HAHN LOESER

EST. 1920 | MORE THAN A CENTURY OF CLIENT SERVICE

LEGAL ALERT

MARCH 9, 2022

ARE REAL ESTATE TAXES GOING TO WRECK YOUR INVESTMENT?

TARA J. ROSE

Hahn Loeser & Parks LLP

Property purchasers often fail to account for the increased tax associated with their prospective sale price when running pro-formas on cashflow. In Ohio, the sales price is considered the fair market value for real estate tax purposes. Prudent buyers should estimate and prorate taxes assuming the sales price as the basis of value for their investment. Otherwise, a "standard" proration provision in the purchase agreement will force the buyer to pay the tax increase on its own, even for the portion of the year the property was owned by the seller.

With real estate values continuing to climb at historic rates, real estate taxes can be a hidden trap when crunching numbers for a seemingly safe real estate investment. Prudent investors should analyze their potential real estate deals based on cash flow, which is the money generated from the property left over after all expenses have been paid, including real estate taxes. But, in many states, such as Ohio and Illinois, real estate taxes are paid in arrears. This means that the taxes for the current year are not due and paid until the following year, and the amount due is often affected by the purchase price of your future deal. This alone causes much confusion when it comes to accurately analyzing a real estate investment, including evaluating the possibility of a new, increased tax burden for the property.

Many fail to realize that, in many cases, real estate taxes are set based on the purchase price of an arm's length transaction. So, if your potential property is currently valued at $2 million by the auditor for real estate tax purposes, and you plan to offer a purchase price of $8 million, you can expect a large increase in the property's real estate taxes to become effective for the current year, but due and payable in the following year. Many investors, even the savviest ones, can forget to take this increase into account by relying on the current tax bill for their cash flow calculations, or severely underestimate the potential tax burden increase. This can cause overpayment on investments and (gulp!) negative cash flow.

So, what can be done to make sure you have solid calculations for your potential investment? First, always check with the county auditor to determine the current market value set by the auditor for tax purposes. This is public information that is easily accessible online. Second, if your proposed purchase price is higher than the auditor's market value, you can usually count on your real estate taxes to increase based on the sale. In order to determine the new tax burden, many counties have online calculators that can be used to estimate the new real estate tax amounts. However, if no tax calculator is available, you can simply divide the current tax bill by the current market value set by the auditor and get the current tax percentage. Then, apply the current tax percentage to your proposed purchase price, and, voila! - you have your new estimated tax bill.

Another issue that investors should be aware of while crunching numbers and determining the best purchase price for a real estate investment is whether there are any tax abatements on the property. A tax abatement is an exception to real estate taxes – meaning none are due. Tax abatements can be for the entire value of the property, or for a portion. Importantly, however, tax abatements are typically for a definite period of time. Therefore, you will want to know when the tax abatement was granted and how much longer it will be in effect. Then, you will need to calculate the new tax burden based on your proposed purchase price and determine when those taxes will ultimately begin to accrue.

Finally, when purchasing a new property, consider requiring favorable terms in the purchase agreement with respect to the deal structure and/or the tax proration paid by the seller at closing. Again, since taxes are paid in arrears in Ohio, buyers typically get a per diem credit from the seller at closing for the portion of the year the seller owned the property. This proration is customary because the tax bill for the year when seller owned the property will be paid in full by buyer when it ultimately becomes due in the following year. Thus, if the tax burden increases based on the sale price, but seller's proration credit is based on the lower, existing tax burden, you are not getting a fair credit for the period of time the seller owned the property. There are also ways to creatively structure a deal to try and dodge a large tax increase. However, these strategies are not guaranteed to work, so the new tax burden should still be considered on your bottom line. It's important to handle these real estate tax issues prior to or at closing as many standard purchase agreements make the proration final at closing. Even if there is language allowing for a post-closing recalculation of the tax proration, the merger doctrine, which states that all issues under the purchase agreement merge into the deed at closing, may preclude such a proration if specific language isn't included in the deed to preserve the issue.

Real estate taxes can get complicated, but help is here! Don't hesitate to reach out to an experienced real estate attorney to walk you through the tax issues and pitfalls before you go under contract for that new investment property!

Tara J. Rose, a real estate, construction and business attorney at Hahn Loeser & Parks LLP, will continue to monitor real estate tax trends. Taking a proactive and responsive approach to client service, Tara is available to assist with a variety of business and real estate needs.

AUTHOR

TARA J. ROSE
trose@hahnlaw.com
216.274.2337