PURCHASE PRICE ALLOCATION IN REAL ESTATE TRANSACTIONS:

Does A + B + C Always Equal Value?

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Purchasers of income-generating real estate generally focus solely on cash flow rather than the individual components generating that cash flow.

This seeming truism has not been true either for larger transactions involving substantial personal property or goodwill or in the context of ad valorem taxation where taxing authorities generate separate tax bills, often at different rates, for real property, personal property and business licensing fees. This proposition is becoming less true in the current economic environment, as lenders face increasing regulatory pressure to "take less risk" by separately valuing the components generating the income and valuing the risk separately.

Originating primarily in the context of valuing hotel properties for proper determination of the project's real estate value for ad valorem tax purposes, the concept of component analysis has far broader applications. The Appraisal Institute[2] currently includes as potential additional candidates for component analysis: (i) health care facilities such as hospitals, nursing homes and ambulatory surgical centers; (ii) regional shopping centers, office buildings and apartments; (iii) restaurants and nightclubs; (iv) recreational facilities such as theme parks, theaters, sports venues and golf courses; and (v) manufacturing firms.[3]

The purpose of this paper is not to present a study of component analysis bur rather to identify some of the areas where component analysis should be considered.

The Concept of Component Analysis

Investors typically look primarily at total cash flow without attributing cash flow to specific components. However, a purchaser of an operating real estate project often internally analyzes components when evaluating how to improve operational performance and to analyze the impact of certain tax consequences on potential overall return. Potential issues include:

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[2] "The Appraisal Institute is a global association of real estate appraisers, with nearly 23,000 valuation professionals in almost 60 countries throughout the world. Its mission is to advance professionalism and ethics, global standards, methodologies, and practices through the professional development of property economics worldwide." "The mission of the Appraisal Institute is to advance professionalism and ethics, global standards, methodologies, and practices through the professional development of property economics worldwide." The Appraisal Institute, *http://www.appraisalinstitute.org/about/*.

[3] HANDBOOK FOR FUNDAMENTALS OF SEPARATING REAL PROPERTY, PERSONAL PROPERTY, AND INTANGIBLE BUSINESS ASSETS 107 – 110 (Appraisal Institute 2011) (hereinafter *AI Handbook*).

- Real estate transfer taxes;[4]
- Allocation of basis for income tax purposes;
- Real and personal property tax assessments and taxes; and
- Segregation of readily depreciable/amortizable assets from nondepreciable/amortizable assets.[5]

Value allocation generally involves four components:

1. Land (non-depreciable);
2. Buildings/improvements (generally depreciable over lengthy time periods);
3. Tangible personal property; and
4. Goodwill/ongoing business value represented by intangible personal property or "business enterprise value."

The terminology surrounding this fourth component is confusing and referred to by multiple names including intangible value, goodwill and business enterprise value ("**BEV**").[6] The *Dictionary of Real Estate Appraisal* defines "business enterprise value" as "the value contribution of the total intangible assets of a continuing business enterprise such as marketing and management skill, an assembled work force, working capital, trade names, franchises, patents, trademarks, contracts, leases, and operating agreements."[7] The *Appraisal of Real Estate* does not specifically define BEV but offers the following comments on the value of a going concern:

> A going concern is an established and operating business with an indefinite future life. For certain types of properties (e.g., hotels and motels, restaurants, bowling alleys, manufacturing enterprises, athletic clubs, landfills), the physical real estate assets are integral parts of an ongoing business. The market value of such a property (including all the tangible and intangible assets of the going concern, as if sold in aggregate) is commonly referred to by laymen as business value or business enterprise value, but in reality it is market value of the going concern including real property, personal property, and the intangible assets of the business.[8]

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4 The applicability of transfer taxes is jurisdiction specific but the taxes are usually based on the "value" of the real estate being sold. *See, e.g.,* S.C. CODE ANN. § 12-24-10 *et seq*. (2000 & Supp. 2011). Including the overall value of the business within the stated consideration on a deed will generally lead to unnecessarily higher transfer taxes.

5 *See* Michael Allen, *Price Allocation, Gain Tax Benefits by Allocating Price Before Closing Sale of Business*, PRACTICAL TAX STRATEGIES, Aug. 25, 2008.

6 *See* AI Handbook, p. 101-107.

7 APPRAISAL INSTITUTE, DICTIONARY OF REAL ESTATE APPRAISAL 25 (5th ed. 2010).

8 APPRAISAL INSTITUTE, APPRAISAL OF REAL ESTATE 29 (13th ed. 2008).

Integrating a well thought out allocation into a purchase transaction can yield significant income, property and transfer tax savings and simplify recordkeeping. In fact, in many transactions, a component analysis is critical, if not required. For example, price allocation can be worth tens of millions of dollars currently and in future depreciation in addition to transfer tax and ad valorem property tax considerations.

When analyzing the value of income producing real estate properties, the Appraisal Institute, Internal Revenue Service ("**IRS**"), Securities Exchange Commission ("**SEC**") and Financial Accounting Standards Board pronouncements of the America Institute of Certified Public Accountants ("**FASB**") all recognize that a property's value includes an intangible value component[9]. Similarly, component analysis is applied in ad valorem taxation where taxing authorities are generally charged with separately taxing (i) real property value, (ii) personal property value, and (iii) intangible value, often at different rates.[10] For example, some jurisdictions do not tax personal property.[11]

While the concept of BEV may be generally recognized, no consensus exists as to how to extract this intangible value from the property's overall value. That lack of consensus may help explain some of the vitriol surrounding the debate in the appraisal world on how to calculate BEV. Some also suggest that the concept raises questions as to the qualifications of real estate appraisers to value at least some of the components creating value, suggesting that this role is better suited for business valuation experts. Although particular circumstances may call for a component analysis for a going concern (e.g., such as to apply those components to specific statutory definitions of taxable value), using a component analysis for appraisal purposes, particularly for a loan appraisal, imposes artificial boundaries on value and creates substantial risk to lenders if they fail to secure the components of a project generating important sources of income, simply because they cannot be easily defined.

Definition of "Highest and Best Use"

Any analysis of a property's value begins with a determination of the property's highest and best use. The 2010 edition of the Appraisal Institute's *Dictionary of Real Estate* alters the definition of "highest and best use." The 2010 edition defines "highest and best use" as:

> "the reasonably probable and legal use of vacant land or an improved property that is physically possible, appropriately supported, financially feasible, and that results in the highest value. The four criteria the highest and best use must meet are legal permissibility, physical possibility, financial feasibility, and maximum productivity. Alternatively, the probable use of land or improved property-specific with respect to the user and timing of the use-that is adequately supported and results in the highest present value."[12]

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9 *See, e.g.,* 2012 Internal Revenue Service Manual, Part 4, Chapter 48, Section 5; FASB Accounting Standards Codification ¶ 350-20-35-3 and 3A-3G.

10 *See, e.g.,* S.C. CODE ANN. §§ 12-37-220; 12-37-930 (2000 & Supp. 2011).

11 Ohio phased out the tax on tangible personal property. *See* OHIO REV. CODE ANN. § 5711.22 (2005).

12 APPRAISAL INSTITUTE, DICTIONARY OF REAL ESTATE APPRAISAL 93 (5th ed. 2010).

The difference stems from the new definition's focus on "highest present value" which implies the need to consider the cost and risk associated with achieving a certain prospective use. Previously, the Appraisal Institute defined "highest and best use" as "the reasonable, probable and legal use of vacant land or improved property, which is physically possible, appropriately supported, financially feasible, and that results in the highest value."[13] The difference is subtle, but potentially significant.

Three Approaches to Value

Real property appraisals recognize three basic approaches to value. In estimating a property's value, all factors affecting market value or would influence the purchaser's mind should be considered, such as location, quality, condition and use.[14] The three basic approaches are:

(i) Replacement cost approach;

(ii) Sales comparable approach; and

(iii) Income approach.[15]

The concept of component analysis applies only to the income approach.

Cost Approach

The cost approach values property based on the amount of money required, using current material and labor costs, to replace the property with similar property. The usefulness of the cost approach is limited to special-purpose properties and properties not frequently exchanged in the market and is questionable when valuing older property.[16]

Sales Comparison Approach

The sales comparison approach involves the examination of sales of similar properties and comparing the values realized in these sales. Put simply, this approach compares the value of all property in the same area/neighborhood to other properties with special emphasis on the prices of properties that have recently sold.

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13 APPRAISAL INSTITUTE, THE APPRAISAL OF REAL ESTATE 277-278 (13th ed. 2008).

14 *See* 84 C.J.S. *Taxation* § 511 (2001).

15 In jurisdictions where the tax assessor is charged with equalizing value during periodic reassessments, there is a fourth approach which is not recognized by the Appraisal Institute. This approach is often called the "equity value" approach. In broad strokes, the "equity value" approach compares tax assessments of similar properties rather than the fair market value of similar properties. *See, e.g., Meeting Street Ventures, LLC v. Charleston County Assessor*, 2004 WL 3154642, Docket No. 03-ALJ-17-0297-CC (S.C.Admin.Law.Judge.Div. Feb. 19, 2004). The income approach is the approach most frequently relied upon in valuing hotels for ad valorem real property tax purposes.

16 *See* APPRAISAL INSTITUTE, THE APPRAISAL OF REAL ESTATE 377-384 (13th ed. 2008).

Proper application of the sales comparison approach requires an investigation into all pertinent information that influenced the reported sales prices to be used for comparison purposes. For example, bulk sales or Section 1031 exchanges of property need to be analyzed, and sometimes discounted, to determine what a willing purchaser paid a willing seller for the particular property regardless of other considerations. Correct application of the sales comparison approach is an essential part of the valuation process, as it provides a probable range of market value for the subject property. In the sales comparison approach, the geographic limits of the appraiser's search for sales data depend on the nature and type of real estate being valued.

To determine a fair market value for property, a comparison of the sales price for properties with similar characteristics may be utilized. While not conclusive, the sales price for comparable properties presents probative evidence of the fair market value of the property at issue.[17] Although many assessors often make a blanket assertion that the sales comparison approach is the most reliable way of determining value of residential property, the market for the property must nevertheless be defined. This concept is particularly true for commercial properties such as hotels and regional malls, among others, which are often considered to have regional or national markets.

Untrained appraisers often fail to analyze the data underlying reported sales to determine whether the sales are in fact comparable. Mistakes associated with the sales comparison approach include using bulk sales of properties or properties involved in Section 1031 exchanges where tax and other considerations often influence the stated consideration for a particular property. These types of sales fail to demonstrate what a willing buyer would pay a willing seller for the property looking at the individual property since other considerations may have been paramount. This statement is particularly true in the current real estate market where a real line of demarcation can be shown to exist after the 2008 collapse of the credit markets. Use of pre-crash data is problematic and requires a careful eye.

Many statutory taxing schemes assume a fictional sale has taken place on the valuation date.[18] In the tax appeal world, nearly all jurisdictions use a similar definition of "value" for ad valorem tax purposes. Under South Carolina law, real property must be valued as follows:

> All property must be valued for taxation at its true value in money which in all cases is the price which the property would bring following reasonable exposure to the market, where both the seller and buyer are willing, are not acting under compulsion, and are reasonably well informed of the uses and purposes for which it is adapted and for which it is capable of being used.[19]

This statutory scheme does not recognize or consider the impact of a complete collapse of credit markets in late 2008 and early 2009. Many properties changing hands since September

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17 *See Sea Pines Plantation Co. v. Beaufort County*, 2002 WL 148696, at *6 Docket No. 01-ALJ-17-0018-CC (S.C.Admin.Law.Judge.Div. June 20, 2002)*; South Carolina Nat'l Bank (Wachovia Bank of South Carolina) v. Anderson County Assessor,* 1996 WL 909127, Docket No. 95-ALJ-17-0271-CC (S.C.Admin.Law.Judge.Div. Feb. 13, 1996).

