

DIFFERENTIATING THE FRANCHISE AND PROPERTY TAX EXPENSE

By: Max Sanders, MAI

Question(s): What impact will the new Franchise Tax have on Commercial Real Estate in Texas? Will the tax be revenue neutral? Should the tax be included in the calculation of net operating income? What factors should be considered in estimating the property tax expense?

Background. Estimating the property tax expense is getting more complex due to the new Franchise Tax. In 2006 the 79th legislature of the State of Texas passed House Bill (HB) 1, 2, 3, 4 and 5. HB 1 mandated that school districts lower their tax rates and give all real estate owners relief from property taxes, and HB 2 mandates the revenue raised from HB 3, 4 and 5 go to property tax reduction. HB 3 closed loopholes in the state's business tax, also called the Franchise Tax, and is likely to have the most impact on commercial real estate. HB 4 requires used car buyers to accurately report the sales price on used vehicle sales, and HB 5 increased the tax rate on cigarettes.

Under HB 3 (79th legislature) and HB 3928 (80th Legislature) all limited partnerships, limited liability partnerships and limited liability corporations are required to pay the new Franchise Tax. Sole proprietorships and general partnerships are exempt from paying the tax because income taxes are prohibited under the Texas Constitution. Other exemptions include properties owned by LLC, LCs, and LLPs generating effective gross rent less than \$300,000. Under the old business tax property owners could get around paying the business tax by splitting the ownership interest into segments with income low enough to be exempt. HB 3 pools the rental income from a property so that more businesses and property based LPs and LLCs will be taxable. Another exemption is for LPs, LLCs and LLPs, that create a tax liability less than \$1,000.

A significant provision of HB 3928 is the ability of small businesses to calculate the tax using an "E-Z Computation." This allows a business with total revenue of \$10 million or less to multiply its apportioned total revenue by a tax rate of 0.575%. With regard to real estate partnerships, the applicable reference to the federal tax return has been changed to require the inclusion of gross rents in the partnership's total revenue. Previously, the applicable reference to the federal tax return required the partnership to include "net rental income. Also of interest to real estate businesses is the requirement that gain from the sale of real estate must be capital gain in order to qualify as passive income for purposes of determining whether an entity is exempt from the Texas franchise tax as a passive entity. Note: because lot sales from subdivisions are treated as ordinary income they will be subject to the tax, but most subdivision owners will elect to calculate the tax based on a higher tax rate but with a deduction for cost of goods/development.

HB 1 mandated that school districts lower their tax rates by 1/3 by 2008. The new maximum tax rate is \$100 per \$100 of appraised property value; however, school districts are permitted to raise their rates to \$1.04 one time without voter approval and \$1.17 with

voter approval. In November, 2007 a large number of school districts raised the tax rate to the maximum of \$1.17

Because the tax expense is a large portion of an income producing property's operating expense it needs to be estimated correctly in order to produce a credible appraisal. The following is a case study in how to estimate the tax expense and the factors that might influence the analysis. This process will vary according to the county and property type being appraised.

Case Study – Office Building, Somewhere County, Tx. A lender asks you to appraise a 25 year old office building in a secondary location for a new loan origination. The building contains 90,000 SF, was renovated in 2005, is 91% occupied, and is currently assessed for \$1.7 million. However, the building is listed on Loopnet for \$9 million, and the owner an LLC is requesting a loan amount of \$4 million dollars.

The current assessed value of the property is \$1.7 million generating a tax liability of approximately \$45,425. Using the current tax expense in the calculation of the NOI will generate a net operating income of \$488,000. A recent Korpacz Study suggests that investors would purchase the property using an overall capitalization rate of 9.5%, and the calculated value is \$5,150,000, rounded ($\$488,000 / 9.5\%$). Is this the correct value? Should the new franchise tax be subtracted as an expense in the calculation of the net operating income?

