Identifying and Allocating Intangible Assets for Property Tax Purposes

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“Not everything that counts can be counted, and not everything that can be counted counts.”
Different Treatment of Intangibles

- Accountants
- Internal Revenue Service
- Business Appraisers
- Real Estate Appraisers
Identifying and Allocating Intangible Assets

1. Identifying Intangible Assets
2. Why It Is Necessary to Allocate the Value of Intangible Assets
3. Methods for Estimating or Allocating Intangible Asset Value
4. Selected Property Types and Intangible Assets
5. Special Topics
Part 1 Identifying Intangible Assets
Intangible Assets

Definition

**Nonphysical Assets** - such as a franchise, trademark, patent, copyright, goodwill, equity, mineral right, security, and contract *that grant rights and privileges, and have value for the owner.*

(ASA - American Society of Appraisers)

Intangible Assets
Tangible Assets

Definition

Physical Assets - such as cash, accounts receivable, inventory, property, plant and equipment, etc.

Tangible Personal Property

- Boats
- Equipment
- Inventory
- Vehicles
- Golf Carts
Real Estate
Real Property

Definition

An interest or interests in real estate.

The interests, benefits, and rights inherent in the ownership of real estate.

All rights, interests, and benefits related to the ownership of real estate.

(IVS - International Valuation Standards)
Real Property

Bundle of Rights

Rights of ownership are also known as the

“Bundle of Rights”

These Are . . .
Bundle of Rights

- Sell
- Lease
- Use/Occupy
- Give away
- Enter/Exit
- Refuse to do any of these
INTANGIBLE ASSET

Four-part Test

IDENTIFIABLE

EVIDENCE OF LEGAL OWNERSHIP

SEPARATE AND DIVISIBLE

LEGALLY TRANSFERRABLE
Four-Part Test

Identifiable

- An intangible asset should be identifiable
Evidence of Legal Ownership

- An intangible asset should have evidence of legal ownership
Four-Part Test

Separate and Divisible

- An intangible asset should be capable of being separate and divisible from the real estate
Four-Part Test

Legally Transferrable

- An intangible asset should be legally transferrable
If an asset does not possess all four characteristics, then the asset does not rise to the level of being an intangible asset.
Part 2 Why It Is Necessary to Allocate the Value of Intangible Assets
Intangible Assets

Five Major Categories of Intangible Assets:

- Marketing Related
- Customer Related
- Artistic Related
- Contract Related
- Technology Based
Intangible Assets

IRS Section 197 List of Intangible Asset Types

Marketing-related
- Trademarks, Trade Names
- Service marks
- Trade dress
- Newspaper mastheads
- Internet domain names
- Non-compete agreements
Intangible Assets

IRS Section 197 List of Intangible Asset Types

Customer-related
- Customer lists
- Production backlog
- Customer contracts
- Customer relationships
Intangible Assets

IRS Section 197 List of Intangible Asset Types

Artistic-related
- Plays, operas, ballets
- Books, literary works
- Musical works
- Pictures, photographs
- Audio/Video material
Intangible Assets

IRS Section 197 List of Intangible Asset Types

**Contract-based**
- Licensing agreements
- Service/supply contracts
- Lease agreements
- Construction permits
- Franchise agreements
- Broadcast rights
- Use rights: drilling, etc.
- Mortgage contracts
- Employment contracts
Intangible Assets

IRS Section 197 List of Intangible Asset Types

Technology-based
- Patented technology
- Computer software
- Unpatented technology
- Databases
- Trade secrets
Typical Reasons for Intangible Valuation

- Accounting Purposes
- Business Purposes
- Real Estate Purposes
Accounting Purposes for Allocating Intangibles

- **Financial Reporting** – Annual reports, balance sheets, income statements
- **Tax Reporting** – Internal Revenue Service (IRS)
Accounting Purposes for Allocating Intangibles

- Financial Reporting – Governed by the Financial Accounting Standards Board (FASB)
- Follow Generally Accepted Accounting Principles (GAAP)
- Intangible valuation/allocation based on FASB’s Accounting Standards Codification topic 805, (ASC- 805) Business Combinations
Accounting Purposes for Allocating Intangibles

Financial Reporting

- **Financial Reporting** = “Fair Value”
- Fair Value is different than Market Value
- No concept of “open market” or “reasonable time” or “cash or its equivalent” or “prevailing market conditions”
Accounting Purposes for Allocating Intangibles

