

# Real Estate Update I

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# THE TAXPAYER RELIEF ACT OF 1997: The Effects of Federal Income Taxes on Real Estate Transactions

## Learning Objectives

After completing this chapter, you should be able to:

- < Explain how the gain on the sale of a personal residence is determined.
- < Identify deductible home mortgage interest.
- < Explain how gross profit on an installment sale is determined.
- < Describe how rental income or loss is calculated.
- < Identify the recovery periods for depreciation of real estate.
- < Explain the limitations on the deductibility of passive losses.
- < Answer progress test questions correctly.

## Federal Income Taxes Affecting Real Estate

Most real estate transactions have tax implications. Licensees should be knowledgeable about the general tax concepts that affect real estate in order to properly advise their clients. This chapter provides a basic outline of some of the tax implications affecting real estate transactions.

Your clients should obtain advice from a Certified Public Accountant or other professional tax advisor prior to entering into a real estate transaction with tax implications.

## Personal Residence

### *Universal Exclusion for Gain on the Sale of a Personal Residence*

Taxpayers who sell their personal residence on or after May 7, 1997 are subject to the new provisions included in the Taxpayer Relief Act of 1997. Under prior law, home sellers could defer the tax on the sale of their personal residence if they purchased a new residence for an amount equal to or greater than the sales price of their prior residence. In addition, qualifying tax payers age 55 and older could elect a one-time exclusion of up to \$125,000 of the gain realized on the sale of their personal residence.

Effective for sales on or after May 7, 1997, the home sale deferral and one-time exclusion rules are replaced with a new **universal exclusion** for the gain on sale of a principal residence. A seller of any age who has owned and used the home as a principal residence for at least two of the five years before the sale can exclude \$250,000 of gain (\$500,000 for those taxpayers who are married and file jointly.) The new exclusion will result in 100% tax-free home sale profits for the vast majority of homeowners who sell their personal residences at a gain. The exclusion can only be used once every two

years. A **personal residence** includes a conventional single-family structure, house trailer, mobile home, houseboat, condominium, cooperative apartment, duplex, or row house. It may include a boat if it contains facilities for cooking, sleeping, and sanitation.

### *Determination of Gain on Sale of Personal Residence*

The gain or loss on the sale of a personal residence is calculated by subtracting the cost basis of the personal residence from the sales price reduced by selling expenses.

The **cost basis** includes the purchase price of a residence and subsequent capital improvements made to the residence. **Improvements** are expenditures made that increase its useful life or add to its value. Improvements include adding a room, paving the driveway, putting up a fence, adding hurricane shutters, and remodeling a kitchen. Repairs such as repainting, fixing roof leaks, and plumbing/electrical repairs are not considered improvements and are not included in the cost basis.

**Example:** A home was purchased for \$300,000 in 1980. Improvements to the home were valued at \$100,000. The home was sold on September 1, 1997 for \$1,000,000. Selling expenses, including real estate brokerage commissions totaled \$60,000. The homeowners (married couple) occupied the home as their principal residence from the date of purchase through the date of sale of the property.

#### **Gain on Sale**

Selling Price	\$1,000,000
Minus:	
Selling expenses	(60,000)
Improvements	(100,000)
Purchase Price	<u>(300,000)</u>
Gain on Sale	\$540,000
Minus: Universal exclusion on sale of principal residence	<u>(500,000)</u>
Taxable Capital Gain	<u>\$ 40,000</u>

## Real Estate Tax and Mortgage Interest Deductions

### *Mortgage Interest Deductions*

Homeowners who are obligated pursuant to a mortgage debt may deduct the mortgage interest actually paid. This interest is called **qualified residence interest**. Homeowners may claim an itemized deduction for qualified residence interest on: (1) up to \$1,000,000 of acquisition debt and (2) up to \$100,000 of home-equity debt. The debt must be secured by the homeowners' qualified residence.

Qualified residence interest is any interest paid during the year on acquisition indebtedness or home equity indebtedness with respect to property that, at the time the interest is paid, is the home-owner's qualified residence.

A **qualified residence** is: (1) the taxpayer's principal residence and/or (2) any other residence (second residence) the homeowner properly elects to treat as qualified for the tax year. A residence under construction may be treated as a qualified residence for a period of up to 24 months, but only if it qualifies as a principle or second residence at the time it is ready for occupancy.

**Acquisition indebtedness** is: (1) incurred in acquiring, constructing or substantially improving the homeowner's qualified residence or adjoining land and (2) secured by the residence. Any new debt the homeowner incurs to refinance his acquisition indebtedness also qualifies as acquisition indebtedness to the extent that the new indebtedness does not exceed the balance outstanding of the refinanced debt.

**Home equity indebtedness** is any debt, other than acquisition indebtedness, secured by the home-owner's qualified residence, to the extent that the aggregate amount of the indebtedness does not exceed the fair market value of the residence by the amount of acquisition indebtedness on it.

Homeowners can deduct the qualified residence interest paid on a home equity loan regardless of whether the funds were used to improve or maintain the qualified personal residence.

### *Points*

A homeowner may deduct points paid separately by check on indebtedness incurred in connection with the purchase or improvement of a principal residence. Points paid by the seller in connection with a loan to the buyer also are deductible by the buyer if he or she subtracts them from the purchase price in computing the basis of the residence when it is sold.

Points paid to refinance an existing mortgage are not deductible in the year they are paid. They are deductible ratably over the term of the loan. If the refinancing is incurred for home improvements, points paid from separate funds may be deducted in the tax year they are paid.

### *Real Estate Taxes*

A homeowner is entitled to a real estate tax deduction in the tax year that real estate taxes imposed on real estate owned by the homeowner are paid.

## Disposition of Income - Producing Real Estate And Real Estate Held For Investment

### *Gain or Loss*

Gain or loss on the sale of income-producing real estate and real estate held for investment is determined by subtracting the basis and selling expenses from the sale price of the property. The basis of the property is the purchase price plus settlement charges such as surveys, title insurance, documentary stamps, and legal fees. The basis of the improved property is increased by capital expenditures such as improvements and additions, and decreased by any depreciation allowed or allowable for federal income tax purposes.

Gain or loss on the sale of income-producing real estate and real estate held for investment is subject to the capital gain and loss provisions of the Internal Revenue code. These provisions were dramatically changed with the passage of the Taxpayer Relief Act of 1997 and are explained below.

Net capital gains on the sale of assets occurring after May 6, 1997 and held for more than 18 months are taxed at a new maximum capital gains rate of 20%. The maximum capital gains tax rate is 10% for taxpayers in the 15% tax bracket.

- < Assets acquired after 12/31/00 and held for at least five years will be taxed at a maximum capital gains rate of 18% instead of 20%.
- < Assets held for less than twelve months when they are sold are taxed at the taxpayers' regular tax bracket.
- < Capital losses are deductible in full against capital gains. Up to \$3,000 of capital losses in excess of capital gains can be deducted against ordinary income. Capital losses in excess of this amount can be carried forward and deducted in future years subject to the \$3,000 limitation.
- < Accumulated depreciation recapture will be taxed at the taxpayers' regular tax bracket. All other depreciation recapture will be taxed at 25%.

### **Update**

The IRS Restructuring and Reform Act of 1998 changed the capital gains tax rates as follows:

- < Assets sold after May 7, 1997 and before January 1, 1998 that were held for more than twelve months are taxed at a maximum capital gains rate of 28%.
- < For tax years ending after 1997, assets held for more than twelve months are taxed at a maximum capital gains rate of 20%.

### **Like-Kind Exchanges**

No gain or loss is recognized when real estate held for investment or income-producing real estate is exchanged for **like-kind property**. However, gain *can* be recognized to the extent that cash or other consideration is received. Like-kind refers to the nature, character, or class of the property, not to its grade or quality.

An exchange of real estate for real estate is an exchange of a like-kind property. It does not matter where the real estate is located or whether, for example, rental property is exchanged for unimproved land. Partnership interests do not qualify for like-kind exchange treatment.

In order to qualify for a like-kind treatment, the property to be received in the transfer must be identified on or before 45 days from the transfer date and must be received within 180 days after the transfer date.

### **Installment Sales**

A seller of real estate who takes back a mortgage must report the sale using the installment sale method, *unless* the seller elects otherwise on his or her tax return.

Under the installment sale method, the seller reports gain as payments are received instead of reporting all the gain in the year of sale. The tax rate to be applied to the gain is based on the capital gain rules discussed above. The installment sale method is not available for dealers of real estate.

Each payment received on the mortgage held by the seller includes interest and may include principal. If no interest rate is stated in the mortgage, the IRS will impute interest based on published interest rates known as Applicable Federal Rate (AFR).

Each principal payment received is partially taxable based on a gross profit percentage that is determined as follows:

Selling Price  
Minus: (Basis minus depreciation)  
(Selling Costs)  
Equals: Gross Profit on Sale  
Gross Profit on Sale ) Selling Price = Gross Profit Percentage

**Example:** A taxpayer sells a rental property on September 1, 1997 for \$100,000 and takes back a \$100,000 mortgage. The property was purchased on January 1, 1985 for \$50,000. The taxpayer has taken \$20,000 of depreciation expense on his tax returns since 1985. The taxpayer paid \$10,000 selling expenses on the sale.

The gross profit is:      100,000    Selling Price  
Less:                            30,000  
Basis minus depreciation (\$50,000 - \$20,000)  
(10,000)    Selling expenses  
\$ 60,000    Gross Profit on Sale

Gross Profit on Sale    (\$60,000) - Selling Price  
(\$100,000) = **Gross Profit Percentage of 60%**

If the taxpayer received \$5,000 in principal payments on the mortgage in 1997, he or she will recognize \$3,000 (\$5,000 x 60%) of capital gains on his or her 1997 tax return. Since the taxpayer held the property for more than twelve months and it was sold after May 6, 1997, he or she will be taxed at a top rate not to exceed 20%.

## **Income - Producing Real Estate (Rental Activities)**

Net income from the rental of real estate is included in taxable income and taxed at the taxpayer's regular tax rates based upon total taxable income. Net losses from the rental of real estate are deducted when determining the taxable income of the taxpayer, subject to the passive activity rules discussed below.

### **Rental Income (Loss)**

Rental income or loss must be determined separately for each rental property. The income or loss from rental real estate is calculated as follows:

Rents received  
Minus: (Rental expenses such as, real estate taxes, mortgage interest, commissions, advertising, repairs, maintenance, property insurance)  
(Depreciation)  
Equals: Rental Income (Loss)

### **Depreciation of Income-Producing Real Estate**

The cost paid for real estate and subsequent expenditures for major improvements, additions, and other capital expenditures are not deductible in the tax year they are acquired. The costs must be depreciated over the useful lives of the assets and are depreciated according to the recovery periods. Generally, income-producing real estate, whether rented or used in a trade or business acquired and/or put into service after 5/12/93 is depreciated using the straight-line method over the following years:

<b>Property Type</b>	<b>Recovery Period</b>
Nonresidential (commercial) rental property	39 years
Residential rental property	27.5 years
Personal Property (appliances, furniture, etc.)	7 years
Computer equipment	5 years

**Example:** A taxpayer purchases a shopping center for \$4,500,000 on July 1, 1997. The land value is \$600,000. Depreciation for 1997 would be calculated as follows:

Purchase Price	\$4,500,000
Minus: Land Value	<u>(600,000)</u>
Depreciable Cost	<u>\$3,900,000</u>
Depreciation Deduction (\$3,900,000 ) 39 years x 1/2 year) =	<u>\$50,000</u>

Unimproved property and non-income-producing real estate purchased for investment are not eligible for depreciation. However, depreciation would be applicable when improved investment property becomes income-producing real estate.

**Example:** An investor purchases two condominiums and holds them for investment purposes. The investor decides to rent one of the condominiums. Depreciation must be deducted when the investor places the rental condominium into service and commences rental activities. The real estate is considered to be income-producing real estate when it is placed into service.

### **Passive Activities**

A passive activity is any activity involving the conduct of a trade or in which the taxpayer does not materially participate. The rental of real estate is considered a passive activity. Losses from passive activities are generally not deductible against other forms of income, such as wages, interest and dividend income, capital gains, etc. Losses from passive activities can be offset against income from passive activities. Passive activity losses in excess of passive activity income are suspended and can be carried forward to future tax years and deducted against passive activity income generated in the future. Suspended passive activity losses attributable to a specific rental activity are fully deductible when the activity is sold or otherwise disposed.

**Material Participation.** Losses from the rental of real estate may offset up to \$25,000 (in any given tax year) of other income if the taxpayer has at least a 10% interest in the rental activity and has actively participated in that activity.

The \$25,000 is reduced by 50% of the amount by which the taxpayer's adjusted gross income exceeds \$100,000. Accordingly, the \$25,000 amount is fully phased out when a taxpayer's adjusted gross income exceeds \$150,000.

A taxpayer is considered to actively participate in a rental activity if he or she makes management decisions regarding: new tenants; capital or repair expenditures; or rental terms. Arranging for others to provide these services is also considered active participation. A taxpayer need not have regular, continuous, and substantial involvement in operations. However, merely formal or nominal participation in management without a genuine exercise of independent discretion and management is insufficient.

