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SPOTLIGHT ON THE ECONOMY

The (Other) Coastal Economy: Mobile is the Economic Engine for Coastal Alabama
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The Structure and Potential Economic Effects of Inclusionary Zoning Ordinances
Dustin C. Read, Ph.D., J.D.

Inclusionary zoning ordinances encourage the private sector to develop geographically dispersed affordable housing through a unique combination of mandates and incentives. This article summarizes the findings of existing research to consider the potential advantages and disadvantages of this type of land use regulation. Emphasis is placed on the legal structure of inclusionary zoning ordinances and their ability to stimulate the production of affordable housing in different economic environments. The results are intended to help both policymakers and real estate practitioners assess the merits of this regulatory tool.

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Not in Our Backyard: Plans, Planners, Regulators and the New Redlining
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Many of the conditions now evident in the failing residential market stem from the conviction that personal accomplishment and economic value are deeply embedded in homeownership. This view is reinforced and codified—in many cases disadvantageously—in our lending and regulatory practices and tax structure, which altogether favor homeownership generally, and single family predominantly. This commentary explores the competing interests and viewpoints which have evolved, and offers some ideas to redirect society's thinking and financial resources.

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Mixed-Use Development and Financial Feasibility: Part II – Physical, Phasing, Design and Public Policy Factors
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As mixed-use development grows in popularity, the economic and financial factors that lead to financial feasibility and success need to be known and understood. Some of them were discussed in Part One of this article, which was published in the previous issue of *Real Estate Issues*. This article, Part Two, extends the discussion to physical factors, design features and public policy factors, and their role in the financial success of the mixed-use development.

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This article recommends an initial evaluation of a proposed project to determine the need for an extended and more detailed financial feasibility study. The data required is available at an early stage during the information-gathering phase of market analysis. The conclusion is an important first indicator of the need to invest the time and expense in a more extensive detailed investigation.

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The (Other) Coastal Economy: Mobile is the Economic Engine for Coastal Alabama
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In a new, and hopefully, regular feature which examines the conditions, developments and trends in local and regional economies, this article takes a look at Mobile, Alabama, an economy that is being called the "economic engine" for the coastal part of the state.

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Editor's Note

BY PETER C. BURLEY, CRE

What I Did on My Summer Vacation

I LOVE THIS JOB. As editor of one of the industry's finest professional journals, I get to read some of the most thought-provoking material written by some of the most distinguished thought leaders in the business. Even during this downtime, while I seek gainful employment, I get to remain grounded and connected to the biggest and best ideas, opinions and guiding principles in the industry. For me, it is a richly rewarding experience to participate in the production of the journal, fun to work with the Editorial Board and the staff, and a remarkable learning experience. And, it is my pleasure to pass along the "best of the best" of my summer reading to the readers of *Real Estate Issues*.

It is clear to me that, while the industry battles the demons of economic downturn and financial market upheaval, our work continues. Indeed, this is probably a singular moment for Counselors to be plying their diverse and various trades—research, advisory, consultative, appraisal, legal—in guiding the industry to safer, stronger, better shores. And, every corner of the industry would be well-advised to seek them out, ask for, and employ their advice, their expertise and their wisdom. Counselors make a remarkable difference.

Over the summer months, we have been blessed with a number of pieces, presented herein, that address issues we face daily, that affect our businesses, our communities and the quality of our lives. Questioning and confirming, addressing issues from their unique perspectives within and beyond The Counselors, the authors in this issue provide intelligent discourse and wise counsel for real estate, for policymakers and for the community at large.

We begin this issue with Dustin Read's "The Structure and Potential Economic Effects of Inclusionary Zoning Ordinances." Read offers an excellent review of the policies and practices of inclusionary zoning in balancing a community's need for affordable housing, the desire to promote economic growth, and the burdens placed on the private sector. Covering the strengths and weaknesses of inclusionary zoning practices, Read provides empirical findings that suggest mixed results with respect to supply, pricing and size of housing in some areas. He further suggests that the measure of success in inclusionary zoning requires a balance between the requirements made of the developer and the public rewards achieved.

The current housing market may open the door to some reconsideration of policy and market influences on housing affordability and on forms of housing other than continuously appreciating owner-occupied single-family units. In Owen Beitsch's discussion, "Not in Our Backyard: Plans, Planners, Regulators and the New Redlining," conflicting policy goals between programs designed to buttress home values and programs that are intended to make housing more affordable are addressed. Beitsch contends that federal intervention, in the form of the Neighborhood Stabilization Program, may result in the continuation of practices that actually limit and constrain the effectiveness of affordable housing initiatives. Beitsch says, "…(T)he need for affordable housing is not supported by the realities of regulatory controls, financial practices, lending policy…" or the consumer. He outlines several disconnects between affordable housing policy and the need to preserve local housing values, and presents interesting financial, land use and market policies that discourage the availability of affordable housing in the marketplace.

In the last issue of *Real Estate Issues*, Joe Rabianski, et al., discussed financial and economic considerations of mixed-use development ("Mixed-Use Development and Financial Feasibility: Part I – Economic and Financial Factors"). In this issue, they present "Mixed-Use Development and Financial Feasibility: Part II – Physical, Phasing, Design and Public Policy Factors." Many public officials view mixed use development as an answer to redevelopment issues and as a creative cure for underutilized infill sites. Developers view mixed use as a route to higher returns through higher density development. Since most zoning ordinances are written to allow a single use on a single site, mixed-use developments, "...often require exceptions to zoning regulations and adaptations of existing building codes." The authors suggest that there is high potential for mixed-use development not only to create additional value but to outperform single-use development through synergies of use and the creation of attractive destinations. A variety of obstacles must be overcome, however, in design, in financing, and in management to achieve investor and community objectives.

"A counselor typically has enough initial available data on a proposed income-producing property or development to estimate initial feasibility (IF)," according to Donald Epley, in "Initial Feasibility as a Recommended Procedure." And, with that information, one can decide whether or not to proceed with a more detailed examination of the market. Initial Feasibility is an essential tool and particularly important if the analyst has data that has not been collected through an extensive market analysis. Epley offers useful methods to approach IF with available data, particularly useful to determine whether more time and expense are justified to move forward.

Mark Levine offers food for thought to the appraisal community in "Appraisal Requirements for Charitable Contribution Deductions." Levine discusses proposed regulations intended to clarify "fair market value" of charitable contributions, including real property (and, importantly, out here in the West, conservation easements). "Although Congress attempted to tighten restrictions of charitable contribution deductions…there continues to be additional concern with such contributions and the determination of the fair market value of the gifts." In proposed regulations, currently under review, come additional requirements for substantiation and support for those contributions. Notable are additional requirements and documentation as to what qualifies as a "qualified appraisal" conducted by a "qualified appraiser."

In another note to the appraisers out there, Jan Sell and Thomas Hamilton offer "Use of the Income Approach in Valuing Sand and Gravel Property in a Condemnation Proceeding." Pointing to condemnation proceedings, the authors carefully spell out various approaches to determining "Market Value" and "just compensation" for special-use or special-purpose properties, including properties owned or leased for sand and gravel operations. They carefully distinguish between the activity of extracting minerals from the property, the business operation, from the value of the income derived from the property, the income stream from procuring the minerals. "In such cases," Sell and Hamilton conclude, "...the royalty income stream is both stable and directly attributable to the property itself, rather than from the business activity conducted on the property."

So, what did *your* summer reading list look like? Maura Cochran and Peter Holland review two books produced by the Urban Land Institute: Gupta and Terzano's *Creating Great Town Centers and Urban Villages*, and Peiser and Schmitz' *Regenerating Older Suburbs*. Their review confirms that ULI produces publications that are not only well-presented but serve as useful tools to the active practitioner, his/her company and clients. Along similar lines, Steve Price reviews Tony Downs' *Real Estate and the Financial Crisis: How Turmoil in the Capital Markets is Restructuring Real Estate Finance*. It's not that I ignored the residential market, but I could have paid closer attention, as the influence of the residential for-sale market has been rather dramatic in the last couple of years as our assumptions of always-rising housing prices have been sorely tested. Downs' assessment of current and future conditions is well worth noting, and the book well worth reading.

In looking at the current state of the economy, most of us are acutely aware of the significant regional differences in the depth and breadth of the downturn. In fact, recession and recovery are never uniform across the country. The editors of *Real Estate Issues* are reaching out to numerous academic institutions across the country, to business schools, to real estate schools, and to economics departments for their keen observations of regional and local economic developments, conditions and trends. Perhaps we might hit on signs of recovery out there, even economic growth, as a result! Don Epley gives us his assessment of the (other) Coastal Economy in Southern Alabama. We hope there are other schools and departments out there who would like to submit their local view to REI in upcoming issues.

So, that's what I did on my summer vacation. And, I learned that business continues—life goes on—and that The Counselors are, indeed, out there making a marked and measurable difference in this business every day, regardless of the weather or the current economic climate.

I love this job. ■

PETER C. BURLEY, CRE
EDITOR IN CHIEF

To send any article and/or the complete issue of REI electronically, please visit www.cre.org and go to the Publications page.

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The Structure and Potential Economic Effects of Inclusionary Zoning Ordinances

BY DUSTIN C. READ, PH.D., J.D.

INTRODUCTION

Inclusionary zoning ordinances encourage or require real estate developers to set aside a percentage of the units included in market-rate residential development projects for low- and moderate-income households. By leveraging the resources of the private sector, this type of land use regulation potentially offers an effective way to expand the housing options available throughout a jurisdiction without the need for costly public subsidies. Surveys indicate inclusionary zoning has produced more than 34,000 affordable units in the state of California alone over the past three decades.[1] Success stories have also been reported in several other states where inclusionary zoning has become much more common in recent years.[2] Nonetheless, concerns have been raised that inclusionary zoning can constrain residential development and increase housing prices in some instances. Understanding its strengths and weaknesses is therefore essential to help policymakers craft regulations that expand housing opportunities, while being mindful of unintended economic consequences.[3] The literature review presented in this article is designed to provide such an understanding.

The analysis begins by describing the structure of inclusionary zoning ordinances and the characteristics that differentiate them from related affordable housing initiatives. Existing research is then reviewed to present a framework suitable to evaluate whether this policy tool encourages the production of affordable housing by offering developers appropriate incentives or by shifting the cost to other market participants. Results of recently completed empirical studies are additionally summarized to examine the impact of these regulations in select areas. The analysis concludes by discussing inclusionary zoning's potential effectiveness in distressed housing markets to illustrate the challenges faced by many municipalities in the current economic environment.

REGULATORY BARRIERS TO AFFORDABLE HOUSING DEVELOPMENT

Inclusionary zoning is sometimes described as the antithesis of "exclusionary" land use regulations, such as minimum lot size requirements and restrictions on multifamily development that have contributed to the shortage of affordable housing in the United States.[4] The description is elegant, but somewhat inaccurate. Inclusionary zoning ordinances do not directly reduce the number of regulations imposed on residential development. Many actually put additional administrative procedures in place to ensure real estate developers produce housing for a specific segment of the market. For this reason, inclu-

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sionary zoning must be differentiated from more direct efforts to remove regulatory barriers limiting the availability of affordable housing.

Municipalities with cumbersome zoning ordinances have the ability to increase their stock of affordable housing by relaxing the regulations governing residential development. Some have done this by expanding the amount of land zoned for multi-family housing and by authorizing higher-density development.[5] These approaches do not guarantee the development of housing accessible to low- and moderate-income families, but can relieve upward pressure on prices by removing supply constraints.

Other municipalities have chosen to leave restrictive land use regulations in place to address a variety of fiscal and social issues. Low- and moderate-income housing may fail to "pay for itself" if it generates a limited amount of tax revenue and attracts residents with relatively high public service demands.[6] All types of residential development also can generate negative externalities such as traffic congestion, loss of green space and overcrowded public schools, when growth is not managed. These factors create economic and political incentives for local officials to restrict the amount of land available for residential development.

While regulations limiting housing supply can increase prices, they are not necessarily inefficient from an economic perspective if they slow development to a socially optimal level reflecting fiscal and social externalities. Unfortunately, imperfect market information may prevent public officials from accurately balancing a community's need for affordable housing against other benefits obtained from controlling growth.[7] Concerns have additionally been raised that local officials enact land use regulations primarily for political reasons with little regard for economic efficiency.[8]

A few states have intervened in these situations by enacting statutes that provide real estate developers with a mechanism to compel municipal governments to accommodate affordable housing. One such example is Massachusetts' so-called "anti-snob" statute, which created a consolidated permitting process at the local level for affordable housing development and an appeals process at the state level for projects denied regulatory entitlements.[9] The legislation requires municipalities denying permits for qualifying projects to demonstrate that the reasons for doing so are more compelling than the need for affordable housing.

Despite the innovative nature of Massachusetts' anti-snob statute and the construction of 23,000 plus affordable units under the program, housing affordability remains one of the state's most challenging issues 40 years after the legislation's enactment.[10] Two underlying assumptions upon which the legislation is based explain the limitations of this policy tool. First, regulatory barriers are presumed to be the main reason municipalities have an inadequate supply of affordable housing. Second, real estate developers are presumed to be willing and financially able to produce affordable housing in the absence of exclusionary land use regulations. Both of these assumptions may be inappropriate in areas where housing prices have increased primarily as a result of strong market demand. Anti-snob statutes are less effective in this type of environment because they do not provide the private sector with financial incentives to produce housing priced below the prevailing market rate.[11] Inclusionary zoning ordinances enacted at the local level potentially have a greater probability of stimulating affordable housing development in these instances.

THE STRUCTURE OF LOCAL INCLUSIONARY ZONING ORDINANCES

Inclusionary zoning ordinances are structured in a number of different ways, but can generally be described as regulations enacted by local governments to encourage the production of mixed-income housing.[12] The approach focuses on integrating affordable housing into neighborhoods throughout a community to provide low- and moderate-income families with better access to public services, area amenities and employment opportunities.[13] Ordinances may be mandatory or voluntary, with some municipalities adopting a hybrid approach that strongly encourages mixed-income housing development without technically requiring it as a matter of law.[14]

The type of ordinance enacted by a local government often is influenced by state statute. A recently completed national survey identified 13 states with enabling legislation expressly authorizing the use of inclusionary zoning at the local level.[15] Some of these statutes permit mandatory inclusionary zoning programs, while others merely authorize the use of incentives to encourage the private sector to include affordable units in market-rate residential development projects. Enabling legislation was also found in two states, Oregon and Texas, expressly prohibiting inclusionary zoning. The results of the survey suggest policymakers in most jurisdictions must look to "home rule" statutes for authority to enact this type of land use regulation.

Home rule statutes provide local governments in some states with significant autonomy in specified policy areas.[16] Large municipalities located in at least seven such states, including California and New York, have relied upon the autonomy to implement inclusionary zoning programs. Even in these situations, the scope of local authority to regulate development may be curtailed by judicial precedent. Policymakers must therefore thoroughly understand their legal environment when evaluating the merits of inclusionary zoning. Ordinances that have been successfully enacted generally share several common characteristics including set-aside requirements, income targets, economic incentives, exemptions, and mechanisms to ensure housing remains affordable over time.[17]

Set-aside requirements are an important component of inclusionary zoning ordinances because they dictate the number of residential units a developer must reserve for low- and moderate-income individuals. They are expressed as a percentage of the total number of housing units included in a project, typically ranging from 5–30 percent according to survey data.[18] Tiered ordinances often have different set-aside requirements for each income group targeted by the ordinance, as well as different set-aside requirements for rental and owner-occupied housing. Hybrid inclusionary zoning ordinances may allow developers and local officials to negotiate set-aside requirements in development agreements on a case-by-case basis depending on the characteristics of a project.

