Understanding Intangible Assets and Real Estate

National Conference of State Tax Judges
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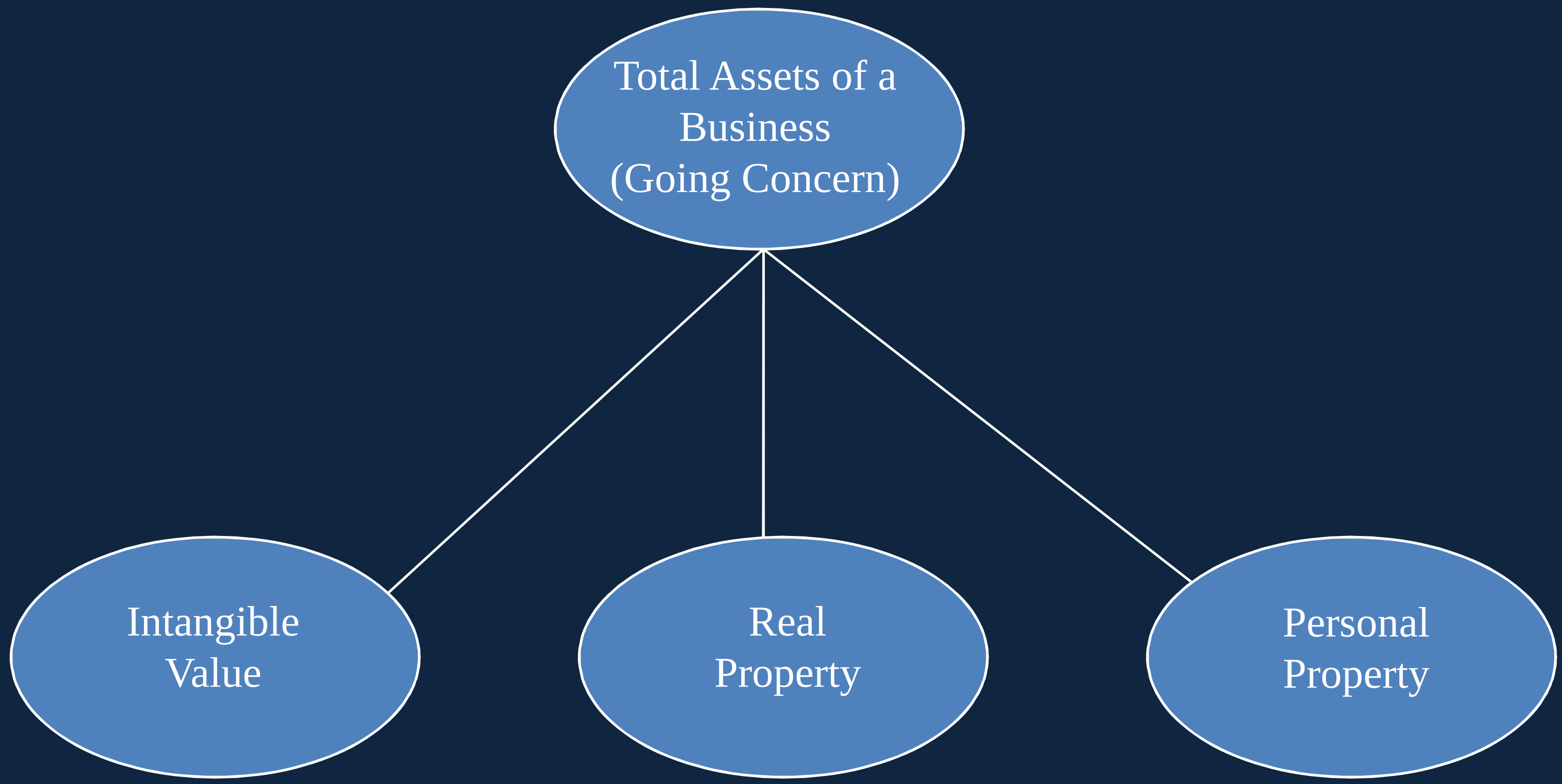
LINCOLN INSTITUTE OF LAND POLICY

Components to Allocate in Property Tax Valuation



Intangible Assets

"…It has been said that the miner is a naked trespasser, without claim of title, a licensee or else a strict tenant at will, not entitled to notice quit, and therefore having no valuable estate."

Hale & Norcross Gold and Silver Mining Company v. County of Storey, 1 Nev. 104 (1865)

Intangible Assets

Section 1 – Identifying Intangible Assets

Section 2 – Why it is necessary to Allocate Intangible Assets

Section 3 – Methods for Estimating Intangible Value

Section 4 – Special Topics

Section 5 – Legal Perspective

Section 1: Identifying Intangible Assets

Identifying Intangible Assets

Intangible Assets: Nonphysical assets, including but not limited to franchises, trademarks, patents, copyrights, goodwill, equities, securities, and contracts as distinguished from physical assets such as facilities and equipment.