**Real estate professional.** During the year in which a taxpayer qualifies as a real estate professional, the rules relating to the treatment of rental of real estate as a passive activity do not apply. Accordingly, there are no limitations as to the deductibility of losses incurred from the rental of real estate.

A taxpayer qualifies as a real estate professional for a particular tax year if: a) more than half of the personal services that the taxpayer performs during the tax year are performed in real estate activities in which the taxpayer materially participates; and, b) the taxpayer performs more than 750 hours of services during the year in real estate trades or businesses in which the taxpayer materially participates.

A real estate trade or business is any real estate development, redevelopment, reconstruction, acquisition, conversion, rental operation, management, leasing, or brokerage trade or business.

## **Other Tax Provisions Of the Taxpayer Relief Act of 1997**

### **Home Office**

For tax years beginning after 1998, the IRS has increased the deductibility of home office expenses. A home office qualifies as the "principal place of business" if (1) the office is used by the taxpayer to conduct administrative or management activities of a trade or business; and, (2) there is no other fixed location of the trade or business where the taxpayer conducts substantial administrative and management activities of that trade or business. This change in the law will result in the liberalization of home office deductions for real estate agents. A real estate agent should be able to deduct a portion of his or her rent or mortgage, repairs, maintenance, utilities, etc. of his or her home office if the agent performs substantial administrative functions such as bookkeeping, setting appointments, and property research from home. A side benefit of this change is that travel between a home office qualifying under this new rule and other places of business (i.e., the broker's office) should be deductible.

### ***Roth IRA***

Effective for tax years beginning after 1997, there is a new type of backend IRA called the Roth IRA. The Roth IRA enables taxpayers and their spouses to make annual nondeductible contributions to their IRA of up to \$2,000. Distributions from a Roth IRA are not taxed to a recipient if they are made after a five-year period beginning with the first tax year for which a contribution to the Roth IRA was made and:

1. after a taxpayer reaches age 59 1/2 or death, or
2. on account of the taxpayer's disability, or
3. for first-time homebuyers' expenses.

### ***IRA Distributions for First-Time Homebuyers' Expenses***

An IRA distribution used within 120 days for qualified acquisition costs of a principal residence is not subject to the otherwise applicable 10% premature withdrawal penalty. There is a \$10,000 lifetime limit on distributions that may qualify for this beneficial treatment. The new rule is applicable to payments made after 1997.

### **Summary**

The federal income tax implications of real estate related transactions can dramatically affect the decision to purchase or sell real property.

Licenseses should make themselves familiar with the federal income tax provisions relating to real estate transactions in order to better assist their clients in making informed decisions.

### **Section Review Questions**

Answer all questions on the attached **Answer Form** found in the back of this book.

The **Answer Form** is the only page to return to CAPE.

1. The gross profit percentage on an installment sale is calculated as:
  - A. selling price divided by selling costs.
  - B. gross profit on sale divided by selling price.
  - C. basis divided by selling price.
  - D. depreciation divided by selling price.
2. The top capital gains tax rate on the sale of assets occurring after December 31, 1997 that are held for more than one year is:
  - A. 10%
  - B. 18%
  - C. 20%
  - D. 28%
3. A homeowner can deduct qualified interest (mortgage interest ) used to purchase a qualified residence on debt not to exceed:
  - A. \$100,000
  - B. \$500,000
  - C. \$1,000,000
  - D. an unlimited dollar amount.
4. Improvements to a residence that increase the cost basis include:
  - A. plumbing repairs
  - B. roof leak repairs
  - C. both a. and b
  - D. none of the above
5. The capital gain and loss provisions of the Internal Revenue Code apply to gain or loss on the sale of:
  - A. vacation land
  - B. office buildings
  - C. rental homes
  - D. all of the above

# Fair Housing & Mortgage Lending

## Learning Objectives

After completing this chapter, you should be able to:

- < List the two additional protected classes added by the Fair Housing Amendments of 1988.
- < Describe the three classes of individuals qualified as disabled by the Fair Housing Act.
- < Explain the housing facilities that are exempt from the Federal Fair Housing Act.
- < Explain the fair housing complaint handling process.
- < Describe the purpose of the Truth-in-Lending Act.
- < Describe the RESPA loan servicing complaint process.
- < Define the purpose of the Equal Credit Opportunity Act (ECOA).
- < List three lender practices that are prohibited by the Equal Credit Opportunity Act.
- < Answer progress test questions correctly.

## Federal Fair Housing Laws

The Civil Rights Act of 1866 is the basis for all federal fair housing laws. The Act was interpreted by the U.S. Supreme Court to prohibit racial discrimination in all sales or rentals of real property in the 1968 *Jones v. Mayer* case. The Act is applicable to all transactions regardless of the involvement of a real estate licensee. There are no exemptions to the Civil Rights Act of 1866.

### *Federal Fair Housing Act*

Civil rights protection was increased in 1968 by the Federal Fair Housing Act (Title VIII of the Civil Rights Act of 1968). This Act expanded the ban on discrimination to the sale, rental, and financing of dwellings based on race, color, religion, sex or national origin. The Fair Housing Amendments of 1988:

- < Expanded prohibition of discrimination to individuals with disabilities and to individuals qualifying for familial status. Families with a child under the age 18 and pregnant women qualify for familial status.
- < Established new Department of Housing and Urban Development (HUD) administrative enforcement mechanisms to allow HUD attorneys to bring court actions before administrative law judges on behalf of housing discrimination victims.
- < revised and expanded the Justice Department's jurisdiction to bring suit on behalf of victims in federal district courts.

The Department of Housing and Urban Development (HUD) had administered the Fair Housing Act since adoption of the law in 1968. The 1988 amendments have greatly increased HUD's enforcement role. Numerous complaints of possible fair housing discrimination have been reported concerning the newly protected classes of individuals.

**Housing for Older Persons Act of 1995 (HOPA).** The 1998 Fair Housing Amendments created an exemption to the provisions barring discrimination on the basis of familial status for those housing developments that qualify as housing for persons age 55 or older. The Housing for Older Persons Act eliminated the requirement that significant facilities and services must be present in the 55 and over housing developments. Also, this Act establishes a good faith reliance immunity from damages for persons who in good faith believe that a 55 and older exemption applies to a particular property. If a person does not actually know that the property is not eligible for the exemption and property development has stated in the writing that it qualifies for the exemption, the person is immune from suit for damages in court.

The Housing for Older Persons Act retains the requirement that housing must have one person who is 55 years of age or older living in at least 80% of the occupied units on the designated property. HOPA still requires that exempt housing owners publish and follow policies and procedures that demonstrate an intent to be housing for persons 55 and older.

Exempt property does not violate the Fair Housing Act if it excludes families with children. The Act exempts 3 types of housing for older persons allowing discrimination based on familial status. These include:

- < housing facilities which meet the Act's requirements that at least 80% of the occupied units are occupied by individuals 55 years of age or older;
- < housing facilities intended for and solely occupied by residents 62 years of age or older; and,
- < housing facilities provided by state or federal programs. [42 U.S.C. 3601, et seq; 24 CFR Parts 100, 103, and 104]

Unless a building or community qualifies as housing for older persons, discrimination against a parent, legal custodian, or families with children under the age of 18 is prohibited. The familial status protection also applies to pregnant women.

**Housing for people with disabilities.** The Fair Housing Act prohibits discrimination in residential real estate transactions. The Act provides protection for people with physical or mental disabilities that substantially limit one or more major life activities. Included are: hearing, mobility, and vision impairments; chronic alcoholism; chronic mental illness; AIDS; AIDS Related Complex; and mental retardation.

The **Americans with Disabilities Act (ADA)** was passed in 1990. The purpose of this Act is to provide the same employment opportunities to qualified individuals with disabilities that are available to individuals without disabilities. The ADA became a part of and amended the Fair Housing Act upon enactment. The ADA covers employment opportunities, public accommodation accessibility, and telecommunications to remove barriers which affect individuals with disabilities.

After March 13, 1991, the Fair Housing Act requires new residential buildings which contain four or more units with an elevator to be designed and constructed in such a way that the public and common areas are accessible to people with disabilities. The units must have doorways, hallways, kitchens, and bathrooms wide enough for wheelchairs with an accessible route into and through the unit. In addition, the unit must have accessible light and environmental controls and bathrooms that allow grab bars to be installed. If a residential building with four or more units ready for occupancy after 3/17/91 does not have an elevator, the above standards apply to ground floor units only.

Landlords are required to make reasonable accommodation in their rules, policies, practices, and services to provide an equal opportunity to people with disabilities to use and enjoy their homes.

**Examples:** A building with a no pet policy must allow a visually-impaired tenant to keep a guide dog.

An apartment complex that offers tenants ample, unassigned parking must honor a request from a mobility-impaired tenant for reserved space near their apartment if necessary to assure access to the apartment.

However, housing need not be made available to a person who is a direct threat to the health or safety of others or who is a current user of illegal drugs.

**Exempt Housing.** The Fair Housing Acts exempts owner-occupied buildings with no more than four units, single-family housing sold or rented without the use of a

broker, and housing operated by organizations and private clubs that limit occupancy to members.

**Prohibited Actions in the Sale and Rental of Housing.** The Fair Housing Act prohibits the following discriminatory actions based on race, color, national origin, religion, sex, familial status, or handicap:

- < refusing to rent or sell housing;
- < refusing to negotiate for housing;
- < making housing unavailable;
- < denying a dwelling;
- < setting different terms, conditions, or privileges for sale or rental of a dwelling;
- < providing different housing services/ facilities;
- < falsely denying that housing is available for inspection, sale, or rental;
- < persuading owners to sell or rent property because a neighborhood is deteriorating or becoming transitional due to an influx of minority persons (blockbusting); and,
- < denying access to or membership in a facility or service such as a multiple listing service related to the sale or rental of housing.

**Prohibited Actions in Mortgage Lending.** The Fair Housing Act prohibits the following discriminatory actions based on race, color, national origin, religion, sex, familial status, or handicap:

- < refusing to make a mortgage loan;
- < refusing to provide information regarding loans;
- < imposing different terms / conditions on a loan;
- < appraising property; and,
- < refusing to purchase or setting different terms or conditions for purchasing a loan;

In addition, it is illegal for anyone to threaten, coerce, intimidate, or interfere with anyone exercising a fair housing right or assisting another to exercise that right. Discriminatory advertising or statements that indicate limitations or preferences based on race, color, national origin, religion, sex, familial status, or handicap are illegal. The prohibition against discriminatory advertising applies to all residential real estate including single-family and owner-occupied housing that is otherwise exempt from the Fair Housing Act.

## Reporting Fair Housing Violations

After an alleged violation of the Fair Housing Act occurs, an individual has one year to file a complaint with HUD. Complaints can be filed with HUD by calling this toll-free hotline number: 1-800-669-9777 or by sending a letter to the nearest HUD office. The information below is required in a complaint:

- < the complainant's name and address, and the date of the alleged violation;
- < the name and address of the person alleged to have violated the Fair Housing Act; and,
- < the address of the housing involved.

**Complaint handling procedure.** Upon receipt of a complaint, HUD notifies both the complainant and the alleged violator that the complaint has been received and filed. The alleged violator is permitted to respond to the complaint. The complaint will be investigated within 100 days to determine if a reasonable cause exists to believe that the Fair Housing Act has been violated. The complaint investigation can result in one of three HUD actions.

- < HUD finds no reasonable cause to justify further action, and the case is closed.
- < HUD can attempt to reach a 'conciliation agreement' with the person against whom the complaint was filed which protects the public interest and the complainant. If a conciliation agreement is reached, HUD will take no further action on the complaint.
- < The HUD complaint investigation finds reasonable cause to believe that discrimination has occurred. The complainant is informed that either an administrative hearing will take place within 120 days or the case will be heard in Federal District Court if the complainant or the alleged violator desires. There is no cost to the party who filed the complaint in either instance.

**Administrative Hearing.** HUD attorneys litigate a case on the complainant's behalf at an administrative hearing. An administrative law judge (ALJ) considers evidence from the complaint, the investigation, and the responding alleged violator. If the ALJ determines that discrimination occurred, the responding violator can be ordered to:

- < compensate the complainant for damages, including humiliation, pain, and suffering;
- < provide injunctive relief by making housing available to the complainant;
- < pay the federal government a civil penalty to vindicate the public interest. The maximum penalties are \$10,000 for a first violation and \$50,000 for a third violation within 7 years;
- < pay reasonable attorney's fees and costs.

**Federal District Court.** If the case is decided in Federal District Court, the Attorney General will file a suit and litigate on the complainant's behalf. The district court can order relief, award actual damages, attorney fees and cost, and also award punitive damages.

