085,570,603.706	35.358	.000	0.527
EffYr_transformed	47,116,735,513.026	8	5,889,591,939.128	14.784	.000	0.220
CDU_transformed	19,051,037,117.811	5	3,810,207,423.562	9.564	.000	0.089
SFLA_transformed	14,013,795,049.716	1	14,013,795,049.716	35.178	.000	0.065
Amenities_transformed	8,309,374,451.337	1	8,309,374,451.337	20.858	.000	0.039
Extwall_transformed	4,742,735,531.744	2	2,371,367,765.872	5.953	.003	0.022
ISD_transformed	4,293,565,808.657	2	2,146,782,904.329	5.389	.005	0.020
CampD_transformed	2,166,808,166.583	1	2,166,808,166.583	5.439	.020	0.010
DOM_transformed	1,618,523,934.327	1	1,618,523,934.327	4.063	.044	0.008
Residual	234,640,428,344.821	589	398,370,846.086			
Corrected Total	1,089,357,683,439.410	618				