Appraisal Institute 2015

Dictionary of Real Estate Appraisal – 6th Edition.

Intangible Assets

Marriott
HOTELS · RESORTS · SUITES

McDonald's

STARBUCKS COFFEE

QT

Sheraton

WYNDHAM
HOTELS AND RESORTS

FedEx Office

THE RITZ-CARLTON®
HOTEL COMPANY, L.L.C.

Marriott
HOTELS · RESORTS · SUITES

HYATT PLACE

Holiday Inn

Intangible Asset 4-Part Test

1. Identifiable, recognized & distinguishable
2. Evidence of Legal Ownership, documentation substantiating ownership
3. Capable of Being Separate and Divisible from the Real Estate
4. Legally Transferrable, can be lawfully conveyed to another entity

There are typically two circumstances in which assessors encounter intangible value.

1. A property sells and intangible assets are included in the price, along with real and personal property

2. Income from a business is used to value the real estate in an income approach, such as hotels and nursing homes.

Income Approach, Real Estate	
Potential Gross Income	$150,000
Less Vacancy	$22,500
Effective Gross Income	$127,500
Less Operating Expense	$75,000
Net Operating Income	$52,500
Capitalization	$583,333
Rounded	$580,000
Example Assumptions:	
Net Rentable Area (SF)	15,000
Market Rent Per SF	$10.00
Vacancy Allowance	15.0%
Expenses PSF	$5.00
Overall Capitalization Rate	9.0%

Selected Property Types and Intangible Assets

It is very unlikely that some property types would ever include intangible value.

Rarely if ever contain intangible Value
Apartments
Big-Box Stores
Chain Drug Store
Corporate Headquarters
Mobile Home and RV Parks
Office buildings
Regional Malls and Shopping Centers
Industrial Properties
Movie Theaters

Selected Property Types and Intangible Assets

Property Types that may contain Intangible Value	
Amusement/Theme Parks	Golf Courses
Auto Dealerships	Hotels & other Lodging Facilties
Auto Repair/Tire Centers	Landfills
Bowling Centers	Marinas
Car wash properties	Race Tracks
Casinos	Restaurants
Convenience Stores/Gas Stations	Senior Care Facilities
Fitness Centers	Ski Resorts
Funeral Homes	Telecommunications

Many property types may include intangible value when the business is included in a transaction Or they are valued using the business income.

Section 2. Why it is necessary to allocate the value of Intangible Assets.

- 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 = "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 –Internal Revenue Service
- Intangible valuation and allocation based on Internal Revenue Code 1060 (IRC-1060)

Accounting Purposes for Allocating Intangibles

Internal Revenue Service IRC-1060 requires assets to be divided into one of 7 classes:

- 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

Accounting Purposes for Allocating Intangibles

Internal Revenue Service (IRS) Section 197 list of Intangible Asset types:

IRS Section 197 Intangible Asset Types				
Marketing-related	**Customer-related**	**Artistic-related**	**Contract-based**	**Technology-based**
a) Trademarks, Trade Names	a) Customer lists	a) Plays, operas, ballets	a) Licensing agreements	a) Patented technology
b) Service marks	b) Production backlog	b) Books, literary works	b) Service/supply contracts	b) Computer software
c) Trade dress	c) Customer contracts	c) Musical works	c) Lease agreements	c) Unpatented technology
d) Newspaper mastheads	d) Customer relationships	d) Pictures, photographs	d) Construction permits	d) Databases
e) Internet domain names		e) Audio/Video material	e) Franchise agreements	e) Trade secrets
f) Non-compete agreements			f) Broadcast rights	
			g) Use rights: drilling, etc.	
			h) Mortgage contracts	
			i) Employment contracts	

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

Form **8594**
(Rev. February 2006)
Department of the Treasury
Internal Revenue Service

Asset Acquisition Statement
Under Section 1060
▶ **Attach to your income tax return.** ▶ **See separate instructions.**

OMB No. 1545-1021
Attachment Sequence No. **61**

Name as shown on return	Identifying number as shown on return

Check the box that identifies you:
☐ Purchaser ☐ Seller

Part I General Information

1 Name of other party to the transaction	Other party's identifying number
Address (number, street, and room or suite no.)	
City or town, state, and ZIP code	
2 Date of sale	3 Total sales price (consideration)

