



2020
PROPERTY TAX VIRTUAL SYMPOSIUM
Webinar Series

1031 Exchanges and Other Non-Market Evidence

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1031 Exchanges and Other Non-Market Evidence

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1031 Exchanges and Other Non-Market Evidence

Analyzing real estate transactions is a significant part of property tax practice; however, many transactions do not meet the standard to qualify as a “market” transaction, such as a 1031 Exchange.

This session will explore non-market transactions and review their treatment in different jurisdictions and options for adjusting or excluding these data points in a property tax analysis.

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At the conclusion of this session you will be able to:

1. Identify the various types of real estate transactions that are not market based or are impacted by non-market influences.
2. Explain why these types of real estate transactions are not representative of the market.
3. Evaluate whether these types of real estate transactions can be analyzed or adjusted for use in a market valuation.
4. Discuss case studies/same transactions and their application in a market valuation.

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Definition of a “market” transaction:

Generally defined by statute:

Varies slightly from state to state, but generally requires: (1) a fair and reasonable exchange between a willing buyer and willing seller; (2) with neither being under any compulsion to act; (3) with both being familiar with all of the facts and circumstances impacting the property; (4) reasonable exposure to the market; and (5) the price being unaffected by unusual financing or concessions.

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Types of Non-Market Transactions That We Will Discuss:

1. 1031 Exchanges
2. Sale-Leasebacks
3. Built-to-Suit Leases
4. Bankruptcy Sales
5. Related Party Sales
6. Portfolio Sales
7. Assemblages

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BIG THINK

THAT'S A MEANINGFUL EXCHANGE

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1031 Exchange

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Polling Question #1

A 1031 Exchange is:

- A. A real estate transaction in which the sale price may not exceed a specified amount.
- B. A real estate transaction in which the sale proceeds must be reinvested into a similar asset.
- C. A real estate transaction in which the buyer and seller must both be a certain type of corporate entity.

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1031 Exchanges

Deriving from section 1031 of the IRC, also referred to as a “like-kind” exchange, a 1031 exchange is a tax deferral tool which allows an investor to defer paying capital gains taxes on investment property when it is sold, as long as another similar property is purchased with the profit gain by the first sale.

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1031 exchanges involve 2 sales:

Downleg: Initial sale -- the proceeds from the sale of this property will be used to purchase a like-kind property.

Upleg: Second sale -- the like-kind property that is purchased using the sale proceeds of the downleg sale.

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Both sales can have non-market features:

Downleg: Seller might be willing to accept a lower price in order to match the sale proceeds to the price of the future upleg investment.

Upleg: Buyer might be willing to pay more in order to match the sale price to the proceeds of prior downleg investment.

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Inland Edinburgh Festival, LLC v. Cnty. of Hennepin, 938 N.W.2d 821 (Minn. 2020)

MN Supreme Court declined to use the sale of the property as evidence of its fair market value, because the sale was part of a 1031 exchange.

“This unique type of transaction **may not** represent the property’s fair market value. . .”

“Here, there is no information in the record that indicates the motivation of the buyers in the exchange of Inland’s property, including to what extent the price was driven by market forces or tax-saving motives.”

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1031 Exchanges

Key Takeway:

Some 1031 exchange transactions can be relied upon as evidence of market value.

Need to have information regarding buyer and seller motivations and the basis for the sale price.