18 *See, e.g.,* S. C. CODE ANN. § 12-37-3140 (2000 & Supp. 2011), which assumes a fictional sale as of December 31 of the year prior to the assessment.

19 S. C. CODE ANN. § 12-37-930 (2000 & Supp. 2011).

2008 have not involved willing sellers and willing buyers due primarily to difficulties with existing or available financing. Other reported sales are distressed sales and the use of these sales is problematic, at best, in calculating value.

The impact of the effect of the financial crisis on sales cannot be overstated as the recent financial crisis rendered transparent the definition of "market value." Appraisal methodology is founded on the concept that, at any given point in time, a "market value" can be clearly discerned in comparison to recent comparable sales. However, the sale comparison method, by definition, is retrospective, and considers stale information, which, for better or worse, may not reflect actual current value. Despite the availability of public information on recent sales in public and proprietary databases, many of the facts about these transactions are silent, and can be easily flawed by non-reported terms such as purchaser's deadline to name a replacement property for a Section 1031 exchange, that substantial personal property was included in the sale, or that the sale was a redemption just prior to a threatened foreclosure. Given the difficulties with conventional bank financing for real estate purchases in the past few years, appraisers discovered no sales in thinly traded markets, or, upon investigation, that every sale was in some way a distressed sale. A recent bulk sale of a comparable property by a distressed seller can significantly impact the market value of comparable properties, especially on lots or condominium units in the same distressed project, so that every succeeding sale has a lowered value based on the reduced sale price of the prior sale, in a race to the bottom. Every succeeding non-distressed sale is encumbered by comparable values taken from distressed sales.

Income Approach:

The income approach to real estate value converts the anticipated future benefits of property ownership into an estimate of present value[20] and requires:

i. a calculation of the net income being generated for a property before debt service; and

ii. a determination of a capitalization rate for such net income.

Net income is divided by a capitalization rate to determine the property's appropriate value. If there are errors with either (i) the capitalization rate; or (ii) the calculation of the net income being generated by a property, the calculated value of a property using the income approach will be flawed. In the ad valorem tax world where the assessor is charged with valuing real estate (as opposed to personal property or "business value"), net operating income is the actual or anticipated net income of the real estate (as opposed to the business) remaining after the deduction of operating expenses but prior to deducting mortgage debt service and book depreciation.[21] Another problem facing appraisers as markets struggle to exit the 2008 economic downturn is that many valuation professionals are being asked to value properties with negative income for the year preceding the valuation date.

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[20] *See* Stephen Rushmore & Erich Baum, *Hotels & Motels: Valuations and Market Studies* 318 (Appraisal Inst. 2001).

[21] APPRAISAL INSTITUTE, THE APPRAISAL OF REAL ESTATE 457 (13th ed. 2010).

Component analysis applies to the income approach. As noted above, taxing authorities in most jurisdictions are charged with separately taxing a property's components for purposes of separately assessing taxes on real property and personal property. However, many properties, such as hotels and nursing homes, operate as businesses, not as individual components. For example, a nursing home cannot generally operate without licenses, some of which are generally not transferable. The same general statement holds true for hotels. For more than two decades, the appraisal industry has recognized the unique challenges posed by hotels in determining net income of a hotel for real estate tax purposes. The argument in the appraisal world regarding the proper methodology for extracting real estate value is quite heated and will be discussed below.

There is an inherent tension between an owner seeking an appraisal to lower ad valorem tax bill by attributing income to non-real estate components and an appraisal sought for loan or sale purposes. .If a component analysis does not perfectly fit for ad valorem purposes (meaning some intangible components of the operation are not valued and therefore not taxed), the owner is not likely to be troubled, because ad valorem taxes, by statutory definition, only apply to certain distinct components of the enterprise. However, if this same methodology is used for purposes of appraisals for financing and sales, the owner will not be forgiving if substantial portions of the income are overlooked simply because they cannot be separately valued. In other words, owners seeking a real estate appraisal for real estate loan purposes generally maximize the "real estate" project's income.

Another challenge in applying the income approach is the determination of the appropriate capitalization rate. The term capitalization rate is generally defined as "any rate used to convert income into value."[22] "From an investor's perspective, the earning power of a real estate investment is the critical element affecting its value."[23] An investment in income generating property represents the exchange of present dollars for the right to receive future dollars.[24] A capitalization rate includes a component for financing as well as a component reflecting what an investor would require for a return on the investment into the real estate.

On its face, the income approach would seemingly not depend on the existence of comparable sales. However, this is not the case. The Appraisal Institute recognizes seven (7) methods for determining the appropriate capitalization rate to apply to property:

i. Derivation from comparable sales;

ii. Derivation from effective gross income multipliers;

iii. Derivation by band of investment – mortgage and equity;

iv. Derivation by band of investment – land and building;

v. Debt coverage formula;

vi. Yield capitalization techniques; and

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22 APPRAISAL INSTITUTE, THE DICTIONARY OF REAL ESTATE APPRAISAL 28 (5th ed. 2010).
23 APPRAISAL INSTITUTE, THE APPRAISAL OF REAL ESTATE 445 (13th ed. 2008).
24 *Id.*

vii. Surveys based on market expectations. [25]

Income Tax Issues

The federal Internal Revenue Code ("**IRC**") applies different depreciation rates to different types of property and taxes components differently.[26]

Owners of many commercial businesses such as hotels, shopping centers, health care facilities, nursing homes and marinas can significantly benefit from a comprehensive allocation analysis as these businesses generally have substantial goodwill associated with their operation. For example, much of the value of health care facilities and nursing homes rests in the ownership of required operating licenses which should not be subject to ad valorem taxation. Intangible assets such as goodwill are generally not subject to ad valorem taxation and reflecting the value of intangible assets accurately will prevent the buyer from overpaying property taxes due to an incorrect allocation of value.

In states where the federal income tax basis is used to calculate property taxes for purchased assets, an allocation analysis must be performed. For federal income tax purposes, the tax basis of purchased assets is allocated according to the residual method which generally allocates purchase price into classes of assets.[27] For example, the Class V asset group broadly consists of most tangible assets including land, buildings, furniture, fixtures and equipment – so called Section 1245 and 1250 property.[28]

Except for land, Class V assets are depreciable for federal income tax purposes. Valuing Class V assets typically involves obtaining a real estate appraisal. The value of the real estate improvements are then extracted from the land. Tangible personal property (typically furniture, fixtures & improvements (FF&E), machinery and equipment) is then valued using the most appropriate methodology for that type of asset.

Because basis of a property for federal income tax purposes is determined at the time of acquisition, allocating the purchase price should be part of due diligence and not wait until after closing. Since a business acquisition is typically an arm's-length transaction, closing offers a great opportunity to establish (with appropriate documentation) the tax basis of the various business assets. Separate conveyance documents (e.g., deed, bill of sale, assignment) should be prepared for each major asset to document the apportioned value of assets contemporaneously.

Allocation Agreements

Purchase agreements in larger transactions often allocate the purchase price between components in a myriad of ways including (i) allocation specifically in the contract; (ii) incorporating various "agreements to agree" later (usually a bad idea); and (iii) establishing a dispute resolution mechanism to address the issue after closing. Experience suggests that the

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25 APPRAISAL INSTITUTE, THE APPRAISAL OF REAL ESTATE 446-449; 464; 501-538 (13th ed. 2008).

26 *See, e.g.*, I.R.S. Pub. 946 (March 22, 2012).

27 *See* 26 U.S.C. § 1060.

28 *See* I.R.S. Form 8594 Instructions (rev. December 2012).

sooner the allocation issue is addressed, the better. The applicability of these allocations on local assessors is a matter of state law.

One simple example of an allocation agreement with a pre-set allocation is as follows:

> Allocation of Purchase Price. The Purchase Price shall be allocated generally in accordance with Schedule ____. Buyer shall submit to Seller proposed detailed allocation schedules that are in all respects consistent with Schedule ____ no less than twenty (20) days prior to the Closing Date. Buyer and Seller shall then use their best efforts to promptly agree to final detailed schedules. If Buyer does not submit such allocation schedules within the allotted period, Seller shall prepare such allocation schedules which shall be binding on both Buyer and Seller. Seller and Buyer shall complete IRS Form 8594 consistent with the Schedule ____ allocations and shall furnish each other with a copy of such form prepared in draft within 60 days after the Closing Date. Neither Seller nor Buyer shall file any return or take a position with any Authority that is inconsistent with the agreed allocations.

Another example would be:

> Purchase Price Allocation. Seller and Purchaser each represent, warrant, covenant, and agree with each other that the Purchase Price shall be allocated among the Assets, as set forth in Schedule ___. Seller and Purchaser agree, pursuant to Section 1060 of the Internal Revenue Code of 1986, as amended, that the Purchase Price shall be allocated in accordance with this Section ___, and that all income tax returns and reports shall be filed consistent with such allocation. Notwithstanding any other provision of this Agreement, the provisions of this Section ___ shall survive the Closing Date without limitation.

The following is a simple example allocating value between real and personal property with no consideration of intangible value:

> Allocation of Purchase Price. Not less than fifteen (15 days prior to the Closing Date, Purchaser shall provide to Seller its proposed allocation of the Purchase Price among the real and personal property comprising the Property. Seller and Purchaser shall thereafter work in good faith to resolve any differences with respect to such allocation. If the parties are unable to so resolve such differences within five (5) days after such fifteen (15) day period, the dispute shall be resolved and determined by arbitration in accordance with the Rules of Commercial Arbitration of the American Arbitration Association in effect at the time such matter is submitted for arbitration and with applicable statutes (each party hereby consenting to such submission and determination). The arbitration shall be conducted in _____________ by a single arbitrator using the expedited procedures provisions of the American Arbitration Association and shall be subject to, and the arbitrator shall have the powers and rights afforded by, the arbitration statute(s) then in effect in the [applicable jurisdiction]. The arbitrator shall have the right to appoint appraisers, accountants, real estate brokers and/or

> other relevant professionals, where applicable. The arbitrator shall have the authority to determine the allocation as may seem appropriate in the arbitrator's sole discretion without regard to whether a court would have such authority and without regard to the arbitration statutes then in effect in the [applicable jurisdiction]. Costs of arbitration shall be borne as the arbitrator determines to be just and equitable under all the facts and circumstances. The decision made pursuant to such arbitration shall be binding and conclusive on all parties involved, the arbitrator shall be requested to provide notice thereof to the parties as soon as reasonably practicable after such decision is made, and judgment upon such decision may be entered in any court having jurisdiction. Seller and Purchaser shall file all federal, [applicable jurisdiction], and any other local income and transfer tax returns consistent with such final allocation.

