

Understanding Intangible Assets and Real Estate:

A Guide for Real Property Valuation Professionals



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BY IAAO SPECIAL COMMITTEE ON INTANGIBLES

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In most U.S. jurisdictions, assessors are responsible for estimating a market value for real property and/or personal property. Laws can vary from state to state, but for the majority of jurisdictions, intangible assets are not taxable, at least not as part of the real estate assessment. As a result, assessors must ensure their real estate assessments are free of any intangible value. Different interpretations of law and proper appraisal approaches for valuing intangibles sometimes result in disputes between taxpayers and assessors. Unfortunately, the identification and valuation of intangible assets is unsettled in the appraisal and assessment community. This guide is intended to assist assessors in understanding and addressing intangible assets in property tax valuation.

What often complicates identifying and valuing intangible assets are the many disciplines that treat intangibles differently. The accounting world is concerned with the treatment of Internal Revenue Code 26 Section 197 intangibles for proper reporting in financial statements and income tax accounting. Internal Revenue Service (IRS) rules and accepted accounting principles dictate

how *intangibles* are treated by those practitioners. Business appraisers have their own methods for estimating the value of intangible assets, and real estate appraisers and assessors must also contend with intangible assets in valuing properties that are part of a going-concern.

Complicating matters more, terms used to describe intangible assets and their valuation approaches have become confusing over time. Some terms are synonymous, such as *going-concern value* and *value of the total assets*, while others have a different meaning depending on the purpose. In this guide, terms are used based on definitions provided by *The Dictionary of Real Estate Appraisal* (Appraisal Institute 2015).

This guide is divided into five sections, a summary, references, and two appendices:

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

5. Special Topics

6. Summary

References

Appendix A. Selected Property Types and Intangible Assets

Appendix B. Glossary

1. Identifying Intangible Assets

There are numerous definitions of intangible assets. IAAO, the Appraisal Institute, the American Society of Appraisers (ASA), The Appraisal Foundation (TAF), the International Valuation Standards Council (IVSC), the IRS, the Financial Accounting Standards Board (FASB), and many other legal, accounting, or tax-related organizations have their own definitions of intangible assets. In addition, many states and jurisdictions define intangible assets in statutes and rules.

All property can be categorized into three types:

- Real property
- Tangible personal property
- Intangible property.

There is an important distinction between real property and real estate. Land and buildings (sticks and bricks) are real estate, while real property is the *bundle of rights* flowing from the ownership of real estate. Real estate and tangible personal property can be observed, while real *property rights* cannot.

There are accepted guidelines for discerning whether something should be considered real estate or personal property, and each has common tests for determining that difference. When an object is permanently affixed to land or buildings, the object is usually considered part of the real estate. If an object is not permanently affixed and is movable, it is usually considered personal property.

Intangible property has no physical substance. *The Dictionary of Real Estate Appraisal* defines intangible property as

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).

These assets derive their value from the rights inherent in their ownership. They are considered intangible because they cannot be seen or touched, yet they have the potential to possess value. The first step in addressing intangible value is to determine whether something is in fact an intangible *asset*.

The courts (In the Matter of the Appeal of Colorado Interstate Gas Co. 2003; *Hardage Hotels, LLC v. Lisa Pope* 2007), real estate texts (Reilly and Schweih 1999, 5), financial accounting standards (FASB 2016, paragraph 20, section 20), state laws (Montana Secretary of State 2015), and industry articles (Wood 1999, 8) have attempted to define intangible assets by identifying specific attributes. Identifying these attributes can assist the assessor in determining whether something intangible rises to the level of an asset. Based on these sources, a four-part test can be used to help determine the existence of an intangible asset, as follows:

1. An intangible asset should be identifiable.
2. An intangible asset should have evidence of legal ownership, that is, documents that substantiate rights.
3. An intangible asset should be capable of being separate and divisible from the real estate.
4. An intangible asset should be legally transferrable.

For an intangible asset to exist, it should be *identifiable*. In some cases, intangible value is presumed but not specifically identified. This can occur when property owners or their representatives report the presence of intangible value, but cannot specifically identify the source. An intangible asset can take many forms, but that form should be explicitly described and identified. If an intangible cannot be identified, it may not rise to the level of an asset. In some cases, goodwill may be present, usually measured as the residual value in a sale transaction involving a going-concern. Although goodwill can be somewhat nebulous, it is recognized as an intangible asset; therefore, it would meet this test. More details on goodwill are presented in Section 5, Special Topics.

An intangible asset should also possess *evidence of legal ownership*. That is true for any asset; without documentation, there are no legal rights. If property owners cannot prove legal ownership, they cannot protect their rights from theft, harm, or damages or be able to legally transfer the asset to another party. There are many documents that evidence ownership of intangible assets, such as contracts, licenses, franchise agreements, management agreements, and leases. If an intangible does not have legal documentation evidencing its legal ownership, then it probably is not an intangible asset. This test is somewhat related to the first test (being identifiable). However, without legal ownership, even an identified intangible does not rise to the level of an asset.

An intangible asset should also be capable of being *separate and divisible* from the real property. In some cases, the real property depends on the intangible asset being successful, such as a franchise agreement for a hotel or a certificate of need for a nursing home. Similarly, many intangible assets require real estate to achieve their full potential. Intangible and tangible property are

often described as being *intertwined*, such that one is dependent on the other and they are not easily separated.

In discussing whether the Southridge Mall in Greendale, Wisconsin, had any intangible value, the court noted,

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 by JMB Group Trust v. Board of Review of the Village of Greenvew 1991).

If the real estate cannot be sold without the intangible, then the intangible is probably not an asset on its own but, instead, part of the real property. For example, the Waldorf Astoria hotel in New York City may sell for a premium because of its historic significance. Some might argue this *historic premium* represents intangible value. However, the hotel cannot be sold without its historic significance in place, so the *historic significance* is not an intangible asset that can be valued separately from the real estate. Instead, it is an attribute of the real property and should be included in the assessment. The same is true for other real property attributes that are intangible in nature, such as view, proximity, prestige, appeal, and potential. All these are intangible in nature but cannot be sold without the real property, nor can the real property be sold without them. These attributes/influences can enhance the value of the real property, but they do not have a value of and to themselves. They contribute to the overall value of real property but cannot be transferred separately from it.

