

# Partial Takings, Missing Items and Double Compensation

Some of the knottier problems in appraising arise in estimating compensation for partial takings under the state rule. This is the rule that total compensation is the value of the part taken plus the net damages to the remainder, if any. In most states, total compensation for a partial taking is calculated under some form of the state rule<sup>1</sup>. The problems arise as follows.

Suppose an improved property to have a freestanding sign in the part to be taken for a road-widening project. The appraiser estimates the value of the part taken to be the value of the land taken plus the contributory value of the sign. All of the comparable improved sales have similar signs. The comparable sales are adjusted downward because the subject remainder has no sign.

When the appraiser turns the completed report over to the client, the reviewer sees that the value estimated for the part taken includes the value which the sign contributes to the property. The reviewer also notes that the comparable improved sales are adjusted downward because they have signs, while the remainder does not, and objects to the report on the grounds that the landowner would be compensated twice for the sign. The appraiser and the reviewer confer. The appraiser argues that the comparable sales have signs but the remainder does not, while the reviewer responds that the landowner has already been compensated for the sign in the value allocated to the part taken. In addition, the landowner has an old, outdated sign, but the appraiser has deducted the cost of a new sign from the prices of his comparable sales.

These disputes occur over and over again. Even leaving depreciation aside, it is easy to deduct the cost of a sign on the remainder in a way that results in too much compensation. This error is especially easy to fall into when using the cost to cure methodology. A second problem arises when the highest and best use of the remainder includes installation of a new sign, but a depreciated sign was on the part taken. It is easy to over-compensate when deducting the cost of a new sign to be installed on the remainder.

In this article, two series of examples are offered to clarify the two issues. In Examples 1.0 through 1.2, it is assumed that neither the subject nor the comparable properties suffer from depreciation. In Examples 2.0 through 2.2, both are assumed to be subject to depreciation. Since the three approaches to the value of the whole property and the value estimate for the part taken are identical in all examples belonging to the first series, they are presented only in the first example. In other words, Examples 1.1 and 1.2 show only the valuation of the remainder and the compensation estimate, and the reader must refer back to Example 1.0 to see the analyses of the whole property and part taken. Examples 2.0 through 2.2 are developed similarly.

Accompanying each example is a short list of the assumptions that differentiate it from some or all of the others. The addendum contains a list of the assumptions underlying all of the examples.

*By William S. Gordon*



**EXAMPLE 1.0**

	<u>COST APPROACH</u>		<u>MARKET DATA APPROACH</u>		<u>INCOME APPROACH</u>
<b>WHOLE PROPERTY</b>					
Sign Cost	\$ 25,000				
Bldg. Cost	375,000	Sale Price	\$500,000	Gross Rent	\$100,000
Land Value	100,000	Adjustment	-0-	GIM	X 5.0
Indicated Value	\$500,000		\$500,000		\$500,000
<b>PART TAKEN</b>					
Sign Cost	\$ 25,000				
Land Value	5,000				
Indicated Value	\$ 30,000				
<b>REMAINDER AFTER TAKING</b>					
				Gross Rent	\$100,000
				GIM	X 5.0
					\$500,000
Bldg. Cost	\$375,000	Sale Price	\$500,000	Land/Bldg.	<5,000>
Land Value	95,000	Land/Bldg.	<5,000>	Sign	<25,000>
Indicated Value	\$470,000	Sign	<25,000>		\$470,000
			\$470,000		
<b>COMPENSATION ESTIMATE</b>					
Whole Property	\$500,000				
Part Taken		\$ 30,000			
Remainder Before	\$470,000				
Remainder After	\$470,000				
Damage/Enhancement		\$ -0-			
Total Compensation		\$ 30,000			

**Assumptions for Example 1.0:** There is no depreciation. The cost of a sign is deducted from the market data and income approaches because the comparable sale and rental property has a sign, and a purchaser would make this deduction. The cost of a sign installed on the remainder after the taking does not exceed the cost of a sign as part of the original construction.

**Conclusion:** If the cost of the sign to be installed on the remainder is deducted only from the market data and income approaches, the result is the correct amount of compensation.

**Comment:** This example shows how the state rule interacts with proper appraisal procedure. It is generally accepted that there is no functional obsolescence due to a missing item if the current cost of the addition is no greater than the cost as part of the original construction<sup>2</sup>. The cost of the addition is no greater in this example, so no deduction from the cost approach is required.

