

# Valuation of Contract-Related Intangible Assets

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*The valuation of contract-related intangible assets is often an issue in matters related to income tax, gift tax, estate tax, generation-skipping tax, and property tax. This discussion explains the different types of contract intangible assets. This discussion summarizes the generally accepted approaches and methods related to the valuation of contract intangible assets. Finally, this discussion presents an illustrative example of the valuation of the hypothetical Taxpayer Corporation contract intangible asset.*

## INTRODUCTION

There are many reasons why a taxation matter may involve the valuation of a contract-related intangible asset. These reasons include gift tax, estate tax, generation-skipping transfer tax, income tax, and property tax. And, such valuations may be used for taxation planning, compliance, appeals, and litigation.

This discussion summarizes the common methods related to contract valuation.

In addition, this discussion:

1. describes the factors that are commonly considered in the contract valuation,
2. summarizes both the internal and external data sources that are commonly considered in the valuation, and
3. presents an illustrative example of a contract valuation.

## CONTRACT-RELATED INTANGIBLE ASSETS

A contract is typically considered to be an agreement between two or more parties creating obligations that are legally enforceable or otherwise recognizable under the law. Analysts often look at the actual writing of the contract that sets forth the agreement of the parties.

## CONTRACT ANALYSIS DUE DILIGENCE

The analyst understands that a contract can be oral as well as written. The analyst will typically consult with counsel regarding the legal enforceability of an oral contract.

Alternatively, a contract may be considered a promise or a set of promises either:

1. the breach of which the law provides a remedy for or
2. the performance of which the law recognizes as a duty.

In this construct, a contract may be viewed as a legal duty or set of duties that is not imposed by the law of tort.

A contract is also an enforceable agreement between two or more parties to either do a thing (or a set of things) or to not do a thing (or a set of things). The analyst considers the rights and duties encompassed in the contract.

The contract document (or the oral agreement) itself is not the intangible asset. The legal rights and duties of the contract are the intangible asset.

Before any valuation can be performed, there should be an enforceable contract. In order for the contract to be enforceable, it should meet certain legal requirements.

The parties to the contract should be competent to enter into such a contract. The subject matter should be legally appropriate for a contract. There should be consideration given in the contract. There should be a mutuality of agreement and a mutuality of obligation.

The analyst should consult with legal counsel if there is a question as to whether the subject contract meets the requisite legal requirements.

The analyst considers the specific terms of a specific contract. The specific contract terms typically include the contract start date and stop date. The contract intangible asset valuation is typically limited to the terms of the contract agreement itself.

## CONTRACTS AND EXPECTED CONTRACT RENEWALS

There is a related intangible asset to the contract: the expected contract renewals. The expected contract renewals intangible asset generally represents the expectation that an individual contract will be renewed at the end of its stated contract term or expiration.

The contract parties may expect that the current, let's say, five-year term contract will renew for a second, third, fourth, and so on, five-year period after the current contract term expires.

If this expectation is reasonable, the analyst may be asked to assess the two intangible asset components of the relationship between the contract parties:

1. The current contract (with a stated or implied termination date)
2. The expected contract renewals that may occur after the termination of the current contract agreement

Some analysts consider the current contract and the expected contract renewals to be two separate but related intangible assets. For some purposes, it may be important to separately analyze these two intangible assets.

For example, each of these two intangible assets may have a different expected remaining useful life (RUL):

1. The current five-year term contract may expire in two years.
2. The expected renewal of the five-year term contract will expire in seven years.

Some analysts consider both intangible asset components to represent a single intangible asset

that may be called contracts and expected contract renewals. In some situations, it may be appropriate to collectively analyze both of the value components as a single intangible asset.

Before performing any quantitative analysis, the analyst should decide if the valuation subject is (1) the current contract only or (2) the current contract and the expected contract renewals. The analyst may accept direction from counsel in making this determination.

## CONTRACT VALUATION APPROACHES AND METHODS

All intangible asset valuation approaches may be applicable to most contract valuations.

This section summarizes the common contract valuation methods within each of the three generally accepted intangible asset valuation approaches.

### The Cost Approach Contract Valuation Methods

In the cost approach, the analyst often uses the replacement cost new less depreciation (RCNLD) method to value contracts. In such an analysis, the direct cost and indirect cost components are generally not the greatest components of the contract value.

Direct costs typically include the labor and overhead costs related to the company employees who negotiate and consummate the contract or who apply for and process the license document. Indirect costs typically include the out-of-pocket expenses related to legal counsel, engineers, consultants, and others retained to help negotiate the contract or obtain the license.