Goodwill is an intangible asset that is arguably inseparable from a business. It is important to note that the test of separability does not suggest that an intangible asset must be capable of being separate and divisible from the *business*.

The point of the separability test is that the intangible asset should be capable of being separate and divisible from the *real estate*. There are intangible assets, such as goodwill, that might not be easily separated from a business. But the question is whether the business (which may include goodwill) could be separated from the real estate.

An intangible asset must also be *legally transferrable*. In some cases, intangible assets can be sold separately from the real estate. For example, the owner of an ice cream store, liquor store, car wash, and the like can sell the business separately from the real estate. Many small businesses transfer this way. However, it is also common for real estate and intangible assets to transfer together. Hotels and certain other property types are often sold with both tangible and intangible assets included in the price. If an intangible cannot be legally transferred, then it is probably not an asset. That is not to say that an intangible asset must be sold separately or independently from real property to qualify as an intangible asset. It is common for certain intangible assets to be sold with real property. This transferability condition simply requires the ability of the asset to be legally transferred, with or without real property included.

The State of Montana defines intangible property in Section 15-6-218 of the Montana Code. In that definition, the code identifies two specific characteristics of intangible property: that it has no intrinsic value and that it lacks physical existence. The Montana Department of Revenue attempted to expand that definition by including four additional attributes, including the requirement that “intangible personal property must be separable from the other assets in the unit” [Admin R.M. 42.22.110 (12)]. Those additional attributes were challenged by a taxpayer in a Montana Supreme Court case in 2013 (*Gold Creek Cellular of Montana Limited Partnership v. Department of Revenue*). In that case, the court struck down the Department

of Revenue’s additional requirements because they were contradictory to state law. The court did not opine as to whether the additional attributes imposed by the Department of Revenue were valid appraisal concepts, only that they expanded and contradicted existing law. Arguably, this case illustrates the need for appraisal guidance on intangible valuation (such as this guide), so that legislatures and revenue departments do not have to define intangibles for property tax purposes.

When a property tax assessment that may contain intangibles is being reviewed, the four-part test can be applied to assist the assessor in determining whether something intangible is in fact an asset. To be an asset, the intangible item should be able to be identified, have documented ownership, be capable of being separated from the real estate, and be legally transferrable from one party to another. If an asset does not possess all four characteristics, then it is probably not an intangible asset.

There are typically two circumstances in which assessors might encounter the possibility of intangible value.

In the first instance, a property sells and intangible assets are included in the price. It is important to identify not only those assets but also their owners. Thus, the owner of a franchised hotel does not own the name licensed by the franchisor but pays a fee for its use. The sale of that property does not include rights to the franchised name. On the other hand, when Starwood Hotels and Resorts Worldwide was sold to Marriott in 2016 for \$14.41 billion, this sale also transferred ownership of the rights to the hotel names using the Starwood brands: Sheraton, Westin, Four Points by Sheraton, W Hotels, St. Regis, The Luxury Collection, Le Méridien, element, Aloft, and Tribute Portfolio. Value of the management agreement inures to the management companies, such as Interstate Hotels and Resorts, Aimbridge Hospitality, or White Lodging Services

Corporation. In short, the sale of a hotel with a franchise and management agreement in place does not include the value of those assets; however, a free-standing restaurant with a well-known nonfranchised name that sold with the real estate has the potential to include intangible assets.

In the second instance, income attributed to the business must be separated from the income attributed to the real estate in valuing the property by the income approach. This is common in the valuation of hotels, senior care facilities, or other property types in which the real estate and business are intertwined, and it is customary in appraisal practice to value the real property using the income from the going-concern.

2. Why It Is Necessary to Allocate the Value of Intangible Assets

There are many circumstances requiring intangible assets to be identified and valued separately from other assets. A company might be reporting assets in financial reports; a partner might be buying out another partner; a company might be depreciating or amortizing intangible assets on tax returns; or a divorce may require an accurate valuation and allocation of all marital assets, including a business. In certain cases, it is necessary to measure and allocate intangible value for property tax purposes. The methods for identifying and valuing intangible assets can vary depending on the purpose. In general, the reasons for

identifying and allocating intangible value can be grouped into three categories:

- Accounting purposes
- Business-related purposes
- Real estate purposes.

Accounting and Intangible Assets

Table 1 is a nonexhaustive list of potential intangible assets. This list is grouped into five major categories: marketing related, customer related, artistic related, contract based, and technology based. Most of these assets are listed in IRS Section 197, “Amortization of Goodwill and certain other intangibles.”

Most of the intangible assets listed in Table 1 are not typically encountered by assessors in real property valuations. It is unlikely that an assessor will ever have to address the impact of intangible values arising from literary works or patents. Meanwhile, it is likely an assessor will encounter a property that is sold as a *going-concern*, in which both the business and real property are included in the price. A primary reason for valuing and allocating *intangibles* is for accounting purposes. Companies purchase and own not only tangible assets such as land, buildings, and personal property, but also intangible assets such as franchises, copyrights, and trademarks. Accountants are often called upon to allocate the value of intangibles for purchase price allocation, financial reporting, income tax preparation, and supporting charitable contributions, among others. Companies

Table 1. Types of potential intangible assets

Marketing Related	Customer Related	Artistic Related	Contract Related	Technology Based
Trademarks, trade names Service marks Trade dress Newspaper mastheads Internet domain names Noncompete agreements	Customer lists Production backlog Customer contracts Customer relationships	Plays, operas, ballets Books, literary works Musical works Pictures, photographs Audio/video material	Licensing agreements Service/supply contracts Lease agreements Construction permits Franchise agreements Broadcast rights Use rights: drilling, etc. Mortgage contracts Employment contracts	Patented technology Computer software Unpatented technology Databases Trade secrets

routinely report the acquisition and presence of these intangibles on financial reports and income tax documents.

Annual reports, balance sheets, profit-and-loss statements, income tax forms, and other financial reports are the tools accountants use to report the financial condition of companies. There are standards and rules accountants use to ensure they are reporting appropriately. The FASB governs financial reporting in the United States, and the International Accounting Standards Board (IASB) sets standards outside the United States. These organizations have issued various standards relating to the valuation and allocation of intangible assets. In addition, the IRS issues rules pertaining to the treatment of intangibles for tax-reporting purposes. Congress enacted 26 U.S. Code §197 to bring “peace to the valley” after the U.S. Supreme Court decided in the *Newark Morning Ledger* case (1993) that the purchaser of the newspaper was allowed to write off paid subscribers, goodwill, and going-concern value.