Part II Original Statement of Assets Transferred

4 Assets	Aggregate fair market value (actual amount for Class I)	Allocation of sales price
Class I	$	$
Class II	$	$
Class III	$	$
Class IV	$	$
Class V	$	$
Class VI and VII	$	$
Total	$	$

5 Did the purchaser and seller provide for an allocation of the sales price in the sales contract or in another written document signed by both parties? . . . . ☐ Yes ☐ No

If "Yes," are the aggregate fair market values (FMV) listed for each of asset Classes I, II, III, IV, V, VI, and VII the amounts agreed upon in your sales contract or in a separate written document? . . . . . . ☐ Yes ☐ No

6 In the purchase of the group of assets (or stock), did the purchaser also purchase a license or a covenant not to compete, or enter into a lease agreement, employment contract, management contract, or similar arrangement with the seller (or managers, directors, owners, or employees of the seller)? . . . . . ☐ Yes ☐ No

If "Yes," attach a schedule that specifies **(a)** the type of agreement and **(b)** the maximum amount of consideration (not including interest) paid or to be paid under the agreement. See instructions.

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 63768Z Form **8594** (Rev. 2-2006)

Business Purposes for Allocating Intangibles

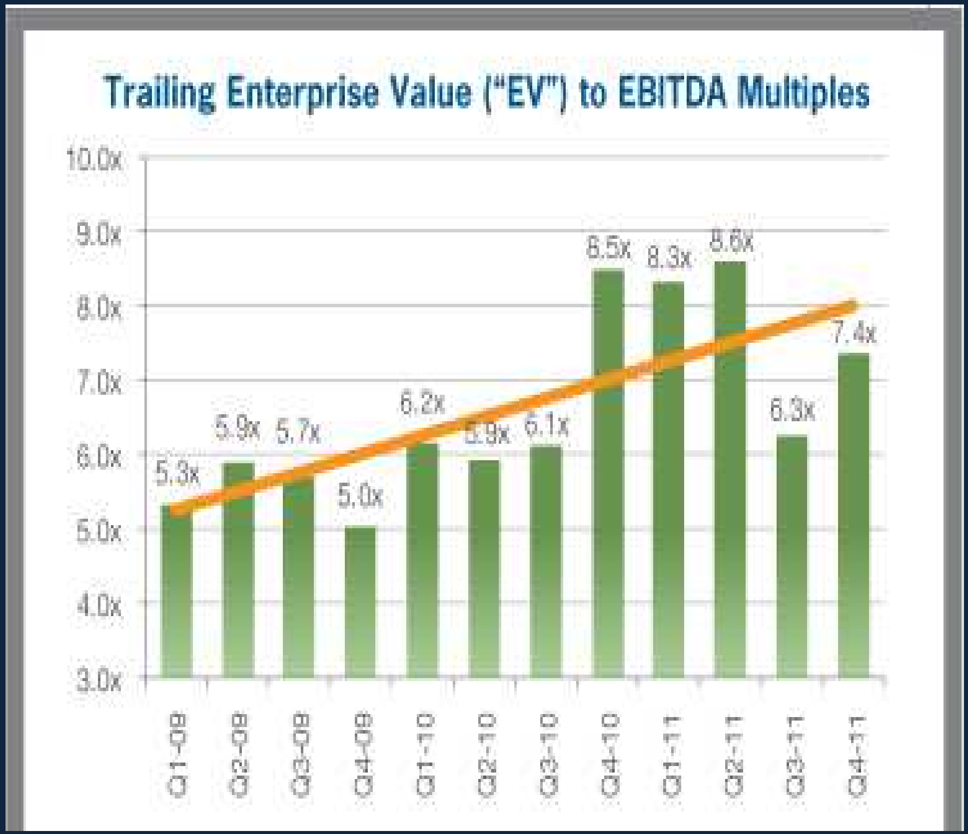
- Sale or purchase of a business
- Small business loans
- Partner buyouts
- Estate settlements
- Divorce/Litigation

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

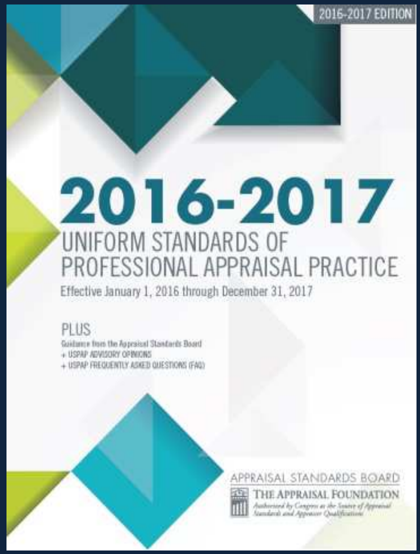
- Appraisals for financing are performed by real estate appraisers who follow the Uniform Standards of Professional Appraisal Practice (USPAP)

