

# **The Appraisal of Real Estate**

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**American Institute of Real Estate Appraisers**

# **The Appraisal of Real Estate**

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**Ninth Edition**



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**American Institute of Real Estate Appraisers  
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# Foreword

**A**s the twenty-first century approaches, increasingly sophisticated methods and procedures have become a familiar hallmark of the appraisal profession. The accelerating tempo of change in economic, fiscal, and technological environments has created greater complexity in real estate appraisal. I am especially proud, therefore, to introduce the ninth edition of *The Appraisal of Real Estate* in anticipation of the practice of appraisal in the upcoming century. It is my firm belief that the ninth edition meets the needs of both students entering the field and those of seasoned appraisers. It presents a comprehensive overview of current appraisal techniques and, at the same time, keeps sight of the fundamental principles that have long guided the development of our profession.

The revision was inaugurated with a survey of 1,100 professors and instructors who teach from *The Appraisal of Real Estate*. Their suggestions for an improved textbook were executed by MAI and RM practitioners whose expertise in the marketplace is manifested throughout the book. The integration of concept and practice, textbook case and realistic application, make *The Appraisal of Real Estate* a unique book. The changes between the eighth and ninth editions are many and diverse. Because of the importance of the consideration of real property rights in an appraisal, the ninth edition includes a new chapter on fee simple and partial interests, and introduces a real property rights adjustment in the application of the sales comparison and cost approaches. This edition also provides an in-depth discussion of the driving concept of market value. The ninth edition features a new chapter on land or site valuation and one on advanced applications of yield capitalization. In addition, there are guidelines for market analysis projections and updated information that reflects current economic conditions, tax policies, and the Appraisal Institute's revised Code of Professional Ethics and Standards of Professional Practice.

Richard Marchitelli, MAI, Chairman of Publications, guided the monumental decision-making process, which over three years was essential to assure that the content of this new edition is useful and contemporary. Readers will benefit from his

astute insights and those of the following contributors and reviewers: E. Nelson Bowes, MAI; Douglas C. Brown, MAI; James H. Bulthuis, MAI; Robert C. Cantwell, IV, MAI; Sheila Crowell; Max J. Derbes, Jr., MAI; John D. Dorchester, Jr., MAI; Stephen F. Fanning, MAI; Clifford E. Fisher, Jr., MAI; Kenneth G. Foltz, MAI; W. West Foster, MAI; James E. Gibbons, MAI; Terry V. Grissom, MAI; J. R. Kimball, MAI; Peter F. Korpacz, MAI; David J. Lau, MAI; A. Scruggs Love, Jr., MAI; C. David Matthews, MAI; Terrell R. Oetzel, MAI; Anthony Reynolds, MAI; Judith Reynolds, MAI; Mark I. Roth; J. Carl Schultz, Jr., MAI; Gary P. Taylor, MAI; Eugene W. Stunard, MAI; and Janice F. Young, MAI.

Mary Jo Thomas, RM; Richard Marchitelli, MAI; and Peter D. Bowes, MAI, were final reviewers of the entire manuscript. The Appraisal Institute is particularly grateful for their contributions of knowledge, experience, time, and energy.

*Richard C. Wolcott, MAI*  
*1987 President*  
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# **1 Real Property and Its Appraisal**

**U**nder all is the land. This statement implies more than a physical reality. Land is the surface of the earth and the major source of all mineral, vegetable, and animal matter; it is the foundation for the social and economic activities of people as well as a commodity and the root of wealth.

Because land is essential to life and human society, it is the subject of various disciplines, including geography, law, sociology, and economics. Each of these disciplines employs somewhat different concepts of real estate. Geography focuses on describing the physical elements of land and the distribution and activities of the people who use it. Law considers land as the subject of ownership. Sociology focuses on the dual nature of land: as a resource to be shared by all people and a commodity to be owned, traded, and used by individuals. In economics, land is regarded as one of the four agents of production, along with labor, capital, and coordination. Land represents all the natural elements of a nation's wealth.

The concept of land value is an economic concept. A common understanding of the attributes of land is shared by geographers, lawyers, sociologists, and economists.

1. Each parcel of land is unique in its location and composition.
2. Land is physically immobile.
3. Land is durable.
4. The supply of land is finite.
5. Land is useful to people.