Historically, accountants allocated the purchase price of a company’s assets predominantly as land, buildings, and personal property, with little regard for the value of intangibles. However, in 2001, more emphasis was given to intangible assets when the FASB issued *Statement of Financial Accounting Standard (SFAS) No. 141*, which required all U.S. companies to report the values of acquired intangible assets on their balance sheets. This standard also eliminated the *pooling of interest* method of accounting, in which the book value of the assets of the merged companies was combined. Instead, under *SFAS No. 141*, the value of acquired assets must be recorded at the fair market value at the time of the transaction, including the value of any intangible assets.

In 2007, the FASB revised *SFAS No. 141* with the issuance of *SFAS No. 141R*, codified under Accounting Standards Codification Topic 805 Business Combinations (ASC-805). ASC-805 provides

guidance when companies merge or acquire other companies or assets in the United States. The IASB issued a similar standard with *International Financial Reporting Standard 3R* (IFRS-3R), “Business Combinations: Accounting for contingent consideration in a business combination.”

The division of a sale price into its various components—land, building, personal property, and intangible assets—is called a purchase price allocation (PPA). In the United States, guidance for preparing a PPA for financial reporting is provided by the FASB. For federal income tax purposes, PPAs are prepared in accordance with Internal Revenue Code Section 1060, “Special Allocation Rules for Certain Asset Acquisitions.” Those rules require a purchase price to be allocated among seven 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, assets not falling within the other classes, including land, buildings, and furniture fixtures, and equipment (FF&E)
- Class VI, Internal Revenue Code Section 197 assets except goodwill and going-concern value
- Class VII, goodwill and going-concern value.

Land, buildings, and FF&E are reported as Class V assets. After a portion of the purchase price has been allocated to tangible assets in Classes I through V, the remainder is then allocated to intangible assets. Class VI assets are those defined in Internal Revenue Code Section 197, which includes a laundry list of intan-

gible assets including licenses, permits, franchises, trademarks, and workforce in place, among others. Goodwill and going-concern value are reported as Class VII assets.

In the accounting world, the classification and valuation of intangible assets vary depending on whether the purpose is financial reporting or tax reporting. Rules can also vary depending on whether a company is public or privately held. The classification and method for estimating and allocating intangible value for accounting purposes are rarely the same for property tax purposes.

The type of value required for financial reporting is typically fair value, as defined by the FASB. The definition of fair value is different from the definition of market value. This distinction is important because market value is typically the standard for most jurisdictions. There are some similarities in the two definitions, but they also have key differences. In particular, the concepts of an open market, reasonable time, cash or its equivalent, prevailing market conditions, and similar key concepts are not embodied in the fair value definition on which financial reporting is based.

Business-Related Purposes and Intangible Assets

Sometimes companies and business owners need to determine the value of a business or other intangible assets separately from real estate. Appraisals are often needed for the sale or purchase of a business, partner buyouts, estate settlements, divorce proceedings, litigation, and other purposes. When the focus of the assignment is the value of a business, rather than real estate value, business appraisers are typically utilized. Like real estate appraisal, these professionals have their own organizations, designations, and methods of estimating the value of a business, which often includes intangible assets. Organizations such as the Institute of Business Appraisers and the ASA

provide training, guidance, and designations, including the Certified Business Appraiser (CBA) and Accredited Senior Appraiser (ASA). Business appraisers use resources such as Pratt's Stats, operated by Business Valuation Resources, LLC, a database of business sales.

Whereas real estate appraisers are typically concerned with the value of real property, business appraisers are focused on the value of a business. The value of a business can be considered intangible value, and business appraisers have their own techniques for estimating value. A common approach is to use EBITDA (earnings before interest, taxes, depreciation, and amortization) multipliers.

Real Estate Purposes and Intangible Assets

Besides valuing intangible assets for accounting and business purposes, often the need arises to value intangibles for real estate-related purposes. These purposes can include eminent domain, real estate financing, or property tax assessments.

Eminent domain, sometimes called condemnation, is the right of government to take private property for public use. Eminent domain is not limited to real property only. The government can also acquire personal property and intangible assets as part of eminent domain proceedings. When a business is negatively affected as a result of eminent domain, compensation is based on the difference between the business's market value before and after the taking. In most cases, compensation for business-related damages is awarded only in partial takings. When government takes a whole property, rarely are damages for business losses awarded. When business damages are a factor, experts, including accountants and business appraisers, are often hired to measure that difference.

Lenders make loans on real estate, personal property, and even businesses. When a business is intertwined with the real estate, financial institutions typically

want a breakout of the collateral. For that reason, lending guidelines often include statements that instruct appraisers to allocate values when going-concern value is sought. For example, the U.S. Small Business Administration's (SBA) appraisal requirements include the following:

If the appraisal engagement letter asks the appraiser for a business enterprise or going-concern value, the appraiser must allocate separate values to the individual components of the transaction including land, building, equipment and business. When the collateral is a special purpose property, the appraiser must be experienced in the particular industry. (U.S. Small Business Administration 2009)

Similarly, the Federal Deposit Insurance Corporation (FDIC) appraisal guidelines state

Value opinions such as 'going-concern value,' 'value in use,' or a special value to a specific property user may not be used as market value for federally related transactions. An appraisal may contain separate opinions of such values so long as they are clearly identified and disclosed. (FDIC 2010)

Property tax assessments in most states require an estimate of market value of real property and, in some cases, personal property. In most jurisdictions, intangible assets are not assessed—at least not as part of the real estate. Because some property types are bought and sold with a business in place, it is necessary to analyze the price to determine whether any consideration was paid for intangible assets. In addition, certain property types are traditionally valued utilizing the income approach. In those cases, it is customary to utilize the property's income from the going-concern to determine the value of the real estate. This is true for hotels, senior care facilities, and other property types in which the revenue from the property's business services is typically included in

an estimate of potential gross income.