Tax Reporting

- **Tax Reporting** – Internal Revenue Service
- Intangible valuation/allocation based on Internal Revenue Code 1060 (IRC-1060)
Accounting Purposes for Allocating Intangibles

Internal Revenue Code Section 1060 requires buyers and sellers to report the allocation of purchased assets on IRS Form 8594.
Accounting Purposes for Allocating Intangibles

Internal Revenue Service IRC-1060

- Class I – Cash and general deposit accounts
- Class II – Actively traded securities
- Class III – Assets marked to market annually
- Class IV – Inventory and property held for sale
- Class V – Land, buildings and FF&E
- **Class VI – IRC Section 197 assets except goodwill and going-concern value**
- **Class VII – Goodwill and going-concern value**
Business Purposes for Allocating Intangibles

- Sale or purchase of a business
- Small business loans
- Partner buyouts
- Estate settlements
- Divorce/Litigation
Business Purposes for Allocating Intangibles

The valuation and allocation of a business is usually performed by a business appraiser.
Business Purposes for Allocating Intangibles

• When determining the value of intangible assets, Business Appraisers use accepted valuation techniques such as EBITDA Multipliers.
Real Estate Purposes for Allocating Intangibles

- Eminent Domain
- Real Estate Financing
- Property Tax Assessments
Real Estate Purposes for Allocating Intangibles

Eminent Domain appraisals are usually performed by real estate appraisers. But.....
Real Estate Purposes for Allocating Intangibles

Appraisals for financing are performed by real estate appraisers who follow the Uniform Standards of Professional Appraisal Practice (USPAP)
Real Estate Purposes for Allocating Intangibles

• Valuations for property tax purposes are typically governed by state/province law, with guidance from the IAAO.
Real Estate Purposes for Allocating Intangibles

State/province laws vary but most do not address the treatment of intangibles for property tax purposes
Real Estate Purposes for Allocating Intangibles

Unlike financial reporting, tax reporting, and business appraising, there has been no accepted guidelines for valuing intangibles for property tax assessment purposes.
Part 3 Methods for Estimating or Allocating Intangible Assets
Professionals Who Estimate & Allocate Intangible Asset Values

Real Estate Appraisers and Assessors

• Estimate real property value
• Independent of intangible assets
• Not always necessary to value intangible assets to determine real property value
• Going concern appraisals are not performed by assessors
• Real property appraisers rarely value going concerns unless they have the requisite knowledge, skills, and experience
Valuation Methodology that Effectively Excludes Value of Intangible Assets
Cost Approach

- Effective approach for fee simple real property value estimates
- Free of any influence from a going concern or other intangible assets
- Cost approach criticism can be overcome
  - Obsolescence difficult to estimate
  - Often not relied upon by buyers and sellers
- Recommend it be used in conjunction with other valuation approaches

Cost Approach

- Procedure:
  - Estimate site value
  - Estimate hard and soft costs of improvements including reasonable profit
  - Estimate accrued depreciation in the structure
  - Add site value to improvement depreciated cost
Sales Comparison Approach - Market Behavior

- Transaction verifications should reveal what sold
  - (Market Survey Method)
    - A going concern, or
    - Real property and possibly personal property
- If sale price reflects going concern,
  - Verify how much of price represented intangible assets (and personal property)
  - Verify how the intangible assets were priced
Sales Comparison Approach - Public Records

- Company annual reports and U.S. Security and Exchange Commission documents (8K, 10K, etc.)
  - Show price allocations by publicly traded companies

- IRS Form 8594 - Asset Acquisition Statement - used when a business is purchased

- Usually an accounting function and may not reflect real property market value
Income Approach - Business Income vs. Real Property Income

• When business income is used to estimate gross income
  - Intangible assets may be present
  - Must subtract all business-related expenses to derive real property income

• When gross income is derived through space rentals
  - Intangibles rarely exist
Income Approach - Management Fee Method

- Applied by including going concern management and franchise fees as an expense
- Deductions of an FF&E replacement reserve and the depreciated or assessed value of the personal property removes its value from the value of the real property
Criticisms of the Management Fee Method Can Be Overcome
Addressing the Criticisms of the Management Fee Method

• Management company and franchise brand are not owned by the hotel property owner

• Making a deduction for return on operating expenses has no foundation in the valuation of a hotel

• Management fee accounts for the management of the business, not only the real estate

• Management fee based on a percentage of revenue
Capitalizing NOI in a Hotel Results in Going Concern Value Argument

- Market participants (buyers and sellers) capitalize real property NOI after applying the management fee method of removing intangible assets.