Suggested Research to solve the problem: It depends on the following:

1. The appraisal and school district in which the property is located. The appraiser should visit the State of Texas Comptroller's website and check the ratio study for the various county appraisal districts (CAD). For example, Harris County has a median level of appraisal of 94%, meaning commercial property is valued within 94% of market value, while Dallas County is at 100% of market value. If a school district is within a CAD that is not within 98% of market value it has two years to bring its ratio study into compliance or the school district begins to lose state funding. If the subject property is located in a county which is not in compliance then the property will be reassessed in the foreseeable future, because the CAD is under pressure to increase the value.
2. Check for assessor equality using comparable sales and not rent comps within the appraisal. If you have five sales within the same county appraisal district compare their assessments with the sales prices. If the assessments are near their sales prices it probably means the local CAD is aggressively researching sales and updating the appraised values. Otherwise the sales variances may suggest a typical percentage difference that can be applied to an estimate of market value.
3. Subtract the tax expense from the estimated NOI and load the market derived OAR with the tax mill rate. This method is typically used by tax reps in arguing for lower assessed values.
4. Finally, reconcile all of the above and support the indicated tax expense with data.

Solution. Because an appraisal is based on market value it assumes that the property is selling on the effective date of appraisal and that the buyer and seller are each acting prudently. In the above example a well informed buyer would research the probability of incurring a higher assessment. In comparing the ratio between the sales prices of the comparable improved sales within the report and their assessed value it was determined that the range was between 95% to 100%, and that the local CAD had a history of chasing sales and a strong ratio study. Therefore, a tax expense higher than \$45,425 cited in the previous case study is justified. Loading the OAR by the tax mill rate increased the cap rate to 12% ($0.095 + \text{tax mill rate of } 0.025$). Adding the existing tax expense to the NOI estimate raised the NOI to \$533,425. Capitalizing the adjusted NOI by 0.12 gives a value indication of \$4,450,000. Consequently, the appraiser had likely overvalued the property. (Had the property been located in a rural county where the assessor was undervaluing property and after reviewing same county sales data it may be more appropriate to use a lower tax expense.)

Franchise Tax. In the case study example the effective gross income was approximately \$1,025,000 and the property was owned by an LLC. Therefore, the franchise tax to the LLC was \$5,894 ($\$1,025,000 \times 0.575\%$). Had the property been owned by a General Partnership, Trust (of a natural person), estate of a natural person or sole proprietorship, the ownership entity would be exempt from the franchise tax.

In regards to appraisers including the franchise tax as part of the expense the appraiser needs to monitor the market. Currently, commercial real estate brokers are excluding the franchise tax from offering brochures. However, the 2007 franchise tax was only payable as of January 1, 2008. Therefore, brokers may be behind in analyzing this expense. Going forward if the commercial brokerage community begins to include the franchise tax as an expense then it may become necessary to include the franchise tax prior to the calculation of net operating income. However, until then it would not seem prudent to include the franchise tax as part of the NOI.

Finally, is the franchise tax revenue neutral? In the above example, prior to HB 1 the school districts tax rate was \$1.50/\$100 of value. After HB 1 it was decreased to \$1.04 and then raised to \$1.17/\$100, with approval from local voters. Therefore, the difference in school taxes was \$5,610 ($\$25,500 \text{ old rate} - \$19,890 \text{ new rate}$). The franchise tax was estimated to be \$5,894. Adding the new franchise tax of \$5,894 to the lower school district tax of \$19,890, results in a total tax expense of \$25,784; virtually the same as under the old tax system. Therefore, there was no effective tax relief for this LLC.

Conclusion. The tax reform act is essentially revenue neutral for commercial property. At the present time the franchise tax **should not be included** in the calculation of NOI; because it is tied to the form of ownership and not to the property. However, as the brokerage community digests the impact of the tax the market may dictate that franchise tax be included as part of the equation. Remember, in 1986 when tax deductions for passive income was no longer deductible its impact on commercial real estate was negative. Therefore, the value impact of this new tax needs to be monitored closely.