### Assumptions Covering All Examples

1. The one available comparable property is adjacent and identical to the whole property. It was sold and leased recently. The price and rent are as shown in the examples. Analysis of these transactions provides the gross income multiplier (GIM).
2. A cost study supports the reproduction costs new shown in the examples.
3. The same sale, rent and GIM are used for the whole property and the remainder.
4. Land value per square foot is the same in all examples and total land values are as shown therein.
5. The quality and quantity of data are equal for all three approaches, and the three approaches are equally applicable.
6. The part taken has little depth and is very small in relation to the depth and area of the whole site. The land taken is not an economic unit, and its value is its pro-rata portion of the whole site's value.
7. There are no adverse effects due to increased proximity to the roadway, changes in vehicular circulation on the site and so forth.
8. There are no adverse effects due to circuitry of travel, diversion of traffic, construction, loss of visibility and so forth.
9. A sign is the only improvement on the part taken.
10. A building is the only improvement on the remainder.
11. Total compensation is the sum of the value of the part taken plus the amount by which the value of the remainder before the taking exceeds that of the remainder after the taking, if any.
12. The highest and best use of the remainder after the taking includes installation of a sign.
13. A 5.0% adjustment for land to building ratio is required in the market data and income approaches for the remainder.
14. The building and sign represent the highest and best use of the land before and after the taking. In other words, the market does not recognize any functional obsolescence in the building after the taking due to the slightly lower land to building ratio.
15. No adjustments are required other than those discussed and shown in the examples.



**EXAMPLE 1.1**

COST APPROACH		MARKET DATA APPROACH		INCOME APPROACH	
REMAINDER AFTER TAKING					
Bldg. Cost	\$375,000	Sale Price	\$500,000	Gross Rent	\$100,000
Land Value	95,000	Land/Bldg.	<5,000>	GIM	X 5.0
Indicated Value	\$470,000		\$495,000		\$500,000
				Land/Bldg.	<5,000>
					\$495,000
VALUE CONCLUSION					
Reconciled Value	\$486,667				
"Cost to Cure"	<25,000>				
Remainder Value	\$461,667				
COMPENSATION ESTIMATE					
Whole Property	\$500,000				
Part Taken		\$ 30,000			
Remainder Before	\$470,000				
Remainder After	\$461,667				
Damage/Enhancement		\$ 8,333			
Total Compensation		\$ 38,333			

**Assumptions for Example 1.1:** There is no depreciation. The market data and income approaches are applied as if a sign existed on the remainder, the three approaches are reconciled by averaging and the cost of a sign is deducted from the reconciled value. The cost of a sign installed on the remainder after the taking does not exceed the cost of a sign as part of the original construction.

**Conclusion:** If the remainder is appraised "as-is" in the cost approach and as if a sign existed on it in the market data and income approaches, deduction of the cost of a sign from the reconciled value by the three approaches will result in too much compensation.

**Comment:** This example introduces the "cost to cure." In connection with the cost approach, it means the cost of restoring an item of deferred maintenance to new or almost new condition<sup>2</sup>. In connection with eminent domain work, it means the cost to remedy damage due to a taking<sup>3</sup>.

Frequently, the estimate of the cost to cure is prepared by a specialist, for example, an architect or engineer. Several types of cost may be covered by the estimate, such as the cost to add missing items on the remainder (the cost of the item plus installation cost plus all indirect costs), the cost to modify or relocate or enlarge items on the remainder, the cost to add items on the remainder which did not exist on the part taken and so forth. The cost of the replacement for an item that was taken should not be called the "cost to cure." Only if the cost of the addition to the remainder exceeds the cost as part of the original construction is there a cost to cure, and then it is only the excess cost (see comment on Example 1.0).

This example shows the undesirable result of reconciling the three approaches before the market data and income approaches are completed. After the reconciliation, the appraiser attempts to complete the appraisal by making a lump-sum deduction of a specialist's estimate from the reconciled value. Unfortunately, the estimate includes the cost of a replacement for an item taken. The cost approach already indicates the correct value for the remainder, but the other approaches do not. If the market data and income approaches were performed correctly, as in Example 1.0, there would be no apparent need to make a further deduction, and reconciliation of the three approaches by averaging would give the correct compensation.

Because the cost approach already indicates the correct value for the remainder, and the three approaches are averaged to arrive at the reconciled value of the remainder before the sign cost is deducted, the compensation is too great by one-third of the cost of the sign ( $\$25,000 \times 0.3333 = \$8,333$ )<sup>5</sup>.