The developers' profit cost component typically includes a fair profit margin applied to the sum of the direct and indirect costs.

Entrepreneurial incentive is typically the most important component of the RCNLD method of contract valuation. Entrepreneurial incentive is often considered to be an opportunity cost. This opportunity cost is often measured as the owner/operator's lost profits during the contract replacement period.

If the analyst expects that it would take, for example, six months to replace the subject contract, then the entrepreneurial incentive may include six months of lost profits during the contract replacement period.

This replacement period typically includes the time period between when the owner/operator first

decides to enter into a contract or obtain a license and when the new contract or license is in place and fully functioning.

In other words, the replacement period includes the time required to negotiate and consummate a new contract or apply for and receive a new license agreement.

The lost income during the replacement period is typically measured as the difference between:

1. the income that the owner/operator will actually earn with the actual contract or license during the replacement period and
2. the income that the owner/operator would have earned without the contract or license in place during the replacement period.

This lost income, or opportunity cost, component of the entrepreneurial incentive is often the largest portion of the contract valuation RCNLD.

## The Market Approach Contract Valuation Methods

In the market approach, the analyst often uses the comparable uncontrolled transaction (CUT) method based on either arm's-length sales of guideline intangible assets or arm's-length licenses of guideline intangible assets.

That is, for certain types of licenses and permits, there may be an actual marketplace for the arm's-length sales of such intangible assets between third parties.

For example, the analyst may be able to assemble empirical data regarding the arm's-length sales of FCC broadcast and spectrum licenses and television and radio network affiliation agreements.

In addition, for certain types of government-issued or private franchises, there may be an actual marketplace for the arm's-length license of such intangible assets between third parties.

For example, the analyst may be able to assemble empirical data regarding the arm's-length license of cable television franchise agreements, hotel and hospitality franchise agreements, and restaurant and food service franchise agreements.

## The Income Approach Contract Valuation Methods

In the income approach, the analyst may use a number of different valuation methods. These methods include the following:



1. The present value of the incremental income related to the contract
2. The present value of the differential income related to the contract
3. The present value of the excess (or residual) income related to the contract
4. The present value of the profit split income related to the contract
5. The present value of the residual profit split income related to the contract

In the application of any of these income approach methods, the analyst considers the following:

1. The income (however measured) that can be directly associated with the contract intangible asset
2. The income that is expected to be earned over the contract intangible asset's RUL

Another common income approach method is for the analyst to compare the value of the owner/operator business with the contract in place to the value of the owner/operator business without the contract in place.

The difference between the two business value estimates (which should equal the present value of the contract-related income) provides an indication of the contract intangible asset value.

## FACTORS TO CONSIDER IN THE CONTRACT VALUATION

Exhibit 1 presents some of the factors that the analyst typically considers in the contract intangible asset valuation.

## Exhibit 1 Factors Commonly Considered in the Contract Intangible Asset Valuation

1. The degree of legal enforceability of the contract or agreement
2. The state law under which the contract is binding
3. The specific terms of the agreement, including the rights, duties, and obligations of each of the parties
4. The expected amount of time required to negotiate a new contract (or to obtain a new license or permit)
5. The degree to which the contract is transferable
6. The degree to which the contract is assignable
7. The party's ability to create or support subcontractors or sublicenses
8. The legal term of the agreement (the contract start date and termination date)
9. The provisions (if any) for a renewal or extension of the agreement
10. The schedule of any payments associated with the contract
11. Whether the determination of contract payments is fixed or variable
12. Does the contract specify that it contains all of the agreements between the parties?
13. Does the contract refer to (and does it depend on) any other contract or agreement between the parties?
14. Is this type of contract between the parties common or unique? (Do all company customers, suppliers, or employees have similar contracts?)
15. Has the contract or agreement ever been tested in court?
16. Does the contract mention (or quantify) liquidation damages?
17. Does the contract describe what happens in the case of a contract dispute (mediation, arbitration, and litigation)?
18. What is the degree of standardization (for example, a standard real estate lease) or uniqueness (a celebrity performance agreement) of the contract?
19. How comparable is the contract to other contracts (of the parties or in the industry)?
20. What did the parties do before the contract? What would the parties do without the contract?

### INTERNAL AND EXTERNAL DATA SOURCES

Most of the documents and data sources that the analyst may rely on in the contract valuation are internal to the intangible asset owner/operator.