The purchase agreement could allocate the price after execution of the contract but prior to closing, leaving a final determination to the filing of an IRS Form 8594. Such a provision might read:

> Within thirty (30) days after Buyer receives the Closing Date Balance Sheet from Seller, Buyer will provide Seller with a draft of IRS Form 8594 and any required exhibits thereto (the "Asset Acquisition Statement") with Buyer's proposed allocation of the consideration paid among the Acquired Assets in accordance with section 1060 of the Code. To the extent that Buyer and Seller have a dispute with respect to the Closing Date Balance Sheet, Buyer will provide Seller with a final Form 8594 within thirty (30) days of settling any such dispute. For purposes of this Section ______, the consideration paid shall be equal to the Purchase Price plus that portion of the Assumed Liabilities that are considered assumed liabilities for federal income Tax purposes. Within thirty (30) days after receiving such Asset Acquisition Statement, Seller will propose to Buyer any changes to such Asset Acquisition Statement (and in the event no such changes are proposed in writing to Buyer within such time, Seller will be deemed to have agreed to, and accepted, the Asset Acquisition Statement). Buyer and Seller will endeavor in good faith to resolve any differences with respect to the Asset Acquisition Statement within thirty (30) days after Buyer's receipt of written notice of objection from Seller.
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> Subject to the provisions of the following sentence of this paragraph (b), the Purchase Price (together with any Assumed Liabilities) will be allocated in accordance with the Asset Acquisition Statement provided by Buyer to Seller pursuant to paragraph (a) above, and subject to the requirements of applicable tax law or election (including but not limited to IRS Form 8594 and any comparable report under state or local tax law), all tax returns and reports filed by Buyer and Seller will be prepared consistently with such allocation. If Seller withholds its consent to the allocation reflected in the Asset Acquisition Statement, and Buyer and Seller have acted in good faith to resolve any differences with respect to items on the Asset Acquisition Statement and thereafter are unable to resolve any differences that, in the aggregate, are material in relation to the Purchase Price, then any remaining disputed matters will be finally and conclusively determined

> by an independent accounting firm of recognized national standing (the "Allocation Arbiter") selected by Buyer and Seller, which firm shall not be the regular auditor of the financial statements of Buyer or Seller or a consultant to Buyer or Seller. Promptly, but not later than thirty (30) days after its acceptance of appointment hereunder, the Allocation Arbiter will determine (based solely on presentations by Seller and Buyer and not by independent review) only those matters in dispute and will render a written report as to the disputed matters and the resulting allocation of the Purchase Price (together with any Assumed Liabilities), which report shall be conclusive and binding upon the parties. Buyer and Seller shall, subject to the requirements of any applicable tax law or election, file all tax returns and reports consistent with the allocation provided in the Asset Acquisition Statement or, if applicable, the determination of the Allocation Arbiter.

An obvious limitation of this type of agreement is the cumbersome nature of the dispute resolution mechanism. Another limitation with IRS Form 8594 allocation for all purposes is that the form does not require segregating value into as many categories, or the same categories, as may be desired in a purchase agreement. Additionally, IRS Form 8594 categories may differ from ad valorem taxing categories. IRS Form 8594 only requires a breakdown of asset value into seven categories, designated as "Classes I through VII." In very general terms, the classes of value for purposes of this form are as follows: Class I: cash; Class II: accounts receivable; Class III: publicly traded securities; Class IV: inventory; Class V everything not classified elsewhere, including real property and tangible personal property; Class VI: intangibles except going concern value; and Class VII: goodwill and going concern. IRS Form 8594 also requires a box be checked regarding whether the purchaser and seller provided for an allocation of the sales price in the contract or in another written document signed by both parties, and if so, whether the statement on the IRS form matches that allocation. The instructions for the form confirm that the purpose of IRS Form 8594 is to report a segregation of value if goodwill, or going concern value attaches, or could attach, to those assets, and if the purchaser's basis in the assets is determined only by the amount paid for the assets. The IRS requests a breakdown into the above-referenced Classes to establish depreciation categories. However, Class V combines the value of many of the assets that could be segregated for other purposes. In some states, such as Wisconsin, real property and personal property are taxed at the same rate and an agreement to allocate using the same classes as in this IRS form may not give a different tax result, but that commitment to the Form 8594 allocation does not take into consideration that there are other property tax exemptions in the applicable state tax code.[29] Every state has different tax rules and rates, and agreeing to a Form 8594 allocation for all purposes will not always result in the best outcome for either party.

An example of an allocation agreement where the purchaser was calling the shots because the seller had special tax considerations rendering it indifferent to what the purchaser did is as follows:

> <u>Allocation of Purchase Price</u>. Not less than ten (10) days prior to the Closing Date, Purchaser shall provide to Seller the allocation of the Purchase Price among

[29] WIS. CONST. art. VIII, §1.

> the real and personal property comprising the Property. Seller and Purchaser shall file all federal, District of Columbia and local income and transfer tax returns consistent with such allocation.

An example of an allocation agreement in a sale of a small hotel deal involving a ground lease where there was no allocation of intangible value is as follows:

> The Purchase Price shall be allocated among the Leasehold Estate, Furnishings, and Equipment, Inventory, Operating Equipment, Property and any other intangible property of Seller conveyed hereunder as follows and the parties shall file all federal income tax returns and other reports required by the Internal Revenue Code of 1986, as amended, in a manner consistent therewith:

(i)	Inventory	$40,000
(ii)	Furniture, fixtures, and equipment	$800,000
(iii)	Leasehold estate	$6,000,000

Allocation of purchase price also impacts transfer taxes and title insurance premiums. If the purchase price allocated to real estate in a transaction is too small, and the title insurance policy insuring the buyer or the buyer's lender is written for less than the real value of the land and improvements, the title insurer may assert the buyer or lender has assumed a ratio of the title risk equal to the percentage of which the property was under-insured. Similarly, in most states which collect a state, local or county transfer tax[30], some type of document, such as an affidavit of "true consideration" or a tax return is signed at closing or recorded as a precondition to recording the deed. In such a document, the buyer or seller swears to the agreed value of the real estate, and in some cases, the value of any personal property sold with the real estate. Under-reporting of real estate value and therefore underpayment of transfer fees is generally subject to challenge, and under-reporting of values could involve interest and penalties.[31] Allocation of too much value to the real estate, intentionally or inadvertently including either personal property value or intangible value, such as a sale/leaseback, can overstate the real estate value in a manner local assessors are only too willing to accept, and can cripple the tenant in a sale/leaseback with real property taxes on amounts that fairly represent only the value of the investment.

<u>Impact of Allocation Agreements for Federal Income Tax Purposes and on Ad Valorem Taxes</u>

States take different positions regarding the impact of allocation agreements for ad valorem property taxes. For example, in South Carolina, allocation agreements are suggestive, but not binding, on local assessors. In South Carolina, recordation of a deed requires the submittal of an affidavit of true consideration where a party to the transaction or attorney must state the value given for the real property and improvements.[32] The primary purpose of this affidavit is to calculate applicable recording and transfer fees. However, assessors typically take

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30 *See, e.g.,* S.C. CODE ANN. § 12-24-10, *et. seq.* (2000 & Supp. 2011).

31 *See, e.g.,* S.C. CODE ANN. §§ 12-24-120 and 12-24-130.

32 S.C. CODE ANN. § 12-24-70.

the consideration provided in these affidavits as a statement of the value of the real estate and improvements. Unfortunately, unsophisticated practitioners often merely use the total consideration for the transaction, rather than the separate value of the real estate and improvements from the business' market value for purposes of this affidavit. This action results in the new buyer being forced to pay years of higher ad valorem real property taxes.

Some local assessors use the consideration for real estate stated in the transfer document for ad valorem tax purposes. In jurisdictions which do not impose ad valorem property taxes on personal property, the importance of an allocation agreement is difficult to understate. For example, Ohio law, which exempts personal property from taxation[33], generally states that the best evidence of the fair market value of real property for tax purposes is the proper allocation of a recent arms' length purchase price, and not an appraisal ignoring the recent sale.[34] The Ohio Supreme Court has established guidelines and principles to be employed in determining the proper allocation of an arms' length purchase for tax purposes and made clear that including the value of personal property in the valuation of real estate for tax purposes is improper.[35] The long term consequences of allocation agreements allocating increased values to personal property, which are exempt from ad valorem taxation and subject to depreciation for income tax purposes, under Ohio law are obvious.

Some states accept or are required by statute[36] to accept the full purchase price in an arm's length transaction as the value for purposes of ad valorem assessment. However, where parties allocate a portion of an overall purchase price to the real estate, the assessor is not bound by the parties' allocation if the assessor concludes that part or all of what was allocated to personal property, goodwill or intangibles was really real estate value. Likewise, the assessor is not bound when the parties to a bulk purchase of multiple real estate parcels allocate the overall purchase price to the individual parcels.

Wisconsin courts have limited efforts of the taxing authorities to overreach on assessing real estate value items that are not truly real estate. For example, in *Walgreen Co. v. City of Madison*, the Wisconsin Supreme Court held that lease payments made to the landlord in excess of the market rent for that location cannot be counted as real estate value for ad valorem tax purposes, because they constitute contract value which cannot be captured in a real estate assessment.[37]

In addition, in *Hormel Foods Corp. v. Wisconsin Department of Revenue*, the Wisconsin Tax Appeals Commission rejected the Department of Revenue's attempt to use a replacement-cost, value-in-use allocation appraisal, which was obtained to comply with accounting rules

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[33] *Supra,* n. 11.

[34] *Conalco, Inc. v. Monroe Cty. Bd. of Revision*, 363 N.E.2d 722 (Ohio 1977) (hereinafter *Conalco I*).

[35] The Ohio Supreme Court reaffirmed the principle that personal property purchased as part of a sale should not be taxed as part of the real estate and held that the failure to include an allocation in the purchase contract would not preclude an allocation through tax complaint proceedings provided such allocation could be supported by reliable, probative evidence. *Hilliard City Schools Bd. of Edn. v. Franklin Cty. Bd. of Revision*, 949 N.E.2d 1 (Ohio 2011).

[36] WIS. STAT. §70.32(1).

[37] 311 Wis. 2d 158, 752 N.W.2d 687 (2008).

following a $335,000,000 stock acquisition, as a basis for determining the fair market value of one of the real estate parcels owned by the company whose stock was acquired.[38]

However, Wisconsin courts also use technicalities to avoid challenges to an incorrect overstatement of real estate value. A recent Wisconsin decision regarding a chain of quick lube operations illustrates this point. In *Great Lakes Quick Lube LP v. City of Milwaukee*, the Wisconsin Supreme Court addressed a bulk sale acquisition of quick-lube operations involving multiple, long-term triple-net leases that could not be modified and imposed the costs and risks of ownership of the building on the tenant, who agreed to pay all real estate taxes, and with a guaranteed rate of return.[39] Investors effectively purchased and sold real estate together with the right to receive an income stream at the stated return. As interest, rents and the rates of return on other investments dropped suddenly, the fixed, now-higher than market, returns under the lease became an attractive investment option, and landlords were able to sell their interests at a premium. However, by classifying these sales on the real estate transfer return as consisting of all real estate, which the local assessors accepted as the value of the real estate, the property taxes on the operation became enormous when compared to a similarly-sized and similarly located quick lube business not involved in a similar bulk-sale transaction.[40]

Ohio law has recently changed to counteract judicial and administrative interpretations which have moved towards adopting a sale price as value regardless of what other evidence may exist to demonstrate that the sale is not representative of "true value." For years, R.C. 5713.03 provided that the county's assessing authority "from the best sources of information available, shall determine, as nearly as practicable," the "true value" of land for tax purposes. With respect to a recent sale, R.C. 5713.03 provided that "the auditor **shall** consider the sale price … to be the true value for taxation."[41] Prior to 2005, Ohio courts had interpreted that law to allow the county auditor as the assessor (as well as the courts) to consider whether a sale price actually represented the property's market value.[42] Under interpretations of that law prior to 2005, appraisal evidence, lease studies or comparable sales were utilized to determine if the sale price was reflective of market value. Moreover, only sales that reflected market value or those which were adjusted to reflect market value were appropriate to use as comparable sales. Rent comparables also were required to be reflective of market value as of the tax lien date rather than the date of inception.