Real estate appraisers also recognize these attributes of land. They are concerned with the concepts of land used in other disciplines because these concepts provide the basic perceptions on which real estate value rests. In real estate appraisal the emphasis is on real estate markets, which result from the actions of people who respond to, and often are directed or limited by, all the important attributes of land delineated in other disciplines.

## CONCEPTS OF LAND

### Geographic

An understanding of land begins with recognizing its diverse physical characteristics and how these characteristics combine in a particular area. Developing a sense of land also includes an awareness of how physical characteristics influence the use of land.

Land is affected by a number of processes. Ongoing physical and chemical processes modify the land's surface, biological processes affect the distribution of all life forms, and socioeconomic processes direct human habitation and activity on the land. Together, these processes influence land capability and, therefore, land use.

Land may be used for many purposes, including agriculture, commerce, industry, habitation, and recreation. Land-use decisions are influenced by climate, topography, and the distribution of natural resources, population centers, and industry. Land use is also affected by economic conditions, population pressures, technological practices, and cultural influences. The influence of each of these factors varies, depending on the geographic area.

Geographic considerations are particularly significant to appraisers. The importance of land's physical characteristics—e.g., climate, geology, soils, water, and vegetation—is obvious, but the distribution of people, facilities, and services and the movement of goods and people are equally important. The geographic concept of land, which emphasizes matters such as resources and resource bases, industrial location, and actual and potential markets, provides much of the background knowledge required in real estate appraisal.

### Legal

A society's cultural, political, governmental, and economic attitudes are reflected in its laws. The legal profession does not focus on the physical characteristics of land, but on the rights and obligations associated with various interests in land. Law maintains the right of individuals to own and use land for material gain, while it also protects the right of all people to use the land. In other words, the law recognizes the conflict between private ownership and public use.

"Whose is the land, his it is, to the sky and the depths." This ancient maxim is the basis for the following legal definition.

Land includes not only the ground, or soil, but everything that is attached to the earth, whether by course of nature, as are trees and herbage, or by the hand of man, as are houses and other buildings. It includes not only the surface of the earth, but everything under it and over it. Thus, in legal theory, a tract of land consists not only of the portion on the surface of the



earth, but is an inverted pyramid having its tip, or apex, at the center of the earth, extending outward through the surface of the earth at the boundary lines of the tract, and continuing on upward to the heavens.<sup>1</sup>

This definition may seem to suggest that land ownership implies complete possession from the center of the earth to the ends of the universe. In practice, however, ownership is limited. For example, the U.S. Congress has declared that the federal government has complete and exclusive sovereignty over the nation's airspace and that every citizen has "a public right to freedom of transit in air commerce through the navigable air space of the United States."<sup>2</sup> Because ownership can be limited, ownership rights are the subject of law, and the value of these rights is the subject of appraisal.

The laws that govern the use and development of land in America give the landowner the greatest possible freedom in deciding how to use the land. The owner's rights are restricted only if they unreasonably harm the rights of others. The definition of reasonable use has been argued in many court cases.

Legal matters of particular concern to appraisers include easements, access regulations, use restrictions, and the recording and conveyance of titles. Appraisers must be familiar with local and state laws because the jurisdiction over lands is vested primarily at the local and state levels.

## Social

As the physical characteristics and legal limitations of land increasingly affect its use, society has become more concerned with how land is used and how rights are distributed. Because the supply of land is fixed, the increased demand for land exerts pressure for land to be used more intensively. Conflicts often arise between groups with different views on proper land use. Some people believe that land is a resource to be shared by all. They want to preserve the land's scenic beauty and important ecological functions. Others view land primarily as a marketable commodity; they believe that society is best served by private, unrestricted ownership. Because land is both a resource and a commodity, there are no clear-cut solutions to this conflict.<sup>3</sup>

Both points of view have legal support. As a resource, land is protected for the good of society. As a marketable commodity, the ownership, use, and disposal of land are regulated so that individual rights are not violated.

In 1876 the U.S. Supreme Court established government's right to regulate "the manner in which [a citizen] shall own his own property when such regulation

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1. Robert Kratovil and Raymond J. Werner, *Real Estate Law*, 8th ed. (Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1983), p. 6.