**Enforcement of Federal Fair Housing Laws.** The federal fair housing laws require an injured party to prove a claim of violation. The injured party, the complainant, can file a complaint with the Department of Housing and Urban Development or sue for damages in court as just explained above. A violation of federal fair housing laws by a real estate licensee is also a violation of Chapter 475. Therefore, a licensee found guilty of a violation of any federal fair housing law

would face possible disciplinary action by the Commission.

### ***Fair Housing***

**Assistance Program.** The Secretary of HUD is authorized by the Fair Housing Act to reimburse state and local government agencies for the administration and enforcement of the fair housing laws. In 1997, reimbursement funding of \$15 million was available to state and local agencies for activities such as complaint processing, training, and implementation of data information systems. [42 U.S.C. 3601, 3616: 24 CFR Part 111]

### **Federal Laws Relating to Mortgage Lending**

The American economy encourages the use of credit to purchase products, automobiles, and residential real property. Retailers and lending institutions extend consumers credit through credit cards, installment loans, home mortgages, and home equity lines of credit. Federal laws provide important safeguards and remedies for consumers in their credit transactions either before or during the transaction. The primary source of consumer protection in consumer credit transactions is the federal Truth-in-Lending Act (TILA).

### ***Federal Truth-in-Lending Act (TILA)[15 U.S.C. 1601 et seq.]***

Truth-in-Lending Act regulations control typical consumer credit transactions such as store credit purchases, credit card agreements, installment loans, auto financing plans, and real property transactions secured by a consumer's principal dwelling. Mortgages, home equity loans, and home improvement loans are regulated by the Act. Truth-in-Lending Act regulations are applicable to loans or extension of credit by creditors such as banks, retailers, finance companies, or individuals in the following instances:

- < Credit is offered to a consumer.
- < Credit is for personal, household, or family purposes.
- < The creditor regularly extends credit to the public.
- < Credit is subject to a finance charge or is repayable by written agreement in more than four (4) installments.

The Board of Governors of the Federal Reserve System is authorized to administer and implement TILA rules regarding consumer loans. Regulation Z, published by the Board of Governors, requires that a lender furnish a borrower with a clear description of the cost of credit in both dollar and percentage form.

Prior to entering into an installment credit contract, the consumer must be given the following information:

- < **Total sale price.** This price includes the price of the item, interest or other charges, and any down payment or trade-in value.
- < **Amount financed.** This includes the amount borrowed plus any cost of extended warranties.
- < **Finance charges.** This is the cost of consumer credit as a dollar amount. It includes cost of the credit transaction such as interest, credit life insurance, discount, and loan origination fees. Not included as finance charges are fees associated with credit application, title examination, credit reports, escrow payments for taxes and insurance, and attorney fees.
- < **Annual Percentage Rate (APR).** The APR is the cost of credit expressed as a yearly percentage rate. The APR includes the total finance charge paid in installments over the term of the loan and then calculates the amount paid each year as a percentage of the amount financed. The APR, which is almost always higher than the base interest rate of the loan, is a uniform true cost of credit designed to allow the consumer to comparison shop for the best credit terms.
- < **Total of payments.** This figure equals the amount financed plus the finance charge.
- < **Payment schedule and amount of each payment.** This figure includes each monthly payment amount with the payment due date.

In addition, lenders are required to disclose late payment assessments, penalties for prepayment of the loan, variable interest rates, and if the lender is given a security interest in merchandise or property by the loan agreement. The borrower is allowed a three-day period to rescind mortgage contracts on principal residences, excluding those mortgages used to build or purchase homes.

**Lender failure to make required disclosures.** If an advertisement includes an interest rate, the advertisement must also state the interest rate in annual percentage rate form. The Truth-in-Lending Act allows a consumer to bring a lawsuit for damages against a creditor who fails to provide required information. All Truth-in-Lending Act disclosure requirements apply to financial institutions or businesses that buy loans from other lenders, including mortgage loans sold on the secondary market.

**Reporting a Truth-in-Lending Act problem.** The consumer should first attempt to resolve the problem with the creditor. If this effort is unsuccessful, the consumer should contact the creditor's primary regulator. If the problem is with either a bank or savings and loan insured by the Federal Deposit Insurance Corporation (FDIC), contact the:

**FDIC, Division of Compliance and Consumer Affairs**  
 550 17<sup>th</sup> St., NW, Washington, DC 20429  
 1-800-934-3342  
 If the problem is with a loan company or retailer, contact the:  
**Federal Trade Commission**  
 101 Merrimack St., Ste 810, Boston, MA 02114-4719  
 1-617-424-5960

***Real Estate Settlement Procedure Act (RESPA) [12 U.S.C. 2601]***

RESPA is a federal consumer protections statute first passed in 1974 to help consumers become better shoppers for real estate settlement services. The primary purpose of RESPA is to eliminate kickbacks and referral fees that increase the cost of real estate settlement services.

RESPA requires that borrowers receive disclosure of costs associated with real estate settlement at various times during a transaction. In addition, RESPA outlines lender escrow account practices, and describes business relationships between settlement service providers. HUD's Office of Consumer and Regulatory Affairs, Interstate Land Sales/RESPA Division is responsible for enforcing RESPA.

Generally, RESPA regulations cover loans secured with a mortgage placed on one-to-four family residential properties. These loans include most purchase loans, mortgage assumptions, refinances, property improvement loans, and equity lines of credit.

**Disclosures at the time of loan application.** The lender must provide the following documents at the time of application or within three (3) business days after application if borrowers apply for a mortgage loan. Mortgage brokers and/or lenders are required to give the borrower the following documents:

- < a consumer information booklet containing consumer information regarding real estate settlement services in the purchase transaction;
- < a good faith estimate (GFE) of settlement costs. If a lender requires the borrower to use a particular settlement provider, the lender must disclose this requirement on the good faith estimate; and,
- < a mortgage servicing disclosure statement that discloses if the lender's intention is to service the loan or to transfer the loan to another lender. Complaint resolution information must also be included.

**Disclosure before settlement occurs.** An Affiliated Business Arrangement (AfBA) disclosure is required if a service provider involved in a RESPA covered transaction refers the consumer to a provider with whom the referring party has an ownership or other beneficial interest.

The affiliated business arrangement disclosure must be given to the consumer by the referring party *at or prior to the time of referral*. The disclosure must describe the business arrangement existing between the two providers and give the borrower an estimate of the second provider's charges. Except in instances where a lender refers a borrower to an attorney, credit-reporting agency, or real estate appraiser that represents the lender's interest in the transaction, the referring party may not require the consumer to use the particular provider being referred.

The Real Estate Settlement Procedures Act allows the borrower to request to see the HUD-1 settlement statement one day before the actual settlement. The settlement agent must provide the borrowers with a completed HUD-1 settlement statement based on information known to the agent at that time.

**Disclosures at settlement.** The HUD-1 settlement statement is a standardized form that clearly shows all charges imposed on the borrower and seller in connection with the settlement. The HUD-1 statement shows the actual settlement costs of the loan transaction. If the borrower and seller do not attend the closing, the settlement agent should mail or deliver the statement to the parties as soon as possible after the settlement.

Also, the settlement agent usually gives the borrower an initial escrow statement that lists the amount of escrow payment and required escrow cushion at settlement. This statement estimates the taxes, insurance premiums, and other charges anticipated to be paid from the escrow account during the first 12 months of the loan. If not delivered at settlement, the lender has 45 days from the date of the settlement to deliver the statement to the borrower.

**Disclosures after settlement.** A loan servicer is required to deliver one Annual Escrow Statement to a borrower each year. The statement summarizes all escrow account deposits and payments during the 12-month period. This statement notifies the borrower of any shortages or surpluses in the account and provides information on any necessary course of correction.

If the loan servicer sells or assigns the servicing rights to another loan servicer, the borrower must receive a service transfer statement 15 days prior to the effective date of the loan transfer. The notice must include the name and address of the new loan servicer, toll-free telephone numbers, and the date the new servicer will begin accepting payments.

## ***RESPA Consumer Protection and Prohibited Practices***

**Section 6: Loan servicing complaints.** Borrowers who have a problem with the servicing of their loan (including escrow account questions) should contact

their loan servicer in writing to outline the nature of their complaint.

The servicer must acknowledge the complaint in writing within 20 business days of receipt of the complaint. Within 60 business days, the servicer must resolve the complaint by correcting the account or giving a position statement for actions taken. The borrower should continue to make the servicer's required payment until the matter is resolved.

**Section 8: Kickbacks, fee splitting, unearned fees.** Section 8 prohibits anyone from giving or accepting a fee, kickback, or anything of value in exchange for referrals of settlement service business involving a federally related mortgage loan. In addition, Section 8 prohibits fee splitting and receiving unearned fees for services not actually performed.

Penalties for violation of Section 8 include the following:

- < **Criminal violation.** Penalty of up to a \$10,000 fine and one year confinement for criminal violations.
- < **Civil violation.** A private law suit penalty provides that violators of Sections 8 can be held liable for charging an illegal settlement service fee in the amount of three times the illegal charge paid.

**Section 9: Seller-required title insurance.** Section 9 prohibits a seller from requiring the home buyer to use a particular title insurance company as a condition of sale. A buyer can sue a seller who violates this provision for an amount equal to three times all charges made for the title insurance.

**Section 10: Limits on escrow accounts.** Section 10 establishes limits on the amount a lender can require the borrower to pay into an escrow account for the purposes of paying taxes, hazard insurance, and other charges relating to the property. Each month the lender can require the borrower to pay no more than 1/12<sup>th</sup> of the total amount of all disbursements during the year and a lender can collect a cushion amount not to exceed 1/6<sup>th</sup> of the total yearly disbursement.

Lenders are not required by RESPA to impose payment into an escrow account, but government loan programs or lenders may require escrow accounts as a loan condition. If a loan servicer does not submit an initial or annual escrow account statement to a borrower, HUD has the authority to impose a civil penalty on the loan servicer.

**RESPA enforcement.** The Department of Housing and Urban Development (HUD), a state Attorney General, or a state insurance commissioner can bring court action to enforce violations of Sections 6, 8, or 9 of RESPA

within three (3) years of the violation. Individuals have the following time periods to bring private law suits in federal district court in which the property is located or the alleged violation is said to have occurred:

- < three years to file a private lawsuit to enforce violations of Section 6;
- < one year to file a private lawsuit to enforce violations of Sections 8 or 9.

**Filing a RESPA complaint.** Affected parties can file a complaint for alleged RESPA violations by a settlement service provider. The complaint should contain an outline of the alleged violation and identification of the alleged violator including name, address, and telephone number. Complaints are confidential and should provide the complainant's name and phone number to answer any follow-up questions by HUD. Complaints should be sent to:

**Director, Interstate Land Sales/RESPA Division,**  
Office of Consumer and Regulatory Affairs  
US Dpt of Housing & Urban Development, Room 9146,  
451 Seventh St SW, Washington, DC 20410

### ***Equal Credit Opportunity Act (ECOA)[12 C.F.R. 202.2]***

The federal Equal Credit Opportunity Act of 1972 (ECOA) made discriminatory practices by creditors unlawful. Creditors are prohibited from denying credit in credit transactions or loan applications on the basis of religion, race, national origin, gender, marital status, or source of income. Regulation B was issued by the Board of Governors of the Federal Reserve System to implement the ECOA. This law covers retail installment contracts, credit cards, mortgages, and all other types of personal consumer loans.

The primary purpose of the ECOA is to prevent discrimination in granting credit by requiring banks and other creditors to make extensions of credit equally available to all creditworthy applicants with fairness, impartiality, and without discrimination on any prohibited basis. The consumer's ability and willingness to repay borrowed money, known as creditworthiness, is based on present debt load, income, past payment record, and general financial stability. A creditor is given 30 days to review an application and make a loan commitment decision. If the creditor denies the credit, the applicant must be given the specific reason for denial.

Lenders are prohibited from making oral or written statements that would discourage a person from making an application. The provisions of the ECOA that relate to the mortgage lending process are explained below.

**Rules concerning the taking of applications.** A lender can collect loan processing information from an applicant by requesting the applicant for the following

information:

- < a list of current credit accounts with contact names and addresses;
- < any name the applicant has previously used to receive credit; and,
- < the source of any applicant income used for lender qualification of the applicant's creditworthiness.

**Example:** If the applicant desires the lender to consider income from alimony or child support to qualify for creditworthiness, the lender can ask what portion of the applicant's income is derived from that source.

**Rules concerning the evaluation of applications.** A lender can consider any information properly obtained in the information is not used in a discriminatory fashion against the applicant. A lender can use the following information as a basis to evaluate the applicant's creditworthiness:

- < age, only if the consideration of age is favorable to the extension of credit to an elderly applicant
- < utility service such as a telephone in the applicant's residence
- < income sources as revealed on the loan application and the probable continuance of the income from the source
- < applicant's credit history or other information the applicant presents to indicate creditworthiness

**Example:** trust fund income, extensive past equity buildup, lottery winnings, etc.

**Rules concerning extension of credit.** A lender may not refuse to grant an individual credit account to a creditworthy applicant on the basis of any of the following:

- < sex, marital status, physical or mental handicap, or any other classification protected from discrimination;
- < requiring the signature of an applicant's spouse or another person. If an individual loan applicant qualifies under the lender's standards of creditworthiness for the amount and terms of the credit requested, a lender cannot require the signature of an applicant's spouse or other person. A lender can require the signature of the applicant's spouse or other joint owner on documents necessary under state law if jointly owned property is used as collateral to secure a loan.

