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Valuation and Extraction of  
Intangible Assets from a  
Legal and Valuation  
Perspective

**John C. Ramirez, ASA**

Vice President  
Willamette Management Associates  
Portland, Oregon, 97204  
[jcramirez@Willamette.com](mailto:jcramirez@Willamette.com)

**David J. Crapo, Esq.**

Partner  
Crapo | Deeds PLLC  
Bountiful, Utah 84010  
[djcrapo@crapodeeds.com](mailto:djcrapo@crapodeeds.com)

# John C. Ramirez, ASA

John Ramirez is a vice president and the practice leader of property tax valuation services at Willamette Management Associates. Willamette Management Associates provides business valuation, forensic analysis, and financial opinion services for transaction, financing, taxation, bankruptcy, litigation, and planning purposes.

John is an accredited senior appraiser (“ASA”) of the American Society of Appraisers, accredited in business valuation. John specializes in unit principle valuations, capitalization rate studies, functional and economic obsolescence analyses, and intangible asset valuations.

John has authored or co-authored numerous valuation journal articles including the following:

- *Extracting Relevant Pricing Data from Market-based Evidence* (Journal of Multistate Taxation and Incentives)
- *The Use and Misuse of Transaction Data in Valuations Prepared for Property Tax Purposes* (Journal of Property Tax Assessment & Administration)
- *The Property Tax Implications of Lease Accounting GAAP Changes* (Journal of Multistate Taxation and Incentives)
- *The Relevance of Fair Value Measurements for Property Tax Purposes* (Journal of Multistate Taxation and Incentives)

## David J. Crapo, Esq.

David Crapo is a partner in the Utah law firm of Crapo|Deeds PLLC. David and the state and local tax attorneys at Crapo|Deeds are nationally recognized for their tax and litigation expertise on complex valuation cases for communications, energy, transportation and other clients.

David graduated from the Brigham Young University Law School and clerked for the Federal 10<sup>th</sup> Circuit Court of Appeals. David has tried hundreds of valuation cases throughout the United States appearing before administrative boards, state tax commissions and district and appellate courts.

# Presentation Summary

- An area of significant controversy in the application of unit principle valuation is the identification and extraction of intangible asset value.
- Disputes often result from differences in:
  - Legal interpretation
  - Appraisal approaches, definitions, and practices
- This discussion will focus on:
  - legal and valuation definitions of intangible assets,
  - legal precedent and areas of continuing controversy involving the extraction of intangible assets from unit valuations, and
  - generally accepted appraisal methods used to identify and extract intangible asset value from unit valuations.

**How did the concept of imposing or exempting  
Intangible Assets from property tax originate?**

# HISTORICAL BACKGROUND

*1620 - Mayflower Compact – tax on land and products of the harvest to pay for education, security and the church.*



# HISTORICAL BACKGROUND

*1788 - The founding fathers debated a national property tax but could not come to an agreement. Article I, Section 2:*

*“Representatives and direct Taxes shall be apportioned among the several States which may be included within this Union, according to their respective Numbers . . .”*



# HISTORICAL BACKGROUND

*1796 - 14 of the 15 states taxed land. Only 4 states taxed inventory (stock in trade)*

*Some states taxed the land based on quantity and others on quality (value).*





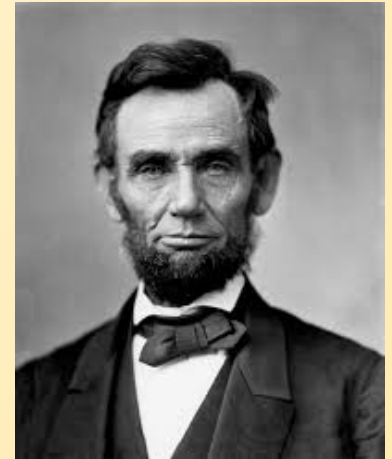
# HISTORICAL BACKGROUND

1850-1860 – Abraham Lincoln was a property tax lawyer:

\* People v. Illinois Central Railroad. “the most experienced and intelligent railroad men in the west, were fully examined on all elements of value.” The state should not evaluate property at its “prospective value” but rather at the “value at the time of taxation or assessment.”