2. The Air Commerce Act of 1926 (formerly 49 USC 171 *et seq.*); the Civil Aeronautics Act of 1938 (formerly 49 USC 401 *et seq.*); and the Federal Aviation Act of 1958 (see 49 USC 401).

3. Richard N. L. Andrews, *Land in America* (Lexington, Mass.: D.C. Heath and Company, 1979) p. ix.

becomes necessary for the public good.” The court quoted the words of England’s Lord Chief Justice Hale: “When private property is ‘affected with a public interest,’ it ceases to be *juris privati* only.”<sup>4</sup>

Throughout American history, land ownership has been recognized as fundamental. John Adams wrote, “If the multitude is possessed of real estate, the multitude will take care of the liberty, virtue, and interest of the multitude in all acts of government.”<sup>5</sup>

In the public interest, society may impose building restrictions, zoning and building ordinances, development and subdivision regulations, and environmental controls. Environmental controls include provisions to protect the air and water from wastes, dirt, chemicals, and excessive noise. To preserve land in its natural state, there are regulations that protect wetlands, beaches, and navigable waters.

### Economic

Land is a physical substance with inherent ownership rights that can be legally limited for the good of society. Land is also a major *source* of wealth, which, in economic terms, is measured in money or exchange value. Land and its products have economic value only when they are converted into goods or services that are useful, desirable, and paid for by consumers. The economic concept of land as a source of wealth and an object of value is central to appraisal theory.

The economic concept of land reflects a long history of thought on the sources and bases of value, which is referred to as *value theory*.<sup>6</sup> Value theory contributes to the definitions of value used in appraisal reports and appraisal literature, and it is an important part of the philosophy that underlies professional appraisal practice. The development of value theory and its relationship to other systems of thought, which form the ideological basis of real estate appraisal, are discussed in Chapter 2.

## THE DISCIPLINE OF APPRAISAL

Geographic, legal, social, and economic concepts of land all relate to the real estate appraiser’s concept of land. Land, legally defined to include everything attached to the land, constitutes real estate. Appraisers study the value of physical real estate and its accompanying ownership rights, recognizing that real estate exists within the

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4. 94 U.S. 113 (1896). Quoted in Richard F. Babcock and Duane A. Feurer, “Land as a Commodity ‘Affected with a Public Interest’ ” in Andrews, p. 110.

5. Andrews, p. 31.

6. Paul F. Wendt, *Real Estate Appraisal: Review and Outlook* (Athens: University of Georgia Press, 1974), p. 17.

context of our society as a whole. Because the potential uses of land are influenced by geographic, legal, social, and economic factors, these considerations form the background against which appraisal activities are conducted.

## REAL ESTATE, REAL PROPERTY, AND PERSONAL PROPERTY

To begin the study of real estate appraisal, an important distinction must be made between the terms *real estate* and *real property*. Although these concepts are different, some state laws treat them as synonymous.

*Real estate is the physical land and appurtenances affixed to the land, e.g., structures.* Real estate is immobile and tangible. The legal definition of real estate includes land and all things that are a natural part of land (e.g., trees and minerals), as well as all things that are attached to it by people (e.g., buildings and yard improvements). All permanent building attachments (e.g., plumbing, electrical wiring, heating installations) as well as built-in items (e.g., cabinets and elevators) are usually considered part of the real estate.

*Real property includes all interests, benefits, and rights inherent in the ownership of physical real estate.* A right or interest in real property is also referred to as an *estate*. Specifically, *an estate in land is the degree, nature, or extent of interest that a person has in it.*

Interests vary, so real property is said to include a “bundle of rights” that are inherent in the ownership of real estate. Ownership rights include the right to use real estate, to sell it, to lease it, to enter it, to give it away, or to choose to exercise all or none of these rights. The bundle of rights is often likened to a bundle of sticks, with each stick representing a distinct and separate right or interest. Private enjoyment of these rights is guaranteed by the U.S. Constitution subject to certain limitations and restrictions.