When real estate and businesses are intertwined, taxpayers and their representatives have challenged property tax assessments on the basis of the improper inclusion of intangible value. The methods for determining and allocating intangible value have been debated for years. Assessors do not typically have the resources to hire a business appraiser or accountant to estimate the value of intangibles independently from the real estate. As a result, they must utilize methods to ensure the value of intangible assets is excluded from real estate assessments. The following section discusses the most common methods for allocating and valuing intangible assets from the perspective of real estate appraisers and assessors.

3. Methods for Estimating or Allocating Intangible Asset Value

There are many methods for estimating and allocating the value of intangible assets, in fact, far too many to include in this guide. The reason there are so many methods is there are so many different professionals who estimate intangible value. Accountants use methods that are accepted by the FASB and the IRS. Business appraisers use methods recognized by the ASA and other organizations. Real property appraisers use methods advocated by professional appraisal organizations.

Accountants and business appraisers are often focused on the value of intangible assets completely independent of real estate. Conversely, real estate appraisers and assessors seek the value of real property independent of intangible assets. Business appraisers apply valuation methods that concentrate on the performance of the business, with no regard for real property, such as EBITDA multipliers. Real property appraisers and assessors seek methods that measure the value of the real property but exclude any intangible asset value.

Although there are many methods for directly valuing an intangible asset, such as EBITDA multipliers, the skill and knowledge necessary to apply those methods typically require a professional business appraiser. However, it is not always necessary to appraise an intangible asset to determine the value of the real property with which it is associated. There are methods for estimating the value of real property that effectively exclude the value of intangible assets. These methods are described in the following sections.

Cost Approach

Because the value of intangible assets can be explicitly excluded, the cost approach has great appeal to assessors when only the value of the real property is sought. The cost approach is very familiar to assessors and appraisers, and the data necessary to complete the approach are readily available. Physical data related to land and improvements are usually easy to obtain, and estimating construction costs can be accomplished using actual costs or data provided by cost services such as the Marshall Valuation Service. Appraisers and assessors are accustomed to estimating replacement cost, depreciation, and land value. In many cases, the courts have embraced the cost approach over the income approach when intangibles complicate the estimate of value (*Minnetonka Country Club Association v. County of Hennepin*, 2003; *Humble Oil & Refining Co. v. Borough of Englewood Cliffs* 1976; *Livingston Mall Corp. v. Livingston Township* 1996; *Redding Life Care, LLC v. Town of Redding* 1999; *GTE Florida v. Todora* 2003; *Heritage Cable Vision v. Board of Review* 1990).

For certain properties, real estate may represent a small percentage of the total value, with personal property and intangible assets being dominant. In those cases, the cost approach is undeniably the best approach, because it inherently excludes intangible value and it is the preferred method for valuing personal property.

The cost approach is often criticized because depreciation (especially functional and external obsolescence) may be difficult to estimate. Even introductory appraisal courses address the three forms of depreciation, so appraisers and assessors have been trained in their identification and measurement. The possible presence of intangibles does not necessarily increase the difficulty in estimating depreciation of the real property. It would seem somewhat contradictory that a property suffers from extreme forms of obsolescence while at the same time commanding a premium for business value.

Although the cost approach may have weaknesses, the difficulty in estimating depreciation often pales in comparison to estimating intangible value independently of real property.

Another criticism of the cost approach is that it is not always the approach that market participants use in determining sale prices. However, for many property types that include intangible assets, such as hotels and senior care facilities, buyers and sellers are most concerned with the value of the going-concern. They typically do not use the cost approach because it reflects only the value of the real property, not the going-concern value. When the goal is an estimate of the real property only, the cost approach is an effective approach. According to *The Appraisal of Real Estate*,

In its classic form, the cost approach produces an opinion of the value of the fee-simple estate (Appraisal Institute 2013).

In many cases, such as newer properties, personal property, and special-purpose properties, the cost approach is clearly the best approach to value. As with any other valuation assignment, sometimes the cost approach may not be sufficient as a stand-alone approach. However, when used in conjunction with other approaches to value, it can be an excellent cross-check, particularly when intangible assets are part of a sales comparison or income approach. The cost approach

can be used to value intangibles directly. The value of a patent can be measured by the cost of bringing that patent to fruition. Nevertheless, most assessors are not interested in valuing intangible assets directly, but prefer to exclude intangibles from an estimate of real property value.

Although the cost approach may not be ideal in every case, it is often the simplest approach for assessors and appraisers to apply. It is free of any influence from going-concern or other intangible assets. When seeking the value of the real property only, assessors and appraisers might be wise to apply a cost approach, ideally with support from the other approaches to value.

Sales Comparison Approach

Some property types sell as a going-concern, in which the price includes real estate, personal property, and an ongoing business. The late William Kinnard, Jr. observed that, “The most important question in any appraisal assignment is: market value—of what and to whom?” (Kinnard and Beron 1984). When appraisers or assessors utilize a sales comparison approach on a property type commonly sold as a going-concern (or include other intangible assets), the appraiser or assessor must first identify intangible assets that were included in the purchase, such as cash and prepaid bookings, but not intangible assets owned by others, such as the franchisor or third-party management company. If the assessor determines the price included intangible assets, he or she should determine the value of such intangible assets. This can often be accomplished by researching and verifying sales through the market survey method.

The market survey method is an approach in which the appraiser or assessor looks to the market to determine how market participants allocate intangible assets. This can be accomplished by verifying specific sales, researching public financial reports, or conducting surveys of market participants.

Verifying individual sales can assist the appraiser or assessor in determining how a buyer or seller allocated a sale price. As part of the verification process, questions should be asked concerning what was included in the price. For example, an appraiser might ask a buyer/seller/broker, “Were there any intangible assets included in the price? If so, what were they and how were they valued?” Market participants are often willing to provide this type of information and can assist the appraiser or assessor in determining whether an adjustment is warranted.

Public financial reports and accounting documents often reveal how buyers and sellers allocate prices of properties that contain intangible assets. Publicly traded companies report their acquisitions and allocations in annual reports and other financial documents. These documents are often available online and can indicate how the buyer allocated the purchase price to real estate, personal property, and intangible assets. In addition, these companies often report the type of intangible assets acquired and even the methods for calculating their value. Sale verification can reveal whether the allocations reported in financial reports were also contemplated in the pricing decision.