#### Internal Data Sources

Generally, those internal data sources include the following:

1. A copy of the subject contract, permit, or license
2. Information about the direct and indirect costs to negotiate the contract or apply for the license
3. The amount and duration of time required to negotiate the contract or apply for the license
4. Historical financial statements for a reasonable time period before the agreement was in place

5. Historical financial statements for the time period since the agreement has been in place
6. Prospective financial statements for the RUL of the contract or agreement
7. Pro forma financial statements that would represent the expected results of the owner/operator without the contract or agreement
8. Pro forma financial statements that would represent the expected results of the owner/operator with a damaged contract or agreement
9. Data regarding any owner/operator revenue, expense, or investment metrics that can be directly associated with the contract or agreement, including the following:
  - Fixed revenue, expense, or investment metrics
  - Variable revenue, expense, or investment metrics

- Total revenue, expense, or investment metrics
10. Information about the owner/operator's historical (and planned, if available) renewals of the contract, license, or permit

## External Data Sources

Some of the documents and data that the analyst may rely on in the contract valuation may come from external sources; that is, these data may relate to selected guideline companies, selected contract license or transfer transactions, or selected owner/operator industry sources.

The general categories of these external data sources include the following:

1. Guideline publicly traded company financial statements (typically SEC filings) for the time period
  - before the valuation date,
  - during the damages period, or
  - before the transfer price calculation date.
2. Sales of guideline licenses, permits, or franchises
  - between the private issuer and private parties (new agreements),
  - between a government agency and private parties (new agreement), or
  - between private parties (seasoned agreements).
3. Licenses of guideline licenses, permits, or franchises
  - between the private issuer and private parties (new agreements),
  - between a government agency and private parties (new agreement), or
  - between private parties (seasoned agreements).
4. Information from government agencies or regulatory authorities about
  - the expected (or actual) costs of a license/permit application and
  - the expected (or actual) time period of a license/permit application.
5. Owner/operator industry data regarding
  - revenue or profit growth rates,
  - cost and expense ratios,
  - profit margins,
  - returns on investment,



- required levels of investment, and
- average costs of capital.

If such data are available, the analyst may rely on the following data from the contract counterparty:

1. Revenue or profit growth rates
2. Cost and expense ratios
3. Profit margins
4. Returns on investment
5. Required levels of investment
6. Costs of capital

## CONTRACT VALUATION ILLUSTRATIVE EXAMPLE

This discussion section presents the facts of the illustrative contract valuation, the contract valuation analysis, and the contract value conclusion.

### The Illustrative Analysis Fact Set

The analyst is retained to estimate the fair value of the assets of Taxpayer Corporation (“Taxpayer”) as of May 2, 2013. One of the Taxpayer assets is an employment agreement that includes a noncompete covenant with Fred Founder (“Fred”).

Fred is one of the founders of this closely held taxpayer company, and he is a key employee of the company. Taxpayer designs and manufactures customized furniture.

Fred has important relationships with the Taxpayer customers, suppliers, and employees. According to his employment agreement, Fred may not compete against Taxpayer in the furniture design and manufacture industry for 10 years after his last date of employment.

## The Illustrative Valuation Methodology

The analyst decided to use the income approach and the comparative business enterprise value method to estimate the value of the noncompete agreement. The analyst decided to use the discounted cash flow (DCF) method to value the Taxpayer business enterprise. Using this business valuation method, the analyst compared the following two scenarios:

1. Scenario 1: the value of the Taxpayer business with the subject contract in place and without competition from Fred
2. Scenario 2: the value of the Taxpayer business without the contract in place and with the expected amount of competition from a noncontractually obligated Fred

## The Contract Valuation Analysis

The analyst discussed with management the expected impact on the Taxpayer revenue if Fred were to compete against the company. The analyst concluded that it would take minimal time (two weeks) for Fred to:

1. develop competing products,
2. acquire the necessary tooling to manufacture the products (or to have the product manufactured),
3. ramp-up production of the competing products,
4. re-establish customer relationships, and
5. begin selling the products into the market.

As a result, the analyst estimated that, absent the noncompete agreement, Fred could effectively start to compete with Taxpayer almost immediately.

The analyst considered the age, health, financial resources, and geographic reach of Fred. The analyst estimated that if Fred were to compete, his competition could reduce the projected Taxpayer revenue by approximately 50 percent.

In addition, based on discussions with management, the analyst estimated that there was a material probability that Fred would compete if he was not contractually prohibited from doing so. In consultation with management, the analyst estimated this probability at 75 percent.