Affordable housing that is set aside for economically disadvantaged residents must be accessible to individuals within a targeted income range, usually defined in terms of area median income (AMI). Ordinances designed to serve low-income households often focus on those earning 60 percent of AMI or less, while those serving middle-income households may include households earning up to 200 percent of AMI. Residential units are deemed affordable if households in the targeted income group spend no more than a specified percentage of their income on rent or mortgage payments.

Set-aside requirements and income targets clearly influence the financial viability of residential development, so most inclusionary zoning ordinances offer economic incentives to mitigate some or all of the private sector's cost of constructing affordable housing. Incentives are essential to encourage participation in voluntary programs, although they also are offered by most mandatory and hybrid ordinances to prevent real estate developers from relocating to other markets in search of more favorable regulatory environments. Economic incentives include density bonuses, expedited project review, fee waivers, alternative design standards, direct cash subsidies and property tax abatements.

Density bonuses allow property owners to construct more residential units on a given parcel of land than would otherwise be allowed by a jurisdiction's zoning ordinance. They are valuable because they reduce a developer's per-unit land cost for both affordable and market-rate housing. Land cost savings enable developers to maintain a competitive rate of return as long as they are sufficient to offset any financial burden created by including affordable housing in a project. Inclusionary zoning ordinances may allow developers to increase the number of units developed on a parcel of land by 25 percent or more in exchange for satisfying set-aside requirements.

Municipal governments find density bonuses attractive because the direct costs are low, and additional housing supply may serve to moderate market-rate housing prices. The value of this type of incentive to the private sector is, however, driven by market demand. Density bonuses stimulate development only in instances where additional housing can be sold or leased at a favorable rate. A developer derives little value from constructing more units on a given site if there is a strong preference for low-density development in the market or if affluent home buyers resist areas with high concentrations of economically disadvantaged residents. These factors must be considered when evaluating the value of density bonuses.

Some inclusionary zoning ordinances also streamline the permitting and regulatory approval process for projects that include a specified number of affordable housing units. Expedited project review benefits the developer by reducing the soft costs required to complete a project. Enabling development to move forward more quickly also limits the private sector's exposure to shifts in housing demand, interest rate fluctuation, and changing market conditions that can influence the financial viability of a project. Expedited project review is a low-cost way to encourage mixed-income development in markets where regulatory approvals take multiple years to obtain. As would be expected, the value is less significant in jurisdictions where regulatory entitlements can be obtained relatively quickly.

Fee waivers create another way to reduce the private sector's cost of obtaining regulatory entitlements for mixed-income housing. This type of incentive is extremely valuable in markets where impact fees and other forms of development exactions are relied on to pay for public infrastructure improvements. Strong political opposition to exactions in some markets may make fee waivers attractive, although they can also result in a need for higher property taxes in the future to offset the public sector's lost revenue.

Alternative design standards, such as relaxed setback requirements and parking ratios, are also authorized by inclusionary zoning ordinances to provide real estate developers with cost savings. Allowing affordable units to be smaller in size than market-rate units is another common approach. The profit motive, rather than strict government regulation, prevents the construction of substandard housing in these jurisdictions because the developer must still attract market-rate home buyers to a project. Municipalities using this approach must nonetheless be cognizant of situations where market competition can be problematic. Developers may be unable to derive value from alternative design standards if mixed-income housing has a negative stigma in the marketplace, and more amenities must be included to attract affluent home buyers.

Two final types of economic incentives are cash subsidies and property tax abatements. While arguably preferred by developers because their value can be easily quantified, these incentives are offered less frequently than others because of direct costs. Local governments often lack dedicated funding sources to support inclusionary zoning ordinances and prefer density bonuses, fee waivers and expedited project review over cash subsidies. Property tax abatements also can be problematic in situations where municipalities already are struggling to satisfy demand for infrastructure and public services.

After identifying the appropriate combination of economic incentives to encourage mixed-income housing development, successful inclusionary zoning ordinances put restrictions in place to ensure units remain affordable over time. Deed restrictions are frequently recorded against rental properties to achieve this objective.[19] Property owners are required to maintain a specified number of affordable units each year and lease them only to tenants satisfying the ordinance's income targets. Several large cities have imposed deed restrictions lasting 15–55 years, while others have opted for indefinite affordability periods.[20]

Deed restrictions also are used to maintain the affordability of owner-occupied housing. The purchaser of an affordable unit may be required to resell it only to a party that meets the income targets of the inclusionary zoning ordinance for a specified number of years. Capital gains realized from the sale are often limited to the amount necessary to cover inflation, real estate brokerage fees and other closing costs. Rolling-resale provisions are included in some deed restrictions, which reset the number of years a home must be held by a qualifying party each time the property is sold.

The downside of deed restrictions is their ability to restrict household mobility by limiting the number of parties eligible to purchase a property. Some inclusionary zoning ordinances address the undesirable result by including equity recapture provisions in deed restrictions or by recording a wrap-around second mortgage against the property. Both approaches enable an affordable unit to be sold at the prevailing market rate to any buyer, but require a portion of the capital gain realized from the sale to be contributed to the local housing trust fund or to a non-profit organization providing affordable housing. Inclusionary zoning ordinances may alternatively provide a governmental agency or non-profit entity with the first right of refusal to purchase the property at a favorable price in the event it is put on the market.

A local government may choose to regulate the conveyance of affordable units only for a limited period of time and then allow profits from sale to be split between the homeowner and a non-profit entity. For example, Montgomery County, Maryland's ordinance prohibits the sale of affordable units for a profit for 15 years.[21] Capital gains are then split equally between the homeowner and the county's housing trust fund after the 15-year affordability period elapses. A homeowner can retain all of the profits from the sale of an affordable unit after 50 years. The approach preserves housing affordability over time, while still enabling low- and moderate-income families to build wealth as their homes appreciate.

Exemptions are a final component of inclusionary zoning ordinances worthy of considerable attention. Municipalities may choose to exempt projects below a specified size to limit the administrative burden imposed on small developers. Others exclude redevelopment projects and condominium conversions to promote infill development and adaptive reuse. More expansive exemptions allow developers to avoid set-aside requirements by paying in-lieu fees, dedicating land or building affordable housing off-site. These practices are controversial for several reasons.[22] First, in-lieu fee provisions often require the private sector to pay a municipality or non-profit less than the full cost of developing equivalent affordable housing elsewhere. Second, inclusionary zoning ordinances rarely have a mechanism in place to ensure fees and land dedications are converted into affordable units. Third, fees and land dedications remove the private sector's incentive to construct affordable housing in a cost-effective manner. Fourth, all of the exemptions discussed may undermine the importance of including affordable housing in geographically dispersed areas.

Some inclusionary zoning ordinances attempt to mitigate the problems discussed above by limiting the use of in-lieu fees, land dedications and off-site development to special situations.[23] For example, these options may be available only when the total number of units included in a project falls below a specified size threshold.[24] More sophisticated ordinances may require developers to demonstrate that mixed-income housing is not financially viable at a particular location or that a greater number of affordable units can be produced elsewhere through alternative mechanisms. Local governments can still promote geographically dispersed affordable housing in these situations by requiring the developer to dedicate land in the same planning area or construct affordable housing on an adjacent site.

Despite the prevalence of these restrictions, many advocates of inclusionary zoning argue that residential developers are all too often able to avoid mixed-income projects by paying modest fees that do not reflect the true cost of producing comparable affordable housing at an alternative location. In-lieu fees of only a few hundred dollars in some jurisdictions provide support for these claims.[25] Nonetheless, other municipalities collect fees in excess of $100,000 per affordable housing unit. The fact that real estate developers voluntarily choose to pay these large fees may suggest that the amount is still insufficient to cover the cost of building affordable housing. On the other hand, real estate developers opting to pay significant in-lieu fees may do so not because the fee is lower than their cost of including affordable housing in a project, but rather because the indirect costs of mixed-income development are anticipated to make it a sub-optimal alternative. Local governments must therefore consider affordable housing's potential effect on the marketability of market-rate residential units before concluding that fees are too low. Continually reviewing in-lieu fee levels may also help ensure they are appropriate for the market and keep pace with construction cost escalations over time.[26]

THE ECONOMIC INCIDENCE OF INCLUSIONARY ZONING

The analysis presented thus far demonstrates that inclusionary zoning encourages the production of affordable housing through a combination of legal mandates and economic incentives. An ordinance's effectiveness hinges upon the costs it imposes on the private sector, a municipality's ability to offset any such costs and the characteristics of the local housing market. Examining the relationship between these variables is essential to evaluate inclusionary zoning's potential for success in different economic environments. It also sheds light on the parties bearing the financial burden of affordable housing development in strong and weak markets.

Inclusionary zoning ordinances impose both direct and indirect costs on the private sector. Set-aside requirements and income targets directly affect the profitability of residential development by limiting the amount of revenue a project can generate. Indirect costs also can be incurred if mixed-income housing projects produce less rent or operate at higher vacancy rates than comparable market-rate properties.[27] Advocates of inclusionary zoning contend these direct and indirect costs do not discourage development because the public sector provides offsetting economic incentives. Some scholars even suggest density bonuses and other incentives are generous enough to make mixed-income housing the most profitable option.[28]

Despite these claims, the cost neutrality of inclusionary zoning has been drawn into question for a number of reasons. Scholars generally agree that mandatory inclusionary zoning ordinances produce more affordable housing than do voluntary programs.[29] Requiring the private sector to participate would presumably be unnecessary if mixed-income development were, in fact, the most lucrative alternative.[30] It has been suggested that developers refrain from participating in voluntary inclusionary zoning programs because they lack the knowledge required to complete successful mixed-income housing projects, but the argument is somewhat unconvincing in light of the level of sophistication present in the real estate industry.[31] The unavailability of appropriate economic incentives to fully compensate developers for the cost and risk associated with mixed-income housing is a more plausible explanation.

Housing market characteristics are another factor making it difficult to assess the cost neutrality of inclusionary zoning. Residential developers may continue to build, irrespective of the economic incentives offered by local government, as long as the financial burden of obtaining regulatory entitlements can be passed along to other market participants. Developers operating in these areas will maintain a competitive rate of return by charging more for market-rate housing or by reducing the amount they are willing to pay for developable land. The former approach is possible in strong markets where buyers are relatively insensitive to price changes, while the latter is anticipated in weak markets where housing demand is soft. Developers will exit the market if the financial burden of an inclusionary zoning ordinance cannot be passed forward or backward in this manner.[32]

Since inclusionary zoning ordinances have characteristics of both public subsidies and excise taxes, their ability to stimulate the production of affordable housing can be predicted by analyzing the interrelationship between the strength of the local housing market and the economic incentives offered by local governments. Inclusionary zoning should produce the most affordable housing in strong markets where generous economic incentives are available. Real estate developers will produce mixed-income housing in this type of environment because public sector incentives offset a large portion of any financial burden imposed by the ordinance. Any additional costs required to construct affordable units, over and above the amount of the incentives, can be passed forward to market-rate home buyers.

Economic incentives are expected to help stimulate the development of affordable housing, but they may not be essential in strong markets. Real estate developers can maintain a competitive rate of return by passing the entire cost of low- and moderate-income housing on to market-rate home buyers when demand is robust.[33] While such an approach may strain the financial resources of households that do not qualify for affordable housing programs, residential units should be produced for the targeted income groups.[34] Critics argue that local governments intentionally use inclusionary zoning to shift the cost of affordable housing to the private sector in this manner. The approach is potentially beneficial for the public sector because it provides a subtle way to raise revenue for the construction of low- and moderate-income housing that may face less political opposition than other initiatives.[35]

Inclusionary zoning is anticipated to be less effective in weak markets where the cost of producing affordable housing cannot be shifted to market-rate home buyers. Real estate developers must reduce land bids or request assistance from the public sector to maintain a competitive rate of return in these cases. It may be impossible for developers to pass regulatory costs backwards in the event they already own buildable sites. Some mixed-income development may occur when generous economic incentives are available, although inclusionary zoning ordinances are expected to be largely ineffective in weak markets when public sector support is limited.

The theoretical conclusions presented above were tested in three recent empirical studies completed by independent authors.[36] The Furman Center for Real Estate and Urban Policy at New York University examined inclusionary zoning's impact on housing supply and prices in the San Francisco and Boston metropolitan areas.[37] Inclusionary zoning encouraged a modest amount of affordable housing development in the San Francisco metro area over time without constraining market-rate housing supply or putting upward pressure on prices. Density bonuses were found to increase the number of affordable units constructed in the market. Municipalities near Boston with mature inclusionary zoning ordinances had a higher probability of affordable housing development than those without. However, economic effects commonly associated with excise taxes were observed in the market. Municipalities with inclusionary zoning ordinances issued 10–30 percent fewer single-family building permits on an annual basis when compared to municipalities without inclusionary zoning. Housing prices also were found to be 2.8–3.9 percent higher in municipalities with inclusionary zoning. Both supply and price effects increased with the amount of time an inclusionary zoning ordinance was in place.

Another study examining inclusionary zoning's impact on housing supply was completed in Los Angeles County and Orange County, California.[38] Seventeen cities with inclusionary zoning ordinances adopted at different times over the last 35 years were evaluated. No statistically significant effect was found on the total number of residential building permits issued. The authors interpreted the results as evidence that "critics of inclusionary zoning misjudge its adverse effects on housing supply" when appropriate economic incentives are provided by the public sector. While this may be true, the results of the study left unanswered questions about the merits of inclusionary zoning because price effects were not considered. Housing starts would not be expected to decline in these municipalities if strong demand during the study period allowed developers to pass additional regulatory costs on to market-rate home buyers.

The National Center for Smart Growth Research and Education completed a more comprehensive analysis of inclusionary zoning in California by examining its impact on the supply, price and size of housing throughout the state.[39] Once again, inclusionary zoning was not found to restrict housing supply. The research did, however, find evidence that inclusionary zoning increased the price of constant quality single-family housing by approximately 2.2 percent after controlling for jurisdictional and temporal factors. A more granular analysis demonstrated that inclusionary zoning ordinances increased the price of housing sold for more than $187,000 by approximately five percent, while increasing the price of housing sold for less than $187,000 by only .8 percent. Homes sold for less than $187,000 were, however, found to be 33 square feet smaller on average in municipalities with inclusionary zoning ordinances. All of the results are consistent with economic theory and suggest inclusionary zoning ordinances can operate as an excise tax. In strong markets, regulatory costs may be passed forward to affluent home buyers in the form of higher housing prices and on to less affluent home buyers in the form of a reduction in the size of residential units.