In 2005, the Ohio Supreme Court changed its interpretation of the statutory language - "the auditor **shall** consider the sale price … to be the true value for taxation" - to mean that there is no further evidence necessary to prove true value.[43] Under this case law, the recorded sale price was binding on assessors. Later, the Ohio Supreme Court expanded the ruling by stating

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[38] Wis. Tax Rep. (CCH) ¶400-741 (WTAC 2004), *aff'd*, No. 04-CV-1278 (Dane Co. Cir. Ct. Oct. 19, 2004) (emphasis added).

[39] 794 N.W.2d 510 (WI. 2011).

[40] However, had the seller reported a portion of the purchase price as investment income on its transfer return, the seller may encounter income tax and securities issues.

[41] Former OHIO REV. CODE ANN. § 5713.03.

[42] *Ratner v. Stark Cty. Bd. of Revision*, 23 Ohio St.3d 59, 91 N.E.2d 680 (1986); *Ratner v. Stark Cty. Bd. of Revision*, 35 Ohio St.3d 26, 517 N.E.2d 915 (1988).

[43] *Berea City School Dist. Bd. of Edn. v. Cuyahoga Cty. Bd. of Revision,* 106 Ohio St.3d 269, 2005-Ohio-4979, 834 N.E.2d 782 (2005).

that leased fee sales were also acceptable.[44] Remarkably, later case law expanded the law to include leased fee sales as comparable sales even when appraising fee simple owner-occupied properties.[45] Finally, other cases severely limited the county auditor and courts from taking into consideration circumstances which indicated that the sale was not representative of market value.[46]

R.C. 5713.03 was recently amended to state clearly that true value is to reflect the **<u>"fee simple estate, as if unencumbered.</u>"**[47] The amendment further provides that where there is a recent arm's length sale, the auditor <u>may</u> consider the sale to be true value.[48] Read together, in order for the auditor to consider the sale to be true value, that sale has to reflect the fee simple estate, as if unencumbered.

Despite the broad language of the *Berea* decision in 2005, the Ohio Supreme Court maintained some recognition that a sale price did not always represent "true value." For instance, the burden upon a property owner in establishing that some part of the sale price was attributable to personal property was recently addressed by the Ohio Supreme Court which stated:

> 'As an owner who "seeks an allocation of the sale price in order to reduce the valuation below the full sale price," Alexander Road bears the burden of showing the propriety of allocating some portion of that reported price to other assets." *Hilliard City Schools Bd. of Edn.*, 128 Ohio St.3d 565, 2011-Ohio-2258, 949 N.E.2d 1, ¶ 18. ***<u>We have clarified that this burden is not a heavy one</u>***, as our discussion in *St. Bernard Self-Storage*, 115 Ohio St.3d 365, 2007-Ohio-5249, 875 N.E.2d 85, ¶ 14, 17, suggests: all that is required is some additional increment of corroborating evidence beyond the bare fact of allocation in the conveyance-fee statement itself. Indeed, in *Hilliard City Schools Bd. of Edn.*, we held that an allocation of $280,000 to personal property was justified on the basis of a written appraisal report prepared for a lender in conjunction with the asset sale, and we did so in spite of the absence of testimony by the appraiser. *Id.* at ¶ 26-28." *Bedford Bd. of Edn. v. Cuyahoga Cty. Bd. of Revision*, 972 N.E.2d 559 at {¶ 36} (Ohio 2012).

The Ohio Supreme Court also recognized that bulk sales may not always represent true value. In *Conalco I*, the Ohio Supreme Court remanded a case to the Ohio Board of Tax Appeals ("**<u>BTA</u>**") because the BTA refused to consider an appraisal prepared after the sale which developed an allocation of a bulk sale for purposes of real estate taxation and instead, relied upon

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[44] *AEI Net Lease Income & Growth Fund v. Erie Cty. Bd. of Revision*, 119 Ohio St.3d 563, 895 N.E.2d 830 (2008); CCleveland OH Realty, L.L.C. v. Cuyahoga Cty. Bd. of Revision, 121 Ohio St.3d 253, 903 N.E.2d 622 (2009).

[45] *Meijer Stores Ltd. Partnership v. Franklin Cty. Bd. Of Revision*, 122 Ohio St.3d 447, 912 N.E.2d 560 (2009).

[46] *Cummins Property Servs., L.L.C. v. Franklin Cty. Bd. of Revision*, 117 Ohio St.3d 516, 885 N.E.2d 222 (2008); *Worthington City Schools Bd. of Edn. v. Franklin Cty. Bd. of Revision*, 129 Ohio St.3d 3, 949 N.E.2d 986 (2011); *N. Royalton City School Dist. Bd. of Edn. v. Cuyahoga Cty. Bd. of Revision*, 129 Ohio St.3d 172, 950 N.E.2d 955 (2011).

[47] OHIO REV. CODE ANN. § 5713.03 (eff. Sept. 10, 2012).

[48] *Id.*

an appraisal which did not take the sale into consideration.[49] The matter returned to the Ohio Supreme Court in 1978.[50] Again, the court rejected the BTA's attempts to determine a proper allocation of the sale price by relying upon appraisal evidence which did not take the recent sale into consideration.[51] Finally, on the third appeal to that court, the BTA's allocation was accepted because it was based upon the consideration of appraisals which considered the actual sale in making the allocation.[52] The Conalco sales contract did not include any allocation in connection with the original sale, and the court held that the consideration of appraisal evidence prepared after the sale specifically for the purposes of the tax valuation litigation, provided sufficient evidence upon which the BTA could rely in determining the proper allocation of the sale price.[53]

In *St. Bernard Self-Storage, L.L.C. v. Hamilton Cty. Bd. of Revision*, the Ohio Supreme Court established that convincing independent evidence of the property allocation of the sale price for real estate tax purposes is required.[54] In *St. Bernard*, the Ohio Supreme Court specifically rejected a claim that an allocation negotiated by the parties to the sale must be accepted for purposes of real estate taxation, stating:

> In bulk sale cases, we typically look for corroborating indicia to ensure that the allocation reflects the true value of the property. Where attendant evidence shows reason to doubt such a correspondence, we decline to use the allocation to establish true value.[55]

Both the BTA and the Ohio Supreme Court in *St. Bernard* accepted the consideration of such an appraisal as an appropriate methodology for determining a proper allocation. Ultimately, in *St. Bernard*, the appraisal rendering an opinion as to the allocation of the sale price was rejected because the BTA found that it was based upon unsound appraisal principles and was not credible.

The previously cited cases illustrate a deduction from the sale price must be made for items of personal property, and once that is established, the issue in the case becomes an issue of whether the allocation is correct. As stated in *St. Bernard*:

> Unlike a simpler transaction where a single parcel of real property is sold individually, a bulk sale may involve the sale of all the assets of a business, whereby a parcel of real property constitutes one of many business assets sold at the same time for an aggregate sale price. Alternatively, a bulk sale may consist of a sale of numerous real estate parcels at an aggregate price as part of a single deal. In all such cases, a question arises beyond the basic pronouncement *of Berea:* whether the proffered allocation of bulk sale price to the particular parcel of real property is "proper," which is the same as asking whether the amount allocated reflects the true value of the parcel for tax purposes.
> ***
> **{¶ 19}** In the area of real property valuation, we have not hesitated to authorize a departure from a recent sale price when a bulk sale price cannot properly be allocated.

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49 *Conalco I,* 363 N.E.2d 722.

50 *Conalco v. Monroe Cty. Bd. of Revision*, 376 N.E.2d 959 (Ohio 1978) (hereinafter *Conalco II*).

51 *Conalco II,* 376 N.E.2d. 959.

52 *Consolidated Aluminum Corp. v. Monroe County Bd. of Revision*, 423 N.E.2d 75 (Ohio 1981) (hereinafter *Conalco III*).

53 *Id.*

54 875 N.E.2d 85 (Ohio 2007).

55 *Id. at* ¶ 17.

[footnote omitted] In all of those cases, value was determined without reference to a sale price because no convincing allocation of the sale price was offered. Cf. *Pingue v. Franklin Cty. Bd. of Revision*, 717 N.E.2d 293 (Ohio 1999).[56]

Prior to the amendment of R.C. 5713.0, judicial interpreations of the prior statute by the Ohio Supreme Court[57] and by the Ohio Board of Tax Appeals. were becoming increasingly inconsistent

Finally, the statutory definition of "value" for ad valorem tax purposes in states such as South Carolina illustrates several current issues. First, like the Appraisal Institute's definition of value,[58] the statutory scheme assumes the existence of (i) a willing seller; (ii) a willing buyer; and (iii) the absence of compulsion. More significantly, the statutory scheme assumes a fixed valuation date.[59] In other words, the statutory scheme assumes that the exposure to the market resulted in a fictional sale on the specific valuation date.[60] This assumption became particularly problematic for jurisdictions using a December 31, 2008 valuation date (immediately after the failures of Lehman, AIG, Wachovia and other major financial institutions) when credit for real estate transactions had effectively vanished. Put differently, how does one value real estate in a market which effectively has ceased to exist as a result of the absence of credit?

Loan Documentation Issues for Incoming Producing Properties Involving Intangible Value

Counsel for purchasers or lenders to real estate centric businesses must ensure that all assets generating the property's income are acquired or pledged respectively.

In the context of nursing facilities, the assets include:

1. The real estate;

2. The tangible personal property, specifically the furniture, fixtures and equipment; and

[56] *Id*. at ¶15.

[57] *Supra* notes 44-46

[58] The Appraisal Institute's Standards of Professional Appraisal Practice and the Federal Deposit and Insurance Commission define market value as "[t]he most probable price which a property should bring in a competitive and open market under all condition requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus. Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from seller to buyer under conditions whereby: (1) Buyer and seller are typically motivated; (2) Both parties are well informed or well advised, and acting in what they consider their own best interest; (3) a reasonable time is allowed for exposure in the open market; (4) Payment is made in terms of cash in United States dollars or in terms of financial arrangements comparable thereto; and (5) the price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions granted by anyone associated with the sale." *See* 12 C.F.R. § 34.42(g); APPRAISAL INSTITUTE, UNIFORM STANDARDS OF PROFESSIONAL APPRAISAL PRACTICE 2008-2009 (2008).

[59] *See supra* notes 18-19 and accompanying text.

[60] *See supra* notes 18-19 and accompanying text.