- Such intangible assets are owned by the management company and not the property owner.

- Assessors and real property appraisers should value hotels in the same way that investors analyze deals.
Part 4 Selected Property Types and Intangible Assets

- Multifamily
- Retail
- Office
- Industrial
- Land
- Specialty
Determining If Intangibles Exist

- The Market is the best source for determining if intangible are included or excluded in real property transactions
- Not theorists or appraisers
- Market participants
  - Buyers, sellers, brokers
Marketplace

Appraisers Should:

• Research the pricing behavior of buyers and sellers
  ➜ Quantify comparable transactions as bona fide and reflective of market value
  ➜ Verify the pertinent attributes of the transaction
  ➜ Verify the allocation of the sales price to real property, personal property and intangibles
  ➜ Understand the transaction!
General Guidelines: Scenario One

- Properties that derive their revenue from a business operating at the real estate often sell with the intangible business assets included in the sales price.

Car Wash

Mini-Mart
General Guidelines: Scenario Two

- Properties that transact with the intangible elements removed
  - Deductions of management fee
  - Pricing decision that represent business related intangible assets
    - Hotels
General Guidelines: Scenario Three

- Some property types may sell as a going concern
  - May include real estate and business included in one transaction; or
  - Real estate and business assets sell separately
    - Restaurant
Getting Specific

Basic Questions:

- In the valuation of the property, is the rent derived from a business or from the real estate?
- Is the property typically bought and sold as a going-concern or real property alone?
- If there is an intangible associated with a property, does it pass the four-part test to rise to the level of an asset?
Rarely Have Intangible Elements

The Easy Ones:

Office  Industrial/Flex  Retail  Apartment
Rarely Have Intangible Elements

A Little Less Obvious:

- Self-storage
- Drugstores
- Corporate headquarters
- Truck terminal
- Shopping Mall
- Mobile home/RV Parks
- Big Box Retail
May Have Intangible Value

- Fast food restaurant
- Automobile Dealership
- Auto Repair/Tire Center
- Hotels/Lodging
- Golf Course
- Casino
May Have Intangible Value (cont’d)

- Convenience Stores
- Marinas
- Fitness Centers
- Ski Resorts
- Bowling Centers
- Funeral Homes
May Have Intangible Value (cont’d)

- Landfill
- Race Tracks
- Movie Theater
- Self-Service/Full Service Car Washes
- Amusement/Theme Parks
- Senior Care
It’s Important to Remember

• If you understand the transaction, you will understand whether or not an intangible element exists
Part 5 Special Topics
SKILLED/ASSEMBLED WORKFORCE
Skilled/Assembled Workforce

- Typical in hotels and service-oriented properties
- "Asset" does not meet four-part intangible test
- MV assumes competent management and H&B Use
- Hotel management, not RE owner, hires workers
- Sale verification process may assist
Start-Up Costs
Start-Up Costs

- Required costs before opening for business
- Mostly soft costs included in cost approach
- Benefit not existent in a vacant property
- Ongoing process included in operating expenses
- May apply to new property and change of use
Leases in Place and Above/Below Market Leases
Leases-In-Place & Above/Below Market Leases

- Considered intangibles in accounting word
- Results from business combinations ASC-805
- For appraisers, leases create RP intangibles
- RP intangibles are “property rights”
- PRs include easements, air rights, minerals, possessory rights, permits, zoning & leases
Excess Rent - An Alternative View

- To Tenant - Negative Leasehold Estate/Value
  - Tenant paying above-market rent
- To Landlord - Positive Leased Fee Estate/Value
  - **NOT** an intangible
Goodwill
Goodwill

- Intangible asset arising as a result of name, reputation, customer loyalty, location, products, and similar factors not separately identified

- Acquisition price less identified asset values

- Appears only after all other assets have been separately identified and quantified

- Difficult to isolate and value

- Management fee technique removes goodwill
THANK YOU!