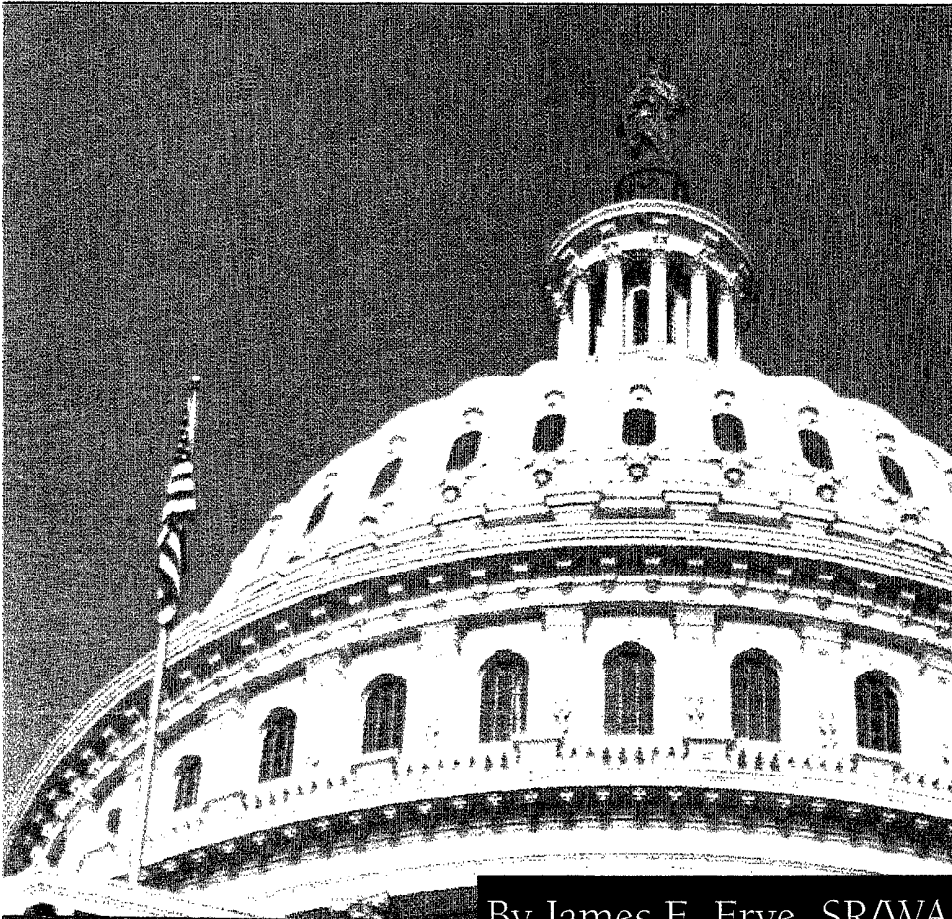


# Partial Acquisitions

## Comparing Federal Rule and State Rule



By James E. Frye, SR/WA

Professional appraisers specializing in right-of-way valuation are required to be proficient in a host of unique regulations and methodologies. One area that has been a source of controversy for some period of time is the difference between the valuation techniques identified respectively as the "federal rule," and the "state rule" for partial acquisitions.

These rules do have some similar characteristics. For instance, with either method an appraiser must use the "rule of the larger parcel" to determine the value of the parcel before the acquisition, known as the "whole value," or the "value before the take." Thus, the entire parcel involved before the take has to be appraised. It is a common appraisal that all appraisers perform. Another area of similarity between the federal rule and the state rule is the valuation of the residue. The residue is the remaining land and improvements, if any, after the acquisition.

### **The Federal Rule**

Following the initial appraisal, what remains to be completed when using the federal rule is to subtract the residue value from the whole value. The resulting figure is the "value of the take." The methodology for the federal rule is straightforward, concise, easy to understand and explain. It uses basic appraisal principals and limits subjective judgement on the part of the appraiser, relying exclusively on market data. Also, it completely eliminates double payment of damages. Note the example on the following page of a typical highway type partial acquisition.

### **The State Rule**

The state rule tends to be somewhat more complex than the federal rule. This is primarily due to the valuation of easements in partial acquisition. One of the basic principles of condemnation law is that an owner must be compensated for property taken and damages attributed thereto. It is a statement that has been subjected to myriad interpretations. However, most jurisdictions have recognized that an easement is a taking of ownership rights, and the owner must be

compensated. Therefore, the state rule has evolved to meet this requirement.