3. The intangible personal property including any agreements with respect to the assembled work force, licenses, certifications, approvals such as certificates of need (CON), patient records, goodwill and management.[61]

Obtaining security interests in the nursing facility's real estate and tangible personal property does not generally create any special issues. However, securing the intangible assets of a nursing facility often requires third party approvals. Typical intangible assets of a nursing facility may include:

- Licenses, certifications and approvals (such as a CON) from state and/or local government agencies and regulators;
- Assembled work forces, including licensed, certified and trained employees, some of whom may have (or need) existing employment agreements;
- Patient records;
- Management agreements;
- Vendor contracts;
- Trade names; and
- Contracts with federal, state or local agencies for the placement of particular residents.

Nursing facility operators usually enter into various agreements with government authorities including licensure agreements, provider agreements with the state agencies that administer the Medicaid program (often contained within the state department of social services) and Medicare.[62] Staff and consultants may need certifications issued by federal, state or local authorities. Similarly, local licensing and other regulations may be required for fire and safety, food services and zoning compliance.[63]

The application of many of these governmental contracts means that the rooms are not effectively "leases" of the guest rooms to residents; rather the use of the rooms carry with them specialized terms on the retention of patients' records, requirements of safekeeping residents' personal property, lengthy notice provisions for termination of a resident's lease, confidential provisions about disclosing medical conditions and records, and obligations to take in residents, retain them and terminate them without violating any anti-discrimination laws. Health care facilities may need to be qualified by the appropriate government agency for specific equipment or facilities above the level required by usual zoning and building laws. Licensing requirements change frequently. Grandfathering in existing equipment and facilities until a new purchaser

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[61] *See generally*, James K. Tellatin, *Nursing Facilities: Assets, Interests, and Ownership Structures*, The Appraisal Journal (Summer 2009).

[62] *Id.*

[63] *Id. See also*, James K. Tellatin, Sterling Short and C. Mark Hansen, *Proprietary Earnings of Assisted Living and Nursing Facilities under HUD Valuation Guideline*, The Appraisal Journal (Winter 2005).

ends that grandfathering may be problematic particularly if the applicable agency requires the new operator to update the facility to satisfy new regulations. Similarly, the application of the Americans with Disabilities Act to health care facilities, and to hotels and resorts, impose different obligations than on other facilities. A property in compliance with all of these laws and regulations can have substantially more value than a property that is operating legally, but under grandfathered codes, due to the risk of substantial improvement costs assumed with the building.

Lenders must confirm that their security documents acquire not only a security interest in all facets of the rights that comprise the ongoing operation but also contain terms allowing the lender, in case of default, to act quickly to take over the business as an operating business in order to preserve its "going concern" value. Appointing a receiver to take over operations may be very problematic and may not satisfy various applicable licensing requirements. For example, notwithstanding anything in the loan documents to the contrary, applicable law may not permit assignment of certain rights, notably liquor licenses for hotels or contracts with local, county and state governmental agencies for nursing facilities. A hotel with a national franchise is dependent upon continued compliance with the requirements of the franchise agreement, and upon failure and termination of that agreement, can lose access to a national reservation system and connection to "rewards" travel, that can destroy the hotel's lifeblood. Despite the best loan documentation, unpredictable and uncontrollable events in a nursing home or injuries to the facility's reputation, such as for theft by employees, residents' escaping or being overmedicated, or publicity about a bad employee, can have an immediate and long lasting impact on the value of the facility. A reputation for bedbugs in a hotel or unsanitary conditions in a restaurant kitchen can have a similar effect.

<u>The Ad Valorem Tax World Generally</u>

Calculation of ad valorem real property taxes is jurisdiction specific but the basic methodology is similar in most jurisdictions. Taxes are assessed against the property's (i) real property value; (ii) tangible personal property value;[64] and (iii) intangible value (usually in the form of a business licensing fee).

<u>Timeline for Appeals (the Basics)</u>

Every state has a procedure for filing and prosecuting ad valorem property tax appeals.[65] The taxpayer and its counsel must be very familiar with the intricacies and the deadlines imposed by the appeals process. However, most jurisdictions employ similar basic procedure involving: (i) the filing of an appeal; (ii) meetings and negotiations with the local taxing authority; (iii) an appeal to a county board which usually consists of laypeople and professionals; (iv) a de novo appeal to a trial court located either locally or at the state level; and (v) an appeal through the judicial system.

A striking aspect of tax appeals is the dearth of reported decisions throughout the United States. The absence of reported decisions can be explained partly by the general absence of a

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[64] Some jurisdictions, such as Ohio, exempt personal property from ad valorem taxation. *See supra* n. 11 and accompanying text.

[65] *See e.g.* S.C. CODE ANN. § 12-60-10, *et seq.* (2000 & Supp. 2011); N.C. GEN. STAT. § 105-322; OHIO REV. CODE § 5715.19.

requirement of the use of counsel prior to a *de novo* appeal to a trial court. Some jurisdictions restrict who can file the appeal for the taxpayer. [66] Consequently, many tax appeals are handled by various consulting firms and appraisers who do not have a license to practice law. Many taxing jurisdictions permit non-lawyers to represent property owners through the first three stages of the appeal described in the paragraph above.[67] However, the fundamental problem in using this approach is that assessors tend not to be as willing to negotiate value when the assessor recognizes the property owner will need to employ counsel to prosecute an appeal beyond the local board. Further, the owner must be careful to use an agent authorized by local law to file the appeal. Failure to comply could result in dismissal of the appeal.

In South Carolina, the South Carolina Revenue Procedures Act[68] establishes appeal procedures for all real and personal property tax assessments and appeals. In a reassessment year, the issuance of the reassessment notice begins the process.[69] The assessor must send the property owner a notice of property tax assessment[70] by July 1st or as soon as after as is practical,[71] and serve it on the taxpayer personally or by mail.[72] The timing and procedure for appeals vary from state to state, and in a few states, deadlines vary by municipality, with very short appeal windows.

Historically, the taxpayer would need to ask whether he would sell the real property for the assessed value if a potential purchaser made an offer for that amount. Until the recent economic downturn, the answer was often "no" since tax valuations typically trailed the market value of properties in many jurisdictions. Second, the taxpayer would need to determine whether the appeal made economic sense. In other words, would potential tax savings exceed the costs of the appeal?

Calculation of Taxes Generally

Methods of calculating ad valorem real property taxes are also jurisdiction specific, but the basic methodology is similar to that employed by South Carolina. In South Carolina, the

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[66] South Carolina Code §12-60-90(C)(e) provides that the taxpayer's representative must comply with the duties and restrictions of United States Treasury Department Circular No. 230 including, among other things, providing a power of attorney to the taxing authority.

[67] The North Carolina Tax Commission only accepts appeals signed by the taxpayer or the taxpayer's attorney. *See generally* North Carolina Tax Commission Rules and Procedures, N.C.A.C. T17: 11 TOC-1.

[68] S.C. CODE ANN. § 12-60-10, *et seq.* The assessment notice must be in writing and include: (i) Fair Market Value, S.C. CODE ANN. § 12-60-2510(A)(1)(a); the value as listed by the Reform Act (iii) Special Use Value (if applicable), S.C. CODE ANN. § 12-60-2510(A)(1)(c); (iv) Assessment Ratio, S.C. CODE ANN. § 12-60-2510(A)(1)(d); (v) Property Tax Assessment, S.C. CODE ANN. § 12-60-2510(A)(1)(e); (vi) Number of Acres or Lots, S.C. CODE ANN. § 12-60-2510(A)(1)(f); (vii) Location of Property, S.C. CODE ANN. § 12-60-2510(A)(1)(g); (viii) Tax Map Number, S.C. CODE ANN. § 12-60-2510(A)(1)(g); and (viii) the appeal procedure, S.C. CODE ANN. § 12-60-2510(A)(1)(j).

[69] The deadlines for appeals in non-reassessment years in South Carolina are quite different. *See, e.g.* S.C. CODE ANN. § 12-60-2510(A)(4). In non-reassessment years, an appeal must be submitted before the first penalty date applicable for the property tax year in which the penalty would apply. The penalty date in South Carolina is generally on or around January 15 of each year. S.C. CODE ANN. § 12-60-2510(A)(4).

[70] S.C. CODE ANN. § 12-60-2510 (A)(1) (2000 & Supp. 2011).

[71] S.C. CODE ANN. § 12-60-2510 (A)(1).

[72] S.C. CODE ANN. § 12-60-2510(A)(2).

assessor is responsible for assessing or appraising the fair market value of the property.[73] The tax liability depends on the real estate's appraised value. This value is termed the "appraised value." The appraised value of the property is then divided by the taxing ratio applicable to properties of that type. Hotels, health car facilities and most other income producing, non-manufacturing properties are taxed in South Carolina at a six (6%) percent assessment ratio.[74] The dividend of this calculation is defined as the "assessment ratio."[75] The assessment ratio is then multiplied by the tax rate, the "millage," applicable in the taxing jurisdiction to determine the amount of the taxes. This ratio is referred to as one mill equals 1/1000th of a dollar or 1/10th of a cent.[76] For example, if the tax rate is 256 mills, the county treasurer multiplies .256 by the assessed value to determine the base amount of real property tax due.[77] The product of this calculation is the amount of taxes owed on the hotel property. Other states, such as Wisconsin, enforce the "uniformity" clause in its Constitution in a way that only allows one assessment rate.[78]

The property owner has no ability to change the assessment or the millage (except at the ballot box). An appeal consequently focuses on the property's appraised value.

Most jurisdictions separately tax both real property and personal property. Historically, calculating these values is relatively easy. However, with the recognition that some real estate centric businesses such as hotels and health care facilities are more operating businesses, and less real estate, the soil for the development of a component analysis to extract intangible value has been quite fertile for more than two decades. As taxing authorities increasingly recognize the existence of intangible value and the need to extract this value from the real estate value of ongoing businesses, the field is almost certain to expand.

The Tax Appeal Process

Any property owner looking to appeal taxes must engage a professional who knows and understands the intricate requirements of the governing jurisdiction.[79]

In determining the statutory "value" under the applicable definition for real property tax purposes, the local assessor is charged with assessing the value of real estate, not the value of the personal property used in the property's operations.[80] By requiring the assessor to value the real estate, as opposed to the business, the ad valorem real property world assumes the existence of

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73 *See* S.C. CODE ANN. § 12-37-3140 (2000 & Supp. 2011).

74 S.C. CODE ANN. § 12-43-220 (2000 & Supp. 2011).

75 *See* S.C. CODE ANN. § § 12-60-30(20) (2000 & Supp. 2011) and 12-43-220 (2000 & Supp. 2011).

76 BLACK'S LAW DICTIONARY 1009 (7th ed. 1999).

77 Assessment ratios often differ for different types of properties within a jurisdiction. Some sample South Carolina assessment ratios include: (a) home (legal residence), 4%; (b) second home (non-legal residence), 6%; (c) agricultural real property (privately owned), 4%; (d) agricultural real property (corporate owned), 6%; (e) commercial real property (which includes all operating hotels) 6%; and (f) manufacturing real and personal property, 10.5%. *See* S.C. CODE ANN. § 12-43-220. In addition, for residential real property, a credit is applied to the base tax thereby reducing the taxes owed by the taxpayer.

78 WIS. STAT. § 70.11 (2011-2012).

79 For purposes of this paper, the South Carolina ad valorem property tax procedures are primarily cited.

80 *See* S.C. CODE ANN. § 12-37-930 (2000 & Supp. 2011).

component analysis and that real property value plus personal property value equals value. The question is whether the real property world should recognize the existence of intangible value, and, if so, how to measure that value.