CONCLUSIONS

Inclusionary zoning ordinances encourage or require the private sector to produce affordable housing for a specific segment of the market through a unique combination of legal mandates and economic incentives. Over the past three decades, this type of land use regulation has proven effective in municipalities with strong housing demand. There is, however, convincing empirical evidence that inclusionary zoning ordinances can operate as an excise tax on residential development in some instances. Policymakers must be aware of potential excise tax effects in the current economic environment because weak housing demand may prevent developers from passing regulatory costs on to market-rate home buyers. Inclusionary zoning may therefore stifle residential development and produce little affordable housing unless the ordinance balances any financial burden imposed on the private sector with offsetting economic incentives. ■

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36. Recent studies expand upon previous research examining the economic effects of inclusionary zoning. See Powell, Benjamin and Edward Stringham (2004). "Housing Supply and Affordability: Do Affordable Housing Mandates Work?" and "Do Affordable Housing Mandates Work? Evidence from Los Angeles County and Orange County," Reason Foundation Research Reports; Rosen, David (2004). "Inclusionary Housing and its Impact on Housing and Land Markets," *NHC Affordable Housing Policy Review*, 3:1, pp. 38–46.

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Not in Our Backyard: Plans, Planners, Regulators and the New Redlining

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While specific and operational proposals beyond HUD's Neighborhood Stabilization Program (NSP) have yet to emerge, the federal government's commitment to maintain housing values in the context of rapidly declining residential demand prompts this discussion of the potential consequences—and missed opportunities.

Viscerally appealing, the NSP and similarly sympathetic strategies designed to support home values do not reconcile with *other* policy goals intended to make housing more affordable to larger numbers of families. By intervention, the failures of the market are not given a chance to correct themselves, leaving the impression that *higher* values are obviously the preferred public policy. Absent price supports provided through federal action, it should follow that a larger inventory of affordable housing units would become available. Thus, the apparent losses experienced in market values become societal gains as housing opportunities are broadened.

Instead, what federal intervention virtually assures are continued practices that limit affordable housing initiatives in almost every market. To be clear, the issues raised in this article are *not* about programmatically created affordable housing—that is, housing supported through federal subsidies or intended for targeted incomes—but about housing *affordability* without regard to specific income or means testing.

Despite broad claims to the contrary, there is little in either practice or policy that works to enhance affordable housing. Almost without exception, the rhetoric proclaiming the *need* for affordable housing is not supported by the *realities* of regulatory controls, financial practices, lending policy and in particular, the expressed wishes of housing consumers themselves. If housing affordability is a socially desirable end state, then programs, policies and capital should reinforce that goal. Instead, we have incubated a contemporary form of redlining with predictable consequences.

The social and economic influences that shape our housing preferences are not new phenomena and generally arise out of fear, expectations and cultural norms.

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Approximately 65–70 percent of America's housing stock is owner-occupied with the balance renter-occupied. This results in a dominant population of households prejudicial to maintaining and advancing their own economic self interest. Policies that promote or assure increasingly high value homeownership are materially more attractive than those that don't. By extension, there is an implicit aversion to smaller homes, attached homes, condominiums, rental housing and the people who live there.

These observations are of course broadly generalized. Still, whatever exceptions there are to these biases, they are rarely sufficient to induce major restructuring or redirection of policy that has social and political as well as economic and physical dimensions. Despite ostensible trends toward diversity, land use policy and personal preference celebrate sameness in housing delivery and choice.

The institutional practices and personal preferences abiding in the residential market are not hard to understand. Unlike now discriminatory neighborhood redlining, they have little to do with perceived racial or income intolerances, although these social factors may be indirectly reinforced. Instead, these practices and preferences stem from the value embedded in the residential homestead which, in the United States, is the principal source of accumulated equity and wealth, certainly for the nation's group of homeowners.

Studies have suggested that 40 percent of the average family's wealth is attributed to the homestead, so asset preservation is a powerful force in shaping outlook as well as policy. Home equity has paid for college, new business startups, weddings, sabbaticals and retirement. When directed into the existing homestead through a remodeling effort, equity offers the prospect of even greater future accumulated wealth. The homestead stands not just for individual accomplishment. It is the single investment vehicle that has enabled almost every American household to achieve cross generational goals and social improvement.

Although new housing designs showcase the advantages of the smaller home, data collected over decades point to increasingly larger as well as increasingly more expensive homes. In 1950, the average new home contained about 850 square feet (SF) and included two bedrooms and a single bath. Astonishingly, the average family of about four people managed to function in this space. Today, the average new home is more than 2,000 SF and usually has two or more bathrooms and three or more bedrooms. No less astonishing—this space supports a family of 2.25 people. How the added space gets used is something of a mystery … today's new house provides almost the same space per person occupied by an entire family in 1950! All things equal, the average new home today would be more than twice as expensive as the basic single-family home constructed a generation ago, simply adjusting for size.

Personal choices drive personal demand. In the United States, the single family suburban home remains the standard by which alternative choices are evaluated. Despite swelling numbers of urban dwellers, the majority of buyers want larger single-family homes because they see opportunities for equity growth and appreciation.

Anything that compromises the single-family unit as a source of economic empowerment is grossly unappealing to America's homeowners. Few households are likely to surrender a belief system that has had generations to mature. Even if a home is of modest price, it is a highly prized investment. Though study after study works to dispel misplaced ideas regarding multi-family and mixed-use forms, poorly executed examples are as painfully visible as the successful alternatives, and these failures are a reminder to exercise caution.

The regulated environment in which America's homesteads are rooted is largely a product of property ownership, homage to this nation's commitment to rights based on English common law. The individuals active in the electorate are largely the families occupying and protecting their homestead interests. When they mobilize to create or influence land use policy, their perspectives are disturbingly, but understandably, narrow. Toiling to create a vision of the community commensurate with their own expectations, they lobby for lower density single-family neighborhoods where they preserve and enhance their homesteads.

An inherent resistance then emerges to land development regulations and policies that encourage smaller lots, higher density, and smaller housing units. Together, these approaches can push housing costs down. Declining *costs,* however, cast a shadow on housing *values* which, conventional thinking suggests, also will decline.

Occasionally, extraordinary design and marketing skills succeed in conveying a compelling landscape through mixed use, height and flexible forms. While the development may get initial approval by the local community, conflict often arises as plans progress. Resulting compromises often undermine the original intent of use and of design. Mixed use becomes defined as *specific* uses or activities without regard to the vagaries of the marketplace or the functional needs of the desired use or users. Height and bulk constraints make it difficult to execute the concept physically or financially. Residential units intended for rental may be discouraged overtly or discreetly through minimum size standards. Whatever planning and design goals may be accomplished within regulatory controls, they rarely *induce* more affordable housing.

To the contrary, there are many examples that suggest regulations have forced cost increases well beyond the benefits of individual or community concerns. In many cases, these controls can literally add thousands to the cost of a basic home. For consumers, these costs are a barrier to homeownership. But for existing residents, these costs reinforce a perceived community value that is realized in the pricing of the homestead.

A transfer of development rights (TDR) is often touted as one way for desired intensity or unit counts, sometimes of a specific configuration, to be achieved. The objective is conceptually intriguing in that it promotes the idea of encouraging specific building activity in targeted areas. These targeted areas have regulated maximum densities that can only be exceeded once rights from another area are acquired. Much oversimplified, the planning fiction associated with the TDR mechanism is that it allows lower cost units to be paired with higher value ones, ostensibly driving down costs overall, an apparent benefit to affordable housing. Viewed through this lens, it takes the appearance of an incentive. Only in the world of land use control can a series of tedious intermediate steps (identify neighborhood, negotiate transaction price for additional units, approve movements with regulators, reassign units to new area, price reallocated to units) be cast as an incentive.

If the goal of a specific policy is to promote density—making housing production more efficient and distributing greater land costs over the available unit count, thus enabling lower overall prices—then why is the policy directed to other considerations? The question, of course, is rhetorical but it focuses attention on the disconnects among stated objectives, community intentions, planning policies generally, zoning specifically, subdivision regulations, building codes, and fundamental economics dictated by personal expectations and demands imposed by the market.

The homebuilder is something of an outsider in this dialectic that yields continuing changes to plans and concepts. Without specific incentives to bolster his business model, the builder of affordable housing must balance the needs of marginally qualified buyers, neighbors and regulators. Often viewed as a pariah within the community, the affordable builder is challenged along the entire continuum of the development process from zoning to capitalization. With the collapse of the mortgage market, this demand segment becomes difficult, if not impossible, to support.

The financial aspects of housing delivery present their own set of constraints to affordable housing. Like America's owner-occupied households, mortgage capital seeks a secure investment. Security takes the form of equity, mortgage insurance and expectations of rapidly increasing value so that the combination of equity and insurance enhance the lender's position. While the subprime nightmare suggests these guidelines were violated, more often than not the escalating value aligned the motives of both lender and borrower. That is, the borrower acquired an appreciating asset and the lender received substantial security in the loan.

In the mortgage industry, loans can be retained by the lender but it is considered prudent to package these loans and sell them on the secondary market. When retained, the security interest is dictated by the lender and the requirements are usually different from those imposed by the secondary market. Again, security takes the form of equity, private mortgage insurance and expectations about rapidly increasing value so that the combination of equity and insurance enhances the lender's position. Where the loan is held, the transaction costs will be high to reflect the risks involved. While these transactional costs are not central to the subject of affordable housing, this market segment is certainly not enhanced.

Condominiums, a source of much affordable housing, have proven especially vulnerable to the restrictions of the secondary market, which prefers to avoid mortgages on such products. Some private insurers are no longer providing coverage for this form of housing. The combination then, of transaction costs and standard underwriting behavior, is to favor conventional single-family loans. Because condominiums are usually constructed at higher densities consistent with allowable zoning, the financial markets work in concert with single-family homeowners to preclude affordable housing options.

HUD, FNMA, FHLMC and other functioning mortgage conduits share in steering people away from affordable housing conceptually; HUD through its historical lending and insuring processes, the latter groups because of the ways they package and evaluate loans suitable for the secondary markets. HUD—together with its predecessor agency FHA—has been implicated in and associated with redlining, suburban low-density settlement patterns, and the imposition of minimum development standards frequently in excess of accepted normal market requirements. While not to dispute the stability that HUD has injected into the market, the organization leaves a legacy that has contributed to expectations about the building industry and what consumers should demand in a housing product. Indeed, today's expectations about the conventional single family home can be traced to HUD and its directives after World War II. Other than benchmarking a specific mortgage limit deemed affordable, HUD's practices have not been that dissimilar to those of other lenders and individual consumers.

As for FNMA and FHLMC, they inject their own biases that drive housing costs upward and, like HUD, push consumers toward a large, conventional single-family product. Their behavior in the secondary market may have fashioned the practices that have dragged the securitized market downward and that now require federal assistance. Specific to condominiums, both FNMA and FHLMC have initiated stricter due diligence procedures that address legal documentation, adequacy of operating budgets, the age of association receivables, and the percentage of units owned by non-residents. Such changes are expected to protect borrowers and manage increasing levels of risk that the market suggests have not been confined to attached units only. Single family homes constructed in characterless tract communities—in this case something of a distinction with little difference—have some limitations, but not the severe restrictions imposed on condominium housing.

America's tax structure contributes to our housing excesses in other ways. Not only is an eligible household allowed deductions, but a gain on sale up to $500,000 has no tax liability! This gain may be exercised every 24 months under the current tax code. Clearly, the largest and most expensive homes generate the greatest opportunity to realize these tax-free gains. While available to all taxpayers, these tax provisions are an additional inducement to construct larger and more expensive housing. Effectively, our tax code pushes buyers to maximize their purchases. Seen in terms of earnings, what other form of activity in the United States literally assures a household an average of $250,000 per year in tax-free income?

Americans have a cozy sentimentality about their homes, confounding the value as *shelter* and as *asset*. Although short-term positions are shaken, newspaper headlines have not fully extinguished the confident visions of American homeowners. Financial return from property ownership remains an expectation. Unless actively selling a home in today's market, the typical homeowner is in a state of denial regarding the value of his or her homestead and the threats to equity. Any proposal to aid troubled borrowers steadies that confidence.

It is with some irony that excess housing production—not price supports, interest rate modifications, controls and lowered underwriting standards—may be the greatest opportunity in a decade to significantly reduce the affordable housing gap. The housing market *may* be in need of price supports but such intervention is an explicit decision to promote *less* affordable housing supply.

The distinction between *value* and *price* is all but misunderstood. In economic terms, home prices are *sticky*. That is, the prices rise quickly but slip slowly because of many interacting variables. Among others, these variables include the resolute determination of the homeowner to hold a price regardless of the implications. With values falling around them, many homeowners still perceive *their* investments as stable or improving. A combination of hope, regulations and policy, it seems, will continue to protect equity and blur the price/value distinction despite societal costs.

So where does ad hoc and disjointed policy leave those who fervently support more affordable housing?

The answer is extraordinarily complex—players in the housing industry have had more than 50 years to codify and entrench their thinking—but a direction might begin with a relatively simple premise. In this construct, shelter has a commodity value as well as an investment value, but the former takes priority. Individuals would be free to select the housing product that serves a personal interest, real or perceived. Presumably, financial vehicles would be available as they are now in varying ways.

Neither homeowners nor community officials would *ever* have the right to resist alternative housing plans that may be inconsistent with their personal value systems. Regulators would universally adopt form-based codes. In residential zones, minimum size standards for shelter would disappear, enabling development by right. These, and related ideas, lead to at least the following recommendations or considerations:

- It may be time to eliminate, certainly to restrict, use of the mortgage deduction which costs the U.S. treasury billions and encourages risky market behaviors. One consideration might be the size of the home to which it applies, rather than just the mortgage balance;
- While cumbersome, the tax code also may also need to be altered to remove the taxless gain on sale which benefits the most expensive homes and also encourages financial independence based on the equity of the homestead;
- Price supports for housing, as proposed by many sources, only delay normal pricing adjustment that should fall even lower. These supports—made possible by efforts such as the NSP—should be reevaluated. Some foreclosures are warranted and need to occur to clear the market of gross economic inefficiencies. Almost every strategy being advanced seems to ignore the difference between affordability and loss of equity. Many homes have unfavorable loan terms but the value of the home may have nothing to do with the owner's ability to continue to service debt;
- Smaller homes need to be encouraged through land use regulations as well as tax structure. Minimal building sizes need to be scrutinized for their alleged public health and safety benefits, with the narrowest of justifications permitted;
- Broad public policy considerations should involve a rethinking of the priority given to home ownership and other forms of housing. The state of the current market virtually demands that fundamental issues and deeply embedded assumptions be reevaluated.

The federal government and the states can play pivotal roles in supporting these practices. The feds would act by producing fair housing policies virtually impossible to circumvent through zoning and similar regulations. The Community Reinvestment Act took a strong position against redlining but discriminatory practices have emerged in a new form, and their effects are now experienced in ways that the lending crisis should make us understand.

Market corrections are painful and should be minimized if possible, but loss, in and of itself, should not be the single subject debated by policymakers. All costs and benefits need to be considered in the mix of strategy. The condition of the market opens the door to spark these discussions as part of an initiative to boost the economy, which needs every foundation poured to bring housing and financial stability. This door will close as soon as housing values suddenly are released from the constraints of the current slowdown. ■

Mixed-Use Development and Financial Feasibility:

Part II – Physical, Phasing, Design and Public Policy Factors

BY JOSEPH S. RABIANSKI, PH.D., CRE; KAREN M. GIBLER, PH.D.;
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Editor's Note: The following article is Part II of "Mixed-Use Development and Financial Feasibility: Economic and Financial Factors," which addresses the physical, phasing, design and public policy factors that affect mixed-use development. Part 1, which addressed the financial and economic factors of mixed-use development, was published in the previous issue of Real Estate Issues*, Vol. 34, No. 1, 2009.*

THE GROWING POPULARITY OF MIXED-USE DEVELOPMENTS is driven by both the developers and regulators. Developers are attracted by potentially higher rates of return from denser development that builds in clientele for on-site uses. Public officials are interested in the potential such developments have to serve as a catalyst for redevelopment and the creative use of in-fill sites. The project can only achieve the objectives of both parties if the combined uses are financially feasible.