**Example:** A lender may request the non-applicant spouse to sign a security agreement (mortgage) to secure a lien on the property if the property is jointly owned by the applicant and non-applicant spouse and is offered as security available to satisfy the debt in the event of loan default.

**Consumer notifications.** The ECOA requires a lender to notify the applicant of:

- < the applicant's right to receive a copy of the property appraisal completed to process a mortgage application on a one-to-four-family dwelling;
- < the results of the lender's application processing within 30 days of receipt of a completed application. If credit is not extended, the lender must either give a statement of the specific reasons for the refusal to extend credit or disclose the applicant's right to a statement of specific reasons for refusal upon request within 30 days.

**Consumer information for monitoring purposes.** As part of the mortgage loan application process, the lender is required by the ECOA to request information regarding the applicant's race, national origin, sex, marital status, and age for federal government monitoring of the lender's compliance with federal statutes. An applicant is not required to supply the requested information. If the applicant does not provide the requested information, the lender is required by law to note the race, national origin, and sex of the applicant on the basis of visual observation.

**ECOA points to remember.** A lender cannot do any of the following:

- < refuse to extend credit to an unmarried person if a married person with the same credit history would receive credit;
- < inquire concerning birth control practices or future plans to have children;
- < refuse to consider, upon applicant's request, any regularly received income from part-time employment, child support, alimony, welfare, or social security;
- < require a person to reapply for credit or to change the terms of a credit contract upon a consumer reaching a certain age or retirement.

**Reporting ECOA problems.** If a consumer believes discrimination has occurred, the consumer should contact the lender's credit manager to discuss the situation. If the problem persists contact:

#### **Mortgage Loan Application Complaints**

US. Department of Housing and Urban Development,  
451 Seventh St. SW, Washington, DC  
1-800-927-9275

## **Section Review Questions**

Answer all questions on the attached **Answer Form** found in the back of this book. The **Answer Form** is the only page to return to CAPE.

6. Which of the following has no exemptions?
  - A. Civil Rights Act of 1866
  - B. Federal Fair Housing of 1986
  - C. Fair Housing Amendments of 1988
  - D. All of the above
7. HOPA does which of the following:
  - A. provides for uniform employment opportunities.
  - B. prohibits discrimination based on sex.
  - C. establishes immunity from suit for damages if a person in god faith believes that a 55 and older exemption applies to a particular property.
  - D. establishes the complaint process HUD must follow to investigate an alleged Fair Housing Act violation.
8. The Fair Housing Act does NOT prohibit which of the following:
  - A. setting different terms and conditions for prospective buyers in the sale or rental of a dwelling.
  - B. charging a higher security deposit for a person in a wheelchair because of possible damage to a rental house.
  - C. pulling a house off the market because an undesirable buyer has inquired about the selling price.
  - D. refusing to rent to college students.
9. After HUD notifies all parties of an alleged fair housing violation they must investigate said complaint within:
  - A. 50 days
  - B. 75 days
  - C. 100 days
  - D. 150 days
10. After reviewing Applicant Mike's credit application, Creditor Anne denies Mike's request for credit. The Equal Credit Opportunity Act requires Creditor Anne to:
  - A. review the credit application a second time to check for discriminatory practices.
  - B. review the credit application again to make sure that all income reported by the applicant as considered in the qualification process.
  - C. review the credit application to verify that signatures of both the applicant and the applicant's spouse are on the application for credit.
  - D. notify the applicant of the lender's specific reason(s) for denial.

# Residential Property Management

## Learning Objectives

After completing this chapter, you should be able to:

- < Describe residential property management and the history of the profession.
- < Explain the development of property management trade associations.
- < Explain what to do when a tenant files bankruptcy.
- < List at least ten different profit centers available to residential property managers and the corresponding benefits to property owners.
- < Answer progress test questions correctly.

## The History of Residential Property Management

Residential property management has become one of the fastest growing professions in the real estate industry. The primary function of a residential property manager is to achieve the goals and objectives of the property owner, while preserving or increasing the value of an investment property and generating income for the property owners.

When a residential property manager takes on a new property, the first step is to meet with the property owner to discuss the owner's goals and objectives for the property. This enables the property manager to establish a plan of action.

Property management is a highly specialized and rapidly growing sector of the real estate profession. This is due primarily to our fast-paced economy and job market. With job transfers, family relocations, and at times slow sales markets, many families have found that hiring a property manager and renting their previous home is their best alternative. It is estimated that over 9.8 million single-family homes and condominiums in the United States today are tenant-occupied rental homes.

Residential property management is the single largest area of involvement for property managers. Freestanding, single-family homes are still the most popular form of residential ownership in the United States. According to the Census Bureau, just over 60% of housing in the United States is owner occupied.

Today's property managers must have at their fingertips the knowledge, communication skills, and technical expertise needed to be dynamic decision-makers. In addition, they must wear many hats to succeed, because they are often called upon to act as market analysts, advertising executives, salespersons, accountants, diplomats, maintenance engineers, and paralegals.

Good property managers are also good people managers. The modern property manager must take into account the value of tenant retention as well as property

retention. Many property managers are involved in the production of newsletters and other positive projects to keep their property owners and residents informed. However, it was not always this way. Residential property management emerged early in this century. In 1908 the first management group, known as The Chicago Building Managers Organization was formed as a trade association for those managing commercial buildings. In 1911 a similar organization known as The Building Owners and Managers Association or BOMA was formed for those who owned or managed commercial buildings.

Residential property management was not established as a profession until the Great Depression of the 1930s. With the repossession of many real estate parcels as a result of the Depression, banks and other lending institutions suddenly found themselves in the role of landlords.

Consequently, the first residential property managers were actually bankers trying to manage the collection of rents, the placement of tenants, and all other tasks associated with residential property management. It was soon realized that a new profession, that of the residential property manager, had become necessary.

## The Development of Property Management Trade Associations

As a consequence of these changing times, The Institute of Real Estate Management (IREM) was formed in 1933 as a trade organization to assist in training and certification of property managers. IREM also adopted a code of ethics for its property managers to follow, and later teamed with the National Association of REALTORS® (NAR) as its primary property management organization.

IREM has not limited its training solely to the management of single-family properties; it provides training for all fields of property management including general commercial, shopping center, office building, management of government sponsored programs, as well as residential.

In 1987 the National Association of Residential Property Managers (NARPM) was created in Dallas, Texas by a group of property manager computer users who had similar needs and desires that were not being met by other trade organizations. Today NARPM has over 1,500 members nationwide and holds two annual conventions, providing training specifically for the residential property manager.

The three primary property management trade organizations, IREM, NARPM, and BOMA each have designations that can be attained through training coupled with experience.

## Property Management Designations

The Institute of Real Estate Management (IREM) designations are:

### **Certified Property Manager (CPM)**

Individual designation

### **Accredited Residential Manager (ARM)**

Individual designation

### **Accredited Management Organization (AMO)**

Company designation

The Certified Property Manager (CPM) designation is considered the premier property management designation in the United States. In order to qualify to apply for this designation, the candidate must have managed at least 300 rental units for at least three years, and must have completed certain college level courses, such as accounting and business management. Once accepted, the candidate must then complete several one-week training courses offered at various locations across the country. These courses include managing residential properties, problem solving, ethics, and testing to measure and evaluate separate courses of action with respect to properties. The average time to complete the CPM designation is five to ten years, although this may be shortened if the candidate is working as an apprentice with a CPM. The cost of completing the CPM designation program (including travel, lodging, and tuition) is approximately \$10,000. To apply as a CPM candidate, you must be recommended by a CPM and provide six other business references attesting to your character and abilities.

The Accredited Residential Manager (ARM) is similar to the CPM designation, except that it is more specifically designed for the manager of an on-site location, such as a large apartment complex. Generally, an ARM will manage the entire property site, oversee the employees and leasing consultants, and be responsible for reporting to the property owner.

The Accredited Management Organization (AMO) is a company designation, not an individual designation. In order for a company to earn the AMO designation, the company must be headed by a CPM and must demonstrate that it complies with a vigorous checklist of

qualifications, such as providing policy and procedure manuals, carrying proper business insurance, and other requirements expected of a prudent property management company.

National Association of Residential Property Managers (NARPM) property management designations are:

### **Professional Property Manager (PPM)**

Individual designation

### **Master Property Manager (MPM)**

Individual designation

### **Certified Residential Management Company (CRMC)**

Company designation

The Professional Property Manager (PPM) designation course of study is considered by many to be the basic primer for those with less than two years experience in the business. To apply for this designation, a candidate must complete three, one-day courses and pass three exams. These courses are offered at various locations throughout the United States. The candidate must also have managed a minimum of 50 residential properties for at least two years and must be recommended by another professional property manager or a master property manager.

The Master Property Manager (MPM) designation is the foremost NARPM designation for residential property managers. To be eligible for this designation, one must have first earned the PPM designation. The candidate must also have managed a minimum of 250 properties for at least two years and must complete an additional four days of training that culminates in the completion of two examinations. The training offered through NARPM is designed specifically for the manager of single-family homes and condominiums.

The Certified Residential Management Company (CRMC) designation is a company designation, not an individual designation. In order for a company to earn the CRMC designation, the company must be headed by an MPM and must demonstrate that it complies with a checklist of vigorous qualifications, such as providing policy and procedure manuals, carrying proper business insurance, and other requirements expected of a professional and prudent property management company.

The Building Owners and Managers Association (BOMA) designation is: **Real Property Administrator (RPA)** Individual designation

The Real Property Administrator (RPA) designation is a personal designation for those who are involved in building management. To achieve this designation, individuals must have several years of experience in the field and must successfully complete the courses in the program curriculum.

## When a Tenant Files Bankruptcy

When a tenant files bankruptcy under the United States Bankruptcy Code, the federal court imposes an **automatic stay**, prohibiting all entities from taking or continuing any action against the tenant to collect any debt. The automatic stay restricts the property manager and property owner from taking or continuing to take any action, including eviction for nonpayment of rents.

The property manager and for that matter the property owner, should be warned that continuing to try to collect from a delinquent tenant who is under the protection of the bankruptcy code is nothing less than contempt of court, and that the punishment can be a fine much higher than any amount of rents due, or even imprisonment.

Any actions that may have been initiated, such as eviction proceedings, are immediately frozen and may not be continued without the permission of the Federal Bankruptcy Court.

Most tenants who file for bankruptcy protection file under Chapter 7, or what is otherwise known as personal bankruptcy. While regaining possession of the rental property under Chapter 7 is a fairly simple legal process it should only be instituted by your attorney.

Your attorney will most likely file a motion to lift the stay, which when granted by the federal court will enable you to proceed in the state or county court for possession by eviction. The average timeframe to have a stay lifted is 60 days.

This section on tenant bankruptcy only deals with what commonly happens when tenants file bankruptcy. There are volumes and volumes of bankruptcy codes and thousands of adjudicated cases. It is imperative that the property manager realize that he or she can take no action whatsoever during the tenant's protection under the bankruptcy code. When served notice of a tenant's bankruptcy, a prudent property manager should immediately notify legal counsel.

## Growing Demand For Property Managers

As our society becomes more of a *rental* or *lease* society, the need for more qualified residential property managers is essential. We have become a society of *leasing it* consumers versus *buying it* consumers. For instance, 15 years ago, when small business owners wanted new vehicles, they purchased them; today business owners lease them. Ten years ago when a business needed new office furniture or equipment, it was purchased; today it is leased. Today, when a family moves to a new area, due to job transfer or relocating, they often lease for a period prior to investing in the

purchase of a home. Often families have been unable to sell their former residence prior to relocating and have subsequently leased their former home. Many people are becoming investment owners by circumstance instead of homeowners by choice.

Another reason for the increasing demand for residential property managers is that many newly married and other young couples do not have the cash or credit to purchase a home. It is this author's opinion that unless Congress mandates less stringent mortgage qualifications or creates a special mortgage program for those who currently do not have cash for a down payment or do not have blemish-free credit, there will be less purchasers of homes and more renters. This trend will increase the need for more trained property managers. The congressional changes would involve the secondary mortgage markets.

Real estate licensees who want to enter the residential property management field usually seek further training from organizations such as NARPM, IREM, and BOMA, or pursue a college degree in property management in order to gain specialized knowledge to practice competently and successfully.

## Residential Property Managers at Work

Once a residential property manager is properly trained, the most important objective is to find and list new properties to lease and manage. Usually, homeowners hire property managers by executing a property management listing or employment agreement. Unlike an exclusive-right-to-sell agreement, a typical property management agreement is for a term of at least one year and may be automatically renewable from year to year.