It is possible to own all of the rights in a parcel of real estate or only some of them. The extent of ownership determines the kind of interest, or estate, that is held. A person who owns all the property rights is said to have *fee simple title*. *A fee simple estate implies absolute ownership unencumbered by any other interest or estate.*

Partial interests in real estate are created by selling, leasing, or otherwise limiting the bundle of rights in a fee simple estate. Partial estates include leased fee and leasehold estates.

*A leased fee estate is an ownership interest held by a landlord with the right of use and occupancy conveyed by lease to others; the rights of lessor (the leased fee owner) and leased fee are specified by contract terms contained within the lease.* An appraisal assignment may call for the appraisal of a fee simple estate or a partial interest such as a *leasehold estate held by a lessee (the tenant and renter) and conveying the right of use and occupancy for a stated term and under certain conditions*. Leased fee interests are frequently valued by considering their income components and comparing them with other leases. (A detailed discussion of the valuation of partial interests is presented in Chapter 6.)

All estates in real property are subject to four powers of government: taxation, eminent domain, police power, and escheat.

*Taxation is the right of government to raise revenue through assessments on valuable goods, products, and rights.* Because the U.S. Constitution effectively precludes the federal government from taxing real property directly, the right of taxation is reserved for state and local governments.

*Eminent domain is the right of government to take private property for public use upon the payment of just compensation.* This right can be exercised by an entity acting under governmental authority such as a housing authority or public utility. *Condemnation is the act or process of enforcing the right of eminent domain.*

*Police power is the right of government under which property is regulated to protect public safety, health, morals, and general welfare.* Zoning ordinances, building codes, air and land traffic regulations, and health regulations are based on police power.

*Escheat is the government right that gives the state titular ownership of a property when its owner dies without a will or any ascertainable heirs.*

The government also controls *overflight, the air space over a property through which aircraft may pass so long as the property's occupants suffer no inconvenience beyond established standards.*

In addition to government restrictions on property, private legal agreements may also impose limitations. One type of agreement is a restriction inserted in a deed. Private restrictions can limit the use or manner of development and even the manner in which ownership can be conveyed. The purchaser of a property may be obligated to use the property subject to a private restriction such as an easement, right-of-way, or party-wall agreement.

The individual rights in the bundle of rights can be sold, leased, transferred, or otherwise disposed of separately, subject to government limitations and private restrictions. Certain parcels of land give their owners a number of options. For example, one property owner could sell or lease the mineral rights to his property and retain the rights to use the surface area. Another owner could lease the property's surface rights to one party and the subsurface rights to another. A third owner could sell or lease the air rights to a property for construction or aviation (i.e., air traffic control). Thus, the ownership of certain rights can be severed from the ownership of the rest of a property and be sold, leased, or given to other parties.

Appraisers must not only understand the distinction between real estate and real property, but they must also differentiate between real estate and personal property.

*Personal property is a movable item of property that is not permanently affixed to, or part of, real estate.* Personal property is not endowed with the rights of real property ownership. Items of personal property include furniture and furnishings, e.g., refrigerators, freestanding shelves, that are not built into the structure. Under specific lease terms, items such as bookshelves and venetian blinds may be installed in apartments or rented houses by the tenant and remain personal property to be removed at the termination of the lease.



### PERSONAL PROPERTY

(H. Armstrong Roberts, Inc.)

Although personal property generally consists of tangible items, called *chattels personal* in the legal profession, an intangible personal property right, called *chattels real*, may be created by a lease.<sup>7</sup>

It is sometimes difficult to determine whether an item should be considered personal property or real estate. Often, the courts must resolve the conflict. *A fixture is an article that was once personal property, but has since been installed or attached to the land or building in a rather permanent manner; it is regarded in law as part of the real estate.* Therefore, a fixture is endowed with the rights of real property ownership and is part of the real estate.

Although fixtures are real estate, trade fixtures are not. *A trade fixture, also called a chattel fixture, is an article that is owned and attached to a rented space or building by a tenant and used in conducting a business.* Thus, trade fixtures are not real estate endowed with the rights of real property ownership; they are, however, personal property regardless of how they are affixed.

