Mergers and Acquisitions: Identify Options, Seize Opportunities and Avoid Pitfalls

Shane Moncrief
Principal, Practice Leader
Commercial Property Tax
Ryan
Atlanta, Georgia
shane.moncrief@ryan.com

Matthew Burke
Managing Director
State and Local Tax Real Estate
PricewaterhouseCoopers LLP
New York, New York
matthew.f.burke@pwc.com
Learning Goals for this Session

• Recognize tax mitigation opportunities in different types of M&A transactions.

• Understand the importance of pre-closing action.

• Overview of how cash flow and ROI can be enhanced through proactive tax planning.

• Understand the tax benefits that accrue to both buyer and seller.
The Problem

• When commercial real estate or tangible personal property is acquired as part of a merger or acquisition transaction, tax issues and mitigation opportunities are rarely considered or incorporated timely into the due diligence or the underwriting of the deal.

• At best, future tax estimates are prepared based on the underwriting assumptions for investor or lender review. Such estimates are for compliance and debt service testing primarily.
The Problem

• It is usually only post-closing, when the acquisition team turns the transaction over to the operations team, that the realization dawns that significant tax mitigation could have been achieved if it had been considered and implemented pre-closing and incorporated into the closing documents.

• Pre-closing tax planning can reduce the cash needed at closing and increase the ROI for the entire transaction, thereby increasing shareholder and investor value.
Structures of Acquisitions

- Single/Multiple Asset of Real Property Transferring by Deed (Asset Deal)
- Single/Multiple Asset of Real Property Transferring by Entity (Entity Deal)
- Merger of Entity that owns Real Property into Other Entity
- Merger of Entity that owns Entities that own Real Property into Other Entity
Structures of Acquisitions

- Understand structure of acquisition (steps)
- Is \textit{real property} transferring by deed or by merger of entity that is the fee owner of real property? Or are only \textit{entities} being transferred and acquired?
- Ownership charts of property and owners (seller)
- Ownership chart of client (buyer)
Due Diligence
Basic Request List

- Property tax bills
- Addresses (and variations)
- Owned and leased
- Parcel numbers
- Abatements
- Exemptions
- PILOT Agreements
- Personal property tax returns
- Appeals
- 3rd party leases and reimbursements
- Construction work in progress
- Title search
Due Diligence
Advanced Request List

Prior deals? Tenants in common?

• California Form BOE-100-B, Statement of Change in Control and Ownership of Legal Entities.
• Florida Form DR-430, Change in Ownership or Control Non-Homestead Property.
• Michigan Form 2766 (L-4260), Property Transfer Affidavit.
• Tenancy in common agreements.
Due Diligence Deliverables

- Fiscal year; assessment methods and reassessment procedures; abatements; tax rates; most recent assessments; billing due dates; payments made and due; tenant reimbursements made and outstanding.
- Post-closing property tax estimate calculation.
- Transfer tax costs of transaction.
- Contrast: (a) single asset with PILOT agreement, tenant pro-rations and new construction, (b) California assets with Prop 13 reassessment and lease protection, and (c) portfolio of NNN-leased warehouses.
Local Assessment Rules

Statutory Reassessment Jurisdictions

• California’s Proposition 13 is the most infamous
• Oklahoma, Michigan, South Carolina, Florida
Statutory Reassessments

California

• Prop 13 limits annual property tax assessment increases to 2% of base year value (FMV at acquisition) until a “change in ownership”.
• “Change in ownership” includes acquisition of “control” of over 50% by single person or entity, or cumulative transfer of over 50% by “original co-owners”.
• Entity changes - must file Form BOE-100-B, Statement of Change in Control and Ownership of Legal Entities with State BOE.
Statutory Reassessments

Michigan

- Taxable value only increases by the inflation amount, until there is a new change in ownership where it resets to state equalized value (50% of market).
- Report transfer of over 50% ownership interests in a legal entity that owns property on the *Property Tax Affidavit* with county assessor.
Statutory Reassessments

