

PROPERTY TAX AND TRANSFER TAX PLANNING

Deal Pricing Analysis

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Three Steps for Hospitality Acquisitions

The much anticipated resurrection of hotel and resort transactions seems to be upon us. Those who were involved in the hot market of 2006 and 2007 will recall that assessors tend to use a sale price as the market price for property tax purposes.

Most buyers use operating pro forma to assist with pricing decisions. These projections use assumptions about income, variable and fixed costs, including property taxes. All too often, pro forma property tax estimates are based on last year's property taxes growing at the expected inflation rates. The disastrous impact of such estimates come post acquisition when the hotel fails to achieve pro forma because real estate taxes have increased dramatically beyond the pro forma assumption.

To avoid property tax surprises, hotel buyers' due diligence checklist should include the following three items regarding property taxes:

(1) PROPER METHODOLOGY FOR ESTIMATING PROPERTY TAXES

Property taxes represent a significant portion of a hotel's bottom line, so accurately estimating future property taxes in a pro forma becomes critical. Savvy investors in hospitality assets understand the hotel business and can make reasonably accurate estimates of income and expenses. However, they find it difficult to accurately project property taxes because these taxes are local, not standardized in all jurisdictions, and, most importantly, they are based on an opinion of value.

The following hypothetical example illustrates the effects of inaccurately projecting property taxes in the pricing pro forma. Let's say an operating hotel sells for \$50,000,000. The real estate component of the hotel amounts to \$35 million. Last year the hotel received a \$25,000,000 real estate tax assessment, and, based on a 2% effective tax rate, its property tax bill was \$500,000. The re-assessment cycle in the jurisdiction is annual.

The first column of the table below shows the result of a typical accounting pro forma treatment for projecting the current million-dollar property tax on the hotel (at 3% inflation). The second column portrays the figures from a more sophisticated methodology, which uses the \$35 million real estate purchase price, the 2% effective tax rate and 3% inflation rate to compute the property taxes across time. Using the wrong method to project property taxes in the pro forma can have dramatic ill effects. In this case, the error projects property taxes almost \$200,000 short each year.



Differing Pro Forma Property Tax Methodologies Cause over Taxation

	Typical Accounting Treatment	Professional Method	Pro-Forma Shortfall
Year 1	\$ 515,000	\$ 700,000	\$ 185,000
Year 2	530,000	721,000	191,000
Year 3	545,364	742,630	197,267
Year 4	562,754	764,909	202,155
Year 5	579,637	789,856	208,219

(2) AT CLOSING PROPERLY RECORD THE TRANSACTION IN THE LAND RECORDS

Once the deal is inked, buyers must insist that the transfer documents are filed correctly. Most states impose a realty transfer tax based on the price paid for real estate. This value should not include amounts paid for all personal property. As an example of correct recordation:

Total consideration:	\$ 50,000,000
Minus Value of Personal Property:	\$ <u>15,000,000</u>
Consideration for which tax is due:	\$ 35,000,000

The \$15,000,000 of personal property consists of \$5,000,000 for the tangible personal property and \$10,000,000 representing the price of the intangible assets.

Typically, buyers tend to separate only the tangible personal property value, the effect of which is to overstate the value of the real estate. In the above example, the transfer tax form would overstate the value of the real estate by \$20,000,000. The transfer tax overpayment amounts to \$200,000 (2% times \$10,000,000). Additionally, the assessor now possesses written proof that the price paid for the real estate was \$45,000,000, not \$35,000,000. Future assessments will be based on the higher purchase price because of the inaccurate recording.

(3) CAREFULLY MAINTAIN CLOSING DOCUMENTATION SUPPORTING THE TRANSACTION.

In a tax appeal, the onus resides with the owner to support his position with proper documentation. The transfer tax return is a sworn document and a representation of the price paid for the real estate. When the assessor attempts to revalue a property at something higher than what was paid, the buyer's documentation stands as a bulwark against such revaluation. A buyer who did not pay adequate attention to properly completing the transfer tax return has little recourse other than paying the higher property tax. Without records, the taxpayer is lost.



Because property taxes represent a significant “fixed” cost, but one that can be controlled, property tax due diligence becomes a hotel buyer’s best friend. Performing a serious due diligence process, as outlined, ensures the buyer of: appropriate pricing, proper recordation, reduced exposure to property tax increases and, ultimately, optimization of profits.

Paradigm Tax Group offers a purchase price allocation specifically for real estate and transfer tax purposes that we call our Deal Pricing Analysis (DPA). Bernice Dowell has provided DPA’s for Pebble Beach, Pinehurst and hundreds of hotels and resorts in between.

For more information on our DPA service, please contact John Hess at 703-626-1895 or at jhess@paradigmtax.com