Examples of trade fixtures include restaurant booths and bars, gasoline station pumps and storage tanks, and the lanes and pinsetters in bowling alleys. In industrial real estate, the term can be used to refer to fixed building equipment

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7. Historically, personal property also included ownership rights to real estate for a fixed number of years, such as a tenant's interest. These were called *chattels real*, to distinguish them from movable personal objects, which were called *chattels personal*. Today, it is more common to refer to a lessee's interest as an interest in, or right to, real estate.

installed for human comfort (e.g., plumbing, lighting, heat, and air-conditioning) and to industrial equipment (e.g., air hoses, water pipelines, craneways, and bus ducts). A trade fixture is to be removed by the tenant when the lease expires unless this right has been surrendered in the lease.

To decide whether an item is a trade fixture, and therefore personal property, or part of the real estate, courts use the following criteria:

1. The manner in which the item is affixed. Generally, an item is considered personal property if it can be removed without serious injury to the real estate or itself. There are exceptions to this rule.
2. The character of the item and its adaptation to the real estate. Items that are specifically constructed for use in a particular building or installed to carry out the purpose for which the building was erected are generally considered permanent parts of the building.
3. The intention of the party who attached the item. Frequently, the terms of the lease reveal whether the item is to be permanent or to be removed at some future time.<sup>8</sup>

Appraisers must know whether an item is personal property or a fixture to decide if it will be included in the property value indication. If an item is classified as a fixture, and therefore part of the real estate, its contribution to value is included in the value estimate; if it is personal property, it contributes nothing to the real estate value. Because this distinction is not always obvious, appraisers should know how courts in their jurisdictions define fixtures.

## APPRAISAL PRACTICE

In our complex society, professional real estate appraisers perform a variety of functions and services. They estimate several types of defined value and may advise clients and participate in decisions about real estate.

*An appraisal is an unbiased estimate of the nature, quality, value, or utility of an interest in, or aspect of, identified real estate and related personalty.* Appraisal involves selective research into appropriate market areas; the assemblage of pertinent data; the application of appropriate analytical techniques; and the use of knowledge, experience, and professional judgment to develop an appropriate solution to the appraisal problem.

The nature of the real estate problem in question indicates whether the appraisal is a valuation or an evaluation. *Valuation is the process of estimating the market value, insurable value, investment value, or other properly defined value of an identified interest or interests in a specific parcel or parcels of real estate as of a given date.* Valuation assignments include market value estimates of fee simple estates, leasehold estates, preservation easements, and many others. *Evaluation is a*

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8. Kratovil and Werner, pp. 18-23.

*study of the nature, quality, or utility of a parcel of real estate or interests in, or aspects of, real property, in which a value estimate is not necessarily required.* Evaluation assignments include land utilization studies, supply and demand studies, economic feasibility studies, highest and best use analyses, and marketability or investment considerations that relate to proposed or existing developments.

In a valuation assignment, the appraiser communicates to the client an estimate of real property value which reflects all pertinent market evidence. In an evaluation assignment, current market activity and evidence are used to form a conclusion that is not a specific value indication. In both types of assignments, conclusions are derived from appropriate data analysis that conforms with standards of professional practice.

The application of appraisal procedures and the communication report of the appraiser's conclusions are guided by the nature of the assignment. To avoid misunderstandings between the client and the appraiser, it is important to determine whether the assignment is a valuation or an evaluation.

## PURPOSE AND USE OF AN APPRAISAL

*The purpose of an appraisal is the stated scope of an appraisal assignment, i.e., to estimate a defined value of any real property interest, or to conduct an evaluation study pertaining to real property decisions.*<sup>9</sup> The purpose of an appraisal is established by the client's question. It points to the information that the client needs to answer specific questions pertaining to real property. If the client's questions are understood, the purpose of the appraisal can be clearly and fully stated in terms of the information requested.

When an estimate of value is required in an appraisal, the type of value sought must be defined at the outset. The defined value may be market value, insurable value, going-concern value, assessed value, use value, or investment value. The distinctions among these terms are discussed in Chapter 2.

The purpose of a valuation appraisal establishes the foundation for the final value conclusion, which does not change to accommodate the use of the appraisal. The structure of an appraisal report may be adapted to the intended use of the valuation estimate, but the valuation estimate itself will not change. For example, the valuation of a single-family property might be reported in a short form for use in a purchase or sale, a long form for mortgage financing, a brief narrative report for rehabilitation decisions, or a full narrative report for use in litigation. Whatever the circumstances, the numbers associated with the defined value type will be the same.