Helpful accounting documents include IRS Form 8594, “Asset Acquisition Statement.” Under Internal Revenue Code Section 1060, buyers and sellers must use this form to report the allocation of the purchase price when a business is purchased. If available, this form can help in determining the amount of personal property and/or intangible value included in a sale price. Appraisers or assessors should request copies of IRS Form 8594 when a taxpayer, attorney, or agent reports that a sale price includes intangible assets.

Although price allocations by real estate investment trusts (REITs) and other publicly traded companies are usually an accounting function, they can assist the appraiser or assessor in determining

adjustments to sale prices, particularly when personal property and intangible assets were included in a sale. Sometimes taxpayers or their agents argue that the allocations reported in financial reports and other documents have nothing to do with property tax and should be ignored. They suggest value attributed to real estate or intangible assets is purely an accounting function and does not necessarily reflect the true value for those components. The issue of conflicting intangible allocations came up in a case involving a Hawthorn Suites hotel (*Hilliard City Schools, Board of Education, v. Franklin County Board of Revision et al.* 2011), in which the taxpayer sought a reduction based on the value of personal property and goodwill, pointing to the amounts it had allocated in its balance sheet to those items. However, an appraisal that was prepared for the owner in conjunction with bank financing allocated different amounts. Based on these conflicting allocations, the Ohio Supreme Court rejected the tax appeal, stating,

Allocating \$800,000 to personal property conflicts with other evidence that more closely relates to the sale. The appraisal prepared for K.D.M.'s lender in December 2004 determined a value of \$3,265,000 for the realty itself and separately stated a value of \$280,000 for personal property and \$34,077 for business value. Given the other reasons for not relying on the year-end financial statement, we conclude that the existence of contrary evidence furnishes a powerful reason to reject it.

Valuation and allocation for accounting purposes may be different from, and possibly not applicable to, the value of real property in a property tax assessment scenario. But like any other valuation assignment, the more information appraisers and assessors have available, the more helpful. Although accounting documents may not prove or disprove the presence or value of intangible assets, they do represent another

piece to the puzzle that could assist the appraiser or assessor in reaching a supportable estimate of value.

Income Approach

The income approach is a common technique for valuing commercial properties. In most cases, the income utilized in this approach is based on an estimate of rent for leasable space. However, in some cases, such as for hotels and senior care properties, it is customary to value the real property using going-concern income (income attributable to all sources, to include the real property, personal property, and business) and then subtracting from the income all business- and personal-property-related expenses. When appraisers or assessors use going-concern income to value real property, the possibility of including intangible value exists. Although that possibility exists, there are techniques for ensuring any value related to the business is excluded. The best method for excluding intangible value in an income approach is the management fee method (also known as the Rushmore approach).

Management Fee Method (Rushmore Approach)

Property owners who choose to have a passive role in operations can hire a management company to oversee the business and real estate. The management fee approach is based on the premise that any intangible value arising from a going-concern can be measured by capitalizing the management fee necessary to compensate a third party to run the business. The approach is similar to another intangible value technique used by business appraisers called the relief from royalty method. If the goal is to exclude intangible value from an estimate of real property value, the management fee approach can be applied by including a going-concern management fee as an operating expense. By including this fee, the net operating income (NOI) is reduced by the amount necessary to

compensate management for running the business. Theoretically, under this method, any value arising from the management of the business has been excluded. Under the theory of substitution, no one would pay more for a business or building than the presumed cost to replace it.

As noted, for lodging properties the management fee technique is commonly called the Rushmore approach. The Rushmore approach was introduced by Stephen Rushmore, an appraiser and author of five textbooks on hotel valuation and three reference books on hotel investing. In his 1992 book on hotel valuation, Rushmore describes his approach for excluding intangible value as follows:

Deducting a management fee from the stabilized net income removes a portion of the business component from the income stream. An additional business value deduction must be made if the property benefits from a chain affiliation. This is accomplished by either increasing the management fee expense or making a separate franchise fee deduction. (Rushmore 1992)

Rushmore's assertion is that, by deducting the costs associated with intangible value and personal property from a property's operating expenses, the remaining NOI is for the real property only. Because the management fee and franchise fee cover the cost of running the business, capitalizing these costs and removing them from the total value theoretically results in the residual value of the real estate.

When owners hire a management company and pay a franchise fee to brand a property, they turn over the entire responsibility to run the business to a third party. The business benefits, and therefore the business value that is achieved by hiring a management company and/or paying a fee for a brand can be duplicated. There are many management companies and franchises that can be chosen by the owner.

The Rushmore approach also requires adjustments to exclude the value of personal property referred to as FF&E. Deducting a reserve expense and the assessed value of the personal property effectively removes FF&E from the value of the real property. Although not intangible assets, these additional adjustments are necessary to isolate the value of the real property (Rushmore 1992).

Critics of the management fee approach argue that 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. They say that cost does not equal value; hence the management fee does not reflect the value of the business. However, since the management fee is based on a percentage of revenue, the intangible value that results from the management fee approach rises and falls with the revenue achieved. If a management company succeeds at increasing revenues, the resulting intangible value increases accordingly. In other words, good management rewards the business with higher revenues and an increased intangible value. Poor management results in lower revenues and lower intangible value.

Critics also argue that including a management fee and franchise fee in an income approach removes no intangible value. The argument states that management fees are standard expenses in an income approach, often included in the appraisal of other properties such as office buildings, apartments, or retail buildings. Including them for a hotel, senior care facility, or other going-concern property does nothing to remove business value. However, these particular management fees account for the management of the business, not only the real estate.

Another criticism of the management fee approach is that simply including the management fee and franchise fee as an expense does not provide a *return*

on those intangible assets, so more needs to be deducted from NOI. However, the management company and franchise brand are not assets owned by the hotel owner. They are simply expenses incurred by the property owner to allow the property to achieve highest and best use. The presence of an expense related to intangible assets (the hotel business) does not automatically necessitate a return on that expense. For example, insurance is one of the expenses an owner incurs to operate the hotel business successfully. Does the owner of a hotel require a return on the insurance expense? Making an additional deduction for return on operating expenses has no foundation and would be improper in the valuation of a hotel.

