

REAL ESTATE TAX APPRAISALS: ECONOMIC REALITY vs. STATUTORY COMPLIANCE

A case study illustrates the problems that can arise from the court's interpretation of laws on the taxation of real property.

by Robert J. Shedlarz and James R. Webb

Use of market value appraisals for real estate tax purposes has a long and legal foundation in every state in the country. Tax equity, mandated by most state laws, demands such an approach. Recently, backward steps were taken regarding real estate taxation in Ohio. The case of *Columbus Board of Education vs. Fountain Square Associates, Ltd., et al* (9 Ohio St. 3d 220 (1984)) demonstrates a return to literal methods of valuation by the Ohio Supreme Court. This case also indicates the court's concern with valuation methods practiced by the State Board of Tax Appeals which previously had not adhered to recognized statutory and accounting guidelines as methods of resolving disputed property valuations.

Background

In Columbus, Ohio, Fountain Square Associates, Ltd. purchased seven parcels of real property together with an office building. This arms-length transaction resulted in Fountain Square paying \$8,855,000 as follows:

- \$1,505,000 in cash
- \$3,532,906.60 financed by a first mortgage to a third-party lender
- \$3,817,093.40 financed by a second mortgage to the seller.

In accordance with the law, transfer taxes were paid on the entire principal amount of \$8,855,000. Following an assessment complaint filed by the Columbus Board of Education with Franklin County Board of Revision, the property was valued for property tax purposes at \$8,854,970. Fountain Square appealed this assessment to the Board of Tax Appeals (BTA), claiming that the

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property was overvalued. Fountain Square said the value of the property should be equated with the cash equivalency value (i.e., present value) of the notes. If this claim would be successful, the property valuation would be reduced. The BTA found Fountain Square's valuation argument was persuasive and reduced the valuation to \$7,435,000. The Columbus Board of Education appealed to the Ohio Supreme Court who found the BTA's valuation to be unreasonable and unlawful and reinstated the Board of Revision's valuation of \$8,854,970 (see Exhibit 1).

The Issue

The question is to what extent should the present value

of cash payments and creative financing devices be equated with the market value of the real property for tax purposes? In an era of high interest rates, creative financing had become a frequent financing device. In its most common application the seller agreed to finance all or part of the sales price taking a note and a first or second mortgage for the balance due. In many instances, the seller also gave the buyer a favorable interest rate reflecting below market cost of money. In exchange the buyer was willing to increase the original principal balance as an offset for the favorable rate of interest. For example, a house with a market value of \$100,000 may sell for \$103,000 however, the seller took back a second mortgage at 9% interest, 10-year term and interest only payments. This was at a time when market rates for second mortgages were 15% from institutional lenders. The net result reflects a total purchase price that was above what it would have been with a third-party financing arrangement at a higher rate of interest.

The Legal Considerations

In considering this enhanced valuation, the law itself is clear in stating this entire issue should be ignored, i.e., the method by which the sales price was computed should have no bearing on the valuation:

“. . . (T)he auditor *shall* consider the sale price of such tract . . . to be the true value for taxation purposes.” (O.R.C. sec. 5713.03).

Previously the Supreme Court of Ohio had not interpreted this statute in a literal fashion:

“. . . (T)he *best evidence* of the true value in money of real property is an actual, recent sale of the property in an arms-length transaction”. (*Conalco vs. Board of Revision*, 50 Ohio St. 2d 129 [1977]).

Best evidence does not mean only evidence. Thus, the court left open certain exceptions to the rote repetition of a recent, arms-length sale as the only method of computing value for tax purposes. Having given the BTA a certain amount of leeway in computing valuation for tax purposes, the court has traditionally exercised a high degree of restraint in second-guessing the BTA's decisions:

“. . . (T)his court will not disturb a decision of the Board of Tax Appeals with respect to such valuation unless it affirmatively appears from the record that such decision is unreasonable or unlawful.” (*Board of Revision vs. Fodor*, 15 Ohio St. 2d 52 (1968)).