In a previous article (*Real Estate Issues,* Vol. 34, No. 1, 2009), the economic and financial factors associated with financial feasibility of mixed-use developments were discussed. In this article, we discuss important physical, phasing, design and public policy factors.

Combining multiple uses on a single site may increase the complexity of the physical requirements for the site and structures. Many mixed-use projects incorporate higher density development, and tenants and customers have different needs and preferences for access and security. These items become critical issues for a project's success. If the project is to serve as a destination for tourists and local residents, the buildings and improvements must go beyond functionality and become an attraction themselves. The ability of a mixed-use proposal to fulfill these needs can be hampered by regulations that were conceived for single-use projects. While complicated, with a little creativity, a mixed-use project can be designed and developed in compliance with local regulations and perhaps even with the benefit of government incentives. [1]

PHYSICAL FEATURES

The physical features of the site and its improvements are key elements of financial feasibility. The site is especially critical for a horizontal mixed-use development on a single parcel of land. The size and shape of the site must be sufficient to allow the placement of the uses on the land in a way that integrates the uses without resulting in overcrowding. While flat acreage is preferred for retail development, other uses can be placed in vertical structures and on slopes, providing views and interconnections with the development on multiple levels. Easy access to the site and parking structures is essential for traffic flow that encourages repeat visits while connecting the development with its surrounding community.

Integrating the project with the neighborhood is essential to winning community approval.[2] Site design can create points of connection between the mixed-use development and the surrounding areas. The pedestrian flow from the surrounding neighborhood to on-site land uses should be easy.

The design and density of the mixed-use development relative to the surrounding area must be considered to ensure harmonious integration.[3] In urban areas, the density of the mixed-use development can be high yet

Mixed-Use Development and Financial Feasibility: Part II
Physical, Phasing, Design and Public Policy Factors

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still be comparable to that of the surrounding area. In suburban settings, if the density of the mixed-use development is higher than that of the surrounding area, the transition should seem natural.

Some developers claim that, "mixed-use is all about place-making."[4] The best definition in the literature for place-making is, "…the creation of vibrant, pedestrian-friendly areas with a mix of complementary land uses."[5] It requires a development in which all the buildings do not look the same, rather they are complementary. The master plan ensures the buildings are integrated with each other and the planned public spaces. The planned public spaces add to the sense of "place" and the success of the commercial tenants in the development. Components such as public gathering areas, walking trails and parks enhance the image of the development and foster the place-making ideology. Even though parks and squares do not pay rent, stores near them have increased sales volumes.[6] Transitional public spaces that integrate uses can be planned as places with multiple functions. They also can serve as buffer zones between the uses.

The design and location of streets, sidewalks and parks is as significant as the design and location of the buildings.[7] It is essential not to overlook the importance of the street features in mixed-use developments. Place-making occurs at the street level through choices regarding paving materials, sidewalks, lampposts, seating areas and landscaping. Pedestrian traffic should have safe access to all uses through visually appealing public areas and transportation corridors. The pedestrian orientation requires connectivity[8] and the ground floor of buildings fronting the street to be designed in a way to provide a sense of activity.[9] One key to success is the proper incorporation of all components to create a seamless whole.[10] Another key is to provide each use a "front door" that is distinct and separated from the other uses. This is more important to single-family housing than rental housing, but residential users do not want to walk through retail to enter their homes. This may mean the construction of a rear street or private walks.[11]

While the overall project needs high visibility, not all uses have the same need for visibility. Highly visible and easy-to-read signage will aid with consumer satisfaction.

A successful vertical mixed-use development shares many of the characteristics of a successful horizontal community; however, unlike horizontal communities, vertical mixed-use communities must be concerned with the additional challenges that arise when constructing a vertical platform. Physical design, staging/phasing and cost financing issues arise when blending residential, retail and office uses in a single tower.

Often the retail space is 90 feet deep, while residential space is 60 feet deep, and each has differing column spreads for load-bearing walls. Architectural ingenuity can make use of the difference in design such as by designing lofts or apartments over the retail space. Retail commonly has open ceilings, but residential uses must have plumbing pipes that may run above this open area. These pipes must be contained, and retail loses the open-air feel that it is trying to capture unless architecturally innovative design is used. Conflicting requirements must be viewed as a challenge that can create value and atmosphere. For example, a Chicago development used the green roof requirement on commercial buildings to add value to the residential component through a landscaped roof terrace.[12]

Another difficulty is the integration of operations once all the buildings are occupied. Many problems can be anticipated and consequently avoided by utilizing proper and sufficient design techniques. Potential problems include noise complaints from residents about commercial uses, conflicts over automobile traffic and parking, and residential complaints about odor and trash. Separating uses and incorporating soundproofing between the commercial and residential components is critical to avoid noise problems created by commercial activity. Providing upfront disclosure or having separate residential parking would go a long way in mitigating potential parking conflicts. Loading and trash collection areas should be hidden from residents. Incorporating proper ventilation systems is imperative because residential users will not tolerate odors and smoke from adjacent restaurants. Fire retardation measures can be incorporated through construction techniques.[13] Finally, the site may need to contain transition areas that separate uses with landscaping, screening, buffer zones and setbacks.

One of the biggest issues associated with the design of a mixed-use development is parking. "The benefit of mixed-use is that collectively, you can reduce the total amount of parking …also, since parking demand peaks at different times during the day for different uses, shared parking is important because it [parking] is a very expensive item in the total construction costs."[14] However, most tenants want the standard parking ratios: retailers want five spaces of free, open access parking per 1,000 square feet of gross leasable area; and office users want four to five spaces per 1,000 square feet of rentable area. Residential users want dedicated spaces separated and secured from the commercial parking areas, with their entrance and exit separated from the commercial entrances and exits.[15] They want dedicated space for their dwelling unit that is open for their exclusive use at all times.

PHASING AND TIMING ISSUES

The mixed-use development has phasing and timing issues that go beyond those typically experienced in single-use development. The first phase of the project sets the theme, tone and quality level for the whole project. The first phase and each subsequent phase must be designed to survive on its own if subsequent phases are not built. However, the developer must recognize that sales and leasing may be slow in the initial buildings if the promised supporting uses in the development are not completed and occupied. Thus, critical mass must be created during the initial phase.

The faster the build-out period and the shorter the lease-up period, the greater the prospect of achieving financial feasibility objectives. Timing of the development phases is essential to controlling cost and enabling the move-in of rent-paying tenants as soon as possible. However, if integrated systems or shared structures such as parking garages are part of the approved development plan, certificates of occupancy may not be granted until the entire project is completed.

To respond to changing market demand and control project costs, the physical size of each phase need not be the same. Also, the length of time between phases need not be the same. The financial feasibility of each phase may not be the same as earlier phase(s). It could be better, or it could be worse.

PUBLIC ISSUES

Most development regulations are written to govern single-use projects. Mixed-use developments often require exceptions to zoning regulations and adaptations of building codes. Some communities encourage innovative development and design, allowing for deviation from standard regulations, while others maintain ordinances that do not readily accommodate mixed-use development. Cities that embrace mixed-use development as an anchor for urban redevelopment may even act as a partner, providing financial assistance to the development.

Mixed-Use Development and Financial Feasibility: Part II
Physical, Phasing, Design and Public Policy Factors

Mixed-use developments are made possible in large part by the condominium form of ownership, which enables developers to overcome potential obstacles in zoning or building codes. Local planning officials often allow developments under a condominium structure that would not be permitted under separate forms of ownership. Setback, parking and density requirements may limit the developer's ability to subdivide into separate ownerships for each use; the condominium form of ownership enables the development to fulfill requirements as a whole. Similarly, building code requirements may be less stringent under the condominium form of ownership with a single tract of land compared with subdividing the land into separate tracts.[16] The condominium form of ownership complicates the rights and responsibilities of the property owners, requiring the formation of a property owners' association and adoption of covenants, codes and restrictions.[17]

If the development requires higher density than in the surrounding area, the developer must be able to persuasively explain how the project will positively influence the community, highlighting transportation and infrastructure use (water, waste treatment, school capacity) and the economic benefits of the mixed-use development (substantiated through economic and fiscal impact studies). In some cases, the developer may be able to arrange transfer of development rights from another site to increase the project's density.[18]

Most zoning ordinances are written to allow a single use on a single site. Mixed-use developments, meanwhile, require approval of multiple uses on a single integrated site.[19] This can be accommodated through either fixed zoning districts that allow a range of uses or a discretionary approach that requires project approval through a zoning overlay district, planned unit development or conditional use permit.[20] The key is to garner support from regulatory officials as well as community residents.

The financial feasibility of mixed-use projects is enhanced in some communities through government assistance with land assembly, tax increment financing, property tax abatements, and historic rehabilitation tax credits.[21] City governments are providing cash in some situations, such as the renovation of an art deco building into a residential, retail and parking structure in Dallas.[22] Federal historic tax credits are a boon to local developers, either through creating savings on income tax bills or through selling to banks and utility companies for equity partnerships.[23] Residential units are constructed above retail spaces in older historic properties in Baltimore, Miami and Durham, North Carolina. Buildings in the National Register of Historic Places may not be razed from existing sites for redevelopment, but state and local historic structures can be removed and/or renovated. One key issue is incorporating the historic elements of the neighborhood into the design to keep the "feel" of the neighborhood. Conversely, a challenge is including the modernization without losing the style and history. This can be overcome with proper planning and design.

If properly designed and positioned, the mixed-use development can be a catalyst to redevelop a blighted area. The mixed-use development can be a generative activity for the area and thereby increase the future level of demand for both on-site and off-site properties. It could be a "town center" for a suburban community, attracting consumers from among residents in surrounding neighborhoods, and giving the area a community focal and gathering point.

A mixed-use development can be located at a transit station to serve as both a community and transportation hub for a suburb. From a public policy perspective, increasing the number of housing options available near transit stations does more to increase ridership on the transport system than any other factor.[24] Transit stations have become extremely popular as the central point for both new mixed-use and single-use developments. The transit station enables easy access for customers and workers whose origin and destination are not in close proximity.

CONCLUSION

With the growing interest in mixed-use development, careful thought must be given to how to analyze financial feasibility and the strengths and weaknesses of these projects relative to traditional single-use development. The potential exists for mixed-use to create additional value and outperform single-use real estate developments through the synergy and appeal of a compact neighborhood that serves the residents' and tenants' needs while providing an attractive destination for community residents and visitors. However, developers and operators must consider the substantial obstacles that must be overcome through design, financing and operation to create a harmonious, integrated whole that achieves the investors' and community's objectives rather than a group of disparate, conflicting uses.

Mixed-Use Development and Financial Feasibility: Part II
Physical, Phasing, Design and Public Policy Factors

Experiences of mixed-use developers can be used as a starting point for identifying the key elements that have led to the success or failure of individual projects. Experience shows that the mixed-use concept can be effectively implemented in both urban and suburban locations containing a variety of different complementary uses. The design (height, density), location (near transit centers or major roadways), and mix of uses (residential, retail, office or hotel) must be tailored to fit the local market. Sufficient demand must exist for all the components of the project. The uses must attract from the surrounding community; the on-site residents will not be sufficient to ensure financial success. The site must be integrated into the local community to provide easy access and visual harmony. This helps the project gain the necessary support from the community and regulatory officials.

Identifying and understanding these physical and public policy factors, in combination with the economic and financial factors discussed in the previous article, is essential to critically evaluating the financial feasibility of mixed-use development. Further research is needed to quantitatively analyze the results of mixed-use projects containing a range of uses in a variety of locations so that we can identify which features are critical to a project's success and what combination of factors is likely to create a financially successful mixed-use development. ■

ENDNOTES

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Initial Feasibility as a Recommended Procedure

BY DONALD R. EPLEY, PH.D., CCIM, MAI

RECOMMENDATION

A counselor typically has enough initial available data on proposed income-producing property or development to estimate an initial feasibility (IF). The results tell the analyst and the client if the initial numbers will generate a minimum targeted value or rate of return to proceed further with a more detailed examination of the market. The IF combines the two concepts of investment analysis and financial feasibility analysis into one initial conclusion on a property's potential profitability. It is an essential tool for the analyst to use in a report that provides a counseling opinion or estimates value.

The IF is important if the analyst has initial data that has not been obtained through an extensive local market investigation. An initial figure might be available from observation, discussion with other professionals, several calls to owners or property managers, and reports from brokerage and appraisal firms. This could be the case with vacancy rates, operating expense ratios and net income ratios.

This recommendation contains two useful techniques that can be used for IF with the data that is available, often in the initial stages, of the analysis. It is a needed first step to decide if more time and expense is justified for a larger market investigation.

LITERATURE SUPPORT

Typical procedure relies heavily on the development feasibility concept recommended in the many publications by Graaskamp[1], who thought projects should produce an acceptable return to the contributors of capital. The first step is a static rate-of-return analysis to produce numbers for the developer to determine the profitability of the proposed project. Initially, cost is compared to value, which enables the developer to inject market numbers on comparable properties. The second uses income and expense estimates to assess the adequacy of the projected income.

Three nested rules are found in the Graaskamp analysis.[2] First, the project must always have positive cash flow to remain solvent, initially from external sources, and eventually, from internal sources. Second, equity returns should be equal to or greater than the project's average equity return requirements from the first year to the end of the holding period. Third, it should be fine-tuned to maximize profit without negatively impacting the equity return.

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This approach can be viewed as an initial "financial feasibility" approach to a new project. If the value does not exceed cost in the first year, and the developer's expected income and expense figures do not meet expected levels, the project is not viable.

Emphasis on the financial analysis aspect of the total project is similar to the illustrations used by Fanning, Grissom, and Pearson in their text on market analysis.[3] Financial feasibility is used as a critical step in the larger study to assure that the project is positioned in the competitive market place to generate an acceptable rate of return. Further, financial feasibility was used in an earlier text by Barrett and Blair on the recommended steps in a real estate market study.[4]

Feasibility, entitled "financial feasibility," is a required step in a common highest and best use analysis used by appraisers to estimate value.[5] The analyst focuses on the legal and physical use that produces income or return equal to or greater than the amount needed to cover various expenses.[6]

The recommendation in this article comes from the first step of the Graaskamp feasibility approach. The results normally provide sufficient information to make an informed decision to justify or cancel further market analysis and expense.

DATA REQUIRED

A comparison of the sections required in a full financial feasibility and the IF is useful to illustrate the initial required information:

FINANCIAL FEASIBILITY

- Initial market study;
- First-year project income and expenses;
- First-year debt service;
- Projected income, expenses and debt service;
- Year-of-sale income, expense and debt requirements;
- Simulation of selected income, expense and debt requirements;
- Calculation of rates-of-return and discount rates;
- Comparison to other competitive properties.

INITIAL FEASIBILITY

- Minimum targeted rates supplied by the client;
- Data on estimated construction cost, operating expenses, expected vacancy rate, and effective gross income;
- The typical financial feasibility analysis requires much more time, expense and expertise.