\* Illinois Central Railroad v. McLean County. A railroad under construction should not be valued as a fully completed railroad but only as it existed as half constructed.

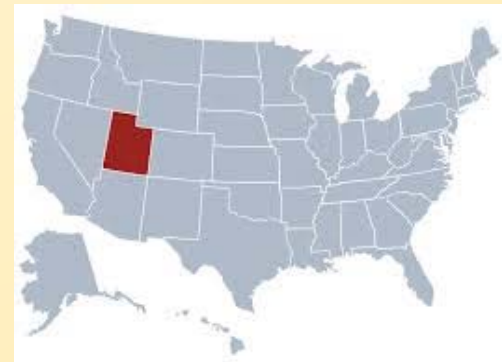
\* Ferry boat that was not in the assessment jurisdiction on the lien date could not be assessed.



## HISTORICAL BACKGROUND

*After the Civil War intangible properties and stock started to take on greater value. However, it was difficult for taxing authorities to locate these assets and tax them. States started to look to income and sales taxes as alternatives to try and capture tax on these assets:*

*“If any intangible property is taxed under the property tax, the income from that property tax may not also be taxed.” Utah Const. art. XIII, sec. 2 (5).*



# HISTORICAL BACKGROUND

*Adams Express Company v. Ohio State Auditor*, 165 U.S. 194 (Feb. 1, 1897).

“the unit is a unit of use and management, and the horses, wagons, safes, pouches and furniture, the contracts for transportation facilities, and the capital necessary to carry on the business, whether represented in tangible or intangible property, in Ohio, possessed a value in combination . . . which could as rightfully be recognized in the assessment for taxation in the instance of these companies as the others.”



# HISTORICAL BACKGROUND

*Adams Express Co. v. Ohio State Auditor*, 166 U.S. 185 (Mar. 15, 1897)

A distinction must be noticed between the construction of a state law and the power of a state. If a statute, properly construed, contemplates only the taxation of horses and wagons, then those belonging to an express company can be taxed at no higher value than those belonging to a farmer. But, if the state comprehends all property in its scheme of taxation, then the good will of an organized and established industry must be recognized as a thing of value. The capital stock of a corporation and the shares in a joint-stock company represent not only the tangible property, but also the intangible, including therein all corporate franchises and all contracts, privileges, and good will of the concern.

Value of Adams Express	\$16,000,000
Value of Tangible Properties	\$4,000,000
Value of Intangible Properties	\$12,000,000

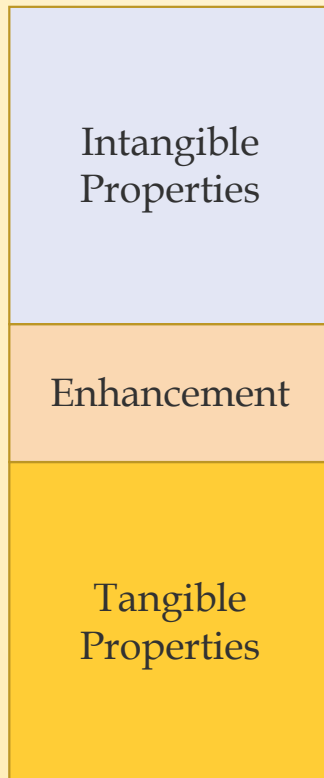
## **Sales Price**

- **Less: Current Assets (cash, receivables)**
  - **Less: Other Intangible Properties  
(Copyrights, software, trademarks)**
  - **Less: Tangible Real and Personal  
Properties**
- 

**Equals: Goodwill (and other unidentified  
Intangible Properties)**

“the Commission finds that the residual method is an appropriate approach to valuing goodwill.”

*WilTel, Inc. v. Property Tax Division*, Appeal Nos. 95-0789 and 95-0824 (Utah State Tax Comm. 1997).