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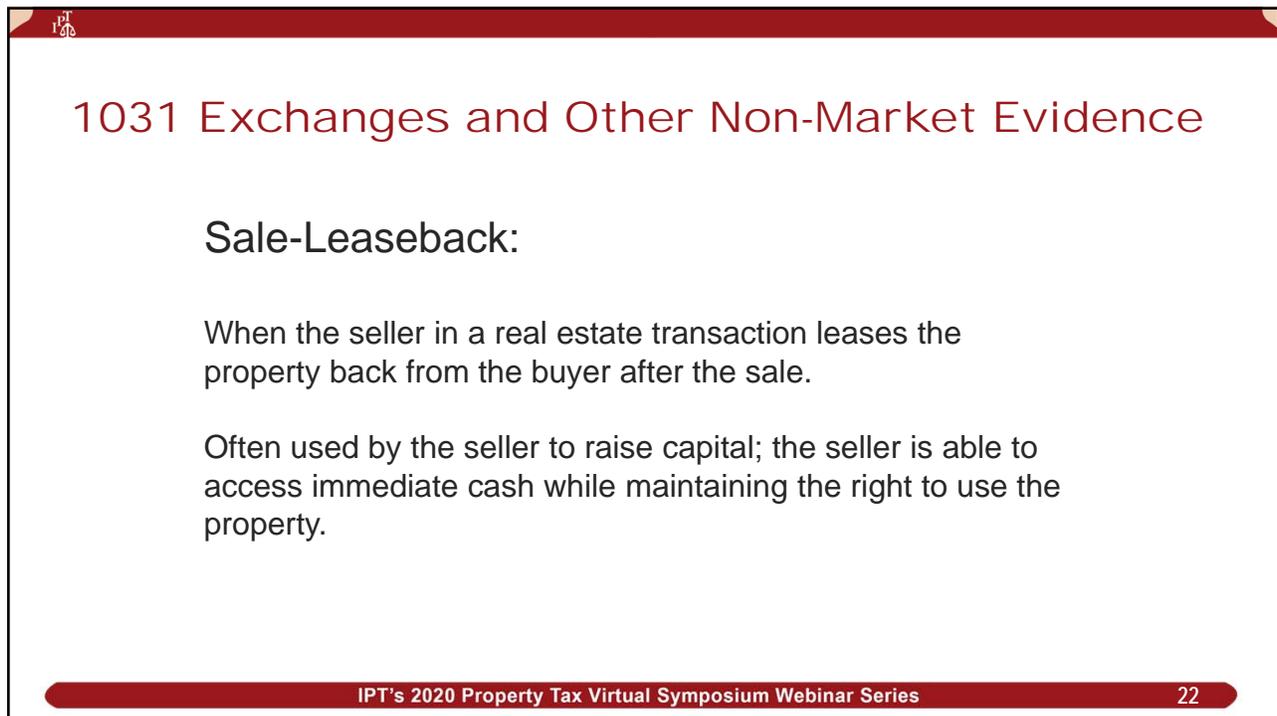




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Sale Leaseback

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Sale-Leaseback:

When the seller in a real estate transaction leases the property back from the buyer after the sale.

Often used by the seller to raise capital; the seller is able to access immediate cash while maintaining the right to use the property.

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Sale-Leasebacks raise two issues:

1. Is the sale price reflective of the market?
2. Is the lease rate reflective of the market?

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Most jurisdictions have refused to rely upon sale leaseback transactions as evidence of market value.

“The transaction is more in the realm of financial convenience than a transaction between a simple buyer and seller.”

L. Bamberger & Co. v. Division of Tax Appeals, 57 A.2d 242, 244, aff'd, 62 A.2d 389 (N.J. 1948).

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“Since sale-leasebacks are actually financing vehicles, they should not be used in estimating market rent.”

The Appraisal of Real Estate, The Appraisal Institute, (14th ed. 2013), p. 466.

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“Sale-leaseback transactions must be used with caution because the lease is usually negotiated as part of the sale rather than as an independent, market-based lease negotiation. Sale-leasebacks that are negotiated as financing vehicles may reflect motivations of the tenant and landlord that are not typical of the market.”

The Appraisal of Real Estate, The Appraisal Institute, (15th ed. 2020), p. 438.

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Sale-Leasebacks:

Key Takeaway:

These generally should not be used as evidence of market value as a comparable sale under the sales comparison approach or a comparable lease under the income capitalization approach.

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Build-to-Suit Lease

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Polling Question #2

A built-to-suit lease is:

- A. A lease that is in place while a property is being built.
- B. Is the same thing as a sale-leaseback.
- C. A lease that is entered into after construction of a property designed exclusively for the tenant is complete.

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Built-to-Suit Leases:

These are similar to sale-leasebacks in that they are generally considered to be a financing vehicle; the financing being for the construction of the property, which was built specifically for the tenant.

1031 Exchanges and Other Non-Market Evidence

“[C]ontract rents in a build-to-suit lease are not designed to capture market value for each period within the lease term, but rather are designed to amortize an investment made at the outset and may vary dependent on factors that are unrelated to the real estate market thereafter.”

“[B]uild-to-suit leases are financing arrangements for new construction and generally do not provide a reliable indication of value for big box facilities that are resold on the secondary market.”

In the Matter of the Equalization Appeal of Prieb Properties, LLC, 275 P.3d 56 (Kan. Ct. App. 2012).

1031 Exchanges and Other Non-Market Evidence

Built-to-Suit Leases:

Key Takeaway:

These also generally should not be used as evidence of market value as a comparable lease under the income capitalization approach.

1031 Exchanges and Other Non-Market Evidence





1031 Exchanges and Other Non-Market Evidence

Bankruptcy Sale

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1031 Exchanges and Other Non-Market Evidence

Bankruptcy Sales:

A “bankruptcy sale” is not a defined legal term. Instead, a number of different types of transactions might be considered a bankruptcy sale by market participants.

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All three of the below transactions might be considered a bankruptcy sale:

- i. The transfer of a property to the bank as part of a foreclosure action incident to a bankruptcy.
- ii. The transfer of a property owned by an entity going through bankruptcy to the entity in charge of liquidating the bankrupt entity's assets.
- iii. The sale of a property by an entity in charge of liquidating a bankrupt entities assets to a third party.