BEV is recognized but identified by various names.[81] The Uniform Standards of Professional Appraisal Practice (USPAP), promulgated by the Appraisal Standards Board (ASB) of the Appraisal Foundation, require separation of components. However, a consensus on the method for calculating BEV does **not** exist. Many recognize that "[t]he business component of a hotel's income stream accounts for the fact that a lodging facility is a labor-intensive, retail type activity that depends upon customer acceptance and highly specialized management skills."[82] Some taxing authorities, and even some appraisers, contend BEV is an illusion conjured by disreputable appraisers and property owners seeking to reduce ad valorem taxes. However, intangible assets are explicitly recognized by the Appraisal Institute, IRS, SEC and FASB pronouncements of the AICPA; hardly a disreputable group.

Many real estate "properties" are complicated operating businesses. For example, hotels derive revenues from sources in addition to the real estate, such as the personal property, a "flag," and a complex, often national, reservation system. Nursing homes and assisted living centers may have sundries shops, florists, beauty parlors, dry cleaners and other assets which provide services to residents. These assets may break even or provide a profit, but their real value is to encourage the decision of a family to choose that facility for its loved one. More importantly, governmental licenses which allow the facility to house patients, the conditional use and other zoning permits which allow this use, and the contracts with counties and states for reimbursement for patient stays, are the most valuable assets of the business but may have no comparable intrinsic value. Separating the value of these permits would require comparing a licensed facility to an unlicensed facility, which means one which is not permitted to operate, and that type of component analysis makes no sense.

Fundamental assumptions in the definition of "value" are being challenged by the reduced real estate valuations and absence of credit in the 2008 economic downturn. With the nearly complete collapse of the credit markets in mid-September 2008, a historic devaluation of real estate and a tepid, at best, recovery in the credit markets, willing sellers or buyers were few and far between.[83] The absence of financing increased the returns demanded by potential buyers to levels which were generally unacceptable to would-be sellers. While more comparable sales exist now in 2013 as compared to the two years immediately following the crash, all comparables must be examined carefully. Further, statutory models assume a sale as of the valuation date even though many markets may have been experiencing few, if any, sales of commercial properties as of that date.

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[81] *Supra* n.6 and accompanying text.

[82] Bernice T. Dowell, *Hotel Investment Analysis: In Search of Business Value*, ASSESSMENT JOURNAL 46-51 (March/April 1977).

[83] The collapse of the financial and credit markets throughout 2008 is evidenced by the failure in September 2008 of Freddie Mac, Fannie Mae, Lehman Brothers, AIG, Washington Mutual, the Troubled Asset Relief Program enacted by the United States Congress in October 2008, and in December 2008 the mergers of Merrill Lynch with Bank of America and Wachovia with Wells Fargo.

The hospitality industry suffered a double hex during the recent economic downturn. Not only did the value of their properties fall due to a lack of financing and a dearth of non-distressed arm's length sales, but hotel traffic fell as consumers curtailed vacation travel to save money, and businesses reduced expenses by reducing business trips. Although apartment building and shopping center values also fell, owners of these projects have some measure of security from tenants obligated under leases to pay stated rent under longer term leases. Conversely, hotel properties "lease" space on a per night basis and are immediately affected by downturns in the economy.

Some jurisdictions reassess properties each year; others do not, and taxpayers generally retain the right to appeal valuations each year. In South Carolina, each county is required to reassess all properties in its jurisdiction once every five years.[84] The South Carolina Department of Revenue has divided the state's forty-six (46) counties so that different counties implement countywide reassessment each year. The goal is to insure "uniformity and equity" in valuations of properties within each county.[85]

The requirement of countywide reassessment forces local assessors to use "mass appraisal techniques" even though these techniques are clearly inappropriate in valuing hotel properties.[86] In other words, as part of the general countywide reassessment program, assessors do not appraise each property individually. Furthermore, many local assessors do not hold appraisal licenses outside of their work for the assessor's office. As a direct consequence, many assessors are not familiar with the complicated methodologies used to extract business value in determining real property value for tax purposes.

In view of the rather dramatic demarcation in the "freezing" of the credit markets in 2008, determining the valuation date for tax purposes is critical. Most experts generally agree that the credit markets essentially froze in September 2008. Consequently, appraisals and valuations of hotels based on pre-September 2008 valuations are arguably of limited probative value. Under current South Carolina law, the valuation date has four different possibilities: (i) December 31st of the prior year; (ii) December 31 of the year in which an "assessable transfer of interest" has occurred; (iii) as determined on appeal; or (iv) after an adjustment has been made to

[84] S.C. CODE ANN. § 12-43-217 (2000 & Supp. 2011). However, a county by ordinance may postpone reassessment for not more than one tax year. *Id.*

[85] S.C. CODE ANN. § 12-43-210 (2000 & Supp. 2011) ("all property must be assessed uniformly and equitably throughout the state . . . and [n]o reassessment program may be implemented in a county unless ***all*** real property in the county . . . is reassessed in the ***same*** year") (emphasis added). S.C. CODE ANN. § 12-43-210(B) provides that no reassessment program may be implemented "unless all real property in the county is reassessed in the same year." However, a 2010 South Carolina Attorney General Opinion creates a potential conflict in statutory interpretation that inhibits the ability of property being valued in the same year. Op. S.C. Atty. Gen. 2010 WL 2678685 (June 9, 2010) (the "Advisory Opinion"). The Advisory Opinion creates a conflict between the South Carolina statutes governing real property taxes. The Advisory Opinion further fails to consider a critical interaction of South Carolina real property tax law and taxpayer rights with respect to the taxation of real property. Specifically, the Advisory Opinion does not consider the significant changes to the real property tax system with the enactment of the Real Property Valuation Reform Act of 2007 and the concurrent 2007 amendment to South Carolina Code Ann. §12-60-2510(A)(4) which allows a taxpayer to appeal the appraised value of real property in non-reassessment years.

[86] "Mass appraisal" is the process of valuing a universe of properties as of a given date using standard methodology, employing common data, and allowing for statistical testing. S.C. CODE ANN. § 40-60-20(15) (2011).

the value due to a countywide reassessment program but limited by the 15% cap discussed above.[87] Mid-cycle appeals, therefore, can lead to inequities when properties are appraised using different valuation dates.

Hotel properties are prime examples of component analysis as the analysis is often a major negotiating point between hotel owners and local assessors. Hotels are generally sold as "going concerns." According to *The Appraisal of Real Estate*:

> A going concern is an established and operating business with an indefinite future life. For certain types of properties (e.g., hotels and motels, restaurants, bowling alleys, manufacturing enterprises, athletic clubs, landfills), the physical real estate assets are integral parts of an ongoing business . . . Going-concern value includes the incremental associated with the business concern, which is distinct from the value of the tangible real property and personal property.[88]

A hotel's tangible personal property, which is subject to a faster depreciation schedule, typically includes FF&E, supplies, uniforms, linens, silver, china, glassware food, liquor, fuel, tools, etc. BEV might include start up costs, an assembled workforce, business organization, non-realty leases and contracts, hotel franchise, web presence, reservation system and residual intangible assets.

Arguments Within the Appraisal World Regarding Business Enterprise Value

Not surprisingly, when attempting to value income producing real property, the income capitalization approach dominates the generally accepted approaches to valuing hotels (the cost approach, the market comparable approach, and the income capitalization approach). The concept of component analysis affects primarily the income capitalization approach. While USPAP, the IRS, SEC and FASB all require separation of components[89], there is no consensus on the method for calculating BEV. The argument is most heated among appraisers.[90]

Initially, the controversy involved primarily hotels and stemmed from lenders and borrowers seeking to use the resulting high real estate values supported by the Rushmore Approach (a more conservative approach described below) to lend and borrow money in amounts greater than the values calculated under the other methodologies which generally calculated a higher BEV and lower real estate value.[91]

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87 S.C. CODE ANN. § 12-37-3140 (A)(1)(d).

88 *Supra* n.8.

89 *Supra* notes 9 and 77.

90 For example, one approach to valuing hotel assets is the Total Assets of the Business (TAB) hypotheses which has been referred to as a "merely contrived academic hypothetical construct[] without any market foundation . . .developed with the sole intent to obtain reduced hotel property tax burdens." *See* Daniel Lesser, Boom, Bust, Recovery: A Hotel and Condo Tale, Presentation Before The Counselors of Real Estate 2012 Annual Convention (October 15, 2012).

91 Eric E. Balfrage, *Business Value Allocation in Lodging Valuation*, THE APPRAISAL JOURNAL 69, 277-282 (July 2001).

For several years, the Appraisal Institute offered a course, known as Course 800, to teach appraisers a methodology to measure BEV. Course 800 generated such an outcry that the Institute dropped, but did not disavow, the course in 2005.

In 2012, the Appraisal Institute began offering a new course entitled "Fundamentals of Separating Real Property, Personal Property, and Intangible Business Assets." As of this writing, the materials of this course have undergone four rewrites and are still subject to vigorous debate and attack. The stated purpose of the course is to provide "the theoretical and analytical framework for separating the tangible and intangible assets of real estate centric businesses. … [P]articipants will apply the theory of the firm and the concept of economic profit to the solution of problems and case studies related to ad valorem taxation, eminent domain, loan underwriting, and transaction price allocation."[92]

Significantly, the new Appraisal Institute course does not advocate a particular theory or method for calculating BEV. "Rather, each appraiser must come to his or her own conclusion based on the property type, local market customs, and scope of work."[93] In other words, **<u>no</u>** guidance is given to appraisers as to **<u>how</u>** to allocate intangible value from an overall value.

The current course materials for the new Appraisal Institute course distinguish between "going concern value" and "market value of a going concern." However, increasingly, some appraisers are starting to discuss a new concept, the concept of "go dark value," which is not discussed in the new Appraisal Institute course materials. "Go dark value" is not liquidation value, but rather an effort to recognize that risk is associated with "ramping up" the different components of a concern that, once operational, will have going concern value. The concept may well be applicable in valuing real estate for ad valorem tax purposes when trying to value real estate in a project which is currently losing money or has in fact gone dark. In essence, this concept attempts to recognize that risk exists both in terms of costs and time in ramping up the concern.

Since real estate appraisers are given very little guidance as to how to allocate intangible value, a question becomes **<u>who</u>** is qualified to appraise intangible value. If a real estate appraiser is in fact qualified to appraise only real estate value, then who should business owners, investors, and lenders turn to in order to appraise certain properties (e.g. hotels) with an intangible value component properly. In order to satisfy appraisal standards in the United Kingdom "it is important that the valuer is regularly involved in intangible asset valuation, as practical knowledge of the factors affecting any particular asset is essential."[94] Like real property, intangible property has many facets and requires a detailed analysis to determine the value of a particular intangible asset.[95]

<u>The Case for the "Rushmore Approach" of Valuing Hotels' Intangible Value.</u>

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[92] AI Handbook, p. ix.

[93] *Id.*

[94] ROYAL INSTITUTION OF CHARTERED SURVEYORS, *The Valuation of Intangible Assets, RICS Guidance Note* 4 (December 2012).

[95] *See, e.g.*, *Id.* at 12.