The analyst also estimated that if Fred competed against Taxpayer, the company would experience employee turnover. That employee turnover would result in an increase in operating expenses in year one due to an increase in employee recruiting and training expense.

This expense would increase because current employees would be expected to leave the company and work for Fred.

These two sets of projection variables (that is, a 75 percent probability that Taxpayer would experience a 50 percent reduction in revenue) result in a reduction in the revenue in year one of the projection period of approximately 30 percent (compared to the revenue reported for the prior year).

Exhibit 2 presents management's projected income statements and cash flow for the fiscal years ended December 31, 2013, through December 31, 2022. These projections are based on the premise that the noncompete agreement is in place.

The projected operating income, depreciation expense, capital expenditures, and net working capital requirements were provided by management.

Taxpayer will continue to generate cash flow beyond fiscal 2022. In order to capture the value represented by the cash flow generated beyond 2022, the analyst's DCF valuation incorporates a terminal value.

The analyst estimated the terminal value using the Gordon growth model. That terminal value model is based on the premise that, after the discrete projection period, the net cash flow will increase at a constant rate of 2 percent per year into perpetuity.

As presented in Exhibit 2, the value of the Taxpayer business enterprise (that is, the total invested capital) under the scenario 1 analysis is approximately \$28.6 million.

## CONTRACT VALUATION SYNTHESIS AND CONCLUSION

Exhibit 3 presents the analyst's adjustments to management's projected income statements and net cash flow under the premise that Fred's covenant is not in place.

In the scenario 2 analysis, the projected revenue was based on:

1. the revenue that Fred would divert from Taxpayer,
2. the probability of Fred competing against Taxpayer (75 percent), and
3. the fact that if Fred were to compete, he could likely reduce the projected revenue by approximately 50 percent.

As presented in Exhibit 3, the value of the Taxpayer business enterprise (that is, the total

## Exhibit 2 Taxpayer Corporation Business Enterprise Value Scenario I: With the Noncompete Covenant in Place As of May 2, 2013

	Projected Fiscal Year Ended December 31,									
	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
	\$000	\$000	\$000	\$000	\$000	\$000	\$000	\$000	\$000	\$000
Discrete Projection Period Net Cash Flow (NCF):										
Net Revenue	33,841	38,071	41,878	46,066	50,673	54,220	58,015	62,076	6,422	71,071
Cost of Sales	23,350	26,524	29,453	32,707	36,317	39,038	41,771	44,695	47,824	51,171
Gross Profit	10,491	11,547	12,425	13,359	14,356	15,182	16,244	17,381	18,598	19,900
Operating Expenses	6,364	6,990	7,621	8,311	9,068	9,664	10,299	10,978	11,702	12,476
Operating Income	4,127	4,557	4,804	5,048	5,288	5,518	5,945	6,403	6,896	7,424
Other Expenses	(2,994)	(4,021)	(3,937)	(3,892)	(3,810)	(3,627)	(3,479)	(3,317)	(3,271)	(3,350)
Pretax Income	1,134	536	831	1,156	1,478	1,891	2,466	3,086	3,625	4,074
Income Taxes	452	214	332	461	590	754	984	1,231	1,446	1,625
Net Income	682	322	499	695	888	1,137	1,482	1,855	2,179	2,449
Net Operating Income	1,485	1,056	1,159	1,257	1,343	1,476	1,693	1,927	2,179	2,449
Calculation of NCF:										
Less: Capital Expenditures	(254)	(286)	(314)	(345)	(380)	(271)	(290)	(310)	(332)	(355)
Plus: Depreciation and Amortization Expense	1,167	2,280	2,315	2,349	2,382	2,402	2,410	2,424	2,441	2,461
Less: (Increase) Decrease in Net Working Capital	1,034	(847)	133	151	168	124	116	124	132	142
<b>Net Cash Flow</b>	3,433	2,203	3,293	3,412	3,513	3,731	3,929	4,165	4,420	4,697
Adjustment Factor (a)	0.67	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Adjusted NCF	2,300	2,203	3,293	3,412	3,513	3,731	3,929	4,165	4,420	4,697
Present Value Factor @ 15% (b)	0.9543	0.8491	0.7384	0.6421	0.5583	0.4855	0.4222	0.3671	0.3192	0.2776
Present Value of NCF	2,195	1,871	2,431	2,191	1,962	1,811	1,659	1,529	1,411	1,304
Present Value of Discrete Period NCF	<u>18,364</u>									

