No SPACE for Intangibles - Understanding How to Identify and Remove Intangibles

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Understanding How to Identify and Remove Intangibles

Discussion Overview

- Intangible assets are valuable property that most corporate taxpayers own
- For property tax purposes, most taxing jurisdictions do not tax intangible assets
- Many assessors/taxpayers fail to exclude intangible assets value from property tax assessments
- Disputes often result from differences in:
  - Legal interpretation
  - Appraisal approaches, definitions, and practices

Learning Objectives

- Define the term "intangible asset"
- Identify common examples of intangible assets
- Identify property valuation approaches and methods that may include intangible asset value
- Recognize the generally accepted intangible asset valuation approaches
- Recognize the methods used to extract intangible asset value from the total property value

The 4 Categories of Business Assets

- For valuation purposes, all business assets may be categorized into one of four categories:

1. Tangible real property – referred to as real estate
2. Tangible personal property – movable items of tangible property
3. Intangible real property – the bundle of rights associated with the ownership of real estate
4. Intangible personal property – includes general intangible assets, intellectual property, and goodwill value

Intangible Asset Definitions

- FASB ASC 805-30-20 Glossary:
  Intangible Assets
  Assets (not including financial assets) that lack physical substance. (The term intangible assets refers to intangible assets other than goodwill.)

- The Appraisal of Real Estate 14th Edition:
  Intangible Assets
  Those assets that are not tangible real property, tangible personal property, or financial assets.

What is an Intangible Asset?

- FASB Statement of Financial Accounting Concepts No. 5 provides guidance on what an asset is:
  - It must provide probable future economic benefits
  - The owner/operator must be able to receive the benefit and restrict others from access to the benefit
  - The event that provides the right to receive the benefit has occurred

What is an Intangible Asset?

- Intangible assets should have the following attributes:
  - Specific identification and description
  - Legal existence and protection
  - The rights of private ownership
  - Some tangible evidence or manifestation of existence
  - Created 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 Recognition

- 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?

Intangible attributes or influences are not intangible assets. Examples include:

1. High market share
2. High profitability
3. Lack of regulation
4. A regulated position
5. Monopoly position
6. Market potential
7. Breadth of customer appeal
8. Mystique
9. Heritage
10. Uniqueness
11. Positive image
12. First to market
13. Technological superiority
14. Consumer confidence or trustworthiness
15. Creativity
16. High growth rate
17. Synergies
18. Economies of scale
19. Efficiencies
20. 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
  - 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 of the following intangible items:
  - 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

Other Examples (cont.)

- Any of the following <u>may</u> be considered intangible items:
  - Design
  - Architecture
  - Engineering
  - Planning
  - Permitting
  - Consulting
  - Etc.

Intangible Asset Exemption

- Are intangible assets exempt from property taxation in your taxing jurisdiction?

- What is an exempt intangible asset in your taxing jurisdiction?

- Answers to both depend on the relevant law, including
  - statutory authority,
  - judicial precedent, and
  - administrative rulings

Intangible Asset Property Taxation Considerations

- If exemptions apply, they typically apply to taxpayer property assessed using either
  - Summation (individual property) valuation methods or
  - Unit (collective property) valuation methods

- Does the assessor's property valuation include the value of intangible assets?
  - That depends on the valuation approaches and methods used, and
  - on the individual valuation variables selected

Property Tax Assessment that May Include Intangible Assets

- Some of the types of property that may encompass identifiable 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, arenas)
  - Service properties (e.g., CATV, marinas)
  - Utility properties (e.g., telecom, water/wastewater)
  - Transportation properties (e.g., railroads, airlines)
  - Oil and gas (e.g., refineries, pipelines)

Property Tax Assessment that May Include Intangible Assets

- For these types of property, it may be difficult to separate the RE and TPP rental income from the business operating income
- These types of property often sell as going-concern businesses
- Unless intangible assets are extracted, property assessments based on income approach, market approach, and (to some extent) cost approach will capture:
  - Real estate, tangible personal property, and intangible asset value

Are Intangible Assets Included in the Property Tax Assessment?

Summation method and unit method property tax 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

Are Intangible Assets Included in the Property Tax Assessment?