**Florida**

- Has a similar scheme to California with 10% limits on increases in assessment for commercial and non-homestead residential (rental property).
- Must file Form DR-430, *Change of Ownership or Control Non-Homestead Property*, after cumulative transfer of control over 50% with county appraiser.
Statutory Reassessments

South Carolina

- Generally properties reassessed every 5 years for whole county. Limit on increases is 15%.
- Exception if there is an Assessable Transfer of Interest (ATI) – sold or otherwise transferred to new owner, then revalued as of 12/31 of year of sale/transfer, and generally at purchase price, but with a new cap that is greater of (1) value calculated after a 25% reduction for sale price, or (ii) the previous owner’s assessed value.
Statutory Reassessments

Oklahoma

- General 5% cap on increases, and 3% on homestead and agricultural.
- Cap lifted when title is transferred, changed, or conveyed to another or improvements made, then assessed at fair cash value.
Cases Where Increase May Follow Sale

- Purchase price exceeds assessment
- “Sales Chasing” by assessors or other parties with standing
- Municipal Advocate (MD), Townships, School Boards (Ohio, Pennsylvania)
Reassessments Regardless

Not Related to Acquisitions

• Not directly related to the transaction itself
• Jurisdictions with set system
• Jurisdictions with defined revaluation cycles
• *Examples: North Carolina, Connecticut, Missouri*
Purchase and Sale or Merger Agreement Issues

- Pro-rations of current year taxes (fiscal vs. calendar year)
- Liability for future assessments on periods of seller’s ownership
- Refunds on active appeals
- Rights to participation on appeals
- Statements about purchase price allocations
- Representations
- Covenants
Use Real Property Values Only

• Many of the taxes collected at closing are as a matter of law, based only on real property value of the property or estate transferred.

• Including any non-realty components of value will cause these taxes to be inflated and overpaid.

• Once taxes and values are reported and overpaid at closing, then this leads to continued over-taxation over the holding period.
Property Tax Transfer Reporting

Deed acquisitions

• California Form BOE-502-A, Preliminary Change of Ownership Report, accompanies deed for assessor
• Michigan Form 2766 (L-4260), Property Transfer Affidavit, is filed with assessor
• New York Form RP-5217PDF or 5217NYC, Real Property Transfer Report, filed with county clerk with deed
• For portfolios, be careful about “consideration” values on deeds
Property Tax Transfer Reporting

Entity acquisitions

- California Form BOE-100-B, *Statement of Change in Ownership and Control of Legal Entities*, filed with State BOE within 90 days
- Michigan Form 2766 (L-4260), *Property Transfer Affidavit*, is filed with assessor within 45 days
- Florida Form DR-430, *Change in Ownership or Control Non-Homestead Property*, is filed with the county property appraiser.
Mergers

• Merger of Entity that owns Real Property into Other Entity

  Generally this will be treated as if the real property transferred by deed

• Merger of Entity that owns Entities that own Real Property into Other Entity

  Generally this will be treated as if the entities owned by merged out entity are transferred to the surviving entity
Mergers

• Merger of Entity that owns Real Property into Other Entity

  Generally this will be treated as if the real property transferred by deed. The diligence and analysis is as if this were a deed transfer.

• Merger of Entity that owns Entities that own Real Property into Other Entity

  Generally this will be treated as if the entities owned by merged out entity are transferred to the surviving entity. The diligence and analysis is as if this were an entity transfer.
Real Property Transfer Taxes

What Are They?
• State and local excise taxes on privilege of either transferring real estate or recording an interest in real estate.
• Can be grantor or grantee or joint and several; fee transfers and lessors/lessees.

Jurisdictions
• Imposed in some way in 37 states.
• States without: Alaska, Arizona, Idaho, Indiana, Louisiana, Mississippi, Missouri, Montana, New Mexico, North Dakota, Texas, Utah and Wyoming.
Real Property Transfer Taxes

• Usually when deed (or lease) is recorded at the local recorder’s office.

• Some jurisdictions impose on the act of transfer, others on the recording.