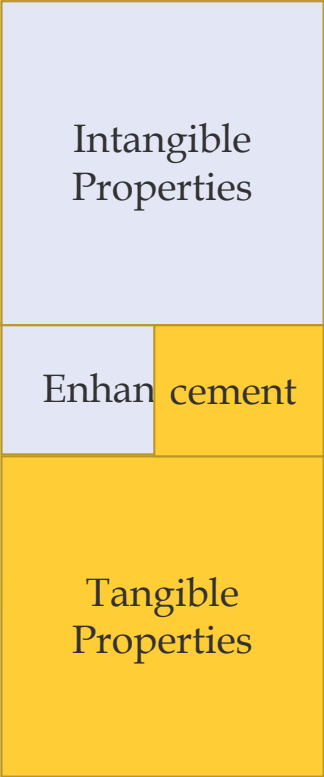


“Enhanced value is, in essence, part of the market value of the tangible personal property in place and operating as a unit.”

*WilTel, Inc. v. Property Tax Division*, Appeal Nos. 95-0789 and 95-0824 (Utah State Tax Comm. 1997).

“the statutory and constitutional fair market value requirements recognize some element of value that is not attributable to either intangibles or simple cost (of tangible property) and that this enhanced value is taxable.”

*Beaver County, et. al. v. WilTel, Inc.*, 2000 UT 29



## HISTORICAL BACKGROUND

*1997 – “Property means property that which is subject to assessment and taxation according to its value, but does not include moneys, credits, bonds, stocks, representative property, franchises, goodwill, copyrights, patents, or other intangibles.” Utah Code Ann. 59-2-102(20) (1997).*





# HISTORICAL BACKGROUND

*1997 – “All intangible elements of a going concern, including goodwill, can theoretically be separately valued, and they are exempt from property tax.”*

*WilTel, Inc. v. Property Tax Division, Appeal Nos. 95-0789 and 95-0824 (Dec. 26, 1997).*



# HISTORICAL BACKGROUND

*“The Commission concludes that ‘other intangibles’ includes but may not be limited to the following:*

1. *Money at interest, bonds, claims, . . .*
2. *All shares of stock in corporations, . . .*
3. *Media constituting business records, electronic files, . . .*
4. *Goodwill.*
5. *Business enterprise value.*
6. *Customer lists.*
7. *Contracts and contract rights, including, but not limited to, favorable leases, . . .*
8. *Intellectual property, including, but not limited to, patents, brands, trademarks, copyrights, . . .*
9. *Assembled workforce.*
10. *Franchises.*
11. *Publishing rights.*
12. *Licenses, including, but not limited to, any licenses issued by the Federal Communications Commission, . . .*

*WilTel, Inc. v. Property Tax Division, Appeal Nos. 95-0789 and 95-0824 (April 21, 1997).*

# HISTORICAL BACKGROUND

*1998 – Intangible property is defined as “property that is capable of private ownership separate from tangible property; and includes (i) money; (ii) credits; (iii) bonds; (iv) stocks; (v) representative property; (vi) franchises; (vii) licenses; (viii) trade names; (ix) copyrights; and (x) patents.*

*Utah Code Ann. 59-2-102(17) (1998).*



## HISTORICAL BACKGROUND

*2011 – “Goodwill is not intangible property as that term is defined in the 1998 Act. . . . We must therefore determine whether goodwill is intangible property under the Utah Constitution and, if so, whether the Legislature elected to tax the income from such goodwill.”*

*T-Mobile USA, Inc. v. Utah State Tax Comm.*, 2011 UT 28.

# HISTORICAL BACKGROUND

*“goodwill is generally defined as ‘[a] business’s reputation, patronage, and other intangible assets that are considered when appraising the business.’ Black’s Law Dictionary 715 (8<sup>th</sup> ed. 2004). . . . We therefore conclude that goodwill constitutes intangible property.”*

*T-Mobile USA, Inc. v. Utah State Tax Comm.*, 2011 UT 28.