### Conclusion of Business Enterprise Value with the Noncompete Covenant:

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Present Value of Discrete Period NCF	\$ 18,364
Present Value of Terminal Period NCF	10,230
Business Enterprise Value with the Noncompete Covenant in Place	<u>\$ 28,594</u>

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Present Value of Terminal Period NCF:	
2023 NCF (c)	\$ 4,791
Direct Capitalization Rate (d)	13%
Terminal Value	36,853
Present Value Factor	0.2776
Present Value of Terminal Period NCF	<u>\$ 10,230</u>

Footnotes:

- [a] Reflects a valuation date of May 2, 2013.
- [b] Calculated as if NCF received at midyear.
- [c] Based on a NCF expected long-term growth rate of 2%.
- [d] Equals the 15% discount rate minus the 2% expected long-term growth rate.

**Exhibit 3, Page 1**  
**Taxpayer Corporation**  
**Business Enterprise Value**  
**Scenario II: Without the Noncompete Covenant in Place**  
**As of May 2, 2013**

	Projected Fiscal Years Ended December 31,				
	2013	2014	2015	2016	2017
Discrete Projection Period Net Cash Flow (NCF) [a]	\$000	\$000	\$000	\$000	\$000
Total Revenue [b]	33,841	38,071	41,878	46,066	30,673
Revenue Adjustment if Competition [c]	50%	50%	50%	50%	50%
Probability of Effectively Competing	75%	75%	75%	75%	75%
Adjusted Revenue [d]	21,151	23,794	26,174	28,791	31,671
Cost of Sales	14,594	16,578	18,408	20,442	22,698
Gross Profit	6,557	7,217	7,766	8,349	8,973
Operating Expenses [e]	4,478	4,369	4,763	5,194	5,668
Operating Income	2,079	2,848	3,003	3,155	3,305
Other Expenses	(2,372)	(2,967)	(2,891)	(2,779)	(2,661)
Pretax Income [h]	(292)	(119)	112	376	644
Income Taxes	(116)	(47)	45	150	257
Net Income	(176)	(71)	67	226	387
Debt-Free Net Income	628	664	728	769	843
Calculation of NCF:					
Less: Capital Expenditures	(159)	(179)	(196)	(216)	(238)
Plus: Depreciation and Amortization Expense	729	1,425	1,447	1,468	1,489
Less: (Increase) Decrease in Net Working Capital	646	(529)	83	94	105
<b>Net Cash Flow:</b>	1,845	1,380	2,062	2,136	2,199
Adjustment Factor [f]	0.67	1.00	1.00	1.00	1.00
Adjusted NCF	1,236	1,380	2,062	2,136	2,199
Present Value Factor @ 15% [g]	0.9543	0.8491	0.7384	0.6421	0.5583
Present Value of NCF	1,179	1,172	1,522	1,371	1,228
Present Value of Discrete Projection Period NCF	<u>11,301</u>				
Present Value of Terminal Period NCF:					
2023 NCF [i]	\$ 2,998				
Direct Capitalization Rate [j]	13%				
Terminal Value	23,060				
Present Value Factor	0.2776				
Present Value of Terminal Period NCF	\$ 6,401				
Indicated Fair Value of the Noncompete Covenant:					
Present Value of Discrete Period NCF					\$ 11,301
Present Value of Terminal Period NCF					6,401
Business Enterprise Value without the Noncompete Covenant in Place					17,702
Business Enterprise Value with Noncompete Covenant					\$ 28,594
Less: Business Enterprise Value without Noncompete Covenant					17,702
Equals: Preliminary Value of Noncompete Covenant					10,892
Tax Amortization Benefit Adjustment [k]					1.20
Fair Value of the Noncompete Covenant					\$ 13,069
Fair Value of the Noncompete Covenant (rounded)					\$ 13,100

Footnotes:

- [a] Reflects a valuation date of May 2, 2013.
- [b] Based on management projections.
- [c] Based on the projection that if Fred were to compete, he would be able to capture 50 percent of the Taxpayer business.
- [d] Calculated as: total revenue minus (total revenue × revenue adjustment if Fred competes × probability of effectively competing).
- [e] Operating expenses in fiscal year 2013 are estimated to increase by \$500,000 due to an increase in recruiting and training workforce costs; this increase assumes that some current employees may leave to work with Fred.
- [f] Reflects a valuation date of May 2, 2013.
- [g] Calculated as if NCF received at midyear.
- [h] Based on the same margin as in Exhibit 2, except for interest expense margin, interest income margin, and income tax margin. Interest expense and interest income is the same as the projections in Exhibit 2. Income tax is calculated as pretax income × 40 percent income tax rate.
- [i] Based on an NCF expected long-term growth rate of 2%.
- [j] Equals the 15% discount rate minus the 2% expected long-term growth rate.
- [k] Based on a 15-year statutory amortization period, a 40 percent income tax, and a 15 percent discount rate.



