

## **ADMINISTRATIVE NOTICE 2009-04**

**SUBJECT:** Property Tax -- State Tax Commissioner's Statement Concerning Primary Reliance on the Income Approach to Value for Appraisals of Producing and Reserve Coal, Producing Oil and Gas, and Producing Other Mined Minerals Pursuant to §§110 CSR 1I-4, 1J-4 and 1K-4.

The Legislative Rule § 110 CSR 1J-1 et seq. concerning the appraisal of producing and reserve oil and gas properties became effective June 1, 2005, § 110 CSR 1I-1 et seq. for the appraisal of producing and reserve coal properties became effective May 1, 2006 and § 110 CSR 1K-1 et seq. for the appraisal of producing other mined mineral properties became effective May 1999. This notice will address these rules' primary reliance on the income approach to value when appraising active and reserve coal, producing oil and gas, and other mined mineral properties for property tax purposes.

### DISCUSSION

There are three (3) generally accepted approaches to value that must be considered when estimating market value of property for ad valorem tax purposes. These are the cost, market, and income approaches. These approaches to value must be considered and should be developed, if appropriate, to properly estimate market value in compliance with generally accepted appraisal principles. The following is a brief discussion of these three (3) approaches to value and their potential use when estimating the market value of producing natural resource properties for ad valorem tax purposes.

### COST APPROACH

The cost approach to value is based upon the assumption that the cost of a property, less depreciation (loss in value), yields a reasonable estimate of market value. There are three (3) generally accepted types of cost approach appraisal methods; these are: original cost less depreciation, reproduction cost less depreciation, and replacement cost less depreciation. Depreciation is a loss in value due to physical deterioration through use, functional obsolescence through design or utility and economic obsolescence due to outside market forces.

Original cost less depreciation is the cost of acquisition of a property less a loss in value due to physical deterioration, functional obsolescence and economic obsolescence. This approach is widely employed in the appraisal of "cost-based" regulated utilities, however it has a limited application when appraising producing natural resource properties, as many of these types of properties were acquired years ago at substantially less than current market value.

Reproduction cost less depreciation is the cost of reproducing an exact replica of a property less physical deterioration, functional obsolescence, and economic obsolescence. This approach is employed in appraising one-of-a-kind properties such as works of art or special purpose properties, an example of which is the State's Capitol Building. Coal, oil and gas, and other mined minerals are a nonrenewable natural resource and can therefore not be reproduced. Because of their nonrenewable nature, producing natural resource properties do not lend themselves to development of a reproduction cost less depreciation appraisal.

Replacement cost less depreciation is the cost of replacing a property with one of like utility less physical deterioration and economic obsolescence. This approach is the most widely used of the three (3) cost approaches to value and is widely employed in the appraising of commercial and industrial personal property. Replacement cost has limited application, however, in the appraisal of nonrenewable natural resource properties, as the resource cannot, by its nature, be replaced.

### MARKET APPROACH

The market approach to value is based upon the assumption that the recent selling price of comparable properties if properly analyzed and adjusted, if appropriate, will yield a reasonable estimate of current market value. This valuation approach is widely employed in the valuation of residential real estate where a considerable number of properties transfer on a reasonably frequent basis. Natural resource properties sell infrequently and when they do sell they are quite often only a portion of the property acquisition thus diluting the purity of the market transaction. Therefore, the market approach to value has limited application because of the lack of a sufficient number of sales of natural resource properties to statistically support development of the approach for natural resource properties.

### INCOME APPROACH

The income approach to value is based upon the assumption that a property is worth the future income, discounted to present worth, that it will generate for a perspective buyer. The income approach is widely used in the appraisal of various types of income producing properties and is appropriately used in several taxing jurisdictions to value producing natural resource properties, i.e. natural resource properties that produce an income stream. In addition, the income approach can be developed for non-producing properties through use of estimating the unit income value and apportioning the value to non-producing properties based upon their probable time of mining.

## APPLICATION

From the above discussion it becomes readily apparent that development of a cost or a market approach valuation for producing and reserve coal and producing oil and gas and other minerals properties is inappropriate. The Tax Department therefore developed and relied upon an income approach appraisal; as the income approach is the only one (1) of the three (3) generally accepted approaches to value that can properly be developed to yield reasonable estimates of current market value when used in a mass appraisal environment.

For further information concerning the use of the income approach to value natural resource properties see §§110 CSR 1I-1, 1J-1 and 1K-1 et seq. or contact the State Tax Department at (304) 558-3940.

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