Summation method and unit method property tax valuations may include intangible assets

- 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 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

Example of Intangible Asset Value included in the Market Approach

- Sales comparison approach hypothetical fact set:
  - Subject company is an operating utility plant
  - Subject 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

- Hypothetical example fact set
  - Subject real estate (RE) and tangible personal property (TPP) cost approach RCNLD—before EO = $10,000,000
  - Identifiable intangible assets (IA) cost approach RCNLD —before EO = $4,000,000
  - Subject property business operating income = $1,000,000
  - Required return on investment (ROI), i.e., cost of capital = 10%

Effect of Intangible Assets on Cost Approach Economic Obsolescence

- Simplified test for economic obsolescence—*without* considering intangible assets:

Required ROI = 10%

Actual ROI

operating income $1,000,000

÷ RE + TPP RCNLD $10,000,000 = 10%

Indicated economic obsolescence = 0%

Value of RE and TPP (RCNLD–after EO) = $10,000,000

Effect of Intangible Assets on Cost Approach Economic Obsolescence

- Simplified test for economic obsolescence—
  with considering intangible assets:

Required ROI = 10%

Actual ROI

operating income $1,000,000

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

Indicated economic obsol. (10%-7.1%)/10% = 29%

Value of RE and TPP (RCNLD—after EO) = $7,100,000

When Intangible Asset Value is Included in Property Assessment

- Taxpayers should
  - Determine if the assessor's property assessment includes the value of exempt intangible assets
  - Identify the exempt intangible assets
  - Value the exempt intangible assets
  - Extract the exempt intangible assets value from the proposed property tax assessment

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

Generally Accepted Intangible Asset Valuation Approaches and Methods

- Market approach methods
  - Relief from royalty method
  - Comparable uncontrolled transactions method
  - Comparable profit margin method

Generally Accepted Intangible Asset Valuation Approaches and Methods

- Income approach methods
  - Differential income (with/without) method
  - Incremental income method
  - Profit split method (or residual profit split method)
  - Residual (excess) income method

Intangible Asset Extraction Procedures

- There are two common procedures to extract intangible asset values from total operating property values:
  - Direct subtraction method
  - Transfer price (income allocation) method

Intangible Asset Extraction Procedures (cont.)

- Direct subtraction method:
  - From: reconciled total value of all operating assets (i.e., BEV derived from the income, market, and/or cost approach)
  - Subtract: value of all identifiable intangible assets
  - To equal: residual value of RE and TPP (and possibly some operating business goodwill/going concern value)

Intangible Asset Extraction Procedures (cont.)

- Direct subtraction method:

  Value of Total Assets (e.g., BEV = TA + IA)

  \- Value of intangible assets

  = Value of tangible assets

Intangible Asset Extraction Procedures (cont.)

Transfer price (income allocation) method assumes the following:

- The subject operating entity is split into two entities:
  - One entity operates the subject RE and TPP
  - One entity holds the intangible assets and licenses (and “rents”) those intangible assets (at an arm’s-length price) to the operating entity
  - The operating entity income is reduced by the intangible asset “rent”

Intangible Asset Extraction Procedures (cont.)

Transfer price (income allocation) method assumes the following:

- The reduced operating entity 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 asset value.

Final Considerations

- When a property assessment is based on:
  - Operating business income,
  - Operating business discount/capitalization rates, or
  - Operating business sale pricing multiples,
- then extract the intangible asset value by either:
  - Direct subtraction method or
  - Transfer price (income allocation) method

Final Considerations

- To avoid the intangible asset extraction issue, be sure to exclude intangible assets from the property valuation by using:
  - Property rental income only (not operating business income)
  - Property-specific discount/capitalization rates (not operating business discount/capitalization rates)
  - Sales of in-place (but not in-use) properties only (i.e., nonoperating refineries, race tracks, hotels, bowling alleys, restaurants, etc.)

Final Considerations

- Alternatively, to exclude intangible assets from the property valuation:
  - 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

Key Points

- Intangible assets are valuable property that most business taxpayers own.
- Many taxing jurisdictions exempt some or all intangible personal property from property taxation.
- Intangible asset value can be included in property assessments derived using the summation methods or unit methods. Unless the assessor/taxpayer makes an effort to exclude the intangible assets, valuation approaches will capture intangible asset values.
- To extract intangible assets from an assessment, use the direct subtraction method or the transfer price method.

Questions and Discussion