Some practitioners argue that capitalizing the NOI in hotel appraisal or assessment results in a going-concern value. This is incorrect because any intangible value has been removed by deducting the management and franchise fees. In fact, by deducting management and franchise fees, the resulting NOI represents the income to real property only. Elgonemy articulated this point in his article, "Clarifying Misunderstandings about Intangible Assets of Hotels," in which he states,

To recap, the misunderstandings about intangible assets center round the following. First, the NOI of a hotel, especially when analyzed by active participants in the market, represents income attributable to the real and tangible personal property only; therefore, when capitalizing the NOI, the resulting amount is the market value of the land, improvements, and equipment that's owned by an investor, not the going-concern value. Second, if the intangible assets of a hotel are fully owned by a management or a franchise company, then the bundle of rights with which the ownership of the real estate is endowed does not include intangible assets of the hotel to start with. Third, if intangible assets of a hotel are not part of the bundle

of rights with which the ownership of the real estate is endowed, then the going-concern value doesn't include intangible assets.

Moreover, appraisals are requested by clients for virtually any reason, such as financings, litigations, and condemnations, etc. Appraisers should be valuing hotels the same way under any circumstances, including property tax appeals. In other words, the assets and the rights being appraised do not change just because the use of an appraisal varies. Appraisers should also value hotels the same way that investors analyze deals. (Elgonemy 2013)

Despite criticism, the Rushmore approach has been widely embraced by the courts. In 1989, the New Jersey Tax Court sided with a taxpayer's appraiser who used the Rushmore approach for excluding intangibles (*Glenpointe Assocs. v. Teaneck Township* 1989). In 1995, the Rushmore approach was used by both appraisers in a New Jersey court case involving the assessment of a Hilton hotel (*Prudential Insurance Co. v. Township of Parsippany-Troy Hills* 1995). In 1999, a Kansas court embraced the Rushmore approach in the assessment appeal of a Marriott hotel (*Marriott Corporation v. Board of Johnson County Commissioners* 1999). A 2001 Michigan Tax Tribunal accepted, with some criticism, the Rushmore method (*Grand Haven Investment, LLC v. Spring Lake Township* 2001). In 2005, the New Jersey Tax Court cited numerous cases in which the Rushmore approach was accepted in its decision in favor of the assessor in a case involving the Saddle Brook Marriott (*Chesapeake Hotel LP v. Saddle Brook Township* 2005). In 2006, the Maryland Tax Court approved the use of the Rushmore approach in the assessment challenge of a Red Roof Inn (*RRI Acquisitions Co. Inc. v. Supervisor of Assessments of Howard County* 2006). Another 2006 case involved the assessment of the Sands Hotel and Casino in Atlantic City (*City of Atlantic City v. Ace Gaming, LLC* 2006). In that case

the court acknowledged the Rushmore approach was applicable. In 2009, a District of Columbia court supported the use of the Rushmore approach in a case involving the Capital Hilton Hotel (*CHH Capital Hotel Partners LP v. District of Columbia* 2009). In another case involving the 2009 assessment of a Ramada Inn hotel in Detroit (*U.S. Can. Hospitalities, LLP v. City of Romulus* 2009), the court also embraced the Rushmore approach.

In 2006, a Maryland court sided with the assessor on the assessment appeal of the Red Roof Inn in Jessup, Maryland, saying the Rushmore approach was “market driven and tested” (*RRI Acquisition Company, Inc. v. Supervisor of Assessments of Howard County* 2006). In 2013, a California court decided the case of the assessment of the Glendale Hilton Hotel in Los Angeles (*EHP Glendale, LLC v. County of Los Angeles* 2011). The primary dispute centered on the proper way to value intangible assets. The court approved the Rushmore approach, despite the California State Board of Equalization *Assessors’ Handbook*, Section 502, disallowing the use of the management fee approach alone (California State Board of Equalization 1998). In another 2013 case, the New Jersey Tax Court once again approved the Rushmore approach in the assessment for a casino (*Marina District Development Co., LLC v. City of Atlantic City* 2013). In that case, the judge approved the use of the Rushmore approach by the taxpayer’s appraiser for the Borgata Casino. The New Jersey Tax Court also allowed the Rushmore approach in another 2013 case involving a Hilton hotel (*BRE Prime Properties, LLC v. Borough of Hasbrouck Heights* 2013). In a 2015 case involving the assessment of the Capitol Hilton Hotel, the District of Columbia Superior Court yet again sided with the assessor who utilized the Rushmore approach for removing intangible assets (*CHH Capital Hotel Partners LP v. District of Columbia* 2015); that case is currently under appeal.

These court cases concerning the Rushmore approach are not exhaustive, but they illustrate the many times courts have embraced the Rushmore approach for removing intangible assets. Although there have been cases in which the Rushmore approach was rejected, those are very rare and are usually found in states where laws or assessor handbook rules prevent the use of the management fee approach, such as California. Finally, and perhaps most significantly, the Rushmore approach reflects market behavior as evidenced by comparable sale transactions verified by many appraisers who routinely value hotel properties. In this committee’s opinion, in valuing real property the Rushmore approach is the most valid approach for excluding intangible assets in an income approach.

4. Selected Property Types and Intangible Assets

Some property types have the potential for possessing intangible value; this often occurs when the real estate is intertwined with the business.

The real estate marketplace determines whether intangibles are included or excluded in verified sale prices of real property transactions. The market participants who invest, divest, or lend are the best sources of the deal terms, although others familiar with the transaction, such as sale brokers, can also shed light on the pricing methodology and allocations, if any, between the real property, personal property, and intangibles.

For non-owner-occupied, income-generating real estate, a management function is usually necessary to deal with tenant issues (lease negotiations, tenant complaints about the operation of the property, and maintenance of the physical plant, including evaluating capital needs for major system replacements, renovations, and so on). How the management function is addressed in the pricing methodology is determined by

buyers and sellers. For instance, whether a deduction of a management fee and related brand expenses adequately removes business or other intangible asset values in a hotel valuation by a real property appraiser should be based on verified market behavior. It is not a function of the opinions of theorists or appraisers. Appraisers, in particular, are responsible for researching the pricing behavior of buyers and sellers and replicating their pricing methodology using methods and techniques consistent with the observed market behavior. This is true for any real property appraisal. The transaction marketplace is the primary source of appropriate valuation methodology to replicate in any appraisal.

