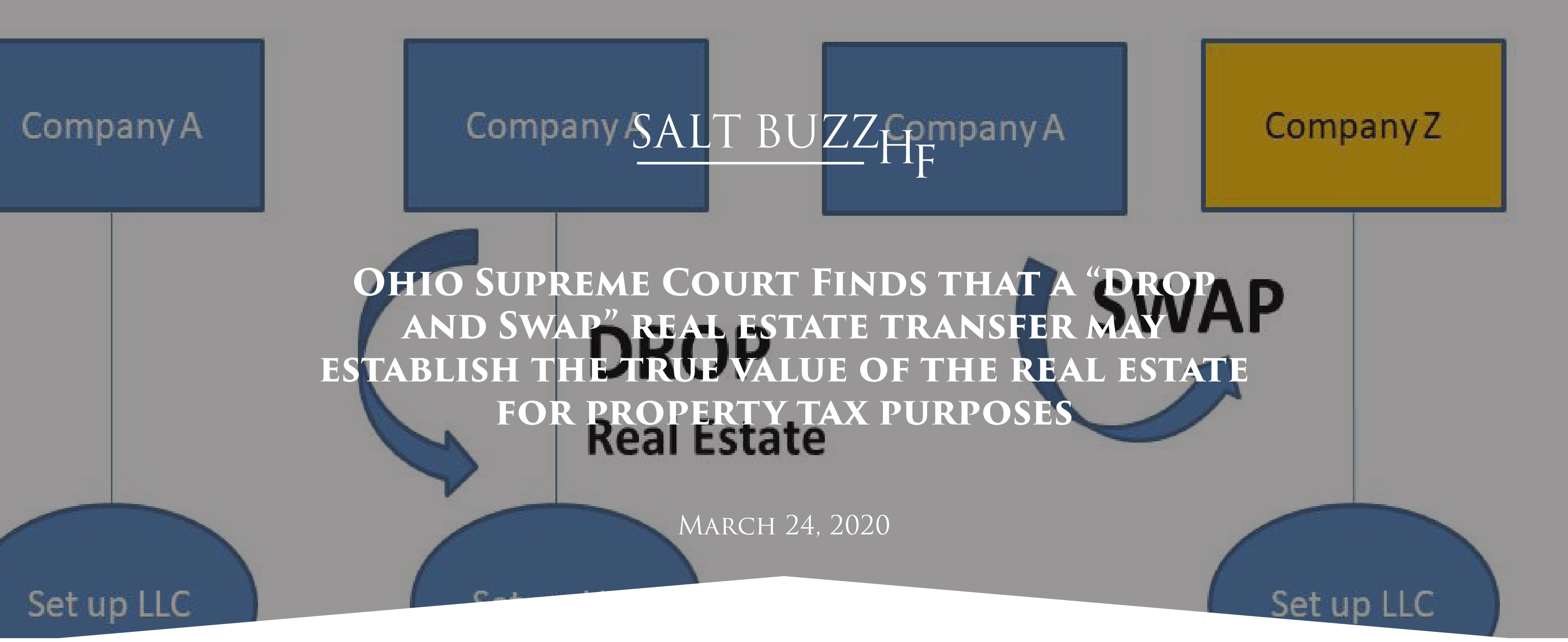

SALT BUZZ HF

Ohio Supreme Court Finds that a "Drop and Swap" Real Estate Transfer May Establish the True Value of the Real Estate for Property Tax Purposes

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On February 6, 2020, the Ohio Supreme Court issued its decision in *Columbus City Schools Bd. of Edn. v. Franklin Cty. Bd. of Revision* , Slip Opinion No. 2020-Ohio-353. The decision addresses real estate transactions in which the subject real property is contributed to a limited liability company ("LLC") and the ownership of the LLC is then sold to a third party, a structure commonly known as a "drop and swap." The case is very significant because it now emboldens school districts, in certain circumstances, to be able to assert (often successfully) that the purchase price paid for the membership units of an entity which holds real estate is the rebuttable value of the real estate for real property tax purposes.

A number of related entities on the seller's side of the transaction have "Palmer" in their names, and this discussion will follow the Ohio Supreme Court's opinion in using "Palmer" to refer to the seller, who is also the appellant.

