Appraisal Issues in a Down Market

Overview
The current real estate recession has placed stresses on certain basic relocation processes, notably the appraisal process where falling values create pressures from a number of sides. Work-arounds implemented to deal with transferee concerns about home values, including the elimination of forecasting and market change adjustments, may be viewed by the IRS as noncompliant with a tax-protected program. Care must be taken to avoid issues of outdated appraisals and directed offers that can result from manipulating the appraisal process and can generate taxable wage income.

Where Did This Problem Come From?
One of the assumptions underlying homesale programs, particularly those with buyout provisions, is that transferees will achieve reasonable success in marketing their homes. Companies count on this success to avoid taking homes into inventory, and employees count on it to move promptly to their new job location.

In a weak and depreciating real estate market, however, employees often make an incorrect assumption that the purpose of the buyout is to guarantee them the “value” of their home. This assumption is wrong for two reasons. First, relocation programs are not designed to keep employees whole, merely to facilitate their relocation. Second, and more to the point, the relocation appraisal does not measure fair market value in the usual sense of the term. Rather, it predicts the home’s probable selling price over a fixed period of time.

This confusion may give rise to instructions to appraisers that have unintended and potentially harmful consequences.

Defining a Relocation Appraisal
To begin with, a relocation appraisal must be understood as a special case. It is only one of many different real estate appraisals, each created for a specific purpose. An insurance appraisal establishes a home’s replacement value. A mortgage appraisal determines whether a home supports a loan of a certain amount.

Yet another type of appraisal establishes the fair market value of a property so an estate can be divided equitably among heirs and its tax liability calculated.

A relocation appraisal is none of these. It serves a purpose defined solely by a 1972 tax ruling extending a tax benefit to relocating employees for a broker’s commission and certain closing costs involve in a qualifying homesale program.

A relocation appraisal defines market value as “the most probable sales price using the market approach to value,” which calls for the home to be “exposed to the market for a reasonable period of time,” which is defined as “up to 120 days.” There is a hidden problem in this definition, however. Although 120 days is closer to the average time to sale in stable and appreciating markets, in weakened markets the difference can be pronounced. Herein lies a major source of confusion and discontent among transferees.

Adjusting the definition to reflect a battered real estate market is no solution, however. Within the
appraisal definition above are concepts, fundamental to the Uniform Standards of Professional Appraisal Practice (USPAP), that embody the appraisers’ code of ethics. Thus, decisions to deviate from these appraisal standards, specifically in technical areas of “forecasting” and “market change adjustments,” can cause significant conflicts for appraisers. They can also generate tax and legal liability for companies directing appraisers to modify the standards underlying a relocation appraisal.

Non-Conforming Appraisals
There are four main areas where companies may consider deviating from standard relocation appraisal practices. They are outlined in detail (together with several other related issues) in a December 2008 White Paper issued by Relocation Appraisers and Consultants (RAC), an established industry group. These areas are:

1. Market Change Adjustments;
2. Forecasting;
3. Client-Directed Marketing Time; and
4. Use of Foreclosure/REO Properties as Comparables

1. Market Change Adjustments
According to ‘The Relocation Appraisal Guide-2001’ published by Worldwide ERC, “The ‘Market Change’ brings the sales prices of comparable homes current with market conditions as of the date of the subject property's inspection. This is accomplished by making adjustments for any changes in market prices that have occurred between the contract dates of the comparable sales and the inspection date of the subject property.”

The adjustment is backward looking and accounts for events in the market that can be documented, such as a change in the supply of homes for sale or fluctuations in mortgage rates. Instructing appraisers to ignore these factors—in effect, to make believe that the subject property was being marketed in better times—produces an artificially high valuation.

2. Forecasting
A forecasting adjustment anticipates events and conditions that are likely to occur in the future. It is forward looking and accounts for events in the market that, in the appraiser’s professional judgment, are likely to affect the probable sales price of a property that is marketed in the immediate future. It balances a number of local, national, and governmental factors that will be in play in the next 120 days, from possible plant closings to government stimulus plans. Instructing appraisers to ignore forecasting adjustments that are negative—as most in the current environment are—inflates the home’s valuation. The Relocation Appraisers and Consultants (RAC) organization has noted that “Worldwide ERC Guidelines strictly require ‘Forecasting’, which is an essential element for an ERC Summary Appraisal Report and a critical component of Anticipated Sales Price.” Appraisers not abiding by these instructions are in violation of the Uniform Standards of Professional Appraisal Practice (USPAP) and state license law.

3. Client-Directed Marketing Time
Relocation appraisals do not use different standards for good and bad markets. This relates to the fact that they are not fair market value appraisals, but follow an arbitrary standard established by the wording of a tax ruling. In a market characterized by extended average time to sale, a 120-day value appears to be a distressed (“quick-sale”) valuation. However, this is a necessary consequence of complying with the IRS's position on a tax-protected transaction. Instructing appraisers to use normal marketing time for the area artificially increases the home's valuation and, in the IRS’s eyes, produces income to the employee that is similar to the more familiar “directed offer,” in which the company instructs Cartus to purchase the employee's home at an amount above that determined by the appraisals.

4. Use of Foreclosures/REO Sales
The subprime crisis has generated unprecedented levels of foreclosures and sales of bank-owned properties. In some markets, more than half of current sales are foreclosed homes. For accounting reasons, banks are motivated to mitigate their losses and remove unproductive assets from their books by accepting what many consider below-market prices, creating what
appears to be an unfair landscape in which to market a home. Hence, some companies have instructed appraisers not to include foreclosed homes as comparables. Unfortunately, from a buyer’s perspective, a foreclosed home and an owner-occupied home are interchangeable, everything else being equal, and the influence of foreclosures on the probable sales price of the employee’s home is real. Again, instructing the appraisers to ignore an active factor in the market artificially increases the valuation they render.

**Outdated Appraisals**

Relocation appraisals have no use in an abstract sense—they do not measure the property’s intrinsic worth, but are designed to be used in a relocation program to calculate the buyout price to be offered to an employee. That offer is accompanied by an opportunity to market the home in the hope of generating a higher external offer. In a weak and depreciating market—despite incentives and prescriptive policy measures such as list price restrictions and use of qualified agents only—companies often find that their employees are seeking additional marketing time. It is not uncommon to hear a transferee say, “I know my home hasn’t sold in the allowed marketing period, but it’s still worth at least your appraised value and if I only had a little more time, I could prove it.”

The value determined by the appraiser is valid for only 120 days, however. Consequently, if the company directs that the offer be extended longer than 120 days, the effect is similar to directing the appraiser to expand allowable marketing time in determining the home’s value. Thus, the appraisals that determine the offer price become outdated, and extending the offer beyond 120 days creates an artificially high offer to the employee that amounts to a form of compensation. Outdated appraisals should therefore be formally updated by the appraisers.

**Tax Implications**

Companies face a potentially serious risk by engineering an inflated offer price to the employee through nonconforming appraisals. The danger is that an IRS audit might find that their relocation program is at variance with applicable wage laws. This could not only jeopardize the tax-protected status of the entire program, it could also generate liability for penalties and interest.

Alternatively, clients considering any of the appraisal adjustments outlined above, in an effort to deliver more money to relocating employees, should weigh the advisability of identifying the additional payment as taxable income to the employee, subject to withholding and payroll taxes and reportable as wages on the employee’s Form W-2. The advice of the company’s tax counsel is an important step in finalizing a position for the company and its relocation program.