**EXAMPLE 1.2**

<b>COST APPROACH</b>		<b>MARKET DATA APPROACH</b>		<b>INCOME APPROACH</b>	
<b><u>REMAINDER AFTER TAKING</u></b>					
Excess Sign Cost	\$ <5,000>	Sale Price	\$500,000	Gross Rent	\$100,000
Bldg. Cost	375,000	Land/Bldg.	<5,000>	GIM	X 5.0
Land Value	<u>95,000</u>	Sign Cost	<u>&lt;30,000&gt;</u>	Land/Bldg.	<5,000>
Indicated Value	\$465,000		\$465,000	Sign Cost	<u>&lt;30,000&gt;</u>
					\$465,000
<b><u>COMPENSATION ESTIMATE</u></b>					
Whole Property	\$500,000				
Part Taken		\$ 30,000			
Remainder Before	\$470,000				
Remainder After	\$465,000				
Damage/Enhancement		\$ 5,000			
Total Compensation		\$ 35,000			

**Assumptions for Example 1.2:** There is no depreciation. Due to the shape and location of the building on the remainder, it costs \$5,000 more to install the sign on the remainder than it would have cost as part of original construction. The cost of a sign is deducted from the market data and income approaches because the comparable sale and rental property has a sign, and a purchaser would make this deduction.

**Conclusion:** If the total cost of the addition to the remainder exceeds the cost as part of original construction, then subtracting the excess cost from the cost approach and the total cost from the market data and income approaches gives the correct compensation.

**Comment:** Compare this example to Example 1.0 to see that double compensation does not result when you deduct the cost of a sign missing from the remainder from the market data and income approaches.

<b>EXAMPLE 2.0</b>					
	<u><b>COST APPROACH</b></u>		<u><b>MARKET DATA APPROACH</b></u>		<u><b>INCOME APPROACH</b></u>
<b>WHOLE PROPERTY</b>					
Sign Value					
\$25,000 - \$6,250 =	\$ 18,750				
Bldg. Value					
\$375,000 - 93,750 =	281,250	Sale Price	\$400,000	Gross Rent	\$ 80,000
Land Value	<u>100,000</u>	Adjustment	-0-	GIM	<u>X 5.0</u>
Indicated Value	\$400,000		\$400,000		\$400,000
<b>PART TAKEN</b>					
Sign Value	\$ 18,750				
Land Value	<u>5,000</u>				
Indicated Value	\$ 23,750				
<b>REMAINDER AFTER TAKING</b>					
				Gross Rent	\$ 80,000
				GIM	<u>X 5.0</u>
					\$400,000
Bldg. Value	\$281,250	Sale Price	\$400,000	Land/Bldg.	<5,000>
Land Value	<u>95,000</u>	Sign	<25,000>	Sign	<u>&lt;25,000&gt;</u>
Indicated Value	\$376,250		\$370,000		\$370,000
<b>VALUE CONCLUSION</b>					
Reconciled Value	\$372,083				
<b>COMPENSATION ESTIMATE</b>					
Whole Property	\$400,000				
Part Taken		\$ 23,750			
Remainder Before	\$376,250				
Remainder After	\$372,083				
Damage/Enhancement		\$ 4,167			
Total Compensation		\$ 27,917			

**Assumptions for Example 2.0:** All improvements are 25% depreciated. The cost of a sign installed on the remainder after the taking does not exceed the cost of a sign as part of the original construction. The cost of a sign is deducted from the market data and income approaches because the comparable sale and rental property has a sign, and the remainder does not.

**Conclusion:** If depreciation is introduced into Example 1.0, and the three approaches are reconciled by averaging, deduction of the cost of the sign in the market data and income approaches results in too much compensation.

**Comment:** This example is exactly like Example 1.0, except that the improvements are assumed to be partly depreciated. It may be surprising that the depreciation does not somehow come out in the wash — but it doesn't. In this example, the market data and income approaches indicate values for the remainder, which are too low because they don't consider depreciation of the sign on the comparable property. Since the three approaches are reconciled by averaging, the compensation is too great by two-thirds the amount of depreciation which has accrued to the sign ( $\$6,250 \times 0.6667 = \$4,167$ ). Example 2.1 shows one way of dealing with this issue.



**EXAMPLE 2.1**

	<u>COST APPROACH</u>		<u>MARKET DATA APPROACH</u>		<u>INCOME APPROACH</u>
<b>REMAINDER AFTER TAKING</b>					
Bldg. Value	\$281,250	Sale Price	\$400,000	Gross Rent	\$ 80,000
Land Value	95,000	Land/Bldg.	<5,000>	GIM	X 5.0
Indicated Value	\$376,250	Sign	<18,750>		\$400,000
			\$376,250	Land/Bldg.	<5,000>
				Sign	<18,750>
					\$376,250
<b>COMPENSATION ESTIMATE</b>					
Whole Property	\$400,000				
Part Taken		\$ 23,750			
Remainder Before	\$376,250				
Remainder After	\$376,250				
Damage/Enhancement		\$ -0-			
Total Compensation		\$ 23,750			

**Assumptions for Example 2.1:** All improvements are 25% depreciated. The contributory value of a sign is deducted from the market data and income approaches because the comparable sale and rental property has a depreciated sign, and the typical purchaser would make such a deduction. The cost of a sign installed on the remainder after the taking does not exceed the cost of a sign as part of the original construction.