  Example: California imposes the documentary transfer tax on the transfer itself, while Alabama imposes a recordation tax. Thus transfer tax is due in California regardless of whether you record a deed as the “transfer” is the taxable act. Maryland imposes both a transfer tax and a recordation tax.
Real Property Transfer Taxes

Rates

• Between 0.01% (Denver) to 5.0% (highest Pennsylvania combined state and local rate; Philadelphia and Pittsburgh city rates are both 4%).

• Cities with substantial rates:
  San Francisco (2.5% if value is over $10 million); New York City (3.025% commercial combined state and local); Seattle (1.78%); Washington D.C. (2.9%); Chicago (1.2%); Miami (1.05%).
Real Property Transfer Taxes

Tax Base

• Consideration paid for the real estate (cash and assumption of debt), or fair market value sometimes if no consideration. Consider here total purchase price that includes personal property and intangibles.

Exemptions

• Common are deeds in lieu of foreclosure, proportional transfers and transfers to newly formed entities (“mere changes in identity or form”), certain mergers (even unrelated).
Real Property Transfer Taxes

Leases

• Length is the issue – consider all options to renew.
• California = 35 years or longer; New Jersey and Connecticut = 99 years; Hawaii = only 5 years or longer; Pennsylvania = 30 years or longer; North Carolina (certain counties) = 10 years or longer; Maryland = no tax on lease of 7 years or shorter, not counting options unless automatic or perpetual.
  • What about a one year lease with unlimited options to renew?
Transfer Tax on Entity Controlling Interest Transfers

• Ownership of entity that owns property changes.
• Not all jurisdictions that impose transfer taxes.

Some States Apply to All Entities

• Some impose on a transfer of a controlling interest in any entity that owns, directly or indirectly, real property, regardless of how far down the chain of entities the real estate is held. Applies to all types of businesses.

Examples – All Entities Jurisdictions

• Certain California cities/counties; Connecticut; Delaware; Maine; New Hampshire; New Jersey; New York City and New York State; Rhode Island; Washington State
Florida Conduit Entity

• Generally, no transfer tax on entity transfers
• If real property was transferred to an entity in the without paying transfer tax (i.e. transfer to wholly owned entity), then the transferee entity is a “conduit entity”. Any sale for consideration within 3 years of direct or indirect interests in the conduit entity triggers the documentary stamp tax on the consideration.
Virginia Drop Kick Rule

• Transfers to (or from) partnership or LLC is only exempt if grantors (or grantees) are entitled to at least 50% of the profits and surplus of the entity, so long as the transfer to an LLC is not a precursor to (or subsequent to) a transfer of control of the assets of the company to avoid recordation taxes.
Anti-Abuse Rules

Minnesota Designated Transfer

• Full deed tax is due on the consideration from a sale of interests in an entity that received real property without payment of full real estate transfer tax within prior six months.
Real Estate Entity States

**Illinois Real Estate Entity**

- Generally greater than 50% of capital, profits or beneficial interest (Illinois and Cook county are over 50%) in any entity that exists or acts substantially for the purpose of holding directly or indirectly real property.
- Rebuttable presumption if FMV of all real property is greater than 75% of FMV of all assets not considering debt.
Pennsylvania Real Estate Entity

- Tax imposed when transfer 90% or more of capital and profits of “real estate entity” within 3 years (and same for Philadelphia).

- A real estate company is an entity, 90% more of which is owned by 35 or fewer persons, that is primarily engaged in the business of holding, selling, or leasing real estate.

- Also meets (1) gross receipts test = 60% or > receipts from ownership or disposition of real estate, or (2) asset test = real estate value is 90% or more of the value of all its tangible assets everywhere except that which is traded on established market.
Real Estate Entity States

Washington D.C. Real Property Holding Company

- Transfer within 12 mo. period of > than 50% of value or voting power of all classes of stock; or > than 50% of the capital, profits, or beneficial interests of partnership, LLC, association or trust.