New sales agents often do not realize that a listing-for-sale of a property generally has no effect on the manager's listing to lease or manage, and vice versa. Listings-for-sale of property have no effect upon listings for management and leasing of property for the following reasons:

- a. The sales listing may be with ABC Realty and the management listing may be with XYZ Realty. A sales listing with one brokerage firm does not terminate or affect the property management listing of another brokerage firm. This point is especially true if the management firm has an **exclusive-right-to-lease-and-manage** agreement.
- b. Because leasing/property management and sales are two separate services of real estate and local boards of REALTORS® have determined that it is not a conflict of interest for two different brokerage firms to have these two different types of listings on the same property.

- c. The property management agreement typically gives the property manager the right to execute leases on behalf of the property owner. A sales listing never (in the absence of a power-of-attorney) gives the sales brokerage the right to sign a sales contract.
- d. Unlike sales listing agreements, residential property management listings generally are for longer terms (one year) and are permitted to be automatically renewable for additional years. Many property managers have management listings for five to ten years or longer, compared to sales listings of say, five to ten months. Similarly, tenants may have been granted an automatic extension in their lease or right to renew their lease for additional years.
- e. A lease gives three of the four **bundle of legal rights** of real estate: possession, use, and exclusion. A sales listing gives none of these.
- f. A lease in some cases may be more effective than an actual deed to the property. A 99-year lease is an example.

While a sales listing has virtually no effect on property management listings, a property management listing may have major effects on a sales listing. Therefore, it is of utmost importance that sales agents and property managers communicate clearly with one another when property owners want to rent or sell their property, whichever comes first.

The residential property manager must be able to market vacant properties promptly when they become available.

The goal is to minimize losses of the property owner. Upon finding prospective tenants, the property manager thoroughly reviews the lease application including completion of credit checks, verification of tenant income and employment, and verification of former landlord references. The property manager then reviews the lease agreement to ensure that all parties have agreed to the terms of the lease. The manager must collect the initial rents and security deposits and conduct the move-in inspection with the residents.

During the term of tenancy, property managers perform regular periodic inspections to confirm that the tenants are complying with the terms of the lease agreement. Timely collection of rents is paramount to the manager's success with the property owner. In the event of delinquencies, the property manager must be ready to take any and all actions, ranging from serving late notices to a full eviction. Most property managers have developed a monthly calendar of events to ensure consistency of procedures. The residential property manager must also keep up-to-date on issues that may affect the property, such as insurance, taxes, and zoning.

They should have a complete knowledge of leases and rental agreements, and how to deal with problems that may arise during the tenant's occupancy of a property.

Professional property managers develop a system of computer-generated letters and forms to deal with the common occurrences of property management. Property managers need to know the answers to the following questions:

1. What if the tenant wants to sublease the property or assign the lease to a third party?
2. What if the property owner desires to sell the property while it is leased?
3. What are the proper procedures for increasing the rent, and when / how can this be accomplished?
4. What should you do if the tenant tenders a bad check?
5. What is the landlord's liability for injuries on the premises and how should such liability be handled?
6. What is the landlord's liability for crimes committed against tenants?
7. What are the consequences of the death of a tenant or property owner?
8. What if the tenant wants to terminate the lease prior to the scheduled expiration date?
9. What if the tenant remains in the property after the lease has expired?
10. What do you do with the abandoned property that a vacating tenant leaves behind?
11. Who is responsible for maintenance and proper operation of the utilities?
12. Who is responsible for maintenance and proper operation of the smoke detectors?
13. What should be done about unauthorized pets?
14. Who holds the security deposit?
15. What if the tenant or property owner files bankruptcy?

These specific situations and their ramifications cannot be addressed in sufficient detail in this course. Courses that prepare licensees for a career in property management are available from many sources as discussed earlier in this chapter.

## Property Maintenance

One of the largest areas of concern to the residential property manager is the maintenance of the property. Preserving the property owner's asset is accomplished by ordering periodic maintenance, such as exterior painting, lawn service, and roof repair. Sometimes the manager may recommend upgrading of certain items such as kitchen appliances or central air conditioning systems. The manager should be able to advise the property owner how much the rent may be increased in exchange for upgrades in the rental property as well as what the payback period should be on these types of investments.

One aspect of maintenance that is of primary importance involves the manager's ability to get a vacant property in "rent ready" condition as quickly as possible, since *rents*

*lost due to vacancy can never be recovered.* A good property manager will have inspected a rental home before the tenants actually move out in order to plan for making the unit rent ready as quickly as possible.

## Accounting

Because property managers collect funds on the property owner's behalf, they must also have a thorough knowledge of accounting. As recently as 15 years ago, property managers had to develop and worked with manual accounting systems. Fortunately, personal computers and modern software packages have made this important job much less time consuming.

Computers also provide the property manager with important information, such as average market rents, rents per square foot, and highest and lowest rents. Compiling this information without computer assistance would take much more time. Additionally, both monthly statements and year-end summary statements are easily produced with the computer. Property owners expect these statements to be professionally produced and timely.

## The Profession

To be successful, residential property managers must continue to build the number of properties they manage, while at the same time building their business (planning, organizing, and staffing). Because of the continual change of customer needs - people moving in and moving out, sales of properties, and relocations - the residential property manager will soon realize this maxim: "All management accounts will leave someday; good management only delays this inevitable process." To combat the loss of business, the successful residential property manager builds business by employing managers and assistant managers who are capable of listing new accounts.

In addition to state laws and regulations governing landlords and tenants, there are certain federal regulations of which residential property managers need to be aware. The primary federal regulations are the Federal Fair Housing laws. The Federal Fair Housing Act of 1968 (Title VIII of the Civil Rights Act of 1968) prohibits discrimination based on race, religion, sex or national origin. The Fair Housing Amendments of 1988 extend protection to handicapped persons and persons with familial status.

Residential property managers may not discriminate against any property owner, renter, or applicant who is a member of a protected class. They must be very careful in advertisements as even unintentional statements may be construed to be discriminatory. To eliminate confusing, in January 1995 the U.S. Department of Housing and Urban Development issued fair housing

advertising guidelines. These guidelines prohibit steering and gender-specific advertisements.

The following statements may *not* be used in advertising of housing for rent or sale.

"Handy Man Special" - Discriminates against a handy woman.

"Bachelor Pad" - Discriminates against families.

"Good Christian Family Wanted" - Discriminates against other religions.

"Quiet, Mature Complex" - Discriminates against families with children.

## Income And Profit Centers For Property Managers

The field of residential property management is growing for several reasons. There is currently a demand for qualified residential property managers, and the profession can be highly profitable. Management companies have expanded their menu of services to include a variety of profitable services. While licensees cannot discuss specific fees charged in the marketplace, we can illustrate some of the profit centers available to residential property managers.

- < Property management fees
- < Leasing fees
- < Lease renewal fees
- < Sales to tenants: commissions
- < Late fees
- < Late notices served fees
- < NSF charges
- < Cost of advertising
- < Contract cancellation fees
- < Hourly fees
- < Maintenance fees
- < Development of a management plan

Any and all fees charged must be clearly disclosed (usually in the management/listing agreement), and they must be agreed upon prior to actually charging the customer. Professional property managers have their listing/employment agreement reviewed and updated by their legal counsel at least once a year to ensure compliance with laws and fairness to all parties.

What services does a property manager offer to the property owner to justify such fees? The following is a brief summary of services offered by residential property managers:

1. Property management fees are charged on a monthly basis for the overall management of the property, including the collection of rents. In addition, an astute property manager will monitor and inspect the property on a regular basis to ensure that the property is well maintained with no deferred maintenance.
2. Leasing fees are charged for the procurement of creditworthy tenants and placing them into the

rental home, after investigating their credit, employment, rental references, and other references to ensure that the tenants are qualified.

Lease renewal fees are charged for the successful renewal of an existing lease, generally for an additional year. Often the property manager will conduct one last inspection prior to renewing the lease.

Application fees are collected from prospective tenants to offset the cost of obtaining their credit report and other verification activities.

The property manager collects late fees from the tenant whenever the rent is delinquent.

Fees for serving notices are charged to the tenant if the manager has to personally drive out to the property to serve the tenant.

Customer-paid advertising has become a standard in the residential property management industry.

Maintenance service fees are often charged by managers for overseeing and managing maintenance work that is above and beyond the maintenance work normally required.

Development of a management plan is a service provided by qualified managers. Management plans are used by property owners to determine the highest and best use of their property, thereby ensuring the highest possible return on their property. Management plans are also prepared for prototype properties (properties not yet constructed) to determine the feasibility of constructing such a property.

Hourly fees are charged for services not agreed to in the standard employment agreement. Serving as an expert witness or appearances before the city government on behalf of the property owner are good examples of hourly-rate services.

## Summary

The growing number of profit centers combined with recent technological advancements allow property managers to manage a larger number of properties more effectively and therefore, more profitable. Using personal computers, property managers have set up automated marketing systems that inform prospects about vacant rentals 24 hours a day. Prospective renters can schedule appointments to view properties automatically. The same is true with automated maintenance systems that allow residents of rental properties to speak directly with vendors and tradesmen about necessary home repairs. The property manager of today saves digital photographs of their properties on

computer and advertises both the company and the properties on the Internet.

In conclusion, an expanding market, uncomplicated licensure, available training, excellent income potential, and recent technological advancements all contribute to the rapidly growing field of residential property management.

## Section Review Questions

Answer all questions on the attached **Answer Form** found in the back of this book.

The **Answer Form** is the only page to return to CAPE.

11. Which of the following is a company designation as opposed to an individual designation?
  - A. CPM
  - B. MPM
  - C. CRMC
  - D. BOMA
12. The first property managers were actually:
  - A. merchants in Manhattan just prior to America's purchase of New York.
  - B. bankers who owned foreclosed properties.
  - C. cavalry officers who established small towns in the Old West.
  - D. unemployed sales agents who were seeking other ways to make a living.
13. Which trade association represents exclusively the managers of residential properties?
  - A. IREM - the Institute of Real Estate Management
  - B. NARPM - the National Association of Residential Property Managers
  - C. BOMA - the Building Owners and Managers Association
  - D. SPM - The Society of Property Managers
14. Property management service listing agreements/employment agreements:
  - A. may be automatically renewable.
  - B. may not be automatically renewable.
  - C. Are available from the Commission.
  - D. are required to be in writing, i.e., no open listings.
15. According to the Census Bureau, just over \_\_\_\_\_ % of housing in the United States is owner-occupied.
  - A. 70
  - B. 60
  - C. 50
  - D. 40



# Mediation for the Real Estate Professional

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## Learning Objectives

After completing this section you should be able to:

- < Describe mediation.
- < Explain the difference between mediation and Alternate Dispute Resolution (ADR) procedures.
- < List at least three Alternate Dispute Resolution (ADR) procedures.
- < Explain when mediation can be used.
- < List at least three desired traits of a mediator.
- < Describe the steps in setting up a mediation.
- < Describe the procedures in a mediation.
- < List at least three advantages of mediation over litigation.

## Mediation for the Real Estate Professional

As a real estate professional, you are likely to encounter situations where a problem or conflict ends up as a threatened or actual lawsuit. Uncertainty over the terms of a sales contract, deed description discrepancies, specific performance enforcement and commission disputes are only a few of the problems which result in a salesperson, broker or real estate agency finding itself entangled in litigation or the threat of litigation. A relatively quick and inexpensive alternative to litigation is readily available in the form of mediation.

### What is Mediation?

An excellent definition of mediation can be found in the Florida Statutes as follows:

Mediation is a process in which a neutral third party acts to encourage and facilitate the resolution of a dispute without prescribing what it is. It is an informal and non-adversarial process with the objective of helping the disputing parties reach a mutually acceptable agreement. (§44.1011 F.S. 1990)

A mediation is essentially a settlement conference. Despite the recent institutionalization of mediation, it has been around since one cave dweller stopped two other cave dwellers from fighting by suggesting they each split a mastodon kill rather than fight over who gets it all. Many cultures consider it unseemly and unacceptable to file lawsuits to resolve disputes, and instead traditionally have relied on mutual friends or respected community leaders to listen to both sides and assist them in working out a solution.

## Mediation: Part of Alternate Dispute Resolution (ADR)

Mediation is just one of an expanding array of ways to resolve potential or actual business or legal conflicts without lawsuits or at least without resorting to trials. It is one of several such methods collectively referred to as Alternate Dispute Resolution (ADR). Each of the following is an ADR procedure designed to avoid or shorten disputes or litigation:

, **Arbitration.** Unlike mediation, arbitration results in a resolution being imposed on the parties by one or more arbitrators following a trial-like proceeding. Though parties may consent to binding arbitration in absence of a written agreement requiring same, it most likely is required because of a contract provision. A court may order "non-binding arbitration" (something of an oxymoron) which, while the decision of the arbitrator(s) is not enforceable, carries penalties for the party which elects to proceed with the litigation and ultimately obtains an adverse adjudication.

