

# City of Milwaukee Department of City Development

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## MEMORANDUM

TO: Ald. Jim Bohl

FROM: Martha Brown  
Deputy Commissioner

DATE: November 21, 2017

SUBJECT: File #170641

This memo responds to your request for feedback from the Department of City Development regarding file #170641. The file would require that the “income capitalization method” of property valuation be used to price City-owned foreclosed property. All tax-foreclosed properties would be priced by this method. The vast majority of affected properties are one- and two-family houses.

The Dept. of City Development does not support this file. We believe its adoption would reduce the sale of foreclosed properties to both investor and owner-occupant buyers. Also, in our estimation, the file is nearly impossible to implement.

### Background

Income capitalization valuation is one of several approaches used by property appraisers to determine the value of property. We note that it is considered a “third tier” appraisal technique, and less favored by appraisers than other approaches.

The income approach, when it is used, is generally used to value commercial buildings that have an ongoing, documented revenue stream; examples would be an occupied office building, apartment building, or shopping center. The appraiser also needs to review verifiable information regarding the real estate market, operating expenses of the building, and reasonable return on investment (the “capitalization rate”) that the buyer seeks to earn once he/she owns the building.

The costs of major repairs to the building are not always considered when valuing property using the income capitalization method. The proposed ordinance seems to provide no discount for the cost of needed property repairs.

### DCD’s concerns

#### ***The method requires data that DCD is unable to obtain.***

The appraiser requires accurate data about the property and the market in order to value it using the income approach. Required data includes:

- Occupancy and vacancy data
- The rental income the building generates.
- The average loss of income caused by nonpayment of rent and vacancy.
- The ongoing expenses to operate the building, such as utilities, property taxes, insurance, maintenance and so on.
- The amount put aside by the landlord to replace items that need to be upgraded periodically. For an apartment building, for example, these items could be appliances.
- Capitalization rate.

DCD has no access to this data for the hundreds of tax-foreclosed properties sold annually, and we understand that the City assessor keeps no such data for one- and two-family properties. Most property is vacant at the time of tax-foreclosure, and the City receives no records regarding

the historic revenue and expenses related to the management of the property prior to City ownership. For those properties that are occupied at the time of acquisition, we have only the tenant's word about what they have paid in rent, with no records regarding actual rent revenue and operating expenses. When the City forecloses, the City does not obtain a copy of any lease that may have been in place. Tax foreclosure, by law, terminates existing leases.

***This valuation method does not recognize the expenses the buyer will need to incur to renovate and repair the property he/she buys.***

When the City sells a property, the City requires the buyer to make certain improvements to the property. The proposal, and its definitions of value as investor-owned and value as owner-occupied, appears to not recognize the dilapidated condition of most of the properties in the City's inventory, and the need for buyers to incur substantial expenses to address code violations.

***There is no known method to determine the monetary value of the mortgage that would be held by the City when property is purchased by an owner-occupant buyer.***

The file assumes that the community experiences certain benefits when a property is purchased by an owner-occupant rather than investor. These benefits are defined as increased resident engagement, improved neighborhood stability, reduced crime, and decreased neighborhood blight.

The file requires that DCD staff assign a monetary value to these benefits for each property purchased by an owner-occupant, in order to calculate the difference between the value of the property as investor-owned and the value of the property as owner-occupied. That dollar value would be recited in a mortgage recorded against the buyer's title with the Milwaukee County Register of Deeds.

While we agree that high rates of owner-occupancy are a positive indicator for neighborhoods, we know of no methodology that will allow staff to accurately calculate the dollar value of these social benefits in order to calculate the value of a mortgage for a particular property. Each piece of real estate is unique, and location is very important in the valuation of property. Thus, it is not appropriate to use a standard mortgage amount. However, a mortgage amount that is not standard, and that varies to recognize uniqueness of each parcel, runs the risk of being arbitrary in practical implementation.

***Property sales will likely fall. Fewer tax-foreclosed properties will be returned to the tax rolls, renovated and re-occupied.***

Typical owner-occupant buyers are low- to moderate-income households that are extremely price-sensitive. All properties would be listed for sale at the "investor" price. These higher prices will make City properties less attractive to the owner-occupant buyers we most want to attract.

The proposal includes a mortgage provision that that seeks to reduce costs for owner-occupant buyers. Earlier in this memo, we have shared concerns about the difficulty in calculating this mortgage. In addition, specific elements of that provision will discourage owner-occupant buyers.

- The provision is difficult for both real estate brokers and buyers to understand. This is a particular concern for buyers who have little familiarity with real estate transactions, including first-time home buyers and buyers for whom English is their second language.
- If a buyer needs to move out of a property or sell it within five years of purchase, the buyer will be hit with a demand from the City to immediately pay the balance of the mortgage. This provision will have a chilling effect on sale to owner-occupants.
- While additional research is needed, it appears the IRS will treat the amount of the mortgage forgiven annually as income to the buyer for tax purposes. This imposes a financial burden on buyers.

Over the past three years, investors have purchased 45 percent of the 1,375 tax-foreclosed properties that have been returned to the tax rolls. The majority of these investors are responsible buyers who have spent considerable sums to turn distressed houses into decent, safe living spaces for Milwaukee residents. The City's investor customers include:

- Developers that have purchased and renovated multiple properties that otherwise would have been razed.
- Agencies that provide home-buying opportunities for low-income families, such as ACTS and Habitat for Humanity.
- "Mom-and-pop" investors who are able to establish a small business by purchasing, renovating and renting properties.

Most neighborhood properties acquired through tax foreclosure are vacant and have suffered significant deferred maintenance, intentional neglect, and/or serious vandalism. Investor buyers must invest funds to restore essential services and make repairs and upgrades before seeking tenants. However, sale prices based solely on the income capitalization valuation method would not recognize that buyers must make major capital investment in order to make properties rentable.

Responsible buyers always take the cost of repairs into consideration when making a property purchase decision. A pricing method that ignores property condition and the costs of renovation and repair will set prices that investors are unwilling to pay, resulting in reduced sales to investors. DCD's discussions with local real estate brokers that list City properties for sale confirm this concern.

Please contact me at ext. 5810 if you have questions about these comments or wish to discuss the proposal in greater detail.