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).