MINIMUM TARGETED VALUE AND MINIMUM TARGETED INCOME

The minimum initial target value must meet expected values, and the minimum initial target income must provide sufficient net income. Both must produce minimum expected levels simultaneously.

Static Part 1: Sufficient Value? Will the property create the minimum targeted value to justify further analysis?

Feasible rule: Project is initially feasible if:
minimum targeted value > actual total cost.

For example, a proposed new building is expected to earn an effective gross income of $650,000, while operating expenses are projected to be $235,000. Hard costs are estimated to be $2 million, and soft costs will be 15 percent of hard costs. The site will cost $1.8 million, and the overall capitalization rate, Ro, is projected to equal nine percent. Is the project feasible?

Begin with:

Value = I / Ro

where I = net operating income in year one

Ro = overall capitalization rate

and $650,000 minus $235,000 = $415,000 which is I,

and $415,000 / .09

= $4,611.111, which is the minimum targeted value

Total cost will equal $2,000,000 hard cost, plus $300,000 soft cost, plus $1,800,000 site cost

= $4,100,000 total cost

The project is initially feasible since the minimum targeted value is greater than the actual total cost.

Static Part 2: Sufficient Income? Will the property in question generate the minimum targeted gross revenue to justify further analysis?[7]

Feasible rule: Project is initially feasible if,
minimum needed pgi < estimated actual pgi

Begin with the estimate of value:

V = I/Ro

Substitute and rewrite:[7]

minimum needed pgi = Ro(cost) / (1-vac)(1-oer)

where:

I = net operating income in year one

pgi = potential gross revenue in year one

vac = vacancy loss, bad debt, and collection loss rate as percent of pgi

oer = operating expenses ratio, or operating expenses as a percent of effective gross income

(1-oer) = net operating income ratio, or net operating income as a percent of effective gross income

Consider an office building that has an expected construction and development cost of $1 million. The vacancy rate, vac, is expected to be 10 percent, and the oer will be 40 percent. What is the minimum needed pgi to justify the development if the expected Ro is 10 percent?

minimum needed pgi = [Ro (total cost)] / [(1-vac)(1-oer)]

= [.10(1,000,000)] / [(1-.10)(1-.40)]

= $100,000 / .54

= $185,185

This same approach can be used when the available data is not the same. Consider a potential retail building with development costs equal to $110 per square foot, excluding site costs that are expected to be $20 million. The oer is expected to be 40 percent; stabilized occupancy will be 90 percent; and the Ro will equal 8 percent. The building contains 400,000 square feet, which will rent at $26 per square foot. Will the project generate enough pgi to be feasible?

minimum needed pgi = [.08($64,000,000)] / [(1-.10) (1-.40)]

= $5,120,000 / .54

= $9,481,481

estimated actual pgi = $26 x 400,000 square feet

= $10,400,000

The minimum needed pgi is less than estimated actual pgi, and therefore, the project is feasible.

MAKING A PROPOSED PROJECT FEASIBLE

An important final question to be answered is one that is always raised when a proposed project is found to be unfeasible. It is: "What can be done to make this project feasible?" The answer is found in simulation and market relevance.

Simulation: Simulation occurs when one variable alone is changed and all others in the analysis remain the same. The objective is to either: a) generate additional income or equity; or, b) reduce expenses. Either one, or in combination, will generate additional dollars within the project, which increases profit.

The usual list of variables includes the following:

Increase income or equity:

- decrease initial purchase price to increase equity;
- increse annual rents to increase income;
- decrease annual vacancy losses to increase income;
- increase projected sales price to increase equity.

Decrease expenses:

- decrease acquisition expense to increase equity;
- decrease projected sales expenses to increase equity;
- decrease or postpone income taxes to increase income and equity;
- lower annual debt service to increase income.

Changing any of these will have a noticeable positive impact on the ratios used in a rate-of-return analysis. They are done one at a time. All variables return to their original positions when each variable is changed. A more interesting and useful simulation can be conducted by altering two at once, such as increasing annual rents and lowering operating expenses.

Market relevance: Once the simulation is concluded, the analyst must return to the local market to determine if the changed variable is reasonable. For example, can annual rents be raised by five percent and not impact the vacancy rate? Is it more realistic to expect an increase in vacant units caused by the rent change?

Each simulation result must be compared to the current local market and future markets. The goal is to find one simulated scenario that can be accomplished by management with acceptable income, equity and profits.

CURRENT ILLUSTRATION

The IF analysis has been useful in the current recession where the investor is reluctant to spend a large sum on a full financial feasibility study without a preliminary indication of the project's merit. Consider the example of a 70-unit apartment complex with the following initial field notes. The initial data and project information were obtained from the investor, the project's accountant and a loan officer. It was quickly verified by a local appraisal firm over a two-day period.

INITIAL FIELD NOTES

70-Unit Apartment Complex

Individual investor	fee simple ownership
Expected capitalization rate	8.5 percent
Asking price	$2,175,000
Potential income:	
20 1 bedroom/efficiency	$400 monthly
30 1 bedroom/1 bath	$450 monthly
20 2 bedroom/2 bath	$500 monthly
Rental income annual expected increase	2 percent annually
Cost recovery allocation	25 percent site, 75 percent building(s)
Vacancy and collection loss	7 percent annually
Operating expenses	38 percent of gross operating income
Expected annual increase	3 percent

Purchase-money mortgage financing:

First loan 9 percent, 20 years, monthly payment	$1,305,814
Expected cash down	$425,000
Balance carried by seller 10 percent, 30-year, 5-year term	$444,186
Projected sales price holding	NOI one year past period divided by terminal cap rate
Projected sales costs	5 percent
Terminal cap rate	10 percent
Projected holding period	60 months
Owner's tax bracket	36 percent
Capital gains tax	15 percent
Cost recovery recapture tax	25 percent

Applying the Static Part 1 Feasible Rule Sufficient Value, the implied value is:

V = I/Ro

I = $378,000 potential rental income
- $26,460 vacancy

= - $143,640 operating expenses

= $207,900 NOI

V = $207,900 / .085 expected Ro

= $2,445,882

Since the minimum targeted value of $2,445,882 is greater than the actual total cost of $2,175,000, the project is initially feasible.

Results for the Static Part 2 Feasible Rule Sufficient Income are:

Minimum needed pgi = .085(2,175,000) / (1-.07) (1-.4086)

= $184,875 / .550002

= $336,135

Since the minimum needed amount of $336,135 is less than the estimated actual pgi of $378,000, the project is initially feasible again. Further, both occurred simultaneously.

CONCLUSIONS

IF is needed to examine the client's targeted rates of return and performance levels using the initial data gathered in a proposed project. The feasible or non-feasible conclusion is valuable information in making a decision to spend the time and money to investigate the market and project further.

The targeted rates are developed from recommendations contained in Graaskamp's earlier publications on feasibility analysis. The calculations begin with the property's value and are extended into minimum levels of income. ■

ENDNOTES

1. Graaskamp, James A. (1981), "Guidelines for Attributing Project Income to Real Estate Components," in "Proceedings from Concepts and Prospects for Policy Making in the 1980s," The Richard B. Andrews Symposium on Institutional Land Economics, May 21, 1981. Reprinted in Stephen P. Jarchow ed. *Graaskamp on Real Estate* (pp. 134–148), 1981.Urban Land Institute, Washington, D.C.

2. Ciochetti, Brian, and Emil Malizia (2000). "The Application of Financial Analysis and Market Research to the Real Estate Development Process," in *Essays in Honor of James A. Graaskamp: Ten Years After*, Research Issues in Real Estate, 8, pp. 135–185, American Real Estate Society.

3. Fanning, Stephen, T. Grissom, and T. Pearson (1994). *Market Analysis for Valuation Appraisals*. Appraisal Institute, Chicago.

4. Barrett, G. Vincent and John Blair, *How to Conduct and Analyze Real Estate Market and Feasibility Studies*, 1987, Van Nostrand, 366 pages.

5. Rabianski, Joseph. (2007). "Comments on the Concept and Definition of Highest and Best Use." *Real Estate Issues*, 32(1), Spring. pp. 39–45.

6. Appraisal Institute, *The Appraisal of Real Estate*, 13th Edition, 2009, p. 279.

7. This relationship is derived as follows:

Know that:	egi = pgi (1-vac)
	net income ratio, noi/egi = (1-oer)
noi =	Ro (costs)
Write:	noi = noi
Substitute:	pgi (1-vac) (1-oer) = Ro (costs)
Solve for pgi:	pgi = Ro (costs) / (1-vac) (1-oer)

Appraisal Requirements for Charitable Contribution Deductions

BY MARK LEE LEVINE, PH.D., CRE, J.D., P.A.P., LL.M.

Most taxpayers are familiar with the benefit of charitable contribution deductions, as provided under the federal income tax law, Code Section 170.[1] These deductions have been in existence for many decades, and most taxpayers recognize the importance of taking what can be significant deductions on their federal and state tax returns.

When donating to charity, assuming the gift is otherwise qualified,[2] taxpayers generally are able to deduct the fair market value of the contribution. The definition of what is "fair value," or "fair market value," along with other related questions as to value, the type of value, etc., is a major issue in federal tax law, as it is within the appraisal industry. However, the summary position is that the meaning of fair market value involves an exchange between a willing buyer and willing seller, without undue pressure. This approach has come from case law. The tax code has no singular definition of fair market value for all purposes.

Generally speaking, one of the major concerns with a charitable gift is determining the fair market value on the date of the charitable contribution, since the fair market value is normally the amount that can be deducted for federal tax purposes.[3] The fair market value is the crucial consideration as to the amount of the deduction; thus the requirements to determine fair market value must be met.

The Code §170 regulations specify the requirements for supporting the deduction relative to a proper appraisal. There have been many articles and discussions on these regulations as to what constitutes a proper appraisal as well as the issue of who is an approved appraiser for purposes of the tax requirements.[4] Not surprisingly, valuation issues spawn much controversy. The regulations, under Treasury Reg. §1.170A-13, and generally under Code §170, attempt to place more controls on the valuation issue because of the importance of this deduction and the concern as to what constitutes fair value.

Valuation of specific property has been in the news of late regarding gifts of paintings, conservation easements,[5] and even contributions of automobiles to charities. In the latter case, Congress recently saw fit to provide additional legislation which limits the deductibility of contributions of automobiles, especially because of what were thought to be abuses.[6]

Although Congress attempted to tighten the restrictions of charitable contribution deductions in some cases, along with the Treasury's issuing Treasury Reg. §1.170A-13 on substantiation of the fair market value of a charitable contribution, there continues to be additional concern with such contributions, and the determination of the fair market value of the gifts. As a result, the IRS promulgated additional Proposed Regulations on the subject of the charitable contribution deduction and substantiation

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requirements. Some of the original Regulations (§1.170A-13) were generated by the Treasury as a result of Acts by Congress, which were passed in 2004 and 2006. These Acts attempted to strengthen the requirements for such deductions.[7] The Proposed Regulations under Treasury §1.170A-17 go further to strengthen the requirements.

PROPOSED REGULATIONS ON SUBSTANTIATION AND REPORTING FOR NON-CASH CHARITABLE CONTRIBUTIONS

Under the Proposed Regulations,[8] the Treasury states: "These Proposed Regulations provide guidance concerning substantiation and reporting requirements for cash and non-cash charitable contributions under Section 170 of the Internal Revenue Code." In particular, the Proposed Regulations were issued in response to additional requirements for substantiation and support for charitable contributions that were provided for under the American Jobs Creation Act of 2004[9] and under the Pension Protection Act of 2006. The Proposed Regulations are intended to apply to contributions that occur after the date the regulations are published as Final Regulations. Therefore, until such time, one could consider these Proposed Regulations as guidance under Treasury Reg. §1.170A. Tax practitioners typically follow Proposed Regulations with very few exceptions as they give notice of the government's position. There is authority for the position that the Proposed Regulations are not binding on the taxpayer; however, most taxpayers are advised to follow them.

The Proposed Regulations provide specific requirements for the deduction of a contribution of real or personal property where the amount claimed for the deduction is in excess of $5,000.[10] One of the requirements in Code §170 and the Proposed Regulations, along with the prior regulations, is to attach a "Qualified Appraisal" (as that term is used and discussed below), where the amount claimed for the deduction is in excess of $5,000.[11] If the appraisal involves a return filed after Aug. 17, 2006, there are specific requirements as to what constitutes a "Qualified Appraisal" and a "Qualified Appraiser."[12]

Code §170 provides that an individual will not meet the requirements to be a "Qualified Appraiser" unless that person: " …(1) demonstrates verifiable education and experience in valuing the type of property subject to the appraisal; and (2) the individual has not been prohibited from practicing before the Internal Revenue Service ... "[13]

This requirement of the appraiser to not only show proper education, as defined in the regulations, but also experience in valuing the type of property in question, should be recognized by any appraiser who attempts to undertake the appraisal and by those who claim the deduction.

Appraisers and others working in the fields of appraising and taxation must remember that the definitions used in the tax regulations are *different* from those used in many professional appraisal organizations and overseeing bodies in the appraisal field. For example, under the Uniform Standards of Professional Appraisal Practice (USPAP), within the Definitions section of the 2008–09 edition, an "appraiser" is "one who is expected to perform valuation services competently and in a manner that is independent, impartial and objective."

The same issue as to definitional differences applies to an appraisal. That is, the Proposed Regulations have a stated definition of an appraisal (Qualified Appraisal), as noted above. Under Code §170(f)(11)(E)(i), the Qualified Appraisal is defined as an appraisal that: "(1) is treated … as a qualified appraisal under regulations or other guidance prescribed by the Secretary [of the Treasury]; and (2) is conducted by a qualified appraiser in accordance with generally accepted appraisal standards and any regulations or other guidance prescribed … " by the Secretary.

However, in contrasting the differences of the Proposed Regulations and USPAP, note that USPAP defines the appraisal as:

> (Noun) the act or process of developing an opinion of value; an opinion of value.
>
> (Adjective) of or pertaining to appraising and related functions such as appraisal practice appraisal services.

Many organizations refer to the USPAP definition of an appraisal.

Since 2006, the federal government, for tax purposes, has attempted to give definitional support for a number of the terms noted, such as Qualified Appraisal, Generally Accepted Appraisal Standards, Appraisal Designation, Education and Experience and Minimum Education and Experience.[14] Without attempting to detail all of the requirements for the Qualified Appraisal and the

Qualified Appraiser, it should be noted that there are many requirements under the Regulations and Proposed Regulations to substantiate the position for the Qualified Activity, including, for example, proper record keeping.[15]

In Proposed Regulation §1.170A-17, there are additional requirements for Qualified Appraisals. As stated in these regulations, the Appraisal Document must be prepared by the Qualified Appraiser in accordance with "Generally Accepted Appraisal Standards." The Proposed Regulations make reference to USPAP.[16] The Proposed Regulations are in line with Notice 2006-96. However, the Proposed Regulations now require compliance with "Qualified Appraisals."