Thus, it is the appraiser's responsibility to (1) qualify comparable transactions as bona fide and reflective of market value and (2) verify all the pertinent attributes of the transaction, including the price paid (allocated to debt and equity), the pricing methodology, and allocations of the price to real property, personal property, and intangibles.

The list in Table 2 summarizes the types of real estate that may or may not sell with intangible values included in the sale transaction price. Properties that derive their revenue from a business operating at the real estate, such as a car wash or minimart, often sell with the intangible business assets included in the sale price of the transaction between the seller and buyer. Other property types, such as hotels, usually sell with the intangibles excluded from the transaction price through deductions in the pricing decision that represent business-related intangible assets. Some properties such as restaurants may sell as a going-concern including the real estate and business assets or through separate sales of the real estate and the business.

This is not to suggest that those properties in the "rarely have intangible value" column would *never* include intangible value. Nor does it mean the properties in the "may have intangible

value" column *always* include intangible assets. The list in Table 2 represents the most common scenarios. As always, verification of actual real estate transactions provides the best opportunity for assessors to determine whether a buyer and/or seller acquired intangible assets and how they were valued in the acquisition price. Additional discussion on selected property types and intangible assets is presented in Appendix A.

5. Special Topics

Skilled and Assembled Workforce

The skilled and assembled workforce argument has found its way from the accounting world to the assessment world. Under FASB Topic 805, an intangible asset is recognized as an asset apart from goodwill only if it arises from contractual or legal rights, such as a patent or trademark, *or* if it is separable, able to be sold, transferred, licensed, rented, or exchanged (FASB 2016). An assembled

Table 2. Types of real estate with possible intangible value

Rarely Have Intangible Value	May Have Intangible Value
Office	Fast-food restaurant
Warehouse	Restaurant
Retail mall	Auto dealership
Self-storage center	Auto repair/tire center
Drugstore	Hotel/lodging facility
Corporate headquarters	Golf course
Truck terminal	Casino
Flex-industrial	Convenience store
Shopping mall	Marina
Shopping center	Fitness center
Apartment building	Ski resort
Mobile home/RV park	Bowling center
Retail store	Funeral home
Big-box retail store	Landfill
Used-auto dealership	Racetrack
	Movie theater
	Self-service car wash
	Full-service car wash
	Amusement/theme park
	Senior care facility
	Telecommunications/utilities

workforce does not typically meet that test, so in the accounting world it is not considered an intangible asset, but rather a residual asset categorized as goodwill. A residual asset arises in the purchase of a business, when all other assets have been categorized and valued. The residual is whatever is left over.

The presence of a skilled workforce does not automatically create a valuable intangible asset. If employees are not bound by contract or noncompete agreements, the owner has little control over whether the employees stay or go. If employees are new or nearing retirement, they likely have little value to a prospective buyer. The Oregon Tax Court rejected the workforce argument in a case involving the assessment of a veneer mill. In that case, the court said,

If the buyer and seller specifically negotiate and set a price on a contract provision retaining management or work force in place, then possibly a value can be attributed to those factors. However, any value assigned is not part of the market value of the property. It would simply be a separate determination of a service contract provision, as opposed to a sale provision. Therefore, it should not be deducted from any estimate of market value. (Boise Cascade Corporation v. Department of Revenue 1991)

The Oregon Tax Court's position differs from that of the authors of a 2001 *Appraisal Journal* article on the topic. In that article, the authors advocate deducting the value of a skilled workforce from the sale price of a hotel, stating,

A skilled work force would have to be assembled and trained by a purchaser of the real estate only. Therefore, a portion of any purchase price of an operating hotel is the opportunity cost of assembling and training the required work force. On average, a period of approximately six weeks of training (and hiring) is reportedly appropriate and reasonable for staff to be assembled and prepared to operate

a first-class full service hotel. (Kinnard, Worzala, and Swango 2001)

In the appraisal or assessment of real property, an estimate of fee-simple market value assumes competent management. It also assumes the presence of necessary intangible assets to achieve highest and best use. Although these intangibles are not separately assessed, they are necessary to achieve the property's intended purpose. For example, a hotel requires a workforce to operate. Typically, the management company of a hotel, not the owner, hires the managers and workers. Therefore any value of the *assembled workforce* belongs to the management company.

The issue of skilled workforce being included in a real estate assessment was addressed by a Canadian court in the assessment of the Fairmont Hotel in British Columbia. The court recognized that a trained workforce is intertwined with the real estate, and its frequent turnover in a hotel negates its value, stating,

With respect to an assembled workforce, while we accept that there must have been an initial investment in hiring and training a workforce, we do not accept that the initial investment necessarily continues to have discreet market value or that its value is separable from the real estate... The business of the hotel is to generate income through the nightly rental of rooms and the provision of other guest services to support that basic function. All of the factors of production, including labor, are integrated to create and maintain the going-concern. To the extent there is or could be value in an assembled workforce, we find that such value is, necessarily, inextricably intertwined with the reality... Furthermore, the evidence was that the workforce of a hotel is constantly turning over, which means that a hotel is constantly re-investing in its workforce. It is constantly recruiting, hiring and training, and all of the expenses associated with this activity are

already deducted from the income stream. To deduct the cost of replacing the existing workforce and equating that cost to an intangible value for the assembled workforce is in our view double counting. In any event, there is nothing to substantiate the assumption that the current replacement cost of assembling a workforce would necessarily equate to its market value upon the sale of the going-concern. (Fairmont Hotels v. Area 01 2005)

The California Court of Appeal arrived at conflicting rulings on the skilled workforce argument. In a case involving the assessment of the Glendale Hilton in Los Angeles, California, the new owner argued for a lower assessment on the basis that the price included intangible assets, including a trained and assembled workforce. The court rejected the workforce argument, stating,

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 2011)

In another hotel case, a different California court came to the opposite conclusion in the assessment of the Ritz Carlton Half Moon Bay Hotel. In that case, the court determined that the assessor failed to remove the value of the hotel's assembled workforce, stating,

... 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 employee parking lot, and the hotel's agreement with the golf course operator. (SHC Half Moon Bay, LLC v. County of San Mateo 2014)

Originally designed in 1922, the Fairmont Jasper Park Lodge is a picturesque resort located in Jasper National Park, Alberta, Canada. Lodging consists of authentic log cabins, and amenities include golf, skiing, skating, and horseback riding. In a case involving the property's assessment, the court recognized an assembled workforce might not be desired by a potential buyer, saying,

... the assembled workforce may actually be a liability, instead of an asset. As acknowledged by (taxpayer's expert witnesses) Mr. Vernor and Mr. Rosen, the buyer in a commercial transaction may require that the seller terminate all, or some, employees. The potential severance pay and pension and health benefit liabilities result in significant liability to the seller. (CP Hotels Real Estate Corporation v. Municipality of Jasper 2005)

In most sales involving real property, buyers are under no compulsion to pay for a workforce. The issue may be resolved in specific cases through the comparable sale verification process. Did the buyers and sellers believe that any intangibles, including the assembled workforce, were included in the transaction price?