**Conclusion:** If depreciation is introduced into Example 1.0, deduction of the contributory value of the sign from the market data and income approaches results in the correct amount of compensation.

**Comment:** This example shows one way of resolving the issue raised by Example 2.0. The sign adjustment applied in the market data and income approaches has changed from the reproduction cost new, \$25,000, to the sign's contributory value, \$18,750. This recognizes that the sign on the comparable property is depreciated.

Unfortunately, this procedure does not make clear how the \$25,000 cost installed of a new sign, which the landowner must bear, affects the calculations. Example 2.2 shows how the market data and income approaches should be set up in order to arrive at the proper compensation after making a \$25,000 deduction for the cost of a sign on the remainder.

**EXAMPLE 2.2**

	<u>COST APPROACH</u>		<u>MARKET DATA APPROACH</u>		<u>INCOME APPROACH</u>
<b>REMAINDER AFTER TAKING</b>					
Bldg. Value	\$281,250	Sale Price	\$400,000	Gross Rent	\$ 80,000
Land Value	95,000	Sign	6,250	GIM	X 5.0
Indicated Value	\$376,250	Land/Bldg.	<5,000>		\$400,000
			401,250	Sign	6,250
		Sign Cost	<25,000>	Land/Bldg.	<5,000>
			\$376,250		401,250
				Sign Cost	<25,000>
					\$376,250
<b>COMPENSATION ESTIMATE</b>					
Whole Property	\$400,000				
Part Taken		\$ 23,750			
Remainder Before	\$376,250				
Remainder After	\$376,250				
Damage/Enhancement		\$ -0-			
Total Compensation		\$ 23,750			

**Assumptions for Example 2.2:** All improvements are 25% depreciated. An upward adjustment of \$6,250 to the market data and income approaches accounts for the fact that they are applied to the remainder as if it had a new sign. The indicated value for the subject as if it had a new sign is \$401,250. The cost of a new sign is deducted as the final step in the market data and income approaches. The cost of a sign installed on the remainder after the taking does not exceed the cost of a sign as part of the original construction.

**Conclusion:** If depreciation is introduced into Example 1.0, and the market data and income approaches are applied to the remainder as if it had a new sign, then adjustment upward of the latter two approaches for the fact that the sign will be new, followed by deduction of the cost new of the sign, gives the correct amount of compensation.

**Comment:** In the course of presenting an appraisal to a jury, it may be desirable to show how the acknowledged cost of a new sign on the remainder fits into the analysis. The method used in this example would facilitate such a presentation.



## Summary

Examples 1.0 and 1.2 show how over-compensation for an item taken can be avoided while making the required deduction from sales that have that item. A similar deduction is required for the income approach.

Example 1.1 shows a common way of over-compensating for the taking of an item. There, we also saw that only if the cost of the addition to the remainder exceeds the cost as part of the original construction is there a cost to cure, and then it is only the excess cost. The phrase "cost to cure" should not be applied to the cost of an addition to the remainder in any of the examples, except the excess portion of the cost in Example 1.2.

Examples 2.1 and 2.2 show two ways in which correct compensation for a depreciated item taken may be estimated while making the required deduction from sales which have that item. Example 2.0 shows a common way of over-compensating for a depreciated item in the taking. There, incorrect appraisal procedure results in a flawed compensation estimate.

The application of simple examples to seemingly unresolvable appraisal problems is the best hope of laying them to rest. ■

## Notes

1. Lawyers Cooperative Publishing, American Jurisprudence, 2nd ed., vol. 26 (Rochester: Lawyers Cooperative Publishing, 1996), 826.

2. See: John D. O'Flaherty, "An Appraiser's Dilemma: The Cost Approach to Value," *The Real Estate Appraiser* (January-February 1969): 12.

3. Appraisal Institute, *The Dictionary of Real Estate Appraisal*, 3rd ed. (Chicago: Appraisal Institute, 1993), 82.

4. Compare: J. D. Eaton, *Real Estate Valuation in Litigation*, 2nd ed. (Chicago: Appraisal Institute, 1995), 296-299.

5. Averaging is not always an inappropriate method of reconciliation. One of the assumptions in the addendum is that the quantity and quality of data are equal for all three approaches and that the three approaches are equally applicable to the property. Under those circumstances, the three approaches should be given equal weight in the reconciliation, and averaging is the only process that gives them equal weight. Were the market data and income approaches applied correctly in Example 1.1, averaging would give the correct answer, as it does in several of the other examples.

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