1031 Exchanges and Other Non-Market Evidence

Use of bankruptcy sales were permitted based on finding that such sales were a market norm.

Lake County Assessor v. U.S. Steel Corp., 901 N.E.2d 85 (Ind. Tax Ct. 2009).

Bankruptcy sale of subject given no weight due to brief marketing period.

Autodie Int., Inc. v. Cty. of Grand Rapids, Docket No. 227535 (Mich. Tax. Tr., Feb. 2, 2001).

Bankruptcy sales considered reliable when marketing period lasted 2 years and sale occurred after negotiations and competing offers.

Port of Umatilla and Hermiston Foods, Inc. v. Dept. of Rev., TC-MD 991438A (OR Tax Ct., Feb. 24, 2004)

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Running theme in caselaw:

Was the property adequately exposed to the market and the sale the result of typical influences in the market?

1031 Exchanges and Other Non-Market Evidence

Which are market transactions?

- A. The transfer of a property to the bank as part of a foreclosure action incident to a bankruptcy. -- No
- B. The transfer of a property owned by an entity going through bankruptcy to the entity in charge of liquidating the bankrupt entity's assets. -- No
- C. The sale of a property by an entity in charge of liquidating a bankrupt entities assets to a third party. -- Maybe

1031 Exchanges and Other Non-Market Evidence

Bankruptcy Sales:

Key Takeaway:

Sales occurring incident to or during a bankruptcy proceeding should be carefully analyzed to determine if the typical indicators of a market transaction are present, including the sale being exposed to the market for a reasonable period of time and there being no immediate legal or financial need to sell.

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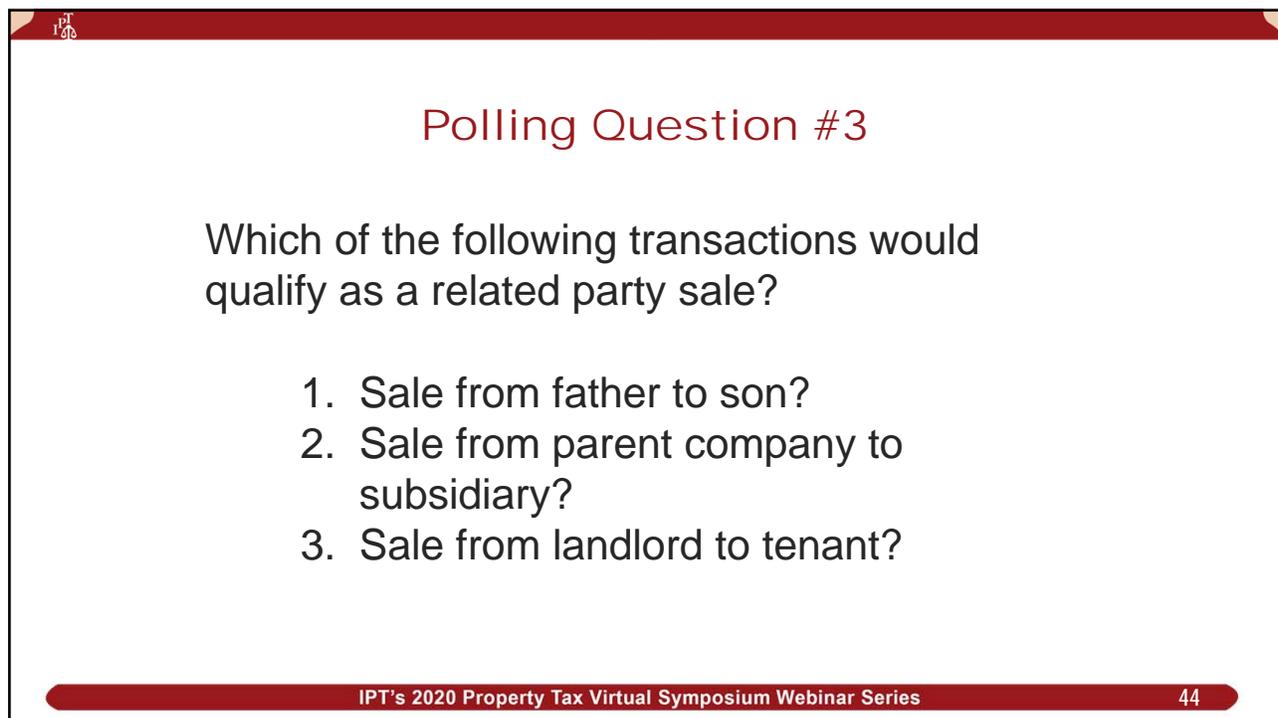
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Related Party Sales

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Polling Question #3

Which of the following transactions would qualify as a related party sale?