, **Private Judge.** In essence, the parties "rent-a-judge" who has retired or otherwise left the bench and who agrees for a fee to serve as the judge in the case. The private judge enters orders and otherwise acts as a regular judge, the parties having agreed to accept rulings and judgments of the private judge as enforceable and binding. Sometimes the private judge even presides over private juries which hear a case in a formal trial-like setting. Private judges are normally used in areas where there is a long wait for trial dates in the public court system. To date, Florida has seen a minimal use of "rent-a-judges."

, **Summary Jury Trial.** A "down-and-dirty" jury trial, usually conducted in front of the first six jurors picked (no jury selection by lawyers or a judge) and with just summaries of evidence presented. Usually only one or

two live witnesses testify, with the attorneys using some exhibits and closing argument rhetoric to explain their party's case to the jury. The resulting "verdict" is purely advisory and non-binding; however, such summary trials frequently result in settlements near or in the amount of the advisory verdicts.

## Mediation: A Different ADR

Mediation differs from the other forms of ADR in several ways.

, **No lawsuit necessary.** Mediation can be conducted long before litigation is initiated. Pre-suit mediation is an excellent time for the parties to sit down with a neutral third party (and possibly without any party represented by counsel) and work out a compromise.

, **It is voluntary.** Especially before a lawsuit is filed, mediation is a voluntary activity. Even after litigation begins, a party may ask the court for permission not to attend a mediation. However, in Florida it is a rare civil case which goes to trial without the parties having first been through mediation.

*Note: Some newer real estate sales contracts contain a provision requiring mediation when disputes arise under the sales or purchase agreement. Be sure to review whatever contract form you are using to see what (if anything) it says about dispute resolution.*

, **It is informal.** Even with attorneys present representing parties, mediation is a very informal proceeding. There are no rules of evidence or objections to presentations, only discussions among the parties as to their differences, with each party allowed to express his or her position on the issues.

, **It is non-adversarial.** The purpose of mediation is to discuss differences, not argue positions or the law. While obvious divisions of opinions will exist, mediation is the time to explore alternative solutions, not to attempt to convince the opposing side of the correctness of your view.

, **It provides confidentiality.** Any matters discussed at mediation are confidential, meaning that references to the discussions cannot be used for any reason in any other proceeding. Confidentiality promotes a more frank and open discussion of the disputed issues than would be possible in a deposition or at trial.

*Note: Though the general rule is that settlement negotiation and mediation conducted pursuant to Florida Statutes or Florida Rules of Civil Procedure are confidential by law, it would be wise to include a confidentiality provision in any private mediation agreement not conducted pursuant to court order.*

, **It is non-binding.** Though it is hoped that a mediation conference will result in a settlement of all issues in dispute, there is no requirement that any party agree to any resolution. In other words, if you do not like the ultimate settlement proposed, you do not have to accept it. However, it is not necessary that all claims be settled by the mediation. It is perfectly acceptable to

agree to settle some parts of the dispute even if the entire matter cannot be amicably resolved at the mediation.

## Why Mediate?

The advantages of mediation are many. The following are just a few of the positive aspects of mediation:

, **It is quick.** Mediation can be done at any time, including before a time-consuming lawsuit is filed. Most mediations take but a few hours, and can normally be scheduled with only a few weeks lead time. Trials can take months or years to go from filing of suit to final adjudication. Even if a judge or jury rules in your favor, the appellate process can add years to the proceedings.

, **It is cost effective.** If done before litigation is commenced or shortly after a lawsuit is filed, mediation can save thousands of dollars in legal fees and court costs. Depending on the issues in conflict, an early resolution of a dispute may save lost revenues, interest on earnings, gain prospective sales, promote goodwill and free up time and money for more profitable enterprises. Other than attorneys' fees, the only direct cost of a mediation is for the mediator's services. Mediators normally bill by the hour, with circuit court certified mediators charging in the range of \$125 to \$150 an hour. The mediator's fees are normally divided equally among the participating parties.

, **The results are assured.** Each party at a mediation keeps control of his or her own destiny. No settlements are imposed, and the result is one with which each party must agree. By reaching a compromised arrangement, each participant is assured of the results of the conflict, unlike a trial where a judge or a jury will impose a resolution on the parties. Most people prefer predictability, and nothing is more unpredictable than the results of a jury trial.

, **It may be repeated.** A trial is normally a one-shot event. If a mediation is unsuccessful, it may be held again if the parties agree. Perhaps new information or events will allow a second or even subsequent mediation to be successful.

, **It is an opportunity to learn.** Being an informal and confidential discussion of facts and opinions, a mediation provides an excellent opportunity for all parties to learn about each other's case or claim. The mediation process is designed not only to allow the parties the opportunity to express the strength of their respective case to the opposition, but also to permit (without rancor) the parties to point out the perceived weaknesses of their opposition's position. The education received by all parties in a mediation is one of the key reasons mediations are so successful. Armed with a better understanding of the opposition's position and a new awareness of some of the problems in its own situation, a party is better able to properly evaluate its case. From this new knowledge and insight comes both the ability and basis for an amicable settlement.

## The Mediation Process -- An Easy Procedure

There is no mystery to the mediation process. Once the decision is made to mediate a dispute, the first order of business is to select a mediator. Even in court-ordered mediation, the parties are usually free to select their own mediator. A site for the mediation should be chosen and a decision made as to whom will attend the mediation. The amount of preparation necessary will vary with the complexity of the issues and the value of the claim.

, **Selecting a Mediator.** Although there is not universal agreement on what qualities all mediators should possess, the following traits are certainly the minimum you should seek:

**Training and Experience.** Though the parties may choose anyone to serve as their mediator, a trained and experienced mediator will likely provide the best service to you. Mediators who have been certified as circuit mediators by the Florida Supreme Court have taken a 40-hour course of study and met other experience requirements. A list of certified mediators should be available from the Circuit Court Clerk. Local attorneys are also an excellent source of information on mediators.

**Impartiality.** Even though a mediator may know one or more of the parties, it is imperative that he or she be completely neutral and impartial throughout the process. If any party to a mediation harbors any doubt of a mediator's ability to be neutral, the process will likely fail.

**Respectful.** A mediator must display respect not only for the parties, but for their respective positions. Being able to have the utmost consideration for the parties during the mediation experience is extremely important.

**Non-judgmental.** A mediator should avoid developing and should never express a personal opinion on the relative merits of any party's position.

**Tough Questioner.** Though a mediator should never express an opinion on the merits of a party's position, a good mediator will ask the tough questions which will challenge assumed facts and make a party thoroughly examine and review its position.

**Knowledge.** How much knowledge a mediator needs on the subject of the mediation is a debatable point. Some very experienced real estate licensees might make lousy mediators, while a trained and experienced mediator, though not a real estate expert, could be very effective. The likely answer is to find someone who is a trained or experienced mediator and who is at least acquainted with the subject of the mediation.

**Other Factors.** Whomever you choose for a mediator should be able to put people at ease. If the parties to a mediation are comfortable with the mediator, the chances for success are greatly heightened. A good sense of humor is an invaluable asset for a mediator, especially if he/she can get a party to see some humor in the situation. Be sure your mediator is not one to quit too soon. Many mediations are successful after all the

parties have indicated there is "no way" the case can settle. Do not forget that the mediator is privy to all parties' confidential thoughts; therefore, though there may be "no-no" on the lips, the mediator may well have seen "yes-yes" in someone's eyes.

, **Where do I mediate?** There is no magic in where a mediation is held. While some parties prefer a neutral site (i.e., neither parties' office), many mediators do not have the facilities to handle mediations, especially if they involve more than four or five people. Be sure to ask the mediator if the mediation can be conducted at the mediator's office. [Note: There is normally no extra charge for using the mediator's office.] If the mediator cannot accommodate the mediation, some private court reporters rent deposition rooms at a very reasonable rate.

If all else fails, check with the Clerk of the Circuit Court or a local hotel. As a rule of thumb, you will need one room large enough to accommodate all parties for the opening session of the mediation, and usually a smaller room for each mediating party. Of course, adequate restrooms should be available, and amenities such as telephones and refreshments are a plus.

, **What do I send the mediator?** Most mediators want to receive from each party a summary of the party's position. This would include a brief history of the problem, the facts and law as seen from that party's perspective and any documents or pleadings which the party believes would help the mediator understand the dispute. Remember, any information given to the mediator, including a pre-mediation summary, is confidential.

, **Who should attend the mediation?** Every mediation should be attended by the individual who has the full authority to settle the case on behalf of a party without (or with minimum) consultation with someone who is not at the session. In other words, the principals to the dispute who have the authority to sign a binding memorandum of settlement should be present. Attendance should be limited to the principals who will be making the final decisions and their attorneys.

, **How do I prepare for a mediation?** If you are represented by counsel, your individual preparation should be minimal. You should go over the facts of your claim or defense, review any documents which are important to the case and otherwise refresh your recollection on the issues. If you have an attorney, ask your counsel how he or she intends to approach the mediation. Be sure they have reviewed the case and are conversant with the issues and the facts. If you are representing yourself in the mediation, make notes or an outline of the points you want to make. Remember, you will be there to discuss your case, not argue with your adversary.

, **It's Showtime! What now?** Mediations have a general routine which is normally followed. While subject to being altered by the mediator for a variety of reasons, the usual procedure is as follows:

**Mediator - Introduction and Explanations.** Normally the mediator will formally introduce himself or herself, and be sure that all the participants have been identified and introduced. The mediator should also take a few minutes explaining the mediation process in general and how the immediate mediation will proceed. The mediator may also give a thumbnail sketch of the non-confidential aspects of the case.

**Opening Statements.** Routinely, each party will be given an appropriate amount of time to present an opening statement. These remarks should be as concise as possible, emphasizing the strengths of the party and reflecting on what are perceived to be the key weaknesses in the other party's case. Since the mediation process by definition is non-adversarial, every effort should be made to educate and not irritate the other side. Each individual party should be encouraged to speak during this opening session, keeping in mind that while differences of opinion on the issues should be squarely addressed and understood by the parties, conduct or language that is in fact or even just perceived to demeaning, sarcastic or rude may very well condemn the process to failure before it has a chance to start. Remember, you and the other side have voluntarily appeared since both of you want to settle your problems as quickly and economically as possible while not being taken advantage of by the other side. The process will have an excellent chance of succeeding if neither party insults the other.

**Caucuses.** After the opening statements and opening session with all the parties present and participating, the mediator will meet privately with each party to more thoroughly discuss the case and see what the party wishes to accomplish. It is in the caucuses that the mediator really earns his/her money. As noted earlier, hard questions must be asked to be sure each party recognizes the weaknesses in its case and understands the potential downside of continuing the litigation/dispute. Frequently, parties may feel the mediator is "picking on me"; however, the good mediator is an equal opportunity questioner, and is undoubtedly putting similarly tough questions to the other parties as well.

Depending on the number of parties and issues, the mediator may hold several caucuses with the parties. Since (hopefully) the parties are learning from what was said in the opening session and what is being discussed in the caucuses, a re-evaluation process is going on with each party. Based on the new information and changed perceptions of their respective positions, each party will normally move off its original demand or offer, and will send the mediator back to the other party with a new proposal.

**, How long will it take?** There is no particular time limit on how long a mediation will last. A relatively simple two-party mediation involving a purely monetary settlement would hopefully not last more than three or four hours. The time may be extended based on the

amount of the settlement. Complex mediations, meaning those claims involving multiple issues or several parties, can take all day or even more than one day.

A competent mediator will not keep the parties in session when it is obvious no agreement is possible. A party normally should not unilaterally decide to terminate a mediation just because it perceives it as being unproductive. Remember, the mediator is talking to all the parties and is in the best position to know if and when to end a mediation. If it appears that a recess would be of assistance, a mediator may adjourn a mediation with the objective of reconvening it in the future. Normally parties will agree to an adjournment to allow time for gathering more information or perhaps to allow some event to occur, the outcome of which has some bearing or influence on the parties or their desire to settle. Keep in mind that if you leave too early, you may save a few minutes of time, but you may miss an opportunity to beneficially and amicably resolve a potentially expensive and time consuming problem.

**, We settled! Get it in writing.** After what frequently seems to be an interminable time and too many caucuses, most infrequently, both parties have gone from their "want to do" position, to their "will do" position, to a "if it will get the case settled I will do it" position. This rule of thumb is, when each party feels it either gave too much or got too little, it is likely a fair settlement.

As the old cartoon noted, the job's not finished unless the paperwork is done. It is imperative that the basic settlement agreement be reduced to writing and signed by the parties before they leave the mediation. The agreement need not be all encompassing, but it needs to cover the basic and essential elements of the settlement, such as:

- who is to pay what, to whom and when;
- what documents are to be prepared, by whom and when
- what other acts, reservations or conditions are involved.

## **Presidential Advice--Mediate!**

Take it from a former president, mediation is a great idea. If current mediation procedures would have been available to **Abe Lincoln**, it is a sure bet he would have used them. As early as 1850, Lincoln is quoted as saying:

*Discourage litigation. Persuade your neighbors to compromise whenever you can. Point out to them how the nominal winner is often a real loser - in fees, expenses and waste of time.*

Keep this valuable procedure in your mind the same way you keep a calculator in your briefcase. After all, it is a procedure that will save you time, money and frustration.