If the system created by statute and case law functions properly, then the BTA becomes the ultimate decision maker with respect to tax valuation. The BTA is given a degree of discretion in its decision-making process, with considerable restraint exercised by the judicial process in reviewing the ultimate result. If the system works as it should, the decision is left to those with the most expertise in formulating the value, and the procedures involved can include accounting standards which may reflect sophisticated analysis such as present value or cash equivalency value. In order for this process to function

effectively, it is necessary for the BTA to develop sufficient expertise in the interpretation of alternate evaluation procedures. This will ensure that the methods for making decisions are predictable and reasonably close to a recent, arms-length sale price for the property in question. A number of established accounting principles can accomplish this dual purpose e.g., a market value for tax purposes reasonably equated to a recent sale. (For present value of noncurrent assets one can use, for example, Accounting Principles Board Opinion No. 16.) Unfortunately, this demonstration of expertise, equated to a statutory set of guidelines, was not chosen by the BTA. In the late 70s and early 80s, a series of court cases demonstrated that ultimate decisions on tax value were more the product of political compromise than standard accounting procedures. The most flagrant example was shown in *Consolidated Aluminum Corp. vs. Board of Revision* (66 Ohio St. 2d 410 [1981]). In this case there were two competing valuations; one by the owner at \$7,816,000 and the other by the Board of Revision at \$15,100,000. Without specifically justifying its computations, the BTA arrived at a value of \$11,950,000. A court majority upheld this appraisal, justifying the result because of the complexity of the facts. In his dissent, Judge Locher stated: “By assigning the \$11,950,000 value, BTA once again splits the difference between the competing values.” Finally the court has indicated its dissatisfaction with the entire program. With the Columbus Board of Education Case (*supra*), the Ohio Supreme Court had evolved a strict interpretation of the statute providing a literal meaning to the arms-length sale approach, and taken the discretionary approach away from the BTA.

Conclusion

The present strict statutory approach has removed the more flagrant abuses formerly practiced by the BTA. Unfortunately, a literal reading of the statute also will ignore all alternate valuation methods confining the tax value solely to the arms-length sale price. Those potential purchasers who engage in various financing arrangements should be aware of this strict approach to value for property tax purposes. It may be that the money saved from creative financing may be spent eventually for property tax bills which reflect the purchase price shown on the auditor's transfer statement, rather than the present value of the creative financing arrangement. For the seller, this strict approach has the tendency to make the property less marketable given a convenient but unrealistic tax valuation when it is transferred.

This strict interpretation is particularly illogical in light of the massive empirical research in real estate which indicates that creative financing does inflate the state purchase price.¹ In addition, many types of financing can be considered creative² although the full effect of various kinds of financing is still not settled.³ Estimates vary from 100% to less than 40% of present value of the difference between standard financing and creative financing. This amount would then be subtracted from the purchase

price to obtain market value. Clearly the statutes discussed here need a more liberal and economically realistic interpretation.

What if someone bought a property using 100 gold double eagles (\$2000 face value) as the legal coin of the U.S.? Could they then claim the transaction and therefore the tax base was merely \$2000? This would seem to be a distinct possibility under current interpretations. Of course, double eagles (\$20 gold pieces) cost \$1000 each or more, depending on condition, etc. These happenings clearly would not represent the intent of the statute just as those of the current strict interpretation do not reflect the meaning of the law.

NOTES

1. Clauretie, T. Mike, "Capitalization of Seller-Supplied Financing:

Implications for Assessment," *Property Tax Journal* (December 1984), pp. 229-238; Edgren, John A. and Hayworth, Steven C., "The Implications of Land Contracts for Property Tax Assessment Practices," *Housing Finance Review* (April 1984), pp. 177-190; Friedman, Jack P. and Lindeman, J. Bruce, "Seller Financing and Cash Equivalence," *The Real Estate Appraiser and Analyst* (May/June 1979), pp. 46-50; Jaffee, Dwight M., "House-Price Capitalization of Creative Finance: An Introduction," *Housing Finance Review* (April 1984), pp. 107-118; Rosen, Kenneth T., "Creative Financing and House Prices: A Study of Capitalization Effects," *Housing Finance Review* (April 1984), pp. 119-128; Schwartz, Arthur L., Jr., "Cash Equivalency: Does It Really Adjust to Market?" *The Real Estate Appraiser and Analyst* (Fall 1983), pp. 38-41; Smith, Halbert C. and Corgel, John B., "Adjusting for Nonmarket Financing: A Quick and Easy Method," *Appraisal Journal* (January 1984), pp. 75-83.

2. Case, Fred E., "Creative Financing Instruments," *The Real Estate Appraiser and Analyst* (Spring 1982), pp. 45-58.

3. Schwartz, Arthur L., Jr. and Kapplin, Steven D., "Economic Implications of Alternative Home Financing," *Housing Finance Review* (April 1984), pp. 165-176.