Start-up Costs

New businesses usually incur start-up costs before they can begin business operations. Examples of these costs include pre-opening marketing and sales expenses, hiring and training of a workforce, and other expenses. Some practitioners argue this cost is an intangible asset that should be excluded from the value of certain properties, particularly hotels (Lennhoff and Reichardt 2011). The theory suggests that unless a hotel is vacant, a buyer would pay a premium to avoid the start-up costs originally incurred. Critics of this approach say a hotel provides short-term occupancy, so marketing and sales is an ongoing process and what can be referred to as *start-up costs* are included in normal

operating expenses. Similarly, a hotel undergoes significant turnover of staff each year, so much of those start-up costs are incurred annually as management replaces staff. According to data from the Bureau of Labor Statistics, the employee turnover rate in the hospitality industry exceeded 70 percent in 2015 (Bureau of Labor Statistics 2016).

The judge in an assessment appeal of the Red Roof Inn in Jessup, Maryland, was skeptical of the start-up costs adjustment for hotels that were not brand-new. In rejecting the approach, the court stated,

In addition, [taxpayer's appraiser] start-up cost adjustment may have some theoretical soundness where the hotel business is actually still benefiting from start-up costs, and the costs can be specifically identified and limited to those that produce business value as opposed to real estate value. However, the subject property is fourteen years old, and there is no data to support such an adjustment. (RRI Acquisition Company, Inc. v. Supervisor of Assessments of Howard County 2006)

A Virginia court allowed the start-up cost adjustments for a 1.2 million-square-foot training center. However, in that case, the building was undergoing a change of use from a training center to a conference center, for which start-up costs were not a historical data point, but instead a current event. The new owner, Oxford, intended to convert the facility into a national conference center, which would require extensive renovation (the buyer ultimately spent \$23 million in renovation costs after the sale). The court acknowledged that start-up costs, in this case, should be considered given the change in use, stating,

[Taxpayer's appraiser] recognized that the use of the property was being changed and, as a result, the value of intangibles, such as start-up expenses and the cost of assembling a work force, has to be determined before the value of the real estate can be ascertained (WXIII/Oxford-DTC

Real Estate, LLC v. Board of Supervisors of Loudoun County 2004).

In 2015, the Superior Court of the District of Columbia rejected the start-up costs approach in an assessment dispute of the Capitol Hilton Hotel in Washington, D.C., stating,

The second major aspect of (taxpayer's appraiser's) critique concerns his contention that an appraiser or assessor must calculate and deduct the 'start-up' costs associated with getting the hotel up and running—even if, as here, that happened in 1943. The Court does not find this plausible on either a practical or theoretical level. (CHH Capital Hotel Partners LP v. District of Columbia 2015)

Other courts have rejected the start-up cost approach for hotels and other property types (*CP Hotels Real Estate Corporation v. Municipality of Jasper* 2005; *Chesapeake Hotel LP v. Saddle Brook Township* 2005; *GGP Maine Mall, LLC v. City of South Portland* 2008). In essence, start-up costs are not applicable for properties that are not actually in a start-up phase. It would be improper to make a start-up costs adjustment on an existing, stabilized property.

Leases-in-Place and Above- and Below-Market Leases

In the accounting world, leases-in-place and above- and below-market leases are considered intangibles. That guidance is provided by the FASB in Accounting Standards Codification Topic 805 "Business Combinations" (FASB 2016). When fair value purchase price allocations are prepared for accounting purposes, leases-in-place and above- and below-market leases are allocated to the category of intangibles.

Although leases-in-place and above- and below-market leases are treated as intangibles for accounting purposes, real estate appraisers and assessors typically consider them part of the bundle of rights

associated with real property. That is not to say they are not intangible assets; leases are essentially contracts. Although leases and contracts are tangible (the paper can be seen and touched), the rights associated with them are intangible. Technically, all *rights*, including the bundle of rights that constitute real property, are intangible. There are real property intangibles inherent in the ownership of real estate, and there are business property intangibles inherent in the ownership of a business (such as a trade name).

Real property intangibles include easements, air rights, mineral rights, possessory rights, building permits, zoning (including variances), and leases (both positive and negative leasehold interests). As expressed in the text, *Valuing Intangible Assets*,

Intangible real property includes all of the individual interests, benefits, and rights inherent in the ownership of the physical real estate (Reilly and Schweih 1999).

Investors would typically pay more for properties that are fully leased or those with above-market leases. Those lease benefits are intangible in nature but are included in the real property when it transacts. When investors purchase real property, they acquire all the rights associated with that property—good or bad. A zoning variance on a property may allow an owner to build at higher density than would normally be permitted. That benefit is intangible in nature, but it is a part of the real property. Similarly, a property may have favorable air rights. By their very nature, air rights are intangible; however, their ownership is part of the bundle of rights.

The distinction is important because, in many cases, real estate appraisers and assessors are required to exclude the value of intangible assets in estimating real property value. However, intangible assets that should be excluded are those that are separate from real property.

Leases, easements, zoning, building permits, air rights, mineral rights, and other real estate-related intangible assets are part of the real property. Trade names, franchises, and employee contracts are business-related intangibles that should be excluded from an estimate of real property value.

TAF addresses the issue of excess rent in USPAP FAQ 193 (TAF 2016, 299). The question is, “Should I allocate the portion of above-market rent to the real estate or treat it as an intangible?” The Appraisal Standard Board’s answer is, “The subject of this appraisal is real property, not intangibles, specifically the leased-fee estate