1. Sale from father to son?
2. Sale from parent company to subsidiary?
3. Sale from landlord to tenant?

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1031 Exchanges and Other Non-Market Evidence

A trick question: All three would technically qualify as a related party sale:

The key – all sales involved parties with some sort of pre-existing relationship

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Related party sales are not conclusive evidence of market value.

American House, LLC v. Bd. of Assessors of Greenfield, ATB Findings of Facts and Reports 2005-39.

Sale of property between related parties for a nominal sum are not “even remotely market or arm’s-length transaction.”

Washtenaw Commons, LLC and NEJ-Washtenaw, LLC v. City of Ann Arbor, Docket No. 18-001381 (Mich. Tax Tr., Feb. 19, 2020).

1031 Exchanges and Other Non-Market Evidence

Related Party Sales:

Key Takeaway:

Most related party sales will not satisfy the definition of a market transaction because they do not satisfy the requirement that the property was exposed to the market; however, the sale price could still be the equivalent of market value, depending on how the sale price is established – i.e.: by appraisal.

1031 Exchanges and Other Non-Market Evidence





1031 Exchanges and Other Non-Market Evidence

A portfolio sale is most commonly considered the sale of multiple properties as part of a single transaction.

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Common Characteristics of a Portfolio Sale

- A. Bulk sale of similar assets in a single transaction.
- B. The portfolio may include assets with a mix of both positive and negative qualities
- C. Individual sale prices may be determined by a “one-sided accounting allocation”.
- D. An allocated sale price for real estate may also be part of the purchase of a business.

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Foxboro Associates v. Board of Assessors of Foxborough, 385 Mass. 679, 682-683 (1982).

In this case, the board was amply justified in disregarding the estimate of value offered by the taxpayer based on this sale.....The board's finding that the \$3,600,000 figure had been "unilaterally determined by the seller," and was not the product of any agreement of the parties, is based squarely on testimony given by one of the taxpayer's partners.

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Portfolio Sales:

Key Takeaway:

A portfolio sale may be influenced by factors others than just the real estate. The individual purchase prices may be determined by a one-sided allocation of the total rather than as part of negotiation between unrelated parties. The sale requires careful analysis before it should be used as evidence of the market.

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Polling Question #4

The following transaction constitutes an assemblage, true or false?

The owner of a parcel of property buys the neighboring parcel in order to build an addition to their existing building.

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Assemblage:

“The combining of two or more parcels, usually but not necessarily contiguous, into one ownership or use; the process that creates plottage value.”

The Appraisal of Real Estate

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Plottage:

“The increment of value created when two or more sites are combined to produce greater utility.”

The Appraisal of Real Estate

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Warren G. Ellis, Trustee v Board of Assessors of the Town of Norwell, ATB Findings of Fact and Reports 2010-687, 700.

Sales of property to abutting property owners are inherently suspect, and, without additional supporting evidence, will not be considered probative evidence of fair cash value.

In order to be a reliable indicator of value, a sale price paid by an abutter requires evidence concerning the circumstances surrounding the sale to ensure that the purchase price was neither artificially inflated by “considerations unique to the purchaser” nor reduced below fair market value because the property was not sufficiently “exposed to the market.”

WB&T Mortgage Company, Inc. v. Assessors of Boston, Mass. ATB Findings of Fact and Reports 2006-379, 416 (quoting *Bainbridge v. Assessors of Chilmark*, Mass. ATB Findings of Fact and Reports 2003-93, 101.)

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Assemblage Sales:

Key Takeaway:

An assemblage typically involves buyers and sellers with different motivations. One motivated to buy and the other motivated not to sell. As a result, it is usually not considered a market transaction. The sale to an abutter is a transaction similar to a sale that is part of an assemblage.

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Questions?

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JUDY S. ENGEL, ESQ., is a Shareholder in the firm of Fredrickson and Byron, P.A. in Minneapolis. Ms. Engel's practice focuses on property tax cases, which utilize her extensive knowledge, skills and experience in the areas of negotiation, valuation and trial advocacy. Ms. Engel takes a pragmatic and open approach when advising her clients regarding whether to settle their case, keeping a careful focus on the risks, costs and benefits of settlement versus trial. She utilizes her extensive skills and knowledge of real estate valuations and appraisals in order to achieve the best possible results for her clients, whether through settlement or trial. She has extensive experience and is regarded by both the bench and the bar as a fierce litigator when her cases proceed to trial. However, Ms. Engel also takes a pragmatic approach when advising her clients regarding whether to settle their cases, keeping a careful focus on the risks, costs and benefits of settlement versus trial. She is known for maintaining an open dialogue with other members of the bar, county attorneys and assessors, which allows her to manage her cases in a professional manner, while maintaining a reputation as a tough negotiator and an aggressive litigator. Ms. Engel focuses primarily on retail, office and multi-family residential real estate appraisals, but also has extensive experience handling tax appeals involving industrial, mixed use, and medical buildings.

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