Consistent with the prior rules, but slightly modified, the Proposed Regulations emphasize the time frames that must be met for the appraisal in conjunction with the gift that is made. One cannot, for example, simply have an appraisal that was made two years before the gift was made to the charity and validly claim the deduction. Rather, the Proposed Regulations provide that the effective date for the appraisal, which is the date to which the value opinion would apply, must be the date of the contribution, in most cases. There is a 60-day window from the time of the appraisal to the actual date of the contribution.[17] Thus, although appraisers will often refer to an "effective date" as used in USPAP, the date that is important for federal tax law is normally the date of the contribution. And, the controlling date for the qualified appraisal under Treasury Regs. Section 1.170-13(c)(3) and Proposed Treasury Regs. 1.170A-17(a)(4) must be "… not earlier than 60 days prior to the date of contribution … " Thus, although most real estate appraisers will be guided by USPAP when distinguishing between an effective date and report date, the federal tax law is looking to the definition noted above.

Filings must be made with the tax return when claiming the charitable contribution deduction of property valued in excess of $5,000. IRS Form 8283 must be attached to the tax return, evidencing the deduction.

As to an appraiser's education and experience, the Proposed Regulations delineate "Minimum Education Requirements" more thoroughly, to assure that the Appraisal and the Appraiser are "Qualified."[18] Although there are other ways to satisfy requirements for education, the Proposed Regulations add that an individual has what is called "Verifiable Education and Experience" if the appraiser in question has completed professional or college-level course work relevant to valuing the type of property in question. Further, there is a statement as to "Minimum Education," requiring two or more years of experience in valuing "That Type of Property."[19] It appears there will be more discussion and regulations issued to determine what "Education and Experience" is necessary for given types of property.

Individuals seeking education and/or designations may be advised to choose professional organizations that follow the requirements of USPAP—although not all organizations connected with appraisals follow USPAP, and clearly the federal tax code, as to charitable contributions, does not refer to a requirement to follow USPAP. Under IRS Notice 2006-96, real estate appraisers have sufficient education and experience if one holds a proper license or certification in the state where the property is located.[20] Thus, indirectly, because of state licensing bodies, USPAP and other standards may be relevant, but the federal tax Code does not directly cite nor rely on such organizations for purposes of Code Section 170 contributions.

The Proposed Regulations emphasize there is no absolute safe harbor to guarantee a deduction simply because one is using a "Qualified Appraisal" and/or "Qualified Appraiser." The statement in the Treasury Regulations notes: "Taxpayers are reminded that the IRS may challenge the amount of a claimed deduction, even if the donor substantiates the amount of the deduction with a Qualified Appraisal prepared by a Qualified Appraiser."[21]

SUBSTANTIATION

The essence of the Code §170 requirements, the existing Regulations and the Proposed Regulations, along with other releases and positions by the Treasury and the IRS, support the position that the key concern is to substantiate the fair market value of the property that is being claimed as a charitable deduction. Such substantiation focuses not only on the number that is concluded to be the fair market value, but also how that number was calculated and supported in the "Qualified Appraisal" and by the "Qualified Appraiser." Such discussion and position are contained in the Code and the Regulations as well as the Proposed Regulations.[22]

In particular, the new substantiation requirements are more burdensome; they require stronger documentation when the amount of the deduction is in excess of $5,000 and involves property other than cash. (See Form 8283, which is utilized with the tax return to help substantiate the claimed deduction, along with other support documentation, including the "Qualified Appraisal.")[23]

Specifically, Treas. Regs. Section 1.170-13(c) states that the substantiation requirements include attaching to the donor's tax return a "fully completed appraisal summary" (as defined in the Code).

FORM 8283:

The substantiation under Code §170 for the requirements of documentation for a gift in excess of $5,000 provides for written acknowledgment, via the Qualified Appraisal, and support for the Qualified Appraiser. This form illustrates some of the requirements necessary to support the tax deduction. These relate to: (1) timing; (2) details on the Qualified Appraiser and the Qualified Appraisal; (3) description of the property being contributed; (4) the fair market value claimed; (5) detail as to the property that is being contributed; (6) information as to the donor and donee; (7) basis of the property; and (8) statements about the contribution itself, such as whether the contribution is a part sale (bargain sale) transaction; relationships, if any, between the donor and donee; declaration as to an understanding by the appraiser of the requirements in connection with the appraisal, including potential penalties that one can incur for improper actions; and so forth.

There is a requirement for the donee to acknowledge the gift in question and to disclose other information as to relationships, if any, between the donee and the donor. Information as to the manner of acquisition of the property and timing of the gift are also noted in Form 8283.

SUMMARY

A qualified charitable contribution offers the taxpayer a deduction equal to the fair market value of the property, as well as avoidance of the current income tax that would be generated if one sold the property at fair market value for an amount in excess of the basis. To support the good faith positions of determining fair market value, the Proposed Regulations amend the existing Regulations and delineate requirements under Code §170, the charitable contribution deduction section, and attempt to implement additional restrictions on such contributions as covered by the American Jobs Creation Act of 2004 and the Pension Protection Act of 2006.

Proposed Regulations under §1.170A-17 adds to the requirements of determining what constitutes a "Qualified Appraiser" as well as what constitutes a "Qualified Appraisal." The Proposed Regulations require a higher level of expertise and experience from the Qualified Appraiser and require documentation of such activity and experience, as well as more information on the property being contributed.

Although the Proposed Regulations are not adding new concepts, they require additional substantiation and documentation for a Qualified Appraisal used to support the claim of a deduction under rules of Code §170. Although we cannot know when or if the Proposed Regulations will become final, they are supported by Code Section 170 and the cautious appraiser will follow them. ■

ENDNOTES

1. See Internal Revenue Code 26 U.S.C.A. Annotated, Code Section 170, herein also referred to as "Code § 170."
2. For details on charitable contributions, see Levine, Mark Lee and Segev, Libbi Levine, *Real Estate Transactions, Tax Planning and Consequences*, Thomson-West (2009 edition). See Chapter 13 of text §234, page 376. See also the article by Harmelink, Philip, and Nichols, Nancy, "Various Motivations Behind Family Charitable Contributions," *Tax Notes* 205 (1/15/2007).

   See also IRS Publication 78, which details the basic rules for charitable contribution deductions.

   See also the Levine text, cited in this note, for a discussion of the tax value issue. In particular, see Chapter 41; see also Internal Revenue Code Section 2512 as one example of the valuation issue as to gifts and gift taxation.
3. There are exceptions to the deductibility of the fair market value of the property. For example, if the item that is given to charity, had it been sold, would generate long-term capital gain, the general rule is that fair market value can be deducted. However, if the item, when sold, would not generate a long-term capital gain deduction, such as a property that is inventory, and would generate ordinary income on a sale, the deduction is generally limited to the adjusted basis of the taxpayer. See Murrills, David, "Donating Inventory: Section 170(e)(3) and Fair Market Value," *Tax Notes* 655 (Feb. 1, 2003). See also Code §170(e) in general for the rules as to when a fair market value deduction is allowed. See also the Levine and Segev text, cited *supra*, Endnote 2, Text §236.
4. See the Levine and Segev text, cited *supra*, Endnote 2. See also the specific regulations for determining a qualified charitable contribution under the valuation issues contained in the Code §170 regulations. In particular, see Treasury Reg. §1.170A-13(c).

See Levine, Mark Lee, "Appraisers' Exposure In Charitable Contributions: Final Regulations," *Journal of R.E. Appraisal & Economics* (1988).

See Levine, Mark Lee, "Appraisers' Exposure In Connection With Charitable Contributions – Revisited," *The Appraisal Journal* (January 2002).

See Levine, Mark Lee, "A Refresher and Tax Baedeker On Charitable Contributions After the JGTRR Act of 2003," *Exchanging Real Estate* (2008). See Levine, Mark Lee, "A Refresher and Tax Baedeker On Charitable Contributions After the JGTRR Act of 2003," *Real Estate Transactions, Tax Planning*, Thomson-West (2004).

See Levine, Mark Lee, "Charitable Contributions of the Automobile: Riding To A Deduction,"*Real Estate Transactions, Tax Planning*, Thomson-West (2005).

See Levine, Mark Lee, "Appraisal Update: New Requirements for Charitable Deductions Put Appraisers At Risk," CIREI-Commercial Investment Real Estate Institute (January-February 2007).

5. See Code §170(h). See also *Turner v. CIR*, 126 T.C. 299 (2006 WL 1330084), See *Glass v. CIR*, 124 T.C. 258 (2005 WL 1231654). See Gerzog, Wendy, "Conservation Easement Under *Turner* and *Glass*," *Tax Notes* 179 (July 10, 2006).

6. See IRS Publication 4303, *A Donor's Guide To Car Donations*. See Levine, Mark Lee, and Segev, Libbi Levine, "Charitable Contributions of the Automobile: Riding To A Deduction," *Real Estate Transactions_Tax Planning,* Chapter 13, Text §243.5, Note 15.

7. The American Jobs Creation Act of 2004 and the Pension Protection Act of 2006.

8. See Proposed Regulations Reg-140029-07 on the issue of substantiation and reporting requirements for cash and non-cash charitable contribution deductions. These Proposed Regulations were issued in connection with Treasury Reg. §1.170A15-18.

9. Public Law 108-357.

10. Code §170(f)(11).

11. Code §170(f), Treasury Reg. §1.170A-13, and Proposed Treas. Regs. Section 1.170A-17.

12. Code §170(f)(11)(E).

    Under Code §170(f)(11)(E)(i), the Qualified Appraisal is defined as " ... an appraisal that is (1) treated as a qualified appraisal under regulations or other guidance prescribed by the Secretary (of the Treasury) and (2) conducted by a qualified appraiser in accordance with generally accepted appraisal standards and any regulations or other guidance prescribed by the Secretary (of the Treasury)."

    However, the term "Qualified Appraiser" has a distinct meaning within the Regulations, because of the concern to be assured that the person undertaking the appraisal has certain education and training. As such, the Proposed Regulations provide: " ... the term 'qualified appraiser' means an individual who (1) has earned an appraisal designation from a recognized professional appraisal organization or has otherwise met minimum education and experience requirements set forth in Regulations prescribed by the Secretary; (2) regularly performs appraisals for which the individual receives compensation, and (3) meets such other requirements as may be prescribed by the Secretary ..." See Code §170(f)(11)(E)(ii).

13. Code §170(f)(11)(E)(ii).

14. IRS Notice 2006-96.

15. See these details in REG-140029-07.

16. See Title XI of the Financial Institution Reform, Recovery and Enforcement Act of 1989, Public Law 101-73, 103 Stat. 183 (12 U.S.C. 3331-3351).

17. For example, the Proposed Regulations provide that the date the "Qualified Appraiser" signs the "Appraisal Report," known as the "Appraisal Report Date" can be no earlier than sixty (60) days before the date that the contribution actually occurs. It cannot be later than the due date, including extensions of the tax return, where the deduction is to be claimed. See also Treasury Reg. §1.170A-13 and Proposed Treas. Regs. Section 1.170A-17.

18. Treasury Reg. §170(f)(11)(E)(iii)(I).

19. "That Type of Property" is the specific language of the Regulations.

20. Notice 2006-96, Section 3.03(a)(ii).

21. Proposed Regulations contained in REG-140029-07.

22. Code §170, existing Treasury Reg. §1.170A and the Proposed Regulations under Proposed Amendment 1.170A-16, contained within the earlier-cited REG-140029-07.

23. IRS Form 8283, as well as Treasury Reg. §1.170(f)(8) and Treasury Reg. §1.170A-13(f).

Use of the Income Approach in Valuing a Sand and Gravel Property in a Condemnation Proceeding

BY THOMAS W. HAMILTON, PH.D., CRE, FRICS; AND JAN A. SELL, MAI, FRICS, SR/WA, SRA, CCIM

INTRODUCTION

The legal concept of "Market Value" is applied by courts to determine the amount of just compensation for takings. "Market Value" has been defined as "what a willing buyer would pay in cash to a willing seller," but "Just Compensation" has no clear definition or valuation methodology. This article finds that valuing sand and gravel property using the income approach is the most appropriate method of valuation, and that valuation experts should use the same valuation process that is used by owner/operators when buying or leasing land.

VALUING SPECIAL USE PROPERTIES

The essential problem in the valuation of special use properties is the lack of availability of adequate data from the sales of comparable properties. In some cases, there may be a lack of sales within a reasonably defined market area or a lack of specific information about the existing sales to make essential adjustments and draw a reasonable value conclusion.

In recent years, the Supreme Court has stated, "…when market value has been too difficult to find, or when its application would result in manifest injustice to an owner or the public, courts have fashioned and applied other standards."[1] This situation is usually considered to exist when the property involved in the taking is a special use property. Sand and gravel properties, by their nature, are special use properties.

Comparable sand and gravel sales are relatively few and infrequent compared to other types of properties, such as office buildings or retail commercial buildings. In instances where some local sales of sand and gravel properties have occurred, it is often difficult, if not impossible, to analyze these sales because the price paid depends on the remaining reserves (or degree of depletion) as of the date of sale, and this information is usually unavailable. According to the Uniform Appraisal Standards for Federal Land Acquisitions:

> In order to properly develop a sales comparison approach to value for a mineral bearing property, the appraiser needs to understand the level of information available concerning the mineralization found on the

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> subject property. It is then important to identify comparable sales that had similar levels of information concerning mineralization available at the time of sale. The verification of data concerning the comparable sales is a critical component of this analysis, and the assistance of experts in identifying all necessary areas of inquiry during the verification process may be required.[2]

Sand and gravel operators mine minerals (aggregate) for use in almost all types of construction. Demand for the materials is based upon the need for new construction materials for both private and public projects. Owners of sand and gravel businesses either purchase or lease land for their operations. When leasing land, they negotiate a rate per ton, or a percentage of gross sales for all extracted materials. This rate is referred to as a royalty rate. When all of the materials are mined, the landowner or operator can then use the property for an inert landfill. Materials deposited for use in reclaiming the land are charged at a rate per ton, and property owners are paid a royalty rate on a per-ton basis.

The income approach is generally reliable for sand and gravel properties because it is based upon estimating the net rental income derived from royalty rates or the sale of material over a period of time. The value is then estimated using a discounted cash flow analysis.

UNDERSTANDING MARKET VALUE AND CONDEMNATION PROCEEDINGS

In a condemnation proceeding, the legal concept of "market value" is applied by the courts to determine the amount of just compensation for takings. Market value has been defined as "what a willing buyer would pay in cash to a willing seller,"[3] and "just compensation"[4] has never been reduced to a single formula. "Rather than a general formula, various ways of valuing property are appropriate depending on the circumstances."[5] The market value concept implies a prospective or hypothetical sale of the subject property and is generally viewed by courts to correspond most closely to the direct sales comparison (or market data) approach to value. Although in most cases this approach is preferred, in the case of "special purpose" or "special use" properties, other methods may be considered by courts to be more appropriate.

"Properties treated by courts as special use properties include church properties, cemeteries, schools, historic properties, commercial enterprises such as a warehouse, a scrap-metal yard, a sand and gravel production business, a horseradish factory... . "[6] The concepts of special use properties and special purpose properties are similar in that they imply peculiar or unique characteristics inherent to the property that would not normally be found in other, recently sold properties. A special purpose property is defined as one that:

- "has physical design features peculiar to a specific use;
- has no apparent market other than to an owner-user;
- has no feasible economic alternative use."[7]

In most jurisdictions, where a property is determined by the courts to be a special use property, three alternative methods of valuation may be considered: the cost approach, the income approach and/or a modified market data approach. The valuation expert's role becomes magnified in the condemnation of a special use property; as such, the selection of methods or techniques must be soundly demonstrated to the jury. The valuation of a special use property is a prime example of where an expert's opinion could be excluded at trial if the expert uses a legally improper valuation method. Additionally, the expert's opinion must meet the Daubert Standard[8] to ensure relevancy and reliability. Applicable questions regarding the admissibility of an approach, method or technique include:

- have you used this approach before when appraising this type of property;
- are there treatises that support use of this approach;
- do other valuation experts use this technique or approach;
- is this technique recognized and used by market participants; and
- are there published articles regarding the valuation approach?