**Exhibit 3, Page 2**  
**Taxpayer Corporation**  
**Business Enterprise Value**  
**Scenario II: Without the Noncompete Covenant in Place**  
**As of May 2, 2013**

Discrete Projection Period Net Cash Flow (NCF) [a]	Projected Fiscal Years Ended December 31,				
	2018	2019	2020	2021	2022
	\$000	\$000	\$000	\$000	\$000
Total Revenue [b]	54,220	58,015	62,076	66,422	71,071
Revenue Adjustment if Competition [c]	50%	50%	50%	50%	50%
Probability of Effectively Competing	75%	75%	75%	75%	75%
Adjusted Revenue [d]	33,888	36,259	38,798	41,514	44,419
Cost of Sales	24,399	26,107	27,934	29,890	31,982
Gross Profit	9,489	10,153	10,863	11,624	12,438
Operating Expenses [e]	6,040	6,437	6,861	7,314	7,798
Operating Income	3,449	3,716	4,002	4,310	4,640
Other Expenses	(2,474)	(2,302)	(2,114)	(2,040)	(2,089)
Pretax Income [h]	975	1,414	1,888	2,270	2,551
Income Taxes	389	564	753	905	1,017
Net Income	586	850	1,136	1,365	1,534
Debt-Free Net Income	925	1,062	1,208	1,365	1,534
Calculation of NCF:					
Less: Capital Expenditures	(169)	(181)	(194)	(208)	(222)
Plus: Depreciation and Amortization Expense	1,501	1,506	1,515	1,526	1,538
Less: (Increase) Decrease in Net Working Capital	78	73	78	83	89
<b>Net Cash Flow:</b>	2,335	2,459	2,607	2,766	2,939
Adjustment Factor [f]	1.00	1.00	1.00	1.00	1.00
Adjusted NCF	2,335	2,459	2,607	2,766	2,939
Present Value Factor @ 15% [g]	0.4855	0.4222	0.3671	0.3192	0.2776
Present Value of NCF	1,134	1,038	957	883	816

Footnotes:

[a] Reflects a valuation date of May 2, 2013.

[b] Based on management projections.

[c] Based on the projection that if Fred were to compete, he would be able to capture 50 percent of the Taxpayer business.

[d] Calculated as: total revenue minus (total revenue × revenue adjustment if Fred competes × probability of effectively competing).

[e] Operating expenses in fiscal year 2013 are estimated to increase by \$500,000 due to an increase in recruiting and training workforce costs; this increase assumes that some current employees may leave to work with Fred.

[f] Reflects a valuation date of May 2, 2013.

[g] Calculated as if NCF received at midyear.

[h] Based on the same margin as in Exhibit 2, except for interest expense margin, interest income margin, and income tax margin. Interest expense and interest income is the same as the projections in Exhibit 2. Income tax is calculated as pretax income × 40 percent income tax rate.

invested capital) under the scenario 2 analysis is approximately \$17.7 million.

## Contract Intangible Asset Value Conclusion

Based on the difference in the business value indications calculated under each scenario, and after consideration of the tax amortization benefit (TAB) adjustment factor, the fair value of Fred's noncompete covenant is approximately \$13.1 million.

The TAB factor results from the present value of the federal income tax deductions related to the amortization of the noncompete covenant value (that is, as an Internal Revenue Code Section 197 intangible asset) over a statutory 15-year period.

Accordingly, the value of Fred's noncompete covenant, as of May 2, 2013, is \$13.1 million.

## SUMMARY

The value of contract intangible assets is often an issue in income tax, gift and estate tax, and property tax matters. These contract valuation analyses arise in the contexts of tax planning, tax compliance, and tax controversy.

This discussion summarized the procedures related to the valuation of contract-related intangible assets. This category of intangible assets includes the following:

1. Contracts
2. Agreements
3. License
4. Permits
5. Leases

This discussion explained some of the attributes that are typically present in a contract intangible asset.

This discussion presented:

1. the most common contract valuation methods,
2. the factors that analysts typically consider in the contact analysis, and
3. an illustrative example of a contract valuation (that is, the valuation of an executive's noncompete agreement).

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