EXHIBIT 1

Columbus Board of Education vs. Fountain Square Associates, Ltd., et al

Cite as 9 OBR 529 or 9 Ohio St. 3d 220.

9 Ohio St. 3d 218.

COLUMBUS BOARD OF EDUCATION,
APPELLANT, v. Fountain Square
Associates, Ltd. et al., Appellees.

Taxation—property valuation: Board of Tax Appeals errs in finding real property's "true value in money" to be other than recent sales price, when, R.C. 5713.03.

(No. 83-1061—Decided February 22, 1984.)

APPEAL from the Board of Tax Appeals.

On December 4, 1980, appellee, Fountain Square Associates, Ltd., purchased, in an arms-length transaction, seven parcels of real property improved with an office building complex located in the city of Columbus.

Appellee paid a total consideration for the property of \$8,855,000 consisting of \$1,505,000 in cash, the assumption of a promissory note secured by a first mortgage with a principal balance of \$3,532,906.60, and a new promissory note secured by a second mortgage executed by appellee to the seller in the principal amount of \$3,817,093.40. Transfer taxes to Franklin County were paid on the amount of \$8,855,000.

On January 29, 1981, appellant, Columbus Board of Education, filed a "Complaint as to the Assessment of Real Property" with appellee, the Franklin County Board of Revision, seeking to increase the appraised value of the subject property to \$8,855,000 to reflect the recent sale price. On July 23, 1981, the board of revision entered its orders valuing the property at \$8,854,970.

[219] Upon appeal to the Board of Tax Appeals, appellee submitted an appraisal which determined the value of the property by reducing the sales price to reflect the cash equivalency value of the notes, that is, the price for which the notes could have been sold on the date the property was purchased. The Board of Tax Appeals accepted appellee's appraisal and, by order dated June 17, 1983, found that the fair market value of appellee's property was \$7,435,000, determined by adding the cash paid to the cash equivalency value of the notes.

The case is now before the court upon an appeal as of right. Messrs. Teaford, Rich & Dorsey, Mr. Jeffrey A. Rich and Mr.

Matthew T. Fitzsimmons, for appellant.

Schottenstein, Zox & Dunn Co., L.P.A., Mr. Robert H. Schottenstein and Mr. Daniel J. Kayne, for appellee Fountain Square Associates, Ltd.

Per Curiam. Appellant argues that the valuation of appellees' property set by the Board of Tax Appeals is unreasonable and unlawful for the reason that it ignores the recent sales price.

R. C. 5713.03 provides, in part:

"*** In determining the true value of any tract, lot, or parcel of real estate under this section, if such tract, lot, or parcel has been the subject of an arms-length sale between a willing seller and a willing buyer within a reasonable length of time, either before or after the tax lien date, the auditor shall consider the sale price of such tract, lot, or parcel to be the true value for taxation purposes.***" (Emphasis added.)

We have consistently adhered to the rule that "(t)he best evidence of the 'true value in money' of real property is an actual, recent sale of the property in an arms-length transaction.***" *Conalco v. Bd. of Revision* (1977), 50 Ohio St. 2d 129 [4 O.O. 3d 309], paragraph one of the syllabus. See, also, *Consolidated Aluminum Corp. v. Bd. of Revision* (1981), 66 Ohio St. 2d 410 [20 O.O. 3d 357]; *Meyer v. Bd. of Revision* (1979), 58 Ohio St. 2d 328, 333 [12 O.O. 3d 305].

Appraisals based upon factors other than sales price are appropriate for use in determining value only when no arms-length sale has taken place (*id.* at 333), or where it is shown that the sales price is not reflective of true value (*Consolidated Aluminum Corp. v. Bd. of Revision, supra*, at 414).

The fact that appellee obtained favorable financing does not render the sales price unrepresentative of true value. Thus, it was unreasonable and unlawful for the board to accept appellees' appraisal rather than the recent sales price in valuing the subject property.

Accordingly, the decision of the Board of Tax Appeals is reversed and the valuation as determined by the board of revision is reinstated.

Decision reversed.

CELEBREZZE, C. J., W. BROWN, SWEENEY, LOCHER, HOLMES, C. BROWN and J. P. CELEBREZZE, JJ., CONCUR.