Because of these issues, an expert witness must be careful that his or her opinions and/or approaches to value are not excluded from court testimony. In order to accomplish this task, certain groundwork must be employed.

THE VALUATION RUBRIC

The valuation expert must be knowledgeable on the property type and have experience in appraising such a property in the geographical area. The valuation expert also must be able to cite treatises or publications that support the methodology, including:

- *The Appraisal of Real Estate 13th Ed.*;
- *Real Estate Valuation in Litigation, 2nd Ed.*, by J. D. Eaton, MAI, SRA;
- Various publications by the International Right of Way Association;
- Local publications that address valuation issues within the particular jurisdiction;
- Case law;
- Numerous articles, guides and references that describe the proper valuation methods and procedures.

A valuation expert must decide upon the methodology that will be employed in a valuation assignment for a special use property that is not atypical to other valuation assignments. It is also the valuation expert's responsibility to use the approaches that are supported by the market. Therefore, even with a multitude of good comparable sales, the valuation expert can also use the income approach.

CASE ANALYSIS

In a study conducted to determine the process for buying or leasing property, eight sand and gravel property owners and/or operators in the Phoenix metropolitan area were surveyed. The survey findings revealed consistent criteria used by the owner/operators in the decision-making process when purchasing or leasing a sand and gravel property. All eight participants stated that their decisions were based upon the quantity and quality of the material beneath the overburden (surface or top soil). To estimate the mineable reserves, owners need reasonably reliable information, and in some cases owners engage an engineer to perform test borings at certain locations and depths across the property. The owner/operator would then develop a mining plan based upon the mineable reserves, which would result in a residual amount that they could pay for the property. All eight participants said that they did not use the price per acre in their decision-making process. The conclusion drawn from these interviews is that the actions of knowledgeable parties in this market segment rely on a cash flow analysis (income approach) in their decision-making process. Under these conditions, it is typical that such special use properties cannot be valued reliably using only the sales comparison approach.

"The income capitalization approach can be especially applicable when the property under appraisal is already being mined, and thus the historical income stream flow from the property is available for analysis."[9] For properties that produce a predictable income stream, the income approach may be considered by the courts. Stated simply, the method involves estimating the annual net income likely to be produced by the property and the number of years over which the owner could reasonably expect this level of income. "The present value of this income stream is calculated by applying a (discount) rate, which is intended to approximate the net rate of return on investment reasonably expected by the owner."[10]

PROFIT CONSIDERATIONS

In most condemnation cases, the profit from a business operation carried on at the property is not considered a valid basis for estimating just compensation. This is due to the speculative nature of profit estimates, and to depending more on the nature of the business operation and/or the skill of the business owner (value of the enterprise) than on the intrinsic characteristics of the property itself (value of the real property). "In applying the income capitalization approach, appraisers must take care to consider only the income that the property itself will produce—not income produced from the business enterprise conducted on the property (i.e., the business of mining)."[11] In specific relation to a sand and gravel property, this situation is unique because operators both purchase and lease properties specifically for the mining of materials. In both scenarios, the cost of operations is taken into consideration. When property is leased, the operator pays rent to the landowner in the form of a royalty. The royalty is a dollar amount per ton of extracted material. The royalty rate is typically based upon the quality of the material, the location of the source relative to the market, the supply and demand for the product, the cost associated with the extraction and the price that the market would bear for the product. "The royalty is the amount that a buyer would pay the landowner for the right to remove the materials, with the buyer bearing the expense of extraction."[12]

COURT PRECEDENCE

"In United States v. 103.38 Acres of Land (1984), the Sixth Circuit Court of Appeals held that the royalty capitalization method would be competent evidence of mineral value if:

- an active market for the minerals in place is established;
- transactions in the market commonly take the form of royalty payments;
- the valuation witness possesses the requisite industry experience to give an opinion."[13, 14]

"The income approach to value, using a royalty rate in a sand and gravel property, was determined to be the appropriate method in Maricopa County v. Robert Barkley, (1990)."[15]

The Supreme Court of Missouri in St. Louis v. Union Quarry accepted the income method based on the income stream being both stable and directly attributable to the property itself rather than to an activity conducted on the property that relies on the talent or skills of the owner. As was explained in Union Quarry: "The general rule (that lost profits are inadmissible), however, must be given an exception *ex necessitate* where the business is inextricably related to and connected with the land where it is located, so that an appropriation of the land means an appropriation of the business; where the evidence of net profits apparently is clear, certain and easily calculable, based upon complete records; where past income figures are relatively stable, average and representative, and future projections are based upon reasonable probability of permanence or persistence in the future, so that conjecture is minimized as far as possible, and where the body fixing the damages would be at a loss to make an intelligent valuation without primary reference to the earning power of the business."[16]

Condemning agencies often argue that an income approach cannot be used in the valuation of a sand and gravel operation because it is a business enterprise. Consequently, the property owner will argue that real property rights are being acquired and an income approach is warranted since "minerals are an integral part of real estate, and mineral rights are real property under U.S. law."[17] In the case of a sand and gravel operation, the business value (business enterprise) is not part of the equation because royalty rates are used as the "rental income" to the real property only. As noted previously, royalty income is what a landowner would charge an operator to mine materials situated on the property. "In developing an estimate of value by the income capitalization approach for a mineral property, it is generally recognized that the most appropriate method of capitalization is yield capitalization, most notably discounted cash flow (DCF) analysis. The income that may be capitalized is the royalty income, and not the income or profit generated by the business of mining and selling the mineral. For this reason, the income capitalization approach, when applied to mineral properties, is sometimes referred to as the royalty income approach. DCF analysis has been recognized by the courts as an appropriate method of valuation to be employed in the valuation of mineral properties."[18]

According to the survey conducted of sand and gravel operators in the Phoenix metropolitan area, it is common practice to pay landowners a royalty rate on a per-ton basis for extracting aggregate materials. Therefore, the market supports the use of an income approach in the valuation of sand and gravel properties. "In developing an estimated income stream, the property royalty rate can be derived from comparable mineral lease transactions, and the mineral unit price to which the royalty rate is applied may be derived from appropriate market transactions."[19]

The U.S. Securities and Exchange Commission (SEC) requirements regarding the reporting of mineable materials focus on investor protection. The basis of this protection is mineable reserves, and these reserves must be proven and probable. The SEC rules similarly restrict the reporting of valuation estimates of reserves. The SEC's definition of a reserve is: "That part of a mineral deposit which could be economically and legally extracted or produced at the time of the reserve."

This SEC policy is intended to reduce speculative value estimates based upon non-quantitative mineral reserves. Therefore, it is imperative for an appraiser to develop his or her opinion of market value based upon the quantity and quality of the mineral reserves. Again, referencing interviews of operators, their purchase or lease decision is based upon mineable aggregate. Everyone surveyed stated that, as part of their "due diligence," they would want information concerning the quantity and quality of the materials. Some indicated that, at times, this may include performing core drillings.

Another recent specific example of special use properties being valued using the income approach for condemnation is that of a privately owned airport parking lot. This case faced the courts in North Carolina in Charlotte v. Huriahe, et. al., (2006). "The matter at stake was substantial—the city's sales comparison approach would award $842,000, while the landowner's income approach totaled $2,000,000. In the end, both the trial court and the Court of Appeals sided with the landowner, finding that a well-constructed income approach provided the more accurate indication of land value of an airport parking lot."[20]

Clearly, this process is also directly applicable to quarry operations, landfill sites, sand and gravel operations and various other extractive industries where the income to the owner is predictable and is directly derived from the land itself. In most of these cases, the property includes a resource or some intrinsic element that is subject to depletion. Based on its rate of extraction, the level and duration of future income may be readily projected. In addition, its value (if any) once depleted may be estimated and taken to be a reversionary value. Therefore, such properties are ideally suited to discounted cash flow analysis and may be valued on the basis of their net present value.

SUMMARY

The income approach may be used in estimating market value in condemnation proceedings for certain property types, including special use properties. Based on the above findings, the most appropriate method of valuing sand and gravel property is the income approach. For this property type, valuation experts should use the same valuation process that is used by owner/operators when buying or leasing land, if only to reflect the marketplace and these market transactions. In such cases, the royalty income stream is both stable and directly attributable to the property itself, rather than to the business activity conducted on the property or one that relies primarily on the talent or skill of the owner. Furthermore, the future royalty income may be reliably forecasted, analyzed and valued based on a conventional discounted cash flow analysis. ■

ENDNOTES

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16. Duvall, op. cit. p. 7.
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20. *The Greenfield Advisor*, Seattle, Washington. Issue 2-3, June 2006, p. 1.

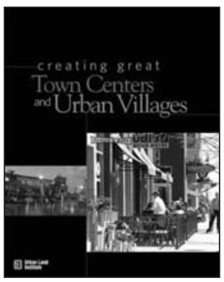
RECOMMENDED READING

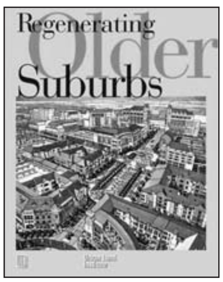
Updating the Corporate Library

Creating Great Town Centers and Urban Villages, *by Prema Katari Gupta and Kathryn Terzano (Urban Land Institute, ©2008)*

Regenerating Older Suburbs, *edited by Richard B. Peiser with Adrienne Schmitz (Urban Land Institute, ©2007)*

REVIEWED BY MAURA M. COCHRAN, CRE, AND PETER L. HOLLAND, CRE





WE RECENTLY OBSERVED that the overall utility and quality of the resource books that we use in our practice have improved in recent years. We should know: Bartram & Cochran's library has tomes going back as many as fifty years. While some dusty volumes will always remain as must-haves (you never know when you are going to need *Ellwood Tables* or *Friedman on Leases*), others are simply coffee table books, more useful as paperweights, but without substance. Others still are esoteric and academic to the extent that they have limited practical use to us as real estate and business advisors.

Over the past several months, our assignments have required us to research urban and inner-ring suburban renewal projects. Our work required recent, innovative and successful case studies. We also needed compelling graphics so that our clients could quickly "get it," and enough substance for us to develop and refine our own analysis.

Two books published by the Urban Land Institute proved very useful in this process: *Creating Great Town Centers and Urban Villages*, Prema Katari Gupta and Kathryn Terzano, ULI 2008, and *Regenerating Older Suburbs*, edited by Richard B. Peiser with Adrienne Schmitz, ULI 2007. Together, they present the "ying and yang" of renewal—namely, case studies of urban areas striving to be more suburban, and suburban areas striving to be more urban. Before these two books arrived in our office, we spent many hours (not always productive) researching appropriate case studies. The ULI publications by comparison were targeted to our needs and provided both detailed and accurate information.

Creating Great Town Centers and Urban Villages has four sections: an Introduction that sets the stage for under-

About the Reviewers

Maura M. Cochran, CRE, SIOR, *joined Bartram & Cochran, Inc. in 1987 and has worked in the commercial real estate industry for more than thirty years. She practices both national and local consulting and project implementation, including due diligence analysis, adaptive reuse studies, marketing plans and corporate relocation assignments.*

Peter L. Holland, CRE, *is a principal with the Hartford, Connecticut-based real estate advisory firm of Bartram & Cochran, Inc. Previously, he served as COO and CFO of CoreNet Global, where he formed part of the thought leadership of the profession and had day-to-day responsibility for the strategic direction, finances and operations of the organization. Before joining CoreNet, Holland served as senior vice president for Hartford Financial Services. He has more than 25 years of experience consulting Fortune 100 and not-for-profit organizations in the field of real estate.*

standing changing attitudes; Development Trends (the integration of civic anchors, non-boutique retail, offices and hotels); Development Principals (which summarizes a 2006 ULI publication *Ten Principles to Developing Successful Town Centers)*; and fourteen individual case studies.

While it is hard to identify any one section as the most relevant, the case studies (which run about eight pages each) stand out for their direct practical usefulness. The case studies detailed the history of the development, site plan, tenant mix and lessons learned. The project data sheets provided the types of tenants, broken down by square footage and number of establishment/units, the development costs and schedule, as well as the entire development team's (developer, master planner, architect(s) and landscape architect and construction firm) location, Web site, as well as the projects. The contact information was particularly helpful. We contacted a number of the developers, architects and planners and were able to interview members of the development teams. Mentioning that we saw a reference to a project in ULI's book gave us an immediate entry and resulted in return calls and productive informative interviews.

The premise of *Regenerating Older Suburbs* is that while inner-city neighborhoods—the most distressed area of the city—have been the recipient of significant study, analysis and funding, the neighborhoods beyond them have been largely ignored by policymakers and developers. However, older first-ring suburbs have many of the problems typically associated with our country's more urban areas.

The book initially was conceived as a monograph funded by a grant from the Royal Institution of Chartered Surveyors to Richard Peiser during a 2003 sabbatical. Peiser serves on the faculty of Harvard University's Department of Urban Planning and Design. The book eventually evolved into fourteen chapters, each of which was contributed by a distinguished author. The book is well organized and is an easy reference tool, being divided into three major sections with helpful subdivisions. In all, ten case studies are provided. We, as well, often find case studies to be repetitive, however, those selected for this book were varied and covered international and domestic locations and a range of issues that the communities and developers were required to confront. As there are different authors for each of the chapters, the chapters are not entirely uniform in content. For example, one case study provided a three-page pro-forma, while others provided taxable sales index charts, a survey that had been sent to real estate professionals, or a listed policy incentive for economic development. This variation is actually a benefit in that each chapter delivers something new to the reader.

The case studies included a development in a "distressed" area (pre-war inner-ring suburb of London); four locations with average economic conditions and three that were ranked as "good to superior"—one of which is the Forbidden City in Beijing.

The book's final chapter presents Peiser's own thoughtful conclusions. No doubt drawing on his years of academic experience, he extracts useful observations from the case studies and we are left with new insights and an effective summary.

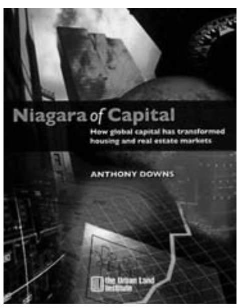
Both books are illustrative of the other high quality publications prepared and issued by ULI. These two books in particular merit a place in your own research library for consulting engagements. New urbanism, public/private partnerships, smart growth, and transportation centric development are all daily words in our vocabulary. Case studies such as presented in these two resources will serve to inform even seasoned practitioners with new ideas and new ways to help clients. ■

RECOMMENDED READING

Real Estate and the Financial Crisis: How Turmoil in the Capital Markets is Restructuring Real Estate Finance

by Anthony Downs (©2009, Urban Land Institute, 180 pages)

REVIEWED BY STEVE PRICE, CRE



TONY DOWNS' 2007 BOOK *Niagara of Capital* documented the causes of hyper-liquidity, loose credit and rapid asset appreciation in commercial and residential real estate markets. His new book follows that excellent account with an equally accurate but more forward-looking volume. *Real Estate and the Financial Crisis: How Turmoil in the Capital Markets is Restructuring Real Estate Finance* was published in April of 2009, but events of the past four months have not dated it. His concerns and scenarios for the future will clearly dog developers and property investors for years to come.