As might be expected, various jurisdictions view ownership rights lost to an easement differently. In some areas, the amount of rights lost is a subjective opinion to be decided on a case-by-case basis. In other areas, the state has set standards or laws to determine the amount. Whatever the scenario, the determination of the amount of rights lost (generally stated as a percentage of fee ownership) is beyond the scope of an appraiser's expertise, and should be decided by legal counsel and existing law, or determined in the courts.

Additional legislative clarification regarding valuation is found in the U.S. Tax Code. The code is clear on the treatment of fee acquisition and damages. The amount received for a property obtained in a full fee acquisition (full purchase of all rights) does not reduce the basis of the remainder or residue. It is therefore subject to taxation as capital gains when the amount received exceeds the amount the owner invested, otherwise known as the tax basis.

The proceeds from a fee purchase can be reinvested by purchasing a "similar type" property within two years of the acquisition with none of the proceeds from the sale being subject to tax. Conversely, all damages are applied against the basis of the residue (original cost plus capital improvements) and become taxable only when the amount of damages awarded exceed the basis of the residue. The tax code treats an easement as both an acquisition and as a damage.

Permanent easements, where a substantial amount of the ownership use is adversely affected, can be treated as a fee acquisition with the monies received being shielded from taxation by reinvestment within the two-year period. Examples of such easements

<b>Example 1</b>	
<b>Whole Tract</b>	
5 acres, zoned commercial, no easements	
Whole value of \$5 per sqft:	\$1,000,000
<b>Take</b>	
Total fee acquisition, 1 acre	
Drainage easement	
Residue A: 25 acre (10,890 sqft)	
Residue B: 25 acre (10,890 sqft)	
Temporary construction easement	
Residue A: 25 acre (10,890 sqft)	
Residue B: 25 acre (10,890 sqft)	
No market data available for easements	
<b>Residues</b>	
Residue A = 3 acres @ \$5 per sqft =	\$653,400
Residue B = 1 acre @ \$4 per sqft =	<u>\$174,240</u>
Total residue value	\$827,640
Residue B value loss due to size	
Value of take =	\$261,360

include permanent drainage or slope easements. Other easements, such as temporary construction easements are subject to the same tax treatment as damages, in which the amount paid exceeds the basis of the residue and cannot be shielded from capital gains taxation. Therefore, not only does the

tax code require the valuation of easements, but also requires that the different types of easements be identified and valued individually.

### Avoiding Double Damages

So, how does an appraiser develop a valuation of easements using the state rule,

<b>Example 2</b>	
<b>Whole Tract</b>	
5 acres @ \$5 per sqft	\$1,000,000
<b>Take</b>	
Fee acquisition, 1 acre @ \$5 per sqft	\$217,800
Drainage easement	
Residue A: 25 acre (10,890 sqft) @ \$5 x 50%	\$27,225
Residue B: 25 acre (10,890 sqft) @ \$5 x 50%	\$27,225
Temporary construction easement	
Residue A: 25 acre (10,890 sqft) @ \$5 x 15%	\$8,168
Residue B: 25 acre (10,890 sqft) @ \$5 x 15%	<u>\$8,168</u>
Value of the take before damages	\$288,586
Value of the remainder before the take	\$800,414

## PARTIAL ACQUISITION

while avoiding "double damages?" Two avenues are available, 1) market data, and 2) arbitrary computation based on a percentage of fee value. Experience indicates that market data meeting the definition of "market value" is almost nonexistent.

Generally, most easements are acquired by an agency that retains the right of "eminent domain." The element of duress on the grantor's behalf associated with potential condemnation prevents the transaction from meeting the definition of market value. Easements between private landowners for the most part do not meet the definition of market value because of the lack of clearly stated compensation (generally a non-monetary trade of rights) or an element of duress on the grantee's behalf who must acquire an easement to maximize monetary use.

If subdivision requires a 60-foot wide easement to a major road, the developer might pay 20 times the normal land value for the easement. The appraiser must then resort to an arbitrary computation based on a percentage of fee rights lost that are dictated by an alternative source.

Referring to the highway acquisition example noted above, we could hypothetically assume 50 percent loss rights lost to the drainage easement and a 15 percent loss for the temporary construction easement. Computation of the value of the easements is elementary with the per-square-foot value of the whole (\$5) being multiplied by the percentage of the easements and then, by the size. That value is then added to the value of the fee take to arrive at a total acquisition value before damages. These computations are illustrated in Example 2, on page 9.