- Subject if during 12 months before transfer, the entity (a) derives more than 50% of its annual gross receipts from the ownership or disposition of real property located in the District; or (b) holds, on the date of the transfer, real property located in D.C., the value of which comprises eighty percent (80%) or more of the value of its entire tangible asset holdings.
Real Estate Entity States

Maryland Real Property Entity

• Imposes recordation and transfer taxes on the transfer of real property with a value of $1.0 million or more when the transfer is achieved through the sale of a “controlling interest” in a specified “real property entity.”

• Controlling interest = > 80% of value of stock, capital and profits, or beneficial interest in trust

• Real property entity = directly or beneficially owns real property that constitutes at least 80% of the value of its assets, and has an aggregate value of at least $1.0 million.
Michigan Real Estate Business

• Imposed on contracts for the transfer or acquisition of a controlling interest in an entity only if the real property comprises 90% or more of the FMV of the assets of the entity determined under GAAP. A "controlling interest" = > 80% of total ownership value or beneficial interest of entity.

• “Controlling interest” = > than 80% of the total value of all classes of stock of a corporation; > than 80% of the total capital and profits of a partnership, association, limited liability company, or other unincorporated form of doing business; or > 80% of the beneficial interest in a trust.
Personal Property Issues

• Transaction Type
• Purchase Price Allocation
• Reportable Basis
Personal Property Issues

• Stock, asset, or deemed asset
• Unlike real property, personal property is driven by “the books”
• *But which books, tax basis or financial?*
• *How to avoid using the seller’s depreciated book value?*
• *What to report for TPP rendition purposes?*
Personal Property Issues

Reportable Basis

- Local Jurisdiction Rules
- Market value or other basis
- Original or historical cost?
- Book or tax basis?
- Assets never fully depreciate for property tax purposes
- Residual value based asset class life and state
Purchase Price Allocation

Not Usually the Solution

• PPA intended primarily for income tax and accounting purposes.
• Does not address most transfer tax issues.
• Relies on cost rather than allocated values.
The Solution

*Tax Mitigation Exists With Asset and Entity Sales*

Depending on the jurisdiction:

- Applies to single/multiple property asset sales (deeds), leasehold assignments, sale of entities owning real property or leaseholds where a constructive sale of the underlying real property is triggered (California).
- Local tax exemptions must be researched, applied to the facts of the transaction and considered carefully.
Allocate Enterprise Value to Four Components

• Key to mitigation at closing, and post-closing, is the accurate and credible allocation of the entire ‘going Concern’ sales price into one of the following categories: (1) Land, (2) Improvements to Land [buildings, site improvements, etc.], (3) Tangible Personal Property, and (4) Intangibles [plus cash/credits if appropriate]
• The amounts assigned to these four categories need to add up to the total consideration paid for the asset/stock being sold.
The Solution

Presumption of “Market Value” and Burden of Proof Transferred

• Allocations made pre-closing, and incorporated in the associated closing documents, have a rebuttable presumption of representing Fair Market Value, and/or Fair Value, as of the date of closing.
• Particularly, if the allocations are incorporated into the closing documents signed by both buyer and seller.
• Transfer and recordation taxes due at closing are often split, so both parties motivated to participate and benefit from the reduced taxes.
The Solution

Presumption of “Market Value” and Burden of Proof Transferred

- Sometimes problem with liquidating selling entity; may need indemnification(s).
- Seller’s tax basis can also create tax issue.
- Okay for buyer to act alone, but less weight potentially may be given to the reported allocations.
The Solution

Allocations of Value – Objective and Supported

• M&A closings are typically chaotic events with a lot of documents being executed at the same time and often not fully reviewed.
• Having a pre-agreed allocation of values is important to ensuring that the right values are recorded and that taxes are not overpaid.
• To convince the buyer and seller to agree to these allocations, needs to be addressed in PSA.
Allocations of Value – Objective and Supported

- Failing that it should be addressed ASAP with their attorneys, accounts, title companies, and other concerned advisors once the PSA is signed; adding addendum to PSA also a good idea.

- Always best to have the underwriting terms, assumptions, valuation methodologies memorialized and circulated in a written format for all of the stakeholders to review and approve pre-closing.