Real Estate Purposes for Allocating Intangibles

USPAP – FAQ 193

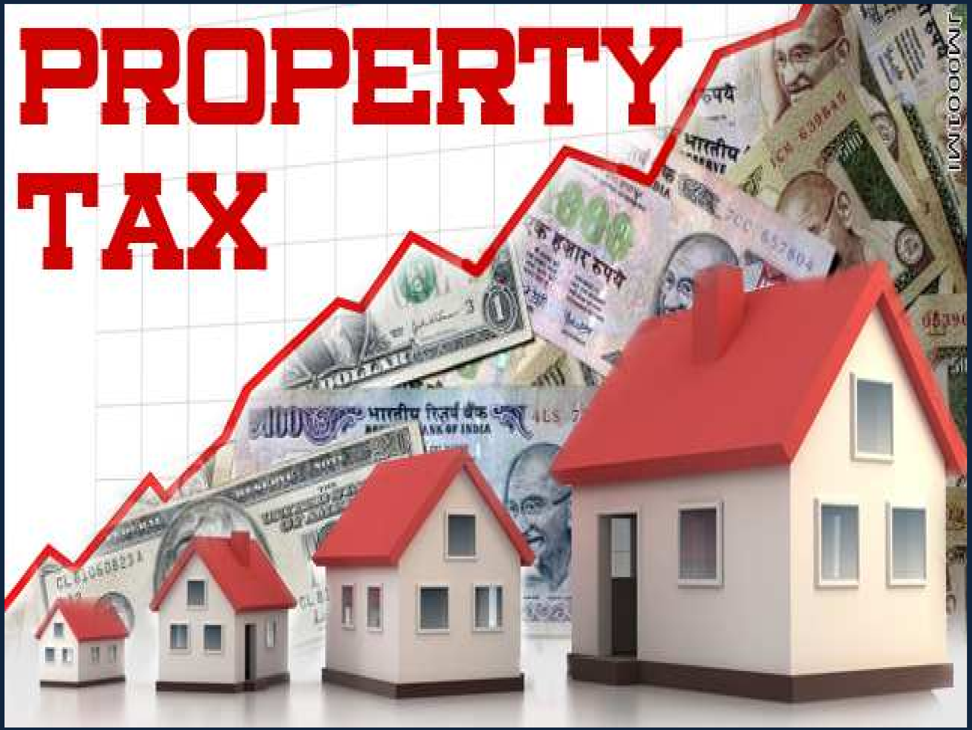
<u>Question</u>: There are also occasions when the client does not specifically request separate valuations of non-real property assets, even though they may be present. Is the appraiser still required to value those assets separately?

<u>Answer</u>: No. This is a scope of work decision to be made by the appraiser; Standards Rule 1-4(g) does not require separate appraisals of these different types of assets.



Real Estate Purposes for Allocating Intangibles

- Valuations for property tax purposes are typically governed by state law, with guidance from the IAAO and the Appraisal Institute.



Real Estate Purposes for Allocating Intangibles

State laws vary but most do not directly address the treatment of intangibles for property tax purposes

Unlike financial reporting, tax reporting, and business appraising, until now there has been no accepted guidelines for valuing intangibles for property tax assessment purposes.

Section 3. Methods for Estimating or Allocating Intangible Assets

Real Estate Appraisers & 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 <u>unless</u> they have the requisite knowledge, skills, and experience

Methods for Estimating or Allocating Intangible Assets

- *Cost Approach*
- *Market Approach*
  - ➢*Market Survey Method*
- *Income Approach*
  - ➢ *Management Fee Method*

Cost approach

- Effective approach for fee simple real property value estimates. Free of any influence from a going concern or other intangible assets

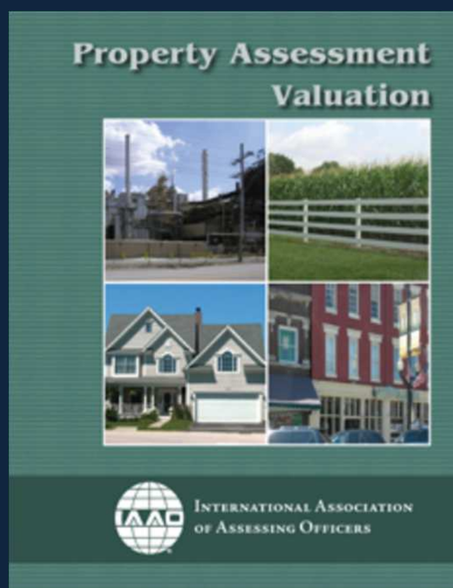
- Easiest approach for assessors and appraisers to apply due to the availability of cost data &d land sales.