In the context of hotels, one of the most cited approaches for extracting the real estate value of an operating hotel is known as the "Rushmore Approach." Named for Stephen Rushmore, the founder of HVS International, the Rushmore Approach subtracts management fees and franchise fees from the cash flow of a hotel which when capitalized results in real estate value.[96]

The Rushmore Approach subtracts management fees and franchise fees from a hotel's cash flow and then capitalizes the resulting cash flow to separate the intangible value from the real estate value of a real estate centric business.[97] The Rushmore Approach would be difficult, if not impossible, to apply to other real estate centric businesses which do not involve management or franchise fees. Rushmore states:

> The most appropriate theory for today's environment is based on the premise that by employing a professional management agent to take over the day-to-day operation of the hotel – thereby allowing the owner to maintain only a passive interest – the income attributed to the business has been taken by the managing agent in the form of a management fee. Deducting a management fee from the stabilized net income thereby removes a portion of the business component from the income stream. An additional business value deduction must also be made if the property benefits from a chain affiliation.[98]

Most tax assessing entities, even those using "mass appraisal techniques," accept the Rushmore Approach for hotels. Although few reported decisions have been rendered in this area, the leading reported decision regarding valuing hotels is that of the New Jersey Tax Court in *Glen Pointe Assocs. v. Township of Teaneck.*[99] The hotel involved in that case, the Lowe's Glen Pointe Hotel, contained 347 guest rooms, two restaurants, a lounge, a lobby bar and a health club known as "The Spa at Glenpointe."[100] The court concluded that the Township of Teaneck inappropriately valued the hotel for ad valorem tax purposes.[101] Using the income method, the court held that to arrive at the "true value" of the real property itself, one must eliminate business value and the value of the personal property.[102] The court held that it was reasonable to extract the hotel's business value and the method used by the expert to be reasonable.[103] The court noted that a hotel, whose income depends on many factors other than

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96 At least four (4) other hotel valuation methods exist. Like the Appraisal Institute, this paper does not endorse any one approach.

97 Stephen Rushmore and Karen E. Rubin, *The Valuation of Hotels and Motels for Assessment Purposes*, THE APPRAISAL JOURNAL 50 (April 1984).

98 *Id.*

99 10 N.J. Tax 380, 1989 N.J. Tax LEXIS 5, at *11-12 (1989) *citing inter alia* Stephen Rushmore, HOTELS, MOTELS, AND RESTAURANTS: VALUATIONS AND MARKET STUDIES 105-06 (Appraisal Inst. 1983)).

100 Secondary literature includes numerous discussions of the *Glen Pointe* decision: Rushmore, *Why the "Rushmore Approach" is a Better Method for Valuing the Real Property Component of a Hotel*, Journal of Property Tax Assessment and Administration (2004); and John Garippa, *The Other Side of the Marriott v. Saddle Brook Decision Fair & Equitable* (April 2006); Lennhoff and Reichardt, *Hotel Valuation Myths and Misconceptions Revisited*, Williamette Management Associates Insights (Winter 2011); Daniel Lesser, 'Total Assets of the Business' and Lodging Facilities: What Should be the Final Chapter, 1 JOURNAL OF PROPERTY TAX ASSESSMENT AND ADMINISTRATION 4, 29-36 (2004).

101 *See generally, Glen Pointe Assocs. v. Township of Teaneck*, 10 N.J. Tax 380.

102 *Id.*

103 *Id.*

the real estate itself, differs from other types of income producing real estate such as an apartment complex, whose value generally depends primarily on the real estate itself.[104] The taxpayer's expert opined that the business value is reflected in the compensation paid to the professional management agent to assume responsibility for daily operations of the hotel. That compensation is measured by a percentage of total hotel revenues.[105]

Under the Rushmore Approach, the valuation expert (i) starts with original income and expense statements; (ii) makes a deduction for business value by analyzing (a) the property's management fee and (b) the franchise fee, if any; (iii) deducts the value of the hotel's personal property; (iv) calculates a value for return on the investment; and (v) calculates a value for return of the investment. The expert then makes adjustments for superior or inferior management usually by adjusting the property's occupancy and average daily rate based on industry data.[106] In doing so, the expert adjusts income and expense data based on comparable operating data considering factors such as (i) location; (ii) design and construction; (iii) market orientation (i.e. extended stay, select service, limited service, etc.); (iv) brand (i.e. Hilton, Marriott); and (v) age.

In adjusting the property's occupancy and daily rate, the expert generally divides hotel properties into classes such as (i) full service and (ii) limited service.

An appraisal of real estate for ad valorem tax purposes which is based on the income derived from the hotel's operations must allow a deduction for the contribution to that income of the business' goodwill because that portion of the property value is not related to its real estate but instead to the hotel's reputation and the services it provides (i.e., goodwill or going concern value).[107]

The attractiveness of the Rushmore Approach includes the ready availability of the necessary data and the simplicity of the calculation. Rushmore further states that the deduction of the management fee in order to arrive at BEV is supported because third party management is widely practiced and in appraisals routinely deduct a management fee.

Rushmore defends his approach against attacks by advocates of the "business enterprise" approach in an extensive article published in 2004[108] and believes that while the business enterprise approach advocated by others significantly reduces a hotel's ad valorem tax assessment, the business enterprise approach also has the potential of reducing the mortgage asset security value relied upon by lenders in making hotel loans.[109] Rushmore notes that there is no hard data pertaining to sales of a hotel business' different components.[110] In essence, Rushmore argues that the results yielded by other more aggressive business enterprise

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[104] *Id.* at 390-392.

[105] *Id.*

[106] Appraisers typically defer to Smith Travel Research and Market Research and/or Korpacz reports to analyze industry specific data.

[107] *Sunwest Hotel Corp. v. Bd. of County Commissioners of Reno County, Kansas*, 1998 WL 982905, at *13 (U.S.D.C Kan. 1998).

[108] Rushmore, *supra* note 90 *at* 17-29.

[109] *Id.* at 27.

[110] *Id.* at 26.

approaches yield real estate values which are not reasonable in the context of an analysis of depreciation taken by most hotel owners.[111]

Criticisms of the Rushmore Approach

While the Rushmore Approach is often preferred by tax assessors and is simple to calculate, it is subject to criticism from many appraisers. According to the critics, the Rushmore Approach offers no support for the theory other than the notion that management fees can be characterized as income to the business. The assumption that the deduction of management and franchise fees effectively removes BEV is counter to market participant expectations that the costs of management and franchise affiliation should result in revenues that exceed cost. Many appraisers suggest that the idea that management and franchise companies capture all of the BEV is to say that a hotel has no business enterprise value. While a management fee may compensate the management company fairly, it does not compensate the owner for his investment in the hotel. From the owner's point of view it is only a cost, like payroll or advertising.

It is important to understand that cost is not the same thing as value. Not only is the management fee a normal cost of operating a hotel, it is already deducted from cash flows in order to arrive at going concern value. Further, the value of a franchise is measured by its ability to deliver customers. If the cost of the franchise only equals the business revenues generated by the franchise, why wouldn't all hotels be independent? Successful hotel franchises derive revenues in *excess* of their cost. If a hotel merely achieves a revenue per available room ("**RevPAR**") equal to the average of its competitive set of hotels, or even falls below, it does not necessarily mean the hotel has no BEV.

A hotel management company has been characterized as comparable to a tenant in a leased property. In a lease, the owner's income, except in the case of a tenant default or turnover, is secure at least to the extent of the base rent. In the case of a management contract, the owner has claim only to the residual after all operating expenses, including management and franchise fees have been deducted. The management fee, far from representing BEV, is an obligation and encumbrance on the owner. In a leased hotel, the lessee operator bears the risk while in a managed hotel the owner bears the risk. Risk demands compensation beyond the operating costs of the hotel. According to Paul Samuelson, "economic activities that involve much uncertainty and risk, which will fall on the people who engage in them, will be forced by competitive entry and exit of risk takers to pay, over the long run, a positive profit premium to compensate for aversion to risk."[112]

Real Estate Lease Method

As noted above, a lease represents the purest form of real estate revenue. Ideally, the cleanest way to identify the value of the real estate component of a going concern would be to calculate the value of lease payments. This would have been fairly simple for hotels in the 1940s or 1950s as the hotel lease was fairly common at that time. In 1947, Fred Eckert wrote:

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111 *Id.* at 26 -27.

112 Paul A. Samuelson, ECONOMICS: AN INTRODUCTORY ANALYSIS 564 (7th ed. McGraw Hill 1967).

> A very considerable number of the hotels of this country, large and small, are operated under contracts of lease between investor owners and independent hotel operators. The practice of leasing is widespread and characteristic of the business in all sections of the country.[113]

Over the past thirty years, the management contract has become the dominant form of operating a hotel and the standard hotel lease is the rare exception. The passive income requirements of Real Estate Investment Trusts (REIT) led to the development of a form of lease that swept virtually all of the taxable income from the related but taxable operating company to the tax free REIT. The REIT lease because of its tax avoidance purpose does not capture the pure real estate value of a hotel.

The Real Estate Lease method would almost never apply to facilities such as health care facilities. This method is more applicable to a hotel that has a food and beverage revenue disproportionate to its room revenue. Essentially, this was a very large and successful restaurant with a rooms component. In this case, it is possible to structure the food and beverage component as a restaurant lease to derive the BEV from the food and beverage operation. Because it is common for restaurant facilities to be leased, finding market comparables is not an issue as it is for hotels.

Cost Method

One approach to separating the value of BEV from the going concern value is to calculate the value of the hotel by way of the cost approach. Once you have this value, subtracting both the cost value and the value of FF&E from the going concern value arrived at through the income approach should yield the BEV. While this approach is commendable for relatively new hotels, more depreciation has to be taken into account for older hotel. This can be subjective and unreliable.

Excess Profits Method

Another way to measure the value of intangible assets such as management or chain affiliation is to evaluate the excess RevPAR that a hotel achieves relative to a set of similar competitors. For two nearly identical hotels with differing affiliations, the excess by which one hotel's RevPAR exceeds another may be attributed to a more competitive affiliation. Care must be taken, however, to allow or adjust for superior or inferior locations or facilities which would be attributes of the real estate and not affiliation. In the real world, it is difficult to find properties that are not influenced by some difference in the real estate attributes. Nevertheless, the professional appraiser must also account for franchise requirements in the construction of the hotel. For example, improvements built to satisfy Clarion standards will generally need to be altered to satisfy Marriott standards if the property is reflagged from Clarion to Marriott.

Even if one determines the difference is due to management and affiliation and not real estate, that is not the end of the story. Assume a Marriott and a DoubleTree hotel are identical in

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[113] Fred W. Eckert, *The Hotel Lease: A Study of the Business Element and Principles Involved in Making Leases That Are Equitable to Both Lessee and Lessor*, vii (The Hotel Monthly Press 1947).

every way except affiliation. Neither has a location advantage over the other. If the Marriott, for example, has a higher RevPAR than the DoubleTree, the difference does not capture all the revenue associated with BEV since the DoubleTree would also have some level of BEV and it would have to be added to the amount identified by the difference.

In addition to RevPAR, a management company that consistently operates with lower expenses (producing a higher net operating income (NOI) than its competitors) also generates BEV. The additional profit generated by the higher NOI is a component of BEV.

