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In this installment of SALT From the Swing State, the authors discuss the recent Ohio Supreme Court decision of *Palmer House*, which will require taxpayers to exercise greater care in the planning stages of drop-and-swap transactions.



To mitigate the risk of increased real property taxes and avoid conveyance fees, practitioners in Ohio often structure commercial real estate transactions as entity sales referred to as "drop-and-swaps." In a drop-and-swap, the seller transfers the real estate into a newly formed single-member limited liability company in a conveyance that is exempt from Ohio conveyance fees. The seller then transfers the membership interests of the LLC to the buyer. Structuring the transaction in this manner generally avoids conveyance fees and, compared with directly selling underlying real estate, reduces the likelihood that a county auditor will increase the property's assessed value for real property tax purposes. However, a recent Ohio Supreme Court decision serves as a point of caution.[1] In the future, *Palmer House* will require taxpayers to exercise greater care in the planning stages of drop-and-swap transactions.

## Background to *Palmer House*

*Palmer House* involved the sale of a large apartment complex in New Albany, Ohio. The transaction began with a real estate purchase and sale agreement (PSA) dated June 22, 2015. The PSA required Palmer Square LLC to transfer real property comprising the apartment complex and its associated personal property to PPG Manhattan Real Estate Partners LLC for $35 million.[2]

Despite being styled as a real estate PSA, the agreement authorized PPG Manhattan to elect a drop-and-swap structure, whereby Palmer Square would convey the property to a single-member LLC, Palmer House Borrower LLC (PHB), and then sell all its interests in PHB to an affiliate of PPG Manhattan. As the court notes in its opinion, the PSA explicitly provided that the drop-and-swap structure was "in lieu" of a direct transfer of the real estate. On October 6, 2015, the parties closed both steps of the drop-and-swap, with conveyance of the property to PHB and transfer of the PHB ownership interests for an adjusted price

[1] *Columbus City Schools Board of Education v. Franklin County Board of Revision*, slip op. No. 2020-Ohio-353. Note that because of the property owner's name, the case is commonly referred to as *Palmer House*.

[2] *Palmer House* at para. 8.

of $35.25 million.[3] The parties did not report a sales price on the conveyance fee statement.[4]

For 2015 the county valued the apartments at only $16 million. Consequently, after PPG's lender recorded a much larger mortgage on the property, the Columbus City Schools Board of Education (the school district) filed a complaint seeking an increase in the taxable value of the property.[5]

The Board of Tax Appeals (BTA) sided with the school district, treating the sale of interests in PHB as the sale of real estate, and thus presuming the sale price for the PHB ownership interests equaled the fair market value of the apartment complex. Because the taxpayer, PHB, failed to rebut this presumption, the BTA adjusted the taxable value based on the purchase price, less a deduction for minor items of personal property included in the transaction.[6]

### Supreme Court's Decision

PHB timely appealed to the Ohio Supreme Court, the primary issue being whether the sale price of membership interests in PHB (and stated in the PSA) should be presumed to reflect the FMV of the underlying real estate.[7]

Under Ohio case law, a recent arm's-length sale is considered the "best evidence" of FMV. The supreme court has "characterized this 'best evidence rule' as a rebuttable presumption that the sale price constitutes the value of the property." This "sale-price presumption" applies unless rebutted with evidence that a sale was either not conducted at arm's length or was not sufficiently recent.[8]

PHB argued that the BTA erred by applying the sale-price presumption for several reasons. First, PHB cited prior cases in which the sales price of an entity was rejected as the value of underlying real estate. However, the court distinguished these cases, noting that in prior cases "the purchase contracts provided for sales of corporate shares or partnership interests without explicit reference to an intent to sell or buy real estate itself."[9] By comparison and in "stark contrast," the agreement between Palmer House and PPG Manhattan was labeled a PSA for the "Sale of Palmer House on Boulevard 4121." As such, the agreement took "the classic form of a purchase agreement for commercial real estate by identifying as the subject matter of the transaction the specific real property" at issue.[10]

Second, PHB argued that the sale-price presumption did not apply because the transaction included personal property and involved the sale of an ongoing business.[11] The court rejected this argument, finding that rental income was "integral" to the value of the apartment complex. Thus, the *Palmer House* transaction fit within "the category of those sales of income-producing properties in which the total contract price constitutes a presumptive starting point for valuing the real estate."[12]

Third, PHB argued that the sale-price presumption did not apply because a sale price was not listed in the conveyance fee statement.[13] However, the court held that this was "immaterial" and that a sale-price presumption could be invoked merely by a purchase contract, such as the PSA.[14]

In the end, the court upheld the BTA's decision to apply the sale-price presumption to the amount of consideration set forth in the PSA between Palmer House and PPG Manhattan.