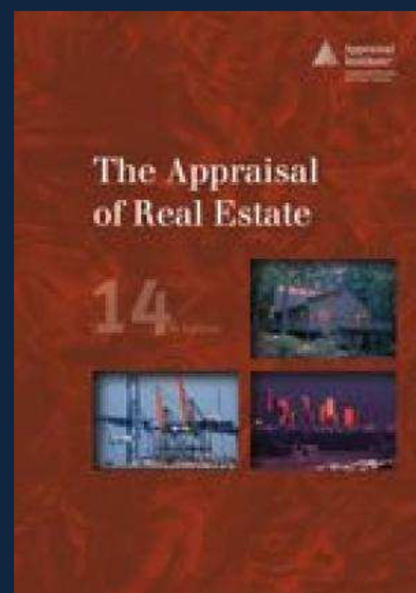
Criticism of the Cost Approach

- Difficult to measure depreciation or obsolescence.
- Not considered by market participants.

Cost approach

There are accepted methods for estimating depreciation and obsolescence.





Cost approach

"…Boehm's rejection of the cost approach is based on his reasoning that a purchaser of the CCRC would consider only the going concern value. This is contrary to what the assessor seeks to do determining the value of the real estate for the purpose of taxation, not the value of the CCRC as a business."

<u>Redding Life Care, LLC v. Town of Redding</u>, 2011 Conn. Lexis 433 (Conn. Super. Ct. Feb.23, 2011)aff'd 61A.3d 461 (Conn.2012)

Market Approach

- Transaction verification should reveal what sold (Market Survey Method)
  - A going concern, or
  - Real property and possibly personal property
  - The Market is the best source for determining if intangible value was included in a real property transaction - Not theorists or appraisers

- If sale price reflects going concern,
  - Verify how much of price represented intangible assets (and personal property)
  - Verify how the intangible assets were priced

Market Approach

- 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
  - Required when a business is purchased

Market Approach

Acquisitions

Hyatt Regency Orlando —During the year ended December 31, 2013, we acquired The Peabody in Orlando, Florida for a total purchase price of approximately $716 million. As part of the purchase, we acquired cash and cash equivalents of $2 million, resulting in a net purchase price of $714 million.

The following table summarizes the preliminary estimated fair value of the identifiable assets acquired and liabilities assumed, which are primarily recorded in our owned and leased hotels segment at the date of acquisition (in millions):

Cash and cash equivalents	$	2
Prepaids and other current assets		3
Property and equipment		678
Intangibles		39
Total assets		722
Current liabilities		6
Total liabilities		6
Total net assets acquired	$	716

Hyatt Hotels Corporation - Securities and Exchange Commission form 10-K
For fiscal year ended 12/31/2013

Criticism of the Market Approach

- Buyer and sellers don’t often know how much of a purchase price was intangible versus real property.

- Allocations for intangibles found in annual reports and other documents are usually an accounting function and may not reflect real property market value

Income approach

- **When space rental income is used to estimate gross income**
  - **Intangibles rarely if ever exist**

- **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**

Income approach

- Management Fee Method – also known as the Rushmore Approach (lodging facilities)
- Applied by including a going concern management and franchise fees as an expense

Criticism of the Management Fee Method

- Simply capitalizing the management fee and franchise fee, (or including them as operating expenses), does not go far enough to capture all the intangible value.

- Management fees and franchise fees are nothing more than a normal cost of doing business. They do not go far enough in accounting for business value.

Defense of the Management Fee Method

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

- Assessors and real property appraisers should value hotels in the same way that investors analyze deals

Section 4. Special Appeal Topics

SKILLED/ASSEMBLED WORKFORCE

SKILLED/ASSEMBLED WORKFORCE

Argument: The workforce is an intangible asset that should be removed from the assessment.

- Argued in service-oriented property tax appeals
- Accounting world considers workforce intangible
- Workforce "Asset" does not meet 4-part intangible test
- Expenses for training workforce already included in the income approach. No need for another deduction.

Start-Up Costs

START-UP COSTS

Argument: The property owner is entitled to a return on the original start-up costs of the business

- Required costs before opening for business
- Mostly soft costs – marketing, training, etc.
- Benefit non-existent in a vacant property
- No evidence for adjustment from market participants
- May apply to new property and change of use

Leases in Place and Above/Below Market Leases

LEASES-IN-PLACE & ABOVE/BELOW MARKET LEASES

Argument: Leases-in-place and above-market leases represent intangible value – not real property.