## Editor's Note:

The *National Association of Realtors*<sup>®</sup> has developed guidelines and criteria, and provides member Boards and Associations with the information they need to endorse, implement and promote the **Homesellers/Homebuyers Dispute Resolution System (DRS) Mediation Program**. Two considerations are noted by NAR as critical to the decision to initiate and promote this DRS mediation program:

1. ***The importance of non-adversarial dispute resolution to the business interests of Realtors***<sup>®</sup>. *While arbitration insures that a dispute will be decided, arbitration, like litigation, is adversarial - one party wins, one party loses. Mediation, on the other hand, is a non-adversarial process that focuses on the mutual goals of the disputing parties and actively involves them in the process. Much of the business brokers and sales agents enjoy is repeat business from clients and customers who are satisfied with the services the agent provides. NAR felt that buyers and sellers would perceive access to DRS mediation as a valuable broker service, and that this non-adversarial process would contribute more to long-term goodwill between brokers and their clients and customers than would arbitration.*
2. ***Legal concerns related to arbitration***. *Because arbitrators are legally empowered to render binding decisions, parties who agree to arbitrate disputes forfeit their rights to file their cases in court. Since mediators do not have such authority, the seller and buyer do not forfeit their legal rights to pursue other remedies if mediation is unsuccessful.*

## Section Review Questions

Answer all questions on the attached **Answer Form** found in the back of this book. The **Answer Form** is the only page to return to CAPE.

16. Almost any problem can be the subject of informal mediation.  
A. True  
B. False
17. Mediation is a trial-like proceeding.  
A. True  
B. False
18. There must be the threat of trial before parties can mediate.  
A. True  
B. False
19. A real estate sales contract can require mediation when disputes arise.  
A. True  
B. False
20. The purpose of mediation is to discuss differences and explore alternative solutions.  
A. True  
B. False

# Property Valuation and Market Forces

## Learning Objectives

After completing this chapter, you should:

- < Know the difference between market price and market value.
- < Understand the principles of value and how they affect property.
- < Know the three distinct stages that typically affect individual properties.
- < Be able to define a CMA.
- < Be able to define an appraisal.
- < Know the basic steps involved in the three approaches to valuation.

## Appraiser Requirements

Prior to 1993, licensing and certification of appraisers was a matter left to individual states, and only a handful of states required appraisers to have even a real estate license.

However, the collapse of a significant number of lending institutions in the late 1980's caused lending and appraisal practices to come under the scrutiny of the federal government. It was determined that the unwise real estate investments made by many of these institutions were often based on faulty property appraisals.

Congress therefore took action to introduce federal appraisal regulation with the passage of the Federal Financial Institutions Reform, Recovery and Enforcement Act of 1989.

As of December 31, 1992 lenders who wish to make use of federal monies, or federally regulated markets (secondary mortgage market), must use only appraisers licensed or certified by the state in which the property is located, and the state licensing criteria must comply with federal law.

To comply with these federal regulations all states now have licensing requirements for appraisers which include educational requirements, experience requirements, and state licensing examination.

## Valuation And Real Estate Licensees

Real estate brokers and salespeople may in the ordinary course of their business give an opinion of the value of real estate for the purpose of a prospective sale, and may advise clients concerning the market value of their property. However, in no instance may this opinion be referred to or construed as an appraisal.

Thus, when it comes to real estate licensees, the "art of appraising" is much like expert tax advice and real estate legal advice: technically, real estate licensees may not do

it, and may not collect fees for it, but they are expected to know about it, be familiar with the terminology, and be able to give clients advice and information about it. Furthermore, and this is most important to keep in mind, clients and customers alike may "rely upon" any such advice given. Licensees must be knowledgeable, and must be careful.

**Competitive Market Analysis (CMA).** It is the seller's responsibility to determine the listing price of his property. It is the agent's responsibility to give good advice concerning an appropriate listing price for the seller's property in the current market. To accomplish this, the agent does a competitive market analysis. He takes recently sold properties which are "comparable" to the subject property in order to arrive at a realistic market value for his client's property. Because of the nature of land and improvements, the "comps" used in the CMA will not be identical to the subject property, but they should be similar enough to allow for easy adjustment. Features which typically need to be considered when evaluating possible adjustments to market value are differences in location, differences in amenities such as pool, landscaping, lot size, fences, walks, modern kitchen, number of bedrooms and bathrooms, and any other feature which is recognized in the marketplace as having value.

## Appraisal & Value Definitions

**Appraisal.** An appraisal is a supportable **estimate** of the value of a parcel of real estate made by a qualified appraiser, as of a **specific date** for a **specified purpose**.

Appraisal is an art, not a science.

**Appraiser.** An appraiser is a licensed individual who possesses the necessary qualifications to estimate the value of a parcel of real estate for a fee. Appraiser's fees are usually based on time and expenses. Fees are never based on a percentage of the appraised value of the parcel. Many businesses such as S&L's, mortgage companies, and city and county governments employ a certain number of appraisers on a full-time, salaried basis.

**Cost (Actual).** In real estate, cost is **capital outlay** required to "create" improved real estate (often referred to as production cost). Cost includes financing, building costs, labor, overhead, and profit. Cost is different from "market price" and "market value". Please compare the three carefully.

**Market Price (Actual).** Price, or market price, is the **actual amount paid** by a buyer to a seller for a particular parcel of real estate. Likewise, market rent (economic rent) is the actual rent that a lessee agrees to pay to a lessor.

**Market Value (Estimate).** The estimate of market value is the goal of an appraiser. Market value is the **most probable price** that a parcel of real estate should bring in an open and competitive market. It is "what the price should be".

In appraising, the following six points are included in the definition of market value:

- Market value represents the most **probable** price, not the average price or highest price.
- The property has been exposed on the open market for a **reasonable** length of time.
- Buyer and seller are reasonably **well informed** as to market conditions and the uses to which the property may be put.
- Buyer and seller are **not** related and **not** acting under undue pressure to conclude the transaction.
- Seller has the capacity to convey **marketable** title.
- Payment is made in cash or its equivalent.

All six of these factors are rarely, if ever, present. For instance, a seller might be forced to sell quickly because of business reasons; an out-of-state buyer may not be well informed about the local market; or a parent may sell below market value intentionally to a son or daughter.

## Valuation and Real Property

Appraisers are hired to determine the value of real property. Value is broadly defined as the power of a good or service to command other goods or services in exchange. There are many different types of value including *market value*, *assessed value* (for tax purposes), *book value*, *insurance value*, *par value*, *rental value*, and *replacement value*. Of these, the real estate agent will most commonly be concerned with **market value**.

## Location or Situs

There are many factors which affect the value of a particular piece of real property. However, of all the factors, location is by far the most important. Location, location, location! You will hear it again, and again, and again.

**Remember situs:** the personal preference of people for one area over another. This fact, coupled with the fact that you can neither move land, nor increase its supply, basically explains why location is so important.

## Essential Elements Of Value

In order for a particular piece of real estate to have value in the real estate market it must have four essential elements (DUST):

**Demand** - there must be a desire to buy, coupled with the ability to pay.

**Utility** - it must be able to satisfy a human need or desire. Example: provide shelter, income, or recreation.

**Scarcity** - refers to a limited supply relative to the demand for a specific type of property. Increased value is caused by continued high demand for something, when the supply cannot be increased.

**Transferability** - the relative ease with which ownership rights can be transferred from one person to another.

## Principles of Value

**Highest and Best Use.** Any one piece of real estate can be put to a variety of different uses. Highest and best use is an appraisal concept which means that legal and reasonable use which, at the time of the appraisal of the property, is most likely to produce the greatest net return. It is that use which will give the property its greatest current value.

**Substitution.** An appraisal principle which states that an informed buyer will pay no more for a property than the cost of acquiring an equally desirable piece of real estate with the same utility and productivity. In other words, the maximum value of a piece of property tends to be set by the cost of acquiring an equally desirable and valuable substitute property.

**Conformity.** This principle means that maximum value is realized if the use of land conforms to existing neighborhood standards. Example: An "over improved" property will tend to conform, and will decrease in value (a \$150,000 house, constructed in a neighborhood of \$90,000 houses, might only be worth \$100,000).

**Increasing and Diminishing Returns.** An appraisal principle which recognizes that after a certain point money spent on improvements will not add to the overall value of a property. As long as money spent produces an increase in value, the "law of increasing returns" is applicable. When money spent no longer produces a proportionate increase in value, the "law of diminishing returns" applies.

**Plottage.** The appraisal principle which holds that merging separately owned pieces of property into one large single lot will increase the value of the separate pieces. Example: A city block is made up of four lots of equal size. One lot has been on the market for over a year at \$200,000. A developer tells the listing agent that he does not want the single lot, but he will pay \$1,000,000 for the entire block. The process of merging lots under one ownership is known as **assemblage**.

**Anticipation.** A person will buy a property based on the benefit he **expects to receive** in the future. Example: An investor will buy a property now, based on its future,

potential income; a home buyer anticipates the benefit of tax shelters as well as future appreciation.

**Contribution.** An improvement to real property is only worth whatever it adds to the market value of the property as a whole. Example: A homeowner adds an elaborate, expensive, free-standing garage to his home-site. When he puts his house on the market a year later, he discovers that his house is worth much less than houses with attached garages because buyers do not like free-standing garage arrangements.

**Regression and Progression.** A principle which addresses how dissimilar properties affect one another's value. Thus, a very luxurious house in a modest neighborhood would tend to be valued down toward the more modest range of values.

Conversely, a modest home would tend to be valued up if located in a neighborhood of more expensive homes.

**Growth, Equilibrium, and Decline.** There are three distinct stages that a single property (and whole neighborhoods) typically go through. (1) Growth is the development stage when improvements are made and demand and property values are typically increasing. (2) Equilibrium is that stage when there are few vacancies left and the property enjoys a long stable period of high value. (3) Decline happens when the property experiences increasing deterioration; the need for upkeep increases, while demand and value decrease.

**Change.** As with all other things no physical or economic condition remains forever the same. Besides changes related to weather and natural wear-and-tear, there are changes in the real estate marketplace itself. People buy property for future benefits, and appraisers must be aware of past happenings and present trends in order to predict possible future change as accurately as possible.

**Competition.** The principle of competition holds that increased or excessive profits tend to attract competitors. As similar competitors move into an area profits will be seriously affected unless the increased numbers attract more shoppers (as can happen with a shopping center or merchandise mart).

**Unearned Increment.** An increase in property value caused by external factors over which the property owner has no control (such as favorable rezoning, or the building of a new expressway).

## The Appraisal Process

The appraisal process is an established, formalized procedure which provides for the collection and systematic analysis of the facts necessary to determine the value of a piece of real property. For our purposes here, we do not need to go into great detail concerning this process. However, you should be aware of the basic steps, and should definitely remember that "defining the problem" is the first step.

-- **Define the problem.** The subject property, the kind of value to be estimated, and the most valid

appraisal approach for that kind of property must be selected.

-- **Inspect the property.**

-- **Gather, record, and verify the data.** Information concerning the economic, social, and political conditions of the nation, region, city, and neighborhood must be obtained. Specific data about the subject property must be collected and verified.

-- **Apply the three approaches to value.** Arrive at three estimates of value for the subject property by applying the market approach, the cost approach, and the income approach separately. (This is not always possible, but it is the most desirable situation).

-- **Reconcile the estimates of value.** The reconciliation of the indicated value from each of the three approaches into a final value conclusion is **not an average** of the three values. An average implies that the data and the methods of the approaches are equally valid and reliable for all properties, and should therefore be given equal weight. This is certainly not the case. Even though, whenever possible, all three approaches should be applied to the subject property, certain approaches are more valid for certain kinds of property. Therefore, the results of the three approaches are **weighted** according to the **appraiser's judgment**.

-- **Prepare the appraisal report.** The report contains the appraiser's opinion of value and the factual basis for that opinion. Appraisal reports can range from fairly simple **form reports** to lengthy complicated **narrative reports**, depending on the type of property being appraised and the needs and desires of the client.

-- The **Uniform Residential Appraisal Report (URAR)** form is required by many governmental agencies (Freddie Mac Form 70, Fannie Mae Form 1004).

## Market Approach

Market approach, market data approach, comparable sales approach, direct sales comparison approach. This approach uses **comparable property** sales as data to arrive at a market value for the subject property.

It is based on the **principle of substitution**: the value of property will not exceed the cost of acquiring a similar substitute.

The market data approach is considered the most reliable of the three approaches when appraising residential property. It is the approach used, whether formally or informally, when arriving at the listing price for a residential property. In order for it to be most effective, however, there must be a fairly active market available. And remember, "market price" is not "asking price".

The market approach is not effective for special use properties such as churches or train stations. But even where there is an active market of fairly comparable properties, no two properties are identical. Therefore, appraisers must go through three basic steps in order to effect a meaningful comparison between the subject property and the comparables.

