Purchase Price Allocation vs. Transaction Price Segregation for Property Tax Valuation Purposes

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When a property is bought or sold, the acquiring company is required to conduct a Purchase Price Allocation (PPA). The financial accounting treatment estimates the *fair value* of the target company during the transaction by allocating tangible and intangible assets based on the total purchase price. While a PPA determines what is considered to be the fair value of a company, it does not determine *fair market value*, which is most commonly used for property tax valuation purposes. There are a number of variables that differentiate fair value from fair market value, and it is crucial for property owners to understand the distinctions between the values and the appropriate situations for both.

Property tax assessors will often either rely on market information from merger and acquisition transactions (which could be completely unrelated to the situation at hand) or the PPA performed during the subject transaction as evidence of the fair market value of the company's taxable unit. But as previously mentioned, there are major valuation differences between fair value estimates, used for accounting purposes, and fair market value estimates, used for ad valorem property tax assessments.

Infrequently, there are situations in which the transaction purchase price accurately represents the fair market value of the business. But even in this scenario, the PPA does not necessarily represent fair market value as well, as this financial accounting method is based on fair value. Fair value is the standard of value that both accounting and valuation professionals use for purchase accounting purposes, in accordance with Accounting Standards Codification (ASC) 820, "Fair Value Measurements and Disclosures." The Financial Accounting Standards Board (FASB) implemented this standard codification method in order to increase consistency for fair value measurements. ASC 820 defines fair value as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (an exit price)."

Another measurement of value is *investment value*, which pertains to the value a particular investor places on a specific property. The investment value is based on the opinion of an individual, thus does not accurately represent the market value. When performing a fair market value analysis, the investment value should not be taken into consideration. An investor will often spend more than the market value on a specific property as they see potential benefits or advantages that other buyers do not. An investor's willingness to pay above market value is based on hypotheticals, and therefore, is not reflective of the fair market value.

Problems begin to arise when the transaction purchase price reflects the investment value or other standards of value that are not the fair market value. As stated before, property tax assessors will frequently use merger and acquisition (M&A) transaction purchase prices as fair market value. Therefore, it is imperative that motivations of the parties in an M&A transaction are understood. For property tax purposes, M&A transaction data is often futile, because it involves the acquisition of shares of stock and the assumption of debt, and not just the company's taxable assets. Another factor included in M&A transaction prices that is inappropriate for property tax purposes is future growth projections. Until those assets are actually purchased, they cannot be subject to property taxation. In ad valorem tax context, it is clear the M&A transactions are most often completed at investment value, use value, or other standards of value that differ greatly from the fair market value.

Another important aspect to take into consideration in the fair value and fair market value differentials is the *assumed buye*r versus the *assumed seller*. When determining the fair value valuation for purchase accounting purposes, the assumed buyer and assumed seller are "market participants," which include both strategic buyers and financial buyers. On the other hand, fair market value assumes conditions as they actually are, using hypothetical buyers and sellers without unique, strategic motivations. Assumed buyers and sellers under the fair market concept need to be hypothetical and only financially motivated.

The typical PPA may include expected post-merger synergies, present value of growth opportunities, and intangible assets (such as lease contracts, unamortized tenant improvements, customer/tenant relationships, unamortized leasing commissions, and marketing costs). Such assets would not be taxable for State and Local Tax (SALT) purposes, and the use of a PPA for a SALT report would result in the over statement and in the over payment of real estate transfer taxes in numerous transactions. The divergence between PPA and a SALT Transaction Price Segregation (TPS) is due to a difference in the underlying value definition. PPA and TPS valuation methods determine two separate and distinct valuations. While PPA is based on the fair value concept, TPS is based on fair market value, and a much more appropriate methodology for property tax valuation purposes. Further, the classification of assets between tangible and intangible personal property under IRC 197 is frequently not the same as that used for SALT purposes. This is again due to the unique definitions and requirements under the two separate taxing regimes.

When conducting a TPS analysis, the buyer/seller's deal is analyzed and the purchase price is allocated across three asset classes: Real Estate, Tangible Personal Property, Intangible Personal Property or Business Value. Ideally, TPS reports are prepared prior to the acquisition, which allows the buyer to paper their deal accordingly and file the allocated values for real estate on the deeds. A TPS analysis helps to minimize transfer taxes for the seller prior to the deal closing, and helps establish a low base year assessment for the buyer, saving money on the front end of the investment holding period. If a TPS is commissioned after the deal is closed, depending on the jurisdiction, it can be used to obtain a refund of real estate transfer tax. Properties with significant amount of business value (such as hotels, golf courses, senior or student housing, and data centers) can benefit the most from TPS reports.

Accurately allocating each component through a TPS analysis can save tens of thousands of dollars in property taxes. Paradigm Tax Group is well-versed in the intricacies of TPS analysis, and can help you ensure your property tax valuation is based on fair market value. If you would like more information, please contact Cameron Moore at (678) 954-6002 or cmoore@paradigmtax.com.