The next computation under the state rule is to determine the amount of damages. Again, the state rule and the federal rule are very similar, because the amount paid for the easements is added back to the residues. In this case, damages are limited to the detached

Original value before acquisition (Residue B) 43,000 sqft @ \$5 per sqft	\$217,800
Less "after take" appraised value (Residue B) 43,000 sqft @ \$4 per sqft	\$174,240
Damages before easements	\$43,560
Less "after take" easement value	
Permanent drainage easement 10,890 sqft @ \$4 x 50%	(\$21,780)
Temporary construction easement 10,890 sqft @ \$4 x 15%	(\$6,534)
Net damages	\$15,246

residue due to severance, with an "after value" of \$4 per square foot. The appraiser has several different methods to compute the associated damages, with all arriving at the same amount. The following method in Example 3, above is one of the most logical and easiest to describe in the courtroom environments.

The amount of the easements is computed on an "after" basis to prevent understating the amount of damages attributable to the acquisition. Some may argue that damages have been awarded in the payment for the easements. However, that payment is for ownership rights taken and not for ensuing damages caused by the acquisition. The subtraction of the

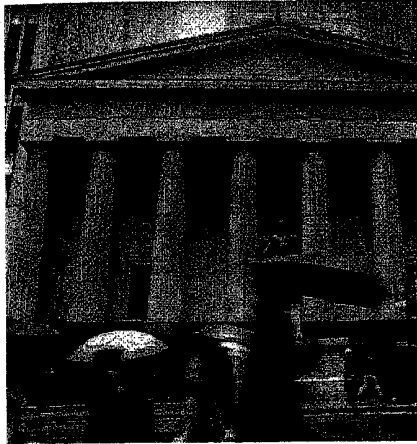
"damaged easement" value prevents the double payment of damages by the acquiring agency and ensures that the fee holder is properly compensated for losses, as required by law.

The appraiser has one final step in computing the value of the acquisition—the addition of the damages and take. This simple step is shown in Example 4, below.

The federal rule has the effect of penalizing the fee holder by not recognizing that partial rights have value. That lack of recognition in the illustrative case equates to a \$42,474 value of the take difference between the computed federal rule value and the state rule value.

The Uniform Standards of Profess-

Value of the acquisition in fee	\$217,800
Drainage easement	
Residue A	\$27,225
Residue B	\$27,225
Temporary construction easement	
Residue A	\$8,168
Residue B	\$8,168
Severance damages (Residue B)	\$15,246
Total value of the take	\$303,832



ional Appraisal Practice (USPAP, 1996-97 p. 19), Standard Rule 2-1 states,

"Each written or oral real property appraisal report must:

- a) Clearly and accurately set forth the appraisal in a manner that will not be misleading;
- b) Contain sufficient information to enable the person(s) who are expected to receive or rely on the report to understand it properly; ... "

When properly computed, the state rule and the federal rule rely on the same amount of subjectivity from the appraiser. The valuation of the original parcel and the value of the residue. The amount of impacted ownership rights attributable to the easements should be dictated to the appraiser prior to the assignment, eliminating any subjective judgement of the appraiser. Should additional damages be attributable to an easement that is greater than the value of the ownership rights, the additional damage will be reflected in the "after" value of the residue.

The state rule may reflect a greater "take value" than the federal rule, because it recognizes the value of specific ownership rights, and clearly defines what those ownership rights are. Does the market reflect those lost rights? Not always, but the state rule, when properly applied, eliminates the subjective opinion of the appraiser as to where and when the market does recognize the loss of ownership rights.

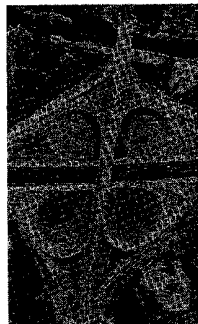
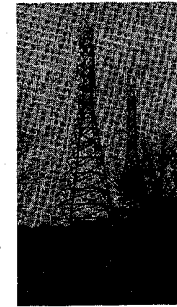
The state rule provides the client with more clearly defined applications

of funds, recognizes that individual ownership rights have value, facilitates tax code requirements and adheres to USPAP. Given that, it is imperative that the right-of-way appraiser be prepared to such an assignment using the state rule. At a minimum, the appraiser should be knowledgeable in the application of the state rule and be able to recognize the computational and potential numeric differences between the federal rule and the state rule. ■

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