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Avoid Unnecessary Real Property Taxes

When Buying an On-Going Business that Includes Real Estate in Ohio

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Beware the valuation pitfalls involved with the purchase of an on-going business that owns real estate. A buyer can accidentally cause its real property taxes on the newly purchased property to increase dramatically if it fails to allocate values properly between personal property and real property. Fortunately, a few preventative measures can be taken at the closing to prevent an unnecessary real property tax increase and litigation.

Imagine the following scenario: Company ABC decides to buy a hotel. The purchase includes the real estate on which the hotel is located, the personal property, including the furniture, fixtures and equipment ("FF&E") within the hotel, and the goodwill associated with the hotel franchise. The purchase price for everything is $3,600,000. Neither the purchase agreement nor the settlement statement allocates this purchase price between the real estate, FF&E and goodwill. After the closing, a title agent goes to record the deed for the real estate at the local recorder's office. The agent is asked to fill out a "Real Property Conveyance Fee Statement of Value and Receipt" (a/k/a "Conveyance Fee Statement"). The agent fills-in the purchase price as the consideration for the real property. Shortly thereafter, Company ABC receives a notice that the County Auditor will be increasing the value of the real property to reflect the $3.6 million purchase price, and the real property taxes will be going up to reflect this new, higher value. Company ABC objects because the $3.6 million price reflects the combined value of the real property, FF&E and goodwill. Now, to challenge the property valuation, Company ABC must file a complaint with the county board of revision and prove that the purchase price, as stated on the Conveyance Fee Statement, does not reflect the fair market value of the real property.

This is exactly what happened in a recent Ohio Supreme Court case, *Hilliard City Schools Bd. of Educ. v. Franklin Cty. Bd. of Rev.*, 128 Ohio St.3d 565, 2011-Ohio-2258, 949 N.E.2d 1. The buyer in that case, K.D.M. and Associates, L.L.C. ("KDM"), purchased an 80-room, fully operating hotel for $3,600,000. Shortly thereafter, the Franklin County Auditor increased the value of the real property from $2,240,000 to $3,550,000. KDM filed a complaint, and the Franklin County Board of Revision reduced the real property value by $800,000 for FF&E, $60,000 for inventory, and $500,000 for goodwill for a final real property valuation of $2,240,000. The local school board appealed to the Board of Tax Appeals ("BTA"), which disallowed the $500,000 allocation to goodwill and the $60,000 allocated to inventory. Thus, the BTA concluded that the value of the real estate was $2,750,000. On appeals by both KDM and the school board, the Supreme Court valued the real estate even higher. The Court decreased the deduction for FF&E from $800,000 to $280,000. In addition, the Court refused to permit the deduction of $500,000 for goodwill. Thus, approximately six years after the plaintiff purchased an operating hotel for $3,600,000, the Ohio Supreme Court determined that the value of the real estate involved was $3,320,000.

What could KDM have done to avoid years of litigation and an additional $1.1 million in real property tax value? First, KDM could have completely filled out the Conveyance Fee Statement. Section 8(E) of this form asks what portion, if any, of the total consideration paid was for items other than real property. After every sale, the auditor will evaluate whether to increase or decrease the property's valuation. This determination is made, in part, based on the Conveyance Fee Statement. If the new property owner allocates the purchase price on the Conveyance Fee Statement and the auditor accepts the allocation at this stage, then the new property owner does not have to challenge the auditor's valuation. Further, if the local school board challenges the property valuation, the school board has the burden of proving a higher valuation. Thus, a fully completed Conveyance Fee Statement can head-off potential valuation disputes.

Second, KDM could have documented the allocation between real property, FF&E and goodwill in the closing documents. Notably, the settlement statement for the hotel purchase did not provide an allocation to personal property. In addition, the bill of sale for personal property was incomplete. The bill included "inventory, equipment, fixtures, assets used by seller in the business in the attached 'Exhibit A'", but there was no Exhibit A, nor any value assigned to that property. Thus, KDM had little evidence from the closing to support its conclusion that $800,000 of the purchase price was for FF&E, $60,000 was for inventory, and $500,000 was for goodwill.

The Supreme Court ultimately concluded that the FF&E was worth $280,000 based on a financing appraisal conducted in anticipation of the purchase. The Court pragmatically concluded that an operating hotel clearly included personal property, and this personal property clearly had value to be allocated as part of the purchase price. Thus, the Court rejected the school board's argument that the sale price, as set forth in the Conveyance Fee Statement, reflected the fair market value of the real property. The Court, however, rejected KDM's representatives' testimony about the value of the FF&E and rejected an unauthenticated, 2005 year-end financial statement showing FF&E of $800,000. With no allocation on the Conveyance Fee Statement or in the closing documents, the best evidence available to the Court was the financing appraisal which presented an estimation of value relied upon by KDM's lender at the time of the sale. The Court utilized such appraisal evidence.

In conclusion, the purchase of an on-going business can have multiple moving parts. If you are contemplating a purchase that includes real estate, remember to document the purchase price allocation between real and personal property in both the Conveyance Fee Statement and closing documents. These simple steps can avoid unnecessary real property taxes and litigation.