### ***Step One: Locate Comparables***

All comparables must be similar in size, shape, design and location, and they must have sold fairly recently in an "arms-length transaction". An arms-length transaction is one in which a willing buyer and a willing seller deal from equal bargaining positions in a formal manner without trusting solely to the other's fairness and integrity.

### ***Step Two: Adjustment Process***

The adjustment process, or comparison process, is accomplished by taking three to five comparables and adjusting the sales price of each comparable to allow for differences between it and the subject property.

Four categories of adjustment:

- **Market Conditions** - adjustments must be made if there have been significant changes since the sale of the comparable (such as economic changes, zoning changes, availability of financing, etc.).
- **Location** - one of the most important considerations. An appraiser might need to make location adjustments between similar properties that are located in different neighborhoods; or even between similar properties in different locations within the same neighborhood; an interior lot in a subdivision would probably be more valuable than a lot on the edge, situated near a busy highway.
- **Physical Characteristics** - differences in lot size, age, number of square feet, construction quality, landscaping, pool, garage, number of bathrooms, etc.
- **Financing** - differences in the terms and conditions of sale, with respect to financing, must be compared and adjusted. An adjustment would need to be made between two similar houses if one offered owner-financing and the other did not. Adjustment would need to be made between two comparables if one had a low-rate assumable first, and the other did not.

### ***Step Three: Value Conclusion***

The value of the subject property is arrived at by reconciling the adjusted sales price of each comparable.

Again, reconciliation is a **judgment process** based on the appraiser's knowledge and experience.

## **Cost Approach**

The cost approach (or cost depreciation approach) is a method of appraising real property based on the land value, plus reproduction cost of the improvements,

minus depreciation. The cost approach is also based on the principle of substitution: a buyer will pay no more for a property than the cost of acquiring an equally desirable property, taking into account time costs and delays in acquiring the substitute property. The cost approach is heavily relied upon when appraising non-income producing, special purpose properties such as churches, schools, and civic centers. There are four basic steps involved.

### ***Step One: Estimate Land Value***

Since land is not "built" there is no reproduction cost.

Thus, the appraiser must use the market approach to estimate land value. The estimate is done as if the land were vacant (whether it is or not), and available to be put to its highest/best use.

### ***Step Two: Estimate Construction Cost***

**Reproduction cost** is the cost of reproducing the improvements using the same or similar materials at today's prices.

**Replacement cost** is the cost of constructing a new building, at today's prices, that has the **same functional utility** but is not necessarily exactly the same as to size, shape, design, or materials. Replacement cost is used frequently in appraising older structures because it allows for the replacement of out-dated features and takes advantage of current construction materials. Example: A house with expensive but out-dated steel kitchen cabinets, would be better off with less expensive but more popular wooden ones.

Three methods to estimate reproduction or replacement costs:

- **Square foot method** - the per square foot cost of building a comparable is multiplied by the number of square feet in the subject building (occasionally cubic feet would be used, as with a storage warehouse).
- **Unit-in-place method** - the total construction cost of the subject building is estimated by adding up the cost of the building's component parts (plumbing, labor, electrical, builder's built-in profit, etc.).
- **Quantity survey method** - the construction cost is estimated by pricing all raw materials separately (lumber, bricks, plaster) and estimating installation costs. It must be very detailed and is time consuming. Used primarily on properties which must be historically restored.

### ***Step Three: Estimate Accrued Depreciation***

Most buildings are not new, and while land does not depreciate, buildings usually lose value as they age. Depreciation is the loss of value for any reason (age, use, deterioration, obsolescence, etc.). Accrued depreciation means the **total loss of value** during the

life of the building. Remember: only improvements depreciate, land does not depreciate.

**Note:** Depreciation for appraisal purposes is different from depreciation for tax purposes (see Chapter 14).

For the purpose of appraisal, depreciation is divided into three categories **according to its cause**: physical deterioration, functional obsolescence, and external (economic) obsolescence. Physical deterioration and functional obsolescence may be of the "curable" or "incurable" variety. External obsolescence is incurable only.

**Physical deterioration.** Physical deterioration is indicated by settled foundations, cracking walls, leaking roof, peeling paint, or any loss of physical soundness, which would include termite damage. Such deterioration is judged to be **curable** if repairs would result in an increased value which would be equal to or exceed the cost of repairs. Physical deterioration would be judged **incurable** if overall value would not increase sufficiently to cover the cost of repairs. The test here is not whether a physically deteriorated building "can" be repaired, but rather, whether or not such repair makes sense economically. For instance, roof replacement might be judged curable physical deterioration in one building (principle of increasing return), but incurable in another (principle of decreasing return), depending on the age and overall condition of each building.

**Functional obsolescence.** Functional obsolescence is the loss of value a building suffers because of out-dated design or materials. Such buildings no longer meet the needs and demands of users (consumers). This not only happens in older buildings, but can, on occasion, be true of a brand new building which has "missed the market" due to poor design or market planning. Such obsolescence is **curable** if the deficiency is economical to correct, and **incurable** if it is not economical to correct. The test is whether or not correction of the deficiency will result in sufficient value increase to cover the cost of that correction:

- Too few electrical outlets - usually curable
- No central air or heat - usually curable
- Outmoded bathroom fixtures - usually curable
- Inadequate number of bathrooms - usually incurable
- 2-story apartment in retirement community - usually incurable
- Poorly designed floor plan - usually incurable.

**External obsolescence.** External obsolescence (economic obsolescence) is caused by factors not on the property itself, so that it is considered **incurable**. It is caused by changes in the surrounding environment which make the subject property less attractive to users, thus reducing its market value. Examples: A change in zoning that allows an undesirable industry to locate near a residential neighborhood; a deteriorating neighborhood which affects the value of all houses in

the neighborhood, even one which is well maintained itself; certain homes may suffer a loss in value if a neighborhood finds itself no longer served by public transportation because of budget cuts; or a gas station business may suffer when a new bypass is built, taking most of the traffic with it.

### ***Step Four: Total Property Value Computation***

Cost (current prices) - Accrued depreciation = Total building value

Total building value + Land value (site value) = Total property value

### **Income Approach**

The income approach (income capitalization approach) to estimating value is based on the theory that the market value of a piece of property is equal to the present worth of whatever future income it can produce over its remaining economic life. This approach assumes that the income derived from a property will control the value of that property. The income capitalization approach is used for valuation of income-producing properties such as apartment buildings, office buildings, shopping centers, industrial parks, and the like. There are five basic steps to determine value using the income capitalization approach. All steps are calculated on an **annual basis**.

### ***Step One: Estimate Annual Gross Income***

When we talk of annual gross income we mean the "potential" annual gross, that is the income that "could be" produced if all units were rented at full market value. This would include all income from all sources, such as sales, rental income, concessions, garage rentals, laundry operations, and vending machines. In order to determine potential gross rental income an appraiser might use contract rent, market rent, or a combination of both.

**Contract rent** - the rent called for in a lease contract.

The appraiser would use this if the lease was long-term and the tenant was a good quality tenant.

**Market rent** - the most probable rent the property could demand in the open market (determined by considering comparables using the market data approach). This would be used by an appraiser when lease contracts are non-existent or not a controlling factor.

### ***Step Two: Estimate Effective Gross Income (EGI)***

The effective gross income is the total potential gross income minus the predicted vacancy and collection loss.

This "predicted" loss is arrived at by analyzing the past record of the subject property and of comparable properties in the market.

### **Step Three: Estimate Net Operating Income (NOI)**

Net operating income is arrived at by taking the effective gross income (EGI) and subtracting from it all fixed and variable operating costs. Operating costs are such things as: real estate taxes, insurance, utilities, management fees, janitorial, garbage removal, yard maintenance.

**Not included** in operating expenses are: financing costs (mortgage interest payments), costs of capital improvements, corporate income tax, depreciation and any other business expenses not directly involved in the operation of the property itself.

The formula for determining net operating income:

Gross income - Vacancy & collection losses = Effective gross income (EGI)

EGI - Operating expenses = Net operating income (NOI)

### **Step Four: Select a Capitalization Rate**

This is the most difficult step in this approach. An appraiser's experience and judgment are critical in selecting an appropriate cap rate for the subject property. Most of you will never be licensed appraisers. For the purposes of this course you will need only a very general understanding of the concepts involved. When reading and reviewing the following explanation of the selection and application of a cap rate please do not get bogged down in details, rather come away with a general understanding of the terms involved.

When using the income approach, an appraiser must determine the "percentage rate of return" that investors are currently receiving on the type of investment property which is being appraised. This rate of return is called the **capitalization rate** (cap rate). It is determined by comparing the relationship of net operating income to the sales price (SP) of similar properties that have sold in the current market.

Comp #1: \$15,600 (NOI) - \$195,000 (Value, SP) = .08 = 8% (cap rate)

Comp #2: \$17,250 (NOI) - \$230,000 (Value, SP) = .075 = 7.5% (cap rate)

Comp #3: \$16,000 (NOI) - \$200,000 (Value, SP) = .08 = 8% (cap rate)

Using these comparables an appraiser might determine an 8% cap rate after making all adjustments and weighing the differences between the subject property and the comparables.

### **Step Five: Apply Capitalization Rate**

Once an appropriate cap rate for the market and type of property involved has been selected, the appraiser then applies this cap rate to the subject property to arrive at the estimated value.

In step four we are given the NOI and the value or selling price, in order to determine the cap rate of the comparable.

$$I (\text{NOI}) - V (\text{Value, SP}) = R (\text{cap rate})$$

In step five we are given the NOI of the subject property and the selected cap rate in order to determine the estimate of market value.

$$I (\text{NOI}) - R (\text{cap rate}) = V (\text{estimated market value})$$

Example: If the subject property is found to have a NOI of \$18,000, and the selected cap rate is 8%, then the estimated market value for this property would be \$225,000.

**Note:** For additional explanation of the math procedures involved and an explanation of the "IRV formula", refer to "capitalization" in the Math Appendix. The IRV formula is a simple process which can be used to determine **value**, **income**, or **rate**.

### **Gross Rent Multiplier (GRM)**

A gross rent multiplier is a crude method for obtaining a quick estimate of property value. A "multiplier" is arrived at by using comparable sales. In step one, the selling price of a comparable piece of property is divided by actual or estimated monthly rents in order to determine an acceptable average or gross rent "multiplier". In step two, the estimated monthly rent of the subject property is multiplied by the multiplier (GRM), thereby arriving at a rough estimate of the subject property's market value.

Formula: Selling price (value) = GRM x GR  
= Estimated Market Value  
Gross rents (GR)

Example 1: Building A has a sales price of \$112,500 and monthly rents of \$1,250. What would be the value of a building having monthly rents of \$1,158?

Step one:  $\frac{\$112,500}{1,250} = 90$

Step two:  $90 \times \$1,158 = \$104,220$  \$  
1,250

Example 2: Building A has a sales price of \$112,500 and annual gross rents of \$15,000. What would be the value of a building having monthly rents of \$1,158?

Step one:  $15,000 - 12 \text{ months} = \$1,250 \text{ per month}$

Step two:  $\frac{\$112,500}{1,250} = 90$

Step three:  $90 \times \$1,158 = \$104,220$  (round up if necessary)

The GRM method makes no allowance for vacancies, uncollectible rents, property taxes, management fees, private tax ramifications for different investors, and similar complicating circumstances.

## Section Review Questions

Answer all questions on the attached **Answer Form** found in the back of this book.

The **Answer Form** is the only page to return to CAPE.

21. Who sets the listing price on parcel of real estate?
  - A. the broker
  - B. the owner
  - C. the appraiser
  - D. the listing agent
22. The use that will produce the greatest net return is known as:
  - A. the current value.
  - B. the market value.
  - C. the zoned use.
  - D. the highest and best use.
23. Parcel A and parcel B in the ABC subdivision are each worth \$20,000. But if sold together they are worth \$60,000. This is referred to as:
  - A. progression.
  - B. plottage.
  - C. anticipation.
  - D. increasing returns.
24. The most probable rent that a property can demand is referred to as the
  - A. contract rent.
  - B. net rent.
  - C. market rent.
  - D. gross rent.
25. A crude method for obtaining a quick estimate of property value is the
  - A. GRM
  - B. RMG
  - C. IVR
  - D. cap rate

## General Review Questions

Answer all questions on the attached **Answer Form** found in the back of this book.

The **Answer Form** is the only page to return to CAPE.

26. No gain or loss is recognized when real estate held for investment or income-producing real estate held for investment or income-producing real estate is exchanged for like-kind property.
  - A. True
  - B. False
27. The primary source of consumer protection in consumer credit transactions is the federal Real Estate Settlement Procedure Act (RESPA).
  - A. True
  - B. False
28. A sales listing gives three of the four bundle of legal rights of real estate: possession, use, and exclusion.
  - A. True
  - B. False
29. Unlike a trial, mediation can be repeated if the parties to the dispute wish.
  - A. True
  - B. False
30. For a particular piece of real estate to have value it must have four essential elements: demand, utility, scarcity, and transferability.
  - A. True
  - B. False

**Student Notes**