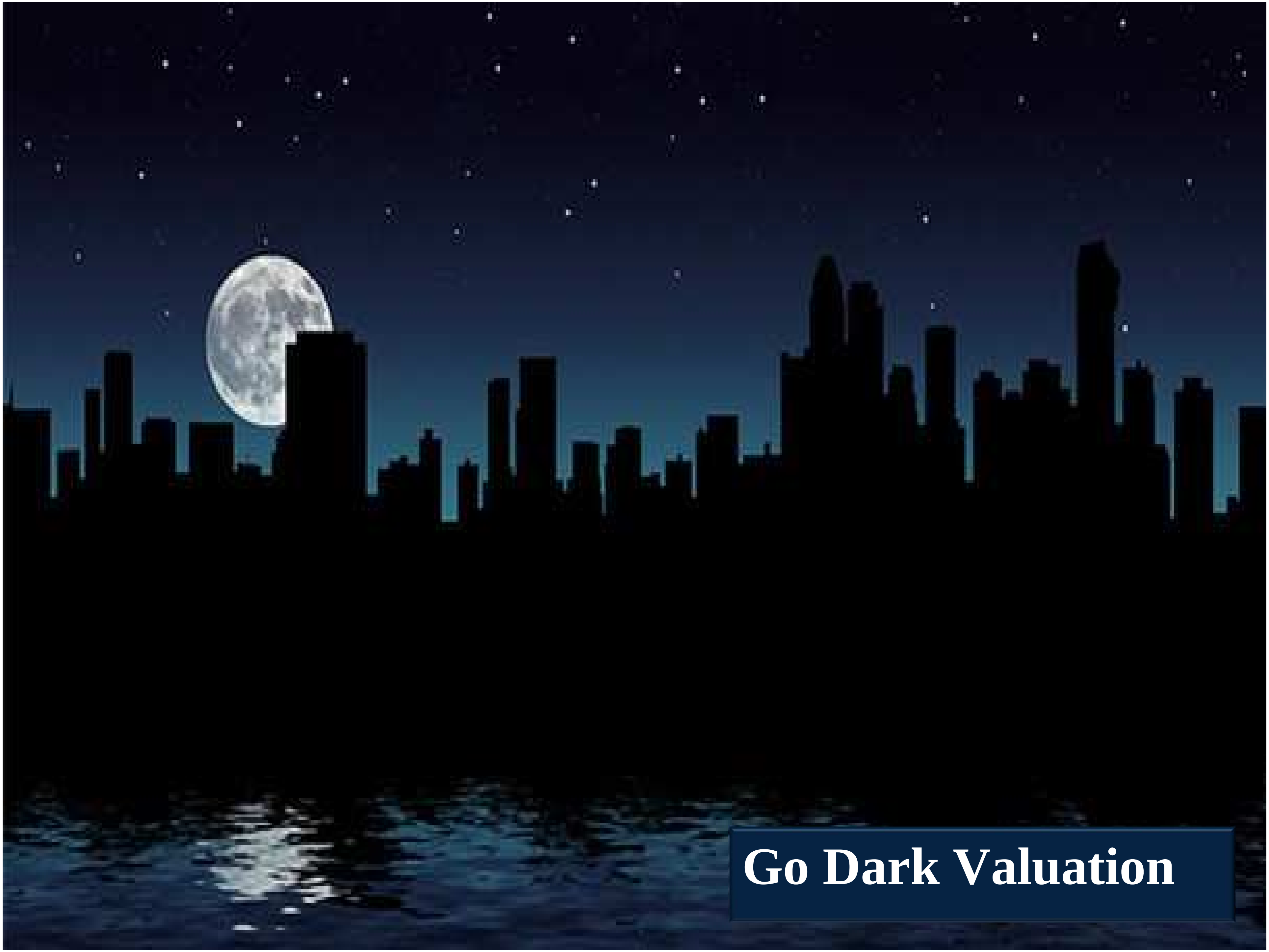
- Considered intangible by accountants
- Results from business combinations ASC-805
- For appraisers, leases create Real Property intangibles
- Real property intangibles are "property rights" that include easements, air rights, minerals, possessory rights, permits, zoning & <u>leases</u>


GOODWILL

GOODWILL

Argument: After deducting the value of identified assets, the remainder is "Goodwill" that should not be assessed.

- Unidentified intangible assets
- Acquisition price less identified asset values
- Also known as "blue sky"
- Usually only argued when a property sells


Go Dark Valuation

GO DARK VALUATION

- Argument: Property should be valued “as vacant” since value as-occupied resulted from management effort – an intangible asset.