### Planning Future Transactions

Planners who desire to use the drop-and-swap structure to achieve real property tax or conveyance fee limitation objectives must carefully consider the form of the purchase agreement. Use of a commercial realtor's form real estate purchase agreement reciting only the sale of the subject real property and improvements without any reference to other elements of the entity that holds the real property

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[3] *Id.* at para. 9-10.
[4] *Id.* at paras. 6 and 45.
[5] *Id.* at para. 3.
[6] *Id.* at para. 14.
[7] *Id.* at para. 30.
[8] *Id.* at para. 29.
[9] *Id.* at para. 37.
[10] *Id.* at para. 28.
[11] *Id.* at para. 41.
[12] *Id.* at para. 42.
[13] *Id.* at para. 43.
[14] *Id.* at para. 45.

will likely be insufficient to withstand challenge. Instead, attention should be given to other assets of a more traditional entity purchase, such as the personal property, accounts receivable, and non-real-estate assets composing the entity.

A more formal entity purchase agreement should be considered, with market representations and warranties regarding various assets held by the entity, indemnification for breaches of those representations and warranties, and related references to the nature of the assets held by the entity other than real property. When cost effective, a cost segregation study can be conducted in support of the non-real-estate assets (cost segregation has other uses for material transactions in the federal income tax planning area). An allocation of purchase price illustrating the agreed-upon, reasonable value for personal property as opposed to real property should also be contemplated (that allocation can serve as the basis for the valuation for the real property reported with the conveyance fee statement, when applicable).

Ideally, the transfer of the real property to the single-purpose entity ultimately transferred to the buyer should occur well in advance of the closing of the transaction. The filing of a deed shortly before the mortgage is filed of record leads one to consider whether there are any legitimate business objectives to the entity sale other than mitigation of real property taxes and conveyance fees. Ideally, a seller that considers listing a property for sale might consider whether the property would be better positioned in a single-purpose LLC well in advance of listing the property. Such an LLC is generally considered to be a disregarded entity for federal income tax purposes, so a transfer of the real property to it can be accomplished without federal income tax consequences. However, planners must also consider whether the "due on sale" or similar restriction in an applicable mortgage will require lender consent to that kind of transfer. Also, title insurance applicable to the subject property may be adversely affected if the property is transferred to a wholly owned subsidiary without a suitable endorsement from the issuing title company.

In some circumstances, purchasers may be willing to purchase the ownership interest(s) in the legacy title-holding entity without the need for a "drop" of the real property into a newly formed entity (that is, no deed filing in furtherance of the closing). The same factors as outlined above relating to the composition of the purchase agreement will typically apply to the purchase agreement relating to the acquisition of the interest(s) in the legacy entity. Such a legacy entity purchase will not be available (without other planning steps) when the legacy entity holds property that the parties do not intend to include in the transaction.

In some situations, the property can be transferred out of the legacy entity to its owner(s) before the closing of the contemplated purchase and sale transaction (assuming that transfer does not involve adverse tax consequences). Notably, using the legacy entity as the "swap" entity also can entail significantly more risk to a prospective purchaser because of historic operating and tax liabilities associated with a legacy entity that are not applicable to a newly formed "drop" entity. As such, the documentation and due diligence associated with a sale of legacy entity interests is frequently more extensive, and the risks may also adversely affect the purchase price for legacy entity interests (as opposed to the purchase price for the assets of the legacy entity, or the purchase price for the interest in a newly formed drop entity).

Even if a more traditional business interest purchase agreement is used and the property is transferred to the subsidiary well in advance of closing (or not transferred at all, in the case of a legacy entity purchase), the drop-and-swap transaction structure risks challenge on grounds that the value of the ownership interest should be evidence of the FMV of the underlying real property (particularly when a mortgage is filed of record by the purchaser's lender). Planners who desire to overcome such objections must be able to point to evidence of the value of non-real-estate assets owned by the LLC in support of any assertion of a lower tax value for the real property. In the absence of evidence, the use of the drop-and-swap structure should be carefully considered, considering the possible additional expense of attending to complaints against value and related administrative and civil proceedings involving the FMV of the real property subject to the transaction.

## Conclusion

Ultimately, planners are likely to continue using drop-and-swaps after *Palmer House*. *Palmer House*, however, may not be the final word on these transactions. H.B. 449, a bill pending before the Ohio House of Representatives, proposes closing the LLC loophole for conveyance fee purposes. If enacted, the legislation would require reporting by a passthrough entity (such as a partnership or LLC taxed as a partnership) whenever specific qualifying percentages of ownership are transferred. Requiring parties to entity transfer to report the purchase price of membership interests on conveyance fee statements could significantly affect the application of the sale-price presumption in future years. ■