*The use of an appraisal is the manner in which a client employs the information contained in an appraisal report.* The use of an appraisal is determined

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9. Specific legal definitions of the terms *appraisal* and *appraisal assignment* are cited in the Code of Professional Ethics and Standards of Professional Practice of the American Institute of Real Estate Appraisers. Members of the Appraisal Institute and candidates for Institute designations should be familiar with these definitions.

by the client's needs. For example, a client may want to know the market value of a residence to avoid paying too much for it or accepting too little for its sale. Corporate clients may need to ascertain the rent levels or demographic trends in an area to help determine the advisability of relocating there. Insurance companies and private citizens may wish to know the insurable value of buildings, and a developer may need to know the supply and demand factors in a community before constructing an apartment complex there.

An appraisal provides the basis for a decision concerning real property, so the use of an appraisal depends on the decision the client wishes to make. In defining the appraisal problem, the appraiser should develop an understanding of the client's requirements that is acceptable to both parties and consistent with accepted standards of professional practice.

An appraisal may be requested in a number of situations. The following list does not include all uses for appraisals, but it does indicate the broad scope of professional appraisal activities.

### Transfer of ownership

- To help prospective buyers set offering prices
- To help prospective sellers determine acceptable selling prices
- To establish a basis for real property exchanges
- To establish a basis for reorganizing or merging the ownership of multiple properties
- To determine the terms of a sale price for a proposed transaction

### Financing and credit

- To estimate the value of the security offered for a proposed mortgage loan
- To provide an investor with a sound basis for deciding whether to purchase real estate mortgages, bonds, or other types of securities
- To establish a basis for a decision to insure or underwrite a loan on real property

### Just compensation in condemnation proceedings

- To estimate the market value of a property as a whole—i.e., before the taking
- To estimate the market value of the remainder after the taking
- To estimate the damages to the property

### Tax matters

- To estimate assessed value
- To separate assets into depreciable (or capital recapture) items such as buildings, and nondepreciable items such as land, and to estimate applicable depreciation (or capital recapture) rates
- To determine gift or inheritance taxes



### Investment counseling and decision making

- To set rental schedules and lease provisions
- To determine the feasibility of a construction or renovation program
- To help corporations or third parties purchase homes for transferred employees
- To serve the needs of insurers, adjusters, and policyholders
- To facilitate corporate mergers, the issuing of stock, or the revision of book value
- To estimate liquidation value for forced sale or auction proceedings
- To counsel clients on investment matters, by considering their goals, alternatives, resources, constraints, and timing
- To advise zoning boards, courts, and planners, among others, on the probable effects of proposed actions
- To arbitrate between adversaries
- To determine supply and demand trends in a market
- To ascertain the status of real estate markets

## SUMMARY

Land is the subject of a variety of disciplines. The uniqueness, fixity, durability, finiteness, and usefulness of land are acknowledged in the fields of geography, law, sociology, and economics. Geography is concerned with the physical characteristics, demographic patterns, and economic uses of land, while the legal profession is concerned with land ownership. In sociology the competition between private and public interests over the use and distribution of land is considered, and in economics land is regarded as an agent of production and a source of wealth.

The distinction between *real estate* and *real property* is fundamental to appraisal. Real estate includes the physical land and all appurtenances affixed to the land. Real property includes all the interests, benefits, and rights inherent in the ownership of physical real estate.

Ownership rights can be held, leased, sold, transferred, or otherwise disposed of as a whole or fractionally. The ownership of real property rights unencumbered by any other interest is known as a *fee simple estate*. An ownership interest held by a landlord with the right of use and occupancy conveyed to a tenant by a lease is a *leased fee estate*. The right of use and occupancy held by a tenant is known as a *leasehold estate*.

All real property is subject to four powers of government: taxation, eminent domain, police power, and escheat.

The distinction between *personal property* and *real estate* is very important to appraisers. Personal property is a movable item of property that is not permanently affixed to, or part of, the real estate. Fixtures are considered real estate, but trade fixtures are personal property.

An *appraisal* is an unbiased estimate of the nature, quality, value, or utility of an interest in, or aspect of, identified real estate and related personalty. Valuation