- For accountants “leases-in-place” are intangibles
- “As If Vacant” or “Dark Store” valuation
- Fee Simple = Leased at market rent & occupancy
- Occupancy should be recognized, just like condition
- Assumed vacancy is a hypothetical condition (contrary to what actually exists) & a liquidation

BEV Approach

BEV APPROACH

Argument: Appraisers and assessors should include adjustments for workforce, start-up costs, and return on personal property, in addition to management fee and franchise fee adjustments already included in management fee approach.

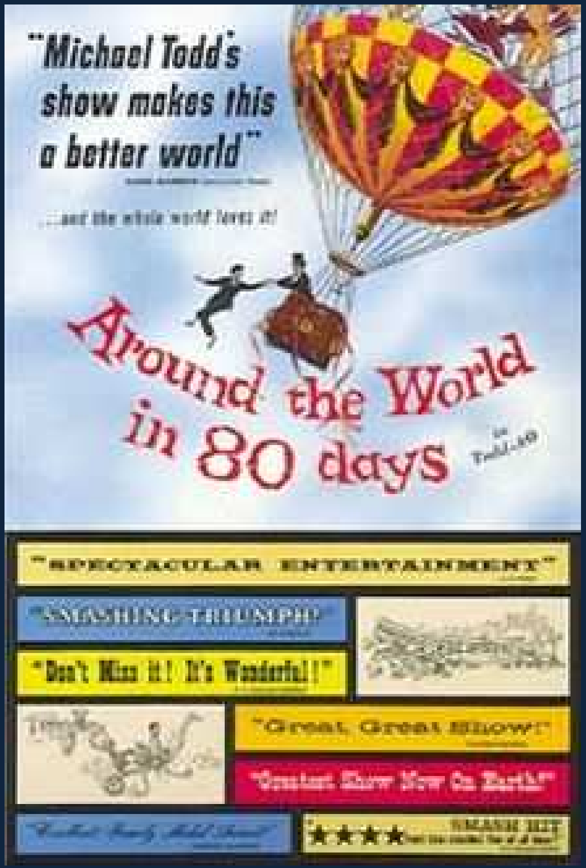
- Advanced by property tax appellants
- Long history, but not universally accepted
- Mostly malls and hotels
- Widely rejected by the courts

Section 5. Legal Perspective

Around the World in 80 days

Personal property tax on film negative of the motion picture “Around the World In Eighty Days.”

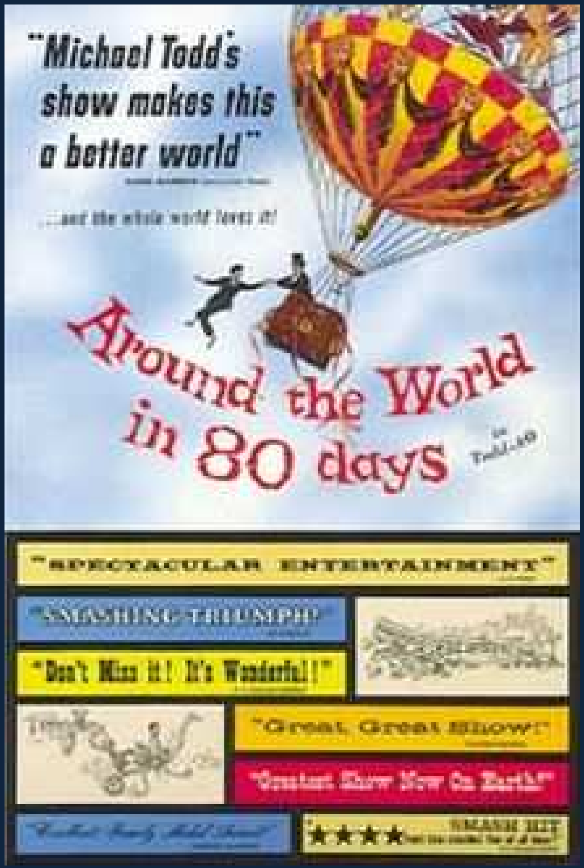
Was the copyright a non-assessable intangible?



Michael Todd Co. v. County of Los Angeles, 57 Cal. 2d 684 [21 Cal.Rptr. 604, 371 P.2d 340] (1962)

Around the World in 80 days

"Market value" for assessment purposes is the value of property when put to beneficial or productive use; it is not merely whatever residual value may remain after the property is demolished, melted down, or otherwise reduced to its constituent elements."



Michael Todd Co. v. County of Los Angeles, 57 Cal. 2d 684 [21 Cal.Rptr. 604, 371 P.2d 340] (1962)

Loews Glenpointe Hotel

"One method of separating the real estate and business interest in hotel valuation is to extract from hotel revenues the fee paid by the owner to a management company pursuant to a management contract. See, e.g., Rushmore, Hotels, Motels and Restaurants: Valuations and Mark et Studies (1983). This is the technique adopted by the expert in this case. I find it to be reasonable."