Franchise Revenue and Cost Method

The value of a franchise is its ability to generate revenue for the hotel owner in excess of the cost of the franchise. Because chain standards enforced on properties create an expectation of a certain level of quality and service in the minds of hotel patrons, a body of brand loyal customers is built up.[114] This loyalty is reinforced by frequent traveler reward programs, the most successful of which include Marriott's "Rewards," Hilton's "HHonors," and Starwood's "Preferred Guest" programs. Customers who are loyal to a brand are less price-sensitive, tend to spend more and are positive sources of word of mouth advertising.[115] Peter Yesawich reported that 85% of business travelers and 76% of leisure travelers prefer chain hotels to non-branded hotels.[116]

Chain reservation systems, frequent traveler programs, and group marketing bookings do not capture all of the demand generated by the franchisor. Often a guest will patronize a hotel because of a brand's reputation but will "walk in" or book outside the identified franchise distribution system. The franchise revenue and cost method does not capture these franchise generated guests and, to that extent, underestimates the value of the franchise.

In calculating the cost benefit premium created by a hotel's affiliation, the costs paid for the franchise affiliation are deducted from the quantifiable benefits received resulting in the net benefit of the affiliation. This methodology shows the cost versus benefit of the actual affiliation of a specific hotel. It employs the chain's own accounting of actual rooms attributed to their distribution channels. These channels provide guests through corporate internet sites, toll-free reservation telephone numbers, and travel agent relationships, as opposed to reasons relating to real estate such as location, physical characteristics, access and exposure.

The value of a franchise to a franchisee results from the brand's ability to generate room revenues. The rooms department generates the highest contribution margin and typically constitutes the largest revenue contribution in a hotel. The hotel's other departments would logically benefit from expenditures made by hotel guests attracted by the franchise but such revenue is not captured in this calculation. To the extent that some food and beverage and other

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[114] John W. O'Neill & Anna S. Mattila, *Hotel Branding Strategy: Its Relationship to Guest Satisfaction and Room Revenue*, JOURNAL OF HOSPITALITY & TOURISM RESEARCH 28, 156-165 (2004).

[115] John W. O'Neill & Qu Xiao, *The Role of Brand Affiliation in Hotel Market Value,* CORNELL HOTEL AND RESTAURANT ADMINISTRATION QUARTERLY 47, 1-14 (Aug. 2006).

[116] P. C. Yesawich, *So Many Brands, So Little Time,* LODGING HOSPITALITY 52, 16 (September 1996).

revenue is derived from guests brought to the hotel by DoubleTree's proprietary efforts, BEV is understated.

All of these arguments, while interesting theoretical pursuits, ignore the most basic truth of hotels, health care facilities and similar real estate: the different components exist in the enterprise purely because the owner or operator has determined the components contribute to the overall merged value of the property and need to be part of its valuation. For example, a strict comparison of the "value" of an item in a hotel room mini-fridge to the value of the same item in a big box superstore is not indicative of true income-producing potential. The hotel operator recognizes a guest will pay an inflated price by virtue of the hotel operator having placed the item in the room to appeal to a guest at a particular time. The free market economy determines that the "value" of such an item is the income it produces in a specific location, at a specific time, and in a specific situation. Similarly, if a restaurant in a hotel, or a beauty shop in a health care facility, does not produce enough income to justify their cost, each operation would likely be replaced.

Regulatory Changes in the Banking Industry?

Despite the writings of Stephen Rushmore, David Lennhoff and others, many owners of income producing real estate have assumed that the argument regarding intangible value was restricted to ad valorem property tax world. That position appears increasingly outdated.

On October 1, 2011, the Small Business Administration ("**SBA**") adopted updated appraisal policies[117] "relative to business valuation requirements and going-concern appraisals when there are changes in ownership." The new regulations require all SBA lenders to obtain a "going concern appraisal" for any real estate property involving an ongoing business.[118] SBA now requires lenders to have an appraisal valuing the separate components prepared by an MAI appraiser who has passed either Course 800 or the Appraisal Institute's new course. Impacted properties include: (i) hospitality uses such as resorts and motels; (ii) healthcare facilities such as hospitals, nursing home and assisted living centers; (iii) restaurants and nightclubs; (iv) recreation facilities such as theme parks, theaters and golf courses; (v) manufacturing firms; (vi) franchised gas stations/convenience stores; and (vii) shopping centers, office buildings and apartments.

Although the SBA claims that nothing has changed, the SBA's requiring lenders to obtain appraisals prepared by appraisers who have passed a specific course is certainly new.

The Office of the Comptroller of the Currency, an independent bureau of the United States Department of the Treasury ("**OCC**"), generally regulates commercial banks.[119] The OCC's regulations are distinct from those of SBA. Unlike the new SBA regulations, relevant OCC regulations do not specifically mandate the appraiser be qualified in business valuation, nor

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117 *See* U.S. Small Business Administration, Office of Financial Assistance, SOP 50 10 5(D) (Oct. 1, 2011).

118 *Id.*

119 The OCC's primary mission is to charter, regulate, and supervise all national banks and federal savings associations. *See* http://www.occ.gov/about/what-we-do/mission/index-about.html.

that the appraiser complete a specific course. Rather, OCC vaguely requires that the appraiser be competent.

While most OCC appraisals need only comply with USPAP, "stricter standards" may apply to certain OCC related appraisals if "principles of safe and sound banking" so require. OCC real estate lending guidelines state that "an institution's real estate lending program should include an appropriate real estate appraisal and evaluation program."[120] The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA)[121] imposed additional requirements on institutions subject to OCC regulations by "requir[ing] each institution to adopt and maintain written real estate lending policies that are consistent with principles of safety and soundness and that reflect consideration of the real estate lending guidelines."[122] What this exactly means is unclear.

USPAP currently "does not require real estate appraisers to value the different elements integrated in an appraisal of the going-concern value" when appraising "potential going-concern property."[123] Although USPAP Standards Rule 1-4(g) states: "[w]hen personal property, trade fixtures, or intangible items are included in the appraisal, the appraiser must analyze the effect on value of such non-real property items," the Appraisal Foundation has made it clear that this standard does not mandate an appraisal of the property's individual components of value. Rather, the appraiser simply must acknowledge that separate components may affect the overall value of a going-concern. This distinction is based on the difference between analyzing and valuing. However, "[a]lthough there is a difference between analyzing and valuing, if the analysis is performed thoroughly, the appraiser may be required to value the individual components because of what the analysis produces and/or the manner in which the analysis was applied."[124] Thus, USPAP implicitly may require an appraiser to allocate values under certain circumstances.

One recent article specifically states "[s]ince at least the enactment of FDICIA…appraisals of going-concern properties…must allocate values…USPAP does not require this, but FIRREA and FDICIA do since most banks calculate their loan-to-value ratios using the market value of real property only."[125] Whether this requirement now requires allocating different interest rates to different components of value is an open question.

The irony in the evolving regulatory approach described above is apparent. On the one hand, regulators are trying to ease credit for a distressed real estate industry. On the other hand, the application of the regulatory approach described above will almost necessarily lower the property's real estate value and encourage financial institutions to reduce available credit or raise

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[120] O.C.C. *Comptroller's Handbook, Commercial Real Estate and Construction Lending* 19 (1998) (codified at 12 CFR Part 34, Appendix A to Subpart D) (hereinafter *Guidelines*).

[121] 12 U.S.C. §1811, et seq.

[122] *Guidelines* at 18.

[123] Going-concern Valuation, 10; 2012-2013 USPAP, Frequently Asked Question 188, F-85 (2012) *available at* http://www.uspap.org/#/334/.

[124] L. DEANE WILSON AND ROBIN G. WILSON, GOING CONCERN VALUATION FOR REAL ESTATE APPRAISERS, LENDERS, ASSESSORS, AND EMINENT DOMAIN 11 (Universe 2012).

[125] GEORGE R. MANN, et al., Federal Agencies Offer Guidance on Appraisals and Evaluations (The Appraisal Institute Summer, 2011) *available at* http://www.freepatentsonline.com/article/Appraisal-Journal/268402649.html.

interest rates. Since the 2008 crash, lenders have been discouraged from using raw land as collateral for real estate loans. In many markets, credit for non-incoming producing property is very difficult to obtain. Consequently, many lenders have rushed to move as much of their portfolio as possible to income producing properties. In the interest of promoting “safe and sound banking practices,” regulatory authorities are simultaneously promoting new regulations which clearly will reduce the values of income producing properties by extracting intangible value. The question which must be asked is whether these new regulatory policies are really encouraging credit or hampering the recovery of the real estate industry from a historic downturn.

For health care facilities, securing financing is already extremely difficult because of the complex web of licenses, permits and contracts which are needed to produce the going concern value. This difficulty is not surprising in view of the difficulty in collateralizing the loan properly. Financing difficulty is generally attributed to a lender seeking a value for each of these components, and closing on a loan without the usual level of certainty and scrutiny of in-place collateral documents. For example, most permits, licenses and reimbursement contracts are not assignable to a new buyer or receiver of this type of facility, without the prior consent of the affected government authority. Regulations require the facility seller to have its permits in effect as long as it is operating (which means right up to the closing), and require the buyer of the facility to have its new permits in place without a gap, from the time of closing, but many of these permits take weeks or months to be approved. Similarly, county reimbursement contracts, paying the operator to house a stated number of residents, at the county's expense, do not allow change in control easily. If the buyer of a facility is changing the type of operation, for example, to change from a Medicare paid facility to a private pay facility, which requires termination of any Medicare paid leases and the removal of those patients before closing, the differing regulations create impossible conflicts that can only be overcome by an understanding lender accepting "comfort letters" in place of hard, issued permits.

In many respects, the difficulty in collateralizing loans to facilities such nursing homes is precisely the point and demonstrates the need to recognize that BEV is a substantial component in the property’s operation and cash flow. However, once BEV’s existence is recognized, how does one calculate this value without engaging in a subjective analysis? Little wonder that the debate in the appraisal world on the “proper” method of calculating BEV is so heated.

The increased emphasis on BEV may also impact banks in other ways. For example, the due diligence for many contemplated mergers or acquisitions of smaller community banks will focus on the target’s books. One potential question is “how clean are the target’s real estate lending books if the underwriting files do not contain appraisals that recognize the existence of BEV and attempt to address this component of value?” The absence of such appraisals could impact the ability to sell participations in real estate loans or raise capital. Predicting the impact of the absence of such appraisals is, at best, problematic in the current unclear bank regulatory environment.

Conclusion

The idea of component analysis or pricing makes little sense in a purely transactional context. A component analysis assumes that A+B+C = value. The arithmetic may sound right, but is it really?

Component analysis makes complete sense in analyzing operations and calculating income and ad valorem property taxes. While the arithmetic may sound right in a transactional context, the ongoing debate originating in the tax appeal world over how to calculate BEV illustrates the difficulty of transporting the concept into the "real worlds" of business transactions and real estate lending. In most of the world, hotel lending is done in the corporate loan department, not the real estate department, and with good reason. Transporting the BEV concept into real estate lending may make sense but no consensus exists as to how implement it.

The arguments surrounding component analysis and the proper method of calculation are about risk. Component analysis recognizes the reality that different components of real estate centric businesses involve different amounts of risk. Mathematically calculating that risk, for whatever purpose, is difficult to do, leading to heated arguments about methodology - arguments that remain unresolved.

An additional question looms: Are SBA and OCC really saying that real estate lending must be based on a mathematical formula evaluating risk in loans secured by operating businesses? If so, what is the formula? Incorporating the concept of component analysis into real estate lending seems likely to lead to higher interest rates at a time when credit for real estate transactions has gotten much tougher. The debate is just beginning.