For a readership with little time to spare, Downs' writing style is wonderful. Excellent organization, clear headings, liberal use of bullet points and well presented graphics enable one to finish the book in about three hours yet still absorb an enormous amount of information. It is literary efficiency in action.

Many commercial practitioners (myself included) largely ignored the single-family residential market. In this particular crisis, subprime loans really did matter; though if you asked many of us in commercial markets three years ago, we would have been unfamiliar with them. Yet residential for-sale markets have enormous influence on consumption and employment in the national economy. As Downs emphasizes, national financial policies were frequently based upon the assumption that housing prices would always rise, which they did like clockwork each year from 1968–2006.

Downs underscores the importance of Hyman Minsky's theories of financial instability: optimism; prosperity and easy money spiraling upward in a feedback loop until sheer over-leverage or an outside event causes a pullback in credit; forced assets sales; falling asset prices; and a reduction in economic growth. As Minsky suggests, the more credit and equity available, the greater the speculative sentiment; and the higher the asset prices, the bigger the slowdown. At the same time, it is difficult to plan, forecast or regulate for "down" times when the good times are so strong. After such a crash, Downs emphasizes the risk of inflation resulting from Minsky's recommended large-scale government intervention.

At the end of the book, Downs describes four distinct scenarios with a probability for each. The second of his scenarios, with a 65 percent probability, looks to be the path we currently are on:

- "Prolonged suspension of real estate credit … well into 2010;"
- Historically high unemployment;

About the Reviewer

Steve Price, CRE, *of Terra Property Analytics LLC in Seattle, works on complex land transactions, eminent domain, construction defects, and government and nonprofit acquisitions and dispositions. He also serves on the board of the Chinese Information and Service Center in Seattle.*

- Banks respond slowly, stay weak and attract little new capital;
- Very few commercial real estate transactions;
- The federal government funds economic stimulus, "aggravating already large federal deficits;"
- Thus, recovery will be slower than other post World War I recessions.

Much is still in question as to factors that will affect our recovery:

- Will Asian countries start spending within their domestic economies or will they continue to save and bolster their financial reserves in order to ensure stability? The former will mean more U.S. exports, but a higher cost of funds. The latter may mean a replay of the excess capital and low interest rates of the past decade.
- How will governments balance the demand for increased financial regulation with their role of providing liquidity to the markets?
- How will debt securitization be rebuilt and what mechanisms will ensure trust and transparency?
- So where will we be five to eight years from now?

There will be lower demand for new supplies of owner-occupied single-family units. From 2000–2007, 75 percent of new construction was for-sale units and 25 percent was rental units. From 1960–1989, for-sale units were only at about 55 percent. We can expect a big swing back to multi-family rentals as a proportion of new construction.

- REITs look well-positioned to reprice, recapitalize and act quickly.
- There will be no flood of consumer or investor dollars back into retail any time soon.
- Success in commercial real estate will not be based upon asset creation, transactions and speculation, but on asset management, cost reductions and property improvement.
- In the government arena, the pendulum of power and finance has swung away from the states and cities and back to the federal government. States and cities have lost much of their available financing—because of declines in real estate transactions and sales taxes—as well as the ease with which they can issue new debt.

In addition to your own reading, this book is a great recommendation for clients and colleagues.

For more on Minsky, read *Manias, Panics, and Crashes: A History of Financial Crises*, by Charles P. Kindleberger and Robert Aliber.

For more on scenario planning, try *The Art of the Long View: Planning for the Future in an Uncertain World*, by Peter Schwartz. ■

The (Other) Coastal Economy:

Mobile is the Economic Engine for Coastal Alabama

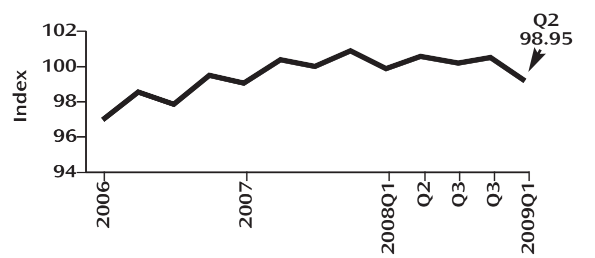
BY DONALD R. EPLEY, PH.D., CCIM, MAI

Editor's Note: Recession and recovery are rarely uniform events geographically. Ever vigilant, and keeping a keen eye out for signs of economic recovery, the editors of Real Estate Issues *intend to invite, on a regular basis, local and regional viewpoints on the business and economic environment from researchers and analysts at academic institutions around the country. Most states, and many, many institutions of higher learning hold within their walls real estate schools, business schools and economics departments that keep a close watch on conditions, developments and trends in the local and regional economies that affect them most directly. We begin in this issue with an analysis and commentary on the Coastal Alabama economy from Donald R. Epley, director of the Center for Real Estate Studies in the Mitchell College of Business at the University of South Alabama.*

THREE VIEWS OF THE COASTAL ALABAMA ECONOMY provide a good cross-sectional analysis of the direction and strength of future activity. The Mobile Business Activity Index is an approximation of economic growth. It tracks employment for 10 NAICS industrial classifications weighted by each industry's personal income-per-worker. It shows the level of workforce spending power in the economy. Business activity declined 0.11 percent from the previous quarter, and 1.57 percent from the same quarter in 2008. The index increased 3.58 percent from the same quarter four years earlier. Although the current index declined slightly, the overall three-year trend is upward with a modest growth.

Figure 1

Mobile Business Activity Index



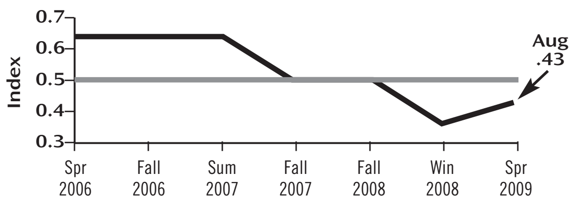
The Mobile Leading Business Activity Index includes 14 time series selected as good indicators of future business activity. All series are assembled for the most recent month or quarter, three statistical tests are applied, and the results are weighted into an index number that provides a good indication of business activity in the next six months. An index above .50 is considered to the positive with moderate strength.

About the Author

Donald R. Epley, Ph.D., CCIM, MAI, *is a USA Distinguished Professor of Real Estate and director for the Center for Real Estate Studies, Mitchell College of Business at the University of South Alabama in Mobile. He holds a doctorate degree in regional and urban economics from the University of Missouri, and was awarded a MAI designation from the Appraisal Institute and a CCIM designation from the Commercial and Investment Institute. Epley served as president of the American Real Estate Society and on its board of directors for fifteen years. He was elected as a trustee of the Appraisal Foundation (Washington, D.C.) and served a term on its executive committee. Epley has authored and co-authored nine textbooks, and has been the editor of two academic journals. He frequently is quoted in the media on his analysis of the local economy and real estate markets.*

Figure 2

Mobile Leading Business Activity Index



The most recent Leading Index was +.43 which is a below average performance. When the four time series representing the U.S. economy and the state of Alabama are removed, the Index increases to .60, representing an above-average performance. This means that the 10 remaining Mobile indicators point to a stronger performance in the next three months.

In the period following 2003, the rate of increase in local employment was higher than the rate of increase in the local civilian workforce, which is a good indicator of the future. This relationship caused the unemployment rate to drop to 3.2 percent. In recent periods, the reverse is true, causing the unemployment rate to increase to 9.5 percent in May.

All four of the national and Alabama indicators were judged to be negative. The U.S. Conference Board Leading Index showed a recent increase, but has not yet indicated a definite positive influence on the local metro area. The Alabama Business Index reached its lowest level ever with a very slight recent increase. In sum, the national and state indicators do not indicate an improving business environment.

The USA Activity Index projection, new residential 1-unit building permits, city sales tax collections, county sales tax collections, and total attraction visitors were all viewed as heading in the right direction.

Figure 3

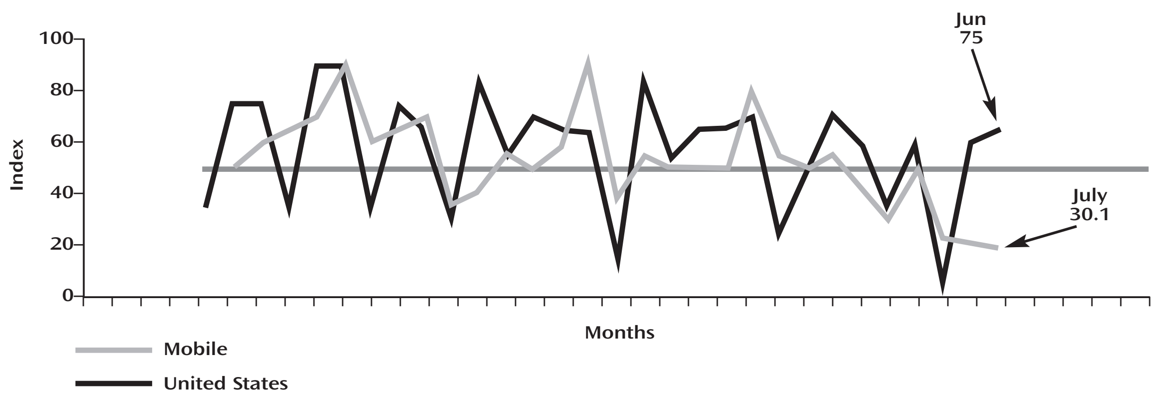
2009 Critical Mobile Economic Indicators
Time Series in the Leading Business Index

Fourteen time series have been selected to represent the indicators of future business activity growth

	COVERAGE	DIRECTION
U.S. CONSUMER AND BUSINESS ATTITUDES:		
Index of Consumer Sentiment	U.S.	–
Non-Mfg. Business Activity Index	U.S.	–
U.S. Leading Economic Index	U.S.	–
ALABAMA BUSINESS MARKETS:		
Alabama Business Outlook	State	–
MOBILE MSA:		
Mobile Business Activity Projection	Mobile	+
Non-Farm Employment	Mobile	–
Unemployment Rate	Mobile	–
New Residential 1-Unit Permits	Mobile	+
Home Affordability	Mobile	+
Housing Sales	Mobile	–
City Sales Tax Collections	Mobile	+
County Sales Tax Collection	Mobile	+
Total Attraction Visitors	Mobile	+
Special Events and Convention	Mobile	–

Figure 4

Mobile and U.S. One-Month Employment Diffusion Index



Negative influences included a recent rise in the unemployment rate, non-farm employment, housing sales, and special events and convention visitors. In sum, the Leading Index indicates an above average performance of the local economy.

The One-Month Mobile Employment Diffusion Index is comparable to a similar index for the U.S. economy. It measures the dispersal and impact on the economy of employment changes in specific industries. Each change in each of the 10 industrial clusters followed is weighted to reflect an expansion or contraction. Expanding industries will have a greater future impact on business activity than those that are contracting.

The latest Mobile Diffusion Index for Mobile in June is 75 compared to 30.1 for the U.S in July. Recent Mobile employment growth indicates a much larger future impact than the changes at the national level. Although the economy did not register large employment growth in any one cluster, six experienced an increase and three remained the same. Only one, Mining and Construction, declined. The overall impact is that the local economy showed a positive response to the negative impact of the national recession.

In conclusion, diversification of the local economy and recent economic development successes will cause business activity to respond to recession more slowly and to recover more quickly. ■

This report can be found at http://cres.southalabama.edu. *For additional information, contact Dr. Don Epley, director, Center for Real Estate Studies, Mitchell College of Business, University of South Alabama, Office: 251-460-6735, E-mail:* depley@usouthal.edu.

REAL ESTATE ISSUES®

Real Estate Issues is a publication of the professional membership organization The Counselors of Real Estate. The publication is not an academic-oriented publication. Rather, it is a commercial real estate journal written for and by practitioners. Its focus, therefore, is on practical applications and applied theory.

Contributions from industry experts—from CRE members and nonmembers alike—have given *Real Estate Issues* a reputation in the real estate industry for offering substantive, timely content about key industry issues and trends. Members of The Counselors receive complimentary subscriptions. Nonmember subscribers include real estate and real estate-related professionals, organizations and institutions.

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Feature articles explore practical applications and applied theory addressing the diversified issues encountered in the broad field of real estate. *REI* accepts manuscript submissions that are no longer than 25 double-spaced pages (about 7,000 words) and no shorter than 10 double-spaced pages (about 2,800 words). Charts, graphs and photos are welcome, when appropriate, to enhance the article. CREs and nonmembers can contribute feature articles.

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3. RESOURCE REVIEWS
Resource reviews provide commentary about real estate-related and business-related books, Web sites and other resources that would be beneficial to real estate practitioners. Reviews are two to five double-spaced pages (500–1,500 words). CREs and nonmembers can contribute resource reviews.

4. CASE STUDIES
Case studies are actual counseling assignments that CREs have performed for clients. These studies should include: commentary on the decisions made regarding the approach to the problem, investigation and analysis; commentary as to why the work was needed; appraisal, brokerage, mediation, and related services; and visuals.

IMPORTANT NOTE: all case study submissions must include confirmation of the client's approval to share the details with a wider audience. Visit www.cre.org>publications>Real Estate Issues>Call for Manuscripts/Editorial Guidelines for a template, and more information.

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2. Graphics/illustrations are considered figures, and should be numbered consecutively and submitted in a form suitable for reproduction. Electronic forms are acceptable.
3. Number all graphics (tables/charts/graphs) consecutively. All graphics should have titles.
4. All notes, both citations and explanatory, must be numbered consecutively in the text and placed at the end of the manuscript.
5. For uniformity and accuracy consistent with *REI*'s editorial policy, refer to style rules in *The Associated Press Stylebook*. The *Real Estate Issues* managing editor will prepare the final manuscript in AP style.

REVIEW AND SELECTION PROCESS
All manuscripts are reviewed by at least three members of the REI Editorial Board: two members of the board and the editor in chief. Author names remain anonymous.

The managing editor makes every effort to notify authors about the status of manuscripts under review at the earliest possible date.

The policy of *Real Estate Issues* is not to accept articles that directly and blatantly advertise, publicize or promote the author or the author's firm or products. This policy is not intended to exclude any mention of the author, his/her firm, or their activities. Any such presentations however, should be as general as possible, modest in tone and interesting to a wide variety of readers. Authors also should avoid potential conflicts of interest between the publication of an article and its advertising value.

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The William S. Ballard Award is presented annually to the author or authors whose work best exemplifies the high standards of William S. Ballard, CRE, and the high standards of content maintained in *Real Estate Issues*. The award-winning manuscript, selected by a three-person committee, is chosen from the published articles that appear in an annual volume of the journal. CRE and nonmember authors are eligible. The award, which is funded by the William S. Ballard Scholarship Fund, includes a $500 honorarium and is presented at a national meeting of The Counselors.

The award is named in honor of William S. Ballard, who was a leading real estate counselor in Boston in the 1950s and 1960s. He was best known for the creation of the "industrial park" concept and developing the HUD format for feasibility studies. He was an educator who broke new ground during his time in the real estate business, and whose life ended prematurely in 1971 at the age of 53.

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