Glenpointe Assocs. v. Teaneck Tp., 10 N.J. Tax 380, 390 (1989)

Southridge Mall

Did sales price of mall include intangible business value?
(Leasing of space to tenants, baby stroller rentals, etc.)

State ex rel. N-S Associates v. Board of Review, 473 N.W. 2d 554 -Wisc. App. 1991

Southridge Mall

"The key of the analysis is whether the value is appended to the property, and is thus transferrable with the property, or whether it is, in effect, independent of the property so that the value either stays with the seller or dissipates upon sale."

State ex rel. N-S Associates v. Board of Review, 473 N.W. 2d 554 -Wisc. App. 1991

Merle Hay Mall

"The mall complains that the assessors violated (the law) by failing to reduce the valuations under a 'business enterprise value' theory. Under this theory, the value of a property, such as a mall necessarily includes certain intangibles, such as the worth of the business organization, management, the assembled work force, working capital, and legal rights."

Merle Hay Mall v. City of Des Moines Bd. of Review, 564 N.W.2d 419, 423 (Iowa 1997)

Merle Hay Mall

"There is another reason to reject the mall's business enterprise value theory. Iowa Code section 441.21(2) requires that any valuation methods used must be "uniform and recognized appraisal methods." The business enterprise value theory is not a generally recognized appraisal method."

Merle Hay Mall v. City of Des Moines Bd. of Review, 564 N.W.2d 419, 423 (Iowa 1997)

Marriott Hotel Saddlebrook NJ

"In the present case, the adjustments proposed… to the Rushmore method have both theoretical and empirical aspects. In other words, they are made for stated reasons, and they rest on particular data. In order for any adjustment to have persuasive force in a factual finding of value, it should rest on cogent reasoning and be founded on reliable data. These proposed adjustments, on the whole, are not persuasive either for theoretical or empirical reasons."

Chesapeake Hotel LP v. Saddle Brook Township 22 N.J. Tax 525 (2005)

Glendale Hilton Hotel

•Taxpayer purchased the Glendale Hilton for $77.3 million, which included real property, personal property, and intangible assets.

•Both parties agreed the personal property was worth $3.4 million

•The assessor assessed the hotel at $73.3 million and taxpayer argued for a value of $62.6 million based on intangible value.

EHP Glendale, LLC v. County of Los Angeles (2013) 219 Cal. App.4th 1015

Glendale Hilton Hotel

"Absent superior management or an exceptional workforce, though, the presence of prudent management and a reasonably skilled workforce are required to put a property to its beneficial and productive use, and no additional value needs to be deducted from the income stream."

EHP Glendale, LLC v. County of Los Angeles (2013) 219 Cal. App.4th 1015

Glendale Hilton Hotel

"…Neither the Board nor the trial court found the assessor's disagreement with Section 502 problematic, nor do we. Assessors handbooks are not regulations and do not possess the force of law, although they serve as a primary reference and basic guide for assessors, and have been relied upon and accorded great weight in interpreting valuation questions."

EHP Glendale, LLC v. County of Los Angeles (2013) 219 Cal. App.4th 1015

Ritz Carlton Half Moon Bay Hotel

"… the deduction of the management and franchise fee from the hotel's projected revenue stream pursuant to the income approach did not—as required by California law—identify and exclude intangible assets such as the hotel's assembled workforce, the hotel's leasehold interest in the parking lot, and the hotel's agreement with the golf course operator".

SHC Half Moon Bay, LLC v. County of San Mateo (2014) 226 Cal.App.4th 471

Capital Hilton Hotel – Washington D.C.

"The method followed by the District – patterned on the Rushmore Approach – seems to the Court well-conceived to yield a fair and accurate estimate of market value for the taxable real property component of the Capitol Hilton Hotel. The approach followed by the District is well-established and broadly accepted, both in its overall outline and in its specifics."

CHH Capital Hotel Partners LP v. District of Columbia, Case No. 2009 CVT 9455
Superior Court of the District of Columbia Tax Division. 21 Jul. 2015

Summary

- Four-part test for intangibles assists identification
- Accountants value intangibles differently than real property appraisers and assessors
- All three approaches to value can be used to ensure intangibles are excluded in assessments.
- The Management Fee method is the most widely used and accepted method in the income approach
- Other methods for extracting intangibles, such as assembled workforce, start-up costs, and the BEV Approach have not been accepted by the appraisal community or courts.

Thank you!

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