On October 6, 2015, an apartment complex was conveyed by deed from an entity called Palmer Square, L.L.C. to Palmer House Borrower, L.L.C. which also assumed from Palmer Square a mortgage loan of $25,536,000. On the same date, PPG Manhattan Real Estate Partners, L.L.C. ("PPG") purchased the membership interests in Palmer House Borrower, L.L.C. for $35,250,000. Prior to this closing date, a Purchase and Sale Agreement, dated June 22, 2015, was executed between Palmer and PPG. The PSA included a provision giving PPG the option to structure the sale as a "Drop Down LLC sale" and PPG chose to use this option in the first amended purchase agreement. The provision described the steps of forming the drop down LLC, conveying the property to it in accordance with a prescribed form of warranty deed, and then, in lieu of a straightforward sale of the property from Palmer Square to PPG, all of the LLC membership interests would be sold and assigned to PPG. The parties agreed to terminate the agreement if the lender would not approve the entity transfer in connection with the purchaser's assumption of the loan obligation. The sale price in the PSA was $35,000,000, increased to $35,250,000 in an amendment.

Before the Board of Revision, the Columbus City School Board of Education ("school board") argued for an increase in value of the Palmer property from its original value of $16,000,000 to $34,000,000, inferring the sale price by applying a loan-to-value ratio to the $25,536,000 recorded mortgage amount. When the BOR rejected this argument, the school board appealed to the Ohio Board of Tax Appeals ("BTA"), where it argued that a sale of real estate was effectuated by the transfer of ownership of Palmer. Palmer, in addition to objecting to the admission of various documents introduced by the school board, argued that the sale of the entity was not equivalent to a sale of real estate. The BTA overruled Palmer's objections to the documents, and then relied on those documents to determine the real estate's value, finding that the transaction was effectively the sale of real estate using the drop-down LLC structure.

In its appeal to the Ohio Supreme Court, Palmer presented three arguments as to why the contract price should not trigger the presumption that it reflects the value of the real estate, and that the appraisal it had obtained from an expert was the best evidence of this value.

The Ohio Supreme Court sided with the school board. Although Palmer cited Ohio case law to support its argument against applying the sale-price presumption to the contract price, the court distinguished the present case on the facts. Only in the present case was the entity sale a true arm's length transaction having sufficiently clear contract terms for the real estate purchase, with no other elements to muddy the valuation waters, such as the going concern value of corporate or partnership interests; the purchase contracts in the cases cited by Palmer did not explicitly reference an intent to sell and buy the real estate itself (although it was the primary asset involved). Palmer also argued that the LLC sale price was impacted by the presence of other assets such as personal property and contingencies such as the assumption of the mortgage loan. However, the sole source of income generated by the Palmer House property is rental income, which the Ohio Supreme Court considered to be integral to the value of the real estate. Therefore, any other considerations were irrelevant, and the total contract price is viewed as a presumptive starting point for valuation, subject to reduction for the proper allocation of some of the price to assets other than real property. Finally, Palmer argued that because the transaction was structured as the sale of an LLC, the parties had no obligation to pay a conveyance fee or file a conveyance-fee statement. As a result, there is no such statement to provide evidence of the sale price of the real estate. The Ohio Supreme Court rejected this argument, however, because a purchase agreement may constitute both evidence of the sale and of the amount of consideration paid for the real estate. As long as there was sufficient evidence of the sale price in the documentation provided, that documentation is sufficient.

The decision of the Ohio Supreme Court is also significant because it can, in certain circumstances, flip the burden of proof needed to establish a property's true value for real property tax purposes. Previously, in a "drop and swap" type of situation, the burden of proof was generally on the advocate seeking to use that value (usually the school district) to present evidence that an actual real property transaction had occurred. Furthermore, some of the previous case law was unclear when "entity sales" like the one at issue in *Palmer* occurred. After *Palmer*, the value discerned from a purchase and sale agreement, as long as it clearly delineates the sale of real property, will likely be presumptively valid and the opponent of using that value will have the burden of proving that the value is something other than the price paid for the LLC interest. In any event, is important to remember that each case is decided on its individual facts and circumstances, and there may be options to avoid what *Palmer* generally concludes – that the price in a drop and swap is the true value of the real estate.

If you would like to further discuss the *Palmer* decision or any other state and local tax matter, please contact Steve Hall, Derek Heyman or one of our other ZHF professionals.

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