# HISTORICAL BACKGROUND

*Computer software was found to be intangible property that should be removed from the unitary valuation. Assembled work force was found to not fit the statutory definition of being capable of separate ownership and the court did not allow it to be deducted as an intangible property.*

*Union Pacific Rail Road v. Utah State Tax Comm., Case No. 0907008730, Memorandum Decision and Order (Utah 2<sup>nd</sup> Dist. Ct. 2013).*

# Identifying Intangible Assets

# Discussion Objectives

- Define the term “intangible asset”
- Identify common examples of intangible assets
- Identify unit valuation approaches and methods that may include intangible asset value
- Recognize the generally accepted intangible asset valuation approaches
- Recognize the common methods used to extract intangible asset value from unit valuations



# What is an Intangible Asset?

- Intangible means something that lacks physical substance
- For an intangible asset, “intangible” means that the economic benefit of the asset does not come from its physical substance
- Intangible asset value is based on the rights and privileges to which it entitles the owner/operator

# Intangible Asset Attributes

- Intangible assets should have the following attributes:
  - Subject to specific identification and description
  - Subject to legal existence and protection
  - Subject to the rights of private ownership
  - Some tangible evidence or manifestation of existence
  - Created or comes into existence as the result of an identifiable event or at an identifiable time
  - Subject to being destroyed or terminated as the result of an identifiable event or at an identifiable time
  - Associated with a specific bundle of legal rights

# Intangible Asset Definitions

- *The Appraisal of Real Estate, 14<sup>th</sup> Edition:*

## Intangible Assets

Those assets that are not tangible real property, tangible personal property, or financial assets.

- FASB ASC 805-30-20 Glossary:

## Intangible Assets

Assets (not including financial assets) that lack physical substance. (For GAAP purposes, the term intangible assets refers to intangible assets other than goodwill.)

# Intangible Asset Recognition Considerations

- FASB ASC 805-30-20 Glossary:

## Identifiable Intangible Assets

The acquirer recognizes separately from goodwill the identifiable intangible assets acquired in a business combination. An intangible asset is identifiable if it meets either (1) the separability criterion or (2) the contractual-legal criterion described in the definition of “identifiable.”

# Intangible Asset Recognition Considerations

- FASB ASC 805-30-20 Glossary: Identifiable
- An asset is identifiable if it meets either of the following criteria:
  1. It is separable, that is, capable of being separated or divided from the entity and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, identifiable assets, or liability, regardless of whether the entity intends to do so.
  2. It arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

# What is Not an Intangible Asset?

- There are intangible attributes or intangible influences that may affect the value of intangible assets
- These attributes or influences are not assets, examples include:
  1. High market share
  2. High profitability or profit margin
  3. Lack of regulation
  4. A regulated (or protected) position
  5. Monopoly position
  6. Market potential
  7. Breadth of customer appeal
  8. Mystique
  9. Heritage
  10. Uniqueness
  14. Positive image
  15. First to market
  16. Technological superiority
  17. Consumer confidence or trustworthiness
  18. Creativity
  19. High growth rate
  20. Synergies
  21. Economies of scale
  22. Efficiencies
  23. Longevity

# Examples of Intangible Assets

FASB ASC 805 Examples Include:

## Marketing-related intangible assets

- Trademarks, trade names
- Service marks, collective marks, certification marks
- Trade dress (unique color, shape, or package design)
- Newspaper mastheads
- Internet domain names
- Noncompetition agreements

# Examples of Intangible Assets

FASB ASC 805 Examples Include:

## Customer-related intangible assets

- Customer lists
- Order or production backlogs
- Customer contracts and related customer relationships
- Noncontractual customer relationships



# Examples of Intangible Assets

FASB ASC 805 Examples Include:

## Artistic-related intangible assets

- Plays, operas, ballets
- Books, magazines, newspapers, other literary works
- Musical works such as compositions, song lyrics, advertising jingles
- Pictures, photographs
- Video and audiovisual material, including motion pictures, music videos, television programs

# Examples of Intangible Assets

FASB ASC 805 Examples Include:

## Contract-based intangible assets

- Licensing, royalty, and standstill agreements
- Advertising, construction, management, and service or supply contracts
- Lease agreements and franchise agreements
- Construction permits
- Operating and broadcast rights
- Servicing contracts such as mortgage servicing contracts
- Employment contracts
- Use rights such as drilling, water, air, timber cutting

# Examples of Intangible Assets

FASB ASC 805 Examples Include:

## Technology-based intangible assets

- Patented technology
- Computer software and mask works
- Unpatented technology
- Databases, including title plants
- Trade secrets, such as secret formulas, processes, and recipes

# Examples of Intangible Assets

## Internal Revenue Code Section 197 Examples:

- Goodwill
- Going concern value
- Any of the following intangible items:
  - Workforce in place
  - Business books and records, operating systems, or any other information base
  - Any patent, copyright, formula, process, design, pattern, know-how, format, or other similar item
  - Any customer-based intangible
  - Any supplier-based intangible, and any other similar item

# Examples of Intangible Assets

## IRC Section 197 Examples: (cont.)

- Any license, permit, or other right granted by a governmental unit or any agency or instrumentality thereof
- Any covenant not to compete entered into in connection with an acquisition of a trade or business
- Any franchise, trademark, or trade name
- Other IRC sections (e.g., 482 and 936) include other lists of intangible assets

# **Identifying Intangible Assets in Unit Valuations**

# Intangible Asset Exemption in the Subject Taxing Jurisdiction

- Unit valuation conclusions typically include all taxpayer company operating assets – both tangible assets and intangible assets.
- Are intangible assets exempt from property taxation in your taxing jurisdiction?
  - The answer depends on the relevant statutory authority, judicial precedent, and administrative rulings
- What is an exempt intangible asset in your taxing jurisdiction?
  - The answer depends on the relevant statutory authority, judicial precedent, and administrative rulings
- Intangible assets include intangible personal property and intangible real property
- Many jurisdictions exempt some or all intangible personal property from property taxation

# Intangible Asset Property Taxation Considerations

- To the extent that such exemptions apply, they typically apply to taxpayer properties that are assessed using either
  - Summation (individual property) valuation methods or
  - Unit (collective property) valuation methods
- Does the subject unit principle property tax valuation include the value of exempt intangible assets?
  - That depends on the valuation approaches and methods used
  - That depends on the individual valuation variables selected



# Are Intangible Assets Included in the Unit Valuation Conclusion?

- Unit principle valuations may include intangible assets
  - In the income approach when
    - either operating business income (and not property rental income) is used or operating business cost of capital (WACC) components are used in the yield cap method or in the direct cap method
  - In the sales comparison approach when
    - pricing multiples are extracted from the sales of going concern businesses or pricing multiples (or direct cap rates) are extracted from public company stock market data
  - In the cost approach when
    - there is economic obsolescence and the economic obsolescence analysis does not assign a fair rate of return to the taxpayer intangible assets

# Unit Valuations of Property that may Include Intangible Assets

- Some of the types of property that may encompass intangible assets include:
  - Hospitality (e.g., hotels, restaurants)
  - Health care (e.g., nursing homes, hospitals)
  - Retail (e.g., regional shopping malls)
  - Entertainment (e.g., theatres, stadiums)
  - Sports (e.g., arenas, race tracks)
  - Service properties (e.g., CATV, marinas)
  - Utility properties (e.g., telecom, water/wastewater)
  - Transportation properties (e.g., railroads, airlines)
  - Extraction (e.g., mines)
  - Oil and gas (e.g., refineries, pipelines)

# Unit Valuations that may Include Intangible Assets

- These types of properties often sell as going-concern businesses
- It may be difficult to separate the RE and TPP rental income from the business operating income
- Unless the assessor/or taxpayer makes an effort to extract the intangible assets, unit valuations based on income approach, market approach, and (to some extent) cost approach methods will capture:
  - Real estate
  - Tangible personal property
  - Intangible assets

# Example of Intangible Asset Value included in the Market Approach Unit Valuation

- Sales comparison hypothetical fact set:
  - Subject entity is an operating utility plant
  - Subject utility plant operating EBITDA = \$1,000,000
  - 6 comparable going-concern utility plants acquired by other going-concern utility companies in past 5 years
  - Average EBITDA multiple from comparable utility plant transactions = 11 x EBITDA
  - Implied subject utility plant value = \$11,000,000
- This implied value would include both tangible asset value and intangible asset value

# Effect of Intangible Assets on Cost Approach Economic Obsolescence

- Subject property actual ROI less than market-derived required ROI = EO
- Hypothetical example fact set:
  - Subject entity is an operating utility plant
  - Subject real estate (RE) and tangible personal property (TPP) cost approach RCNLD (before economic obsolescence) = \$10,000,000
  - Identifiable intangible assets (IA) cost approach RCNLD (before economic obsolescence) = \$4,000,000
  - Market-derived required return on investment (ROI)/cost of capital = 10%

# Effect of Intangible Assets on Cost Approach Economic Obsolescence

- Simplified test for economic obsolescence – not considering intangible assets:

Required ROI = 10%

Actual ROI

$$\div \frac{\text{operating income } \$1,000,000}{\text{RE + TPP RCNLD } \$10,000,000} = \underline{10\%}$$

Income loss/economic obsolescence = 0%

Value of RE and TPP (i.e., RCNLD after EO) = \$10,000,000

# Effect of Intangible Assets on Cost Approach Economic Obsolescence

- Simplified test for economic obsolescence – considering intangible assets:

Required ROI = 10%

Actual ROI

operating income \$1,000,000

÷ RE + TPP RCNLD + IA RCNLD \$14,000,000 = 7.1%

Income loss/economic obsolescence (10%-7.1%)/10% = 29%

Value of RE and TPP (RCNLD of \$10,000,000 - 29% EO) = \$7,100,000

# When Intangible Asset Value is Included in the Unit Valuation

- Assessor/Taxpayers should
  - Determine if the unit property tax valuation includes the value of exempt intangible assets
  - Identify the exempt intangible assets
  - Value the exempt intangible assets
  - Extract the value of the exempt intangible assets from the unit property tax valuation



# Generally Accepted Intangible Asset Valuation Approaches and Methods

- Cost approach methods
  - Reproduction cost new less depreciation method
  - Replacement cost new less depreciation method
  - Trended historical cost less depreciation method
- Market approach methods
  - Relief from royalty method
  - Comparable uncontrolled transactions method
  - Comparable profit margin method
- Income approach methods
  - Differential income (with/without) method
  - Incremental income method
  - Profit split method (or residual profit split method)
  - Residual (excess) income method

# Extracting Intangible Assets

# Intangible Asset Extraction Methods

- There are two common methods used to extract intangible asset values from unit valuations
  - Direct subtraction method
  - Transfer price (income allocation) method

# Intangible Asset Extraction – Direct Subtraction Method

- Direct subtraction method: the concluded value of the exempt intangible assets is subtracted from the concluded unit value to result in the value of the tangible assets only.
  - From: reconciled total unit value of all operating assets (i.e., unit value derived from the income, market, and/or cost approach)
  - Subtract: value of all identifiable intangible assets
  - To equal: residual value of RE and TPP
- Direct subtraction method formula:
  - Total Unit Value (Total Unit = TA + IA)
  - - Value of intangible assets
  - = Value of tangible assets

# Intangible Asset Extraction – Transfer Price (Income Allocation) Method

- Transfer price (income allocation) method:
- Assumes an economic rent is charged to the exempt intangible assets; and that rent (or “capital charge”) is subtracted from the unit operating income
  - The intangible asset rent (or “capital charge”) is based on an arm’s-length price
  - The unit operating income is reduced by the intangible asset “rent”
  - The reduced unit operating income is included in any income approach analysis or any sales comparison approach analysis to estimate the subject property value
  - No additional adjustments are needed to extract the intangible asset value because the intangible asset-related income is already excluded from the total unit value

# Intangible Asset Extraction Example

- Let's construct a simple hypothetical example:
- The subject Taxpayer Refinery ("Refinery") total unit is assessed at \$1,000,000,000
- The assessor used several income approach methods and sales comparison approach method to reach that assessment
- Internally developed computer software is an important intangible asset at the Refinery
- Intangible assets are exempt from property taxation in the subject jurisdiction
- The taxpayer valued the Refinery computer software at \$160,000,000 using the Cost Approach - Replacement Cost New less Depreciation (RCNLD) Method
- To simplify the example, let's ignore all other exempt intangible assets

# Intangible Asset Extraction Example

## Assessor Valuation of Taxpayer Refinery Total Unit

<u>Unit Valuation Method</u>	<u>Value Indication</u>
<u>Income Approach:</u>	
Yield Capitalization Rate Method [a]	1,100,000,000
Direct Capitalization Rate Method [b]	900,000,000
<u>Sales Comparison Approach:</u>	
Direct Sales Comparison Method [c]	<u>960,000,000</u>
Valuation Synthesis and Concluded Value of Refinery Total Unit	1,000,000,000

[a] Based on present value of Refinery total net cash flow

[b] Based on direct capitalization of Refinery total net operating income

[c] Based on comparable sales of other operating refineries and market-derived income pricing multiples

# Intangible Asset Extraction Example - Direct Subtraction Analysis

Direct subtraction analysis:

\$1,000,000,000 synthesized value of Refinery total unit

minus: \$160,000,000 (RCNLD) value of Refinery computer software

equals: \$840,000,000 residual value of Refinery RE and TPP (assuming no  
other intangible assets)



# Intangible Asset Extraction Example - Transfer Price (Income Allocation) Analysis

Transfer price (income allocation) analysis:

\$160,000,000 value of Refinery computer software

×12.5% fair rate of return on Refinery computer software

\$20,000,000 annual transfer price (a.k.a. capital charge) for use of the software

- The fair return can be the taxpayer WACC or some other industry/taxpayer ROI measure
- The \$20,000,000 transfer price (or economic rent) is subtracted from the Refinery net operating income or net cash flow included in any income approach analysis or any sales comparison approach analysis
- The Refinery income is reduced by the “rent” of the software, so the Refinery unit value is reduced by the value of the software
- The taxpayer can apply the same Refinery unit valuation approaches and methods that the assessor used, but with lower income metrics

# Intangible Asset Extraction Example

## Revised Valuation of Taxpayer Refinery Total Unit Excluding Software Value

<u>Unit Valuation Method</u>	<u>Value Indication</u>
<u>Income Approach:</u>	
Yield Capitalization Rate Method [a]	950,000,000
Direct Capitalization Rate Method [b]	750,000,000
<u>Sales Comparison Approach:</u>	
Direct Sales Comparison Method [c]	<u>800,000,000</u>
Valuation Synthesis and Concluded Value of Total Unit Excluding Software Value	840,000,000

[a] Excludes net cash flow related to fair return on Refinery software

[b] Excludes net operating income related to fair return on Refinery software

[c] Excludes EBITDA related to fair return on Refinery software

# Key Points

- Intangible assets are valuable property that most business taxpayers own, such as trademarks, software, customer/supply/employee contracts, and databases.
- Many taxing jurisdictions exempt some or all intangible personal property from property taxation.
- Unit valuations based on business operating income, business discount/capitalization rates, or business sale price multiples will include the value of intangible assets.
- To extract intangible assets value from the unit value, use the direct subtraction method or the transfer price (income allocation) method.
- Or, alternatively, rely on cost approach valuation methods – and include RE and TPP only in the cost components analysis – but be careful to consider the value of intangible assets in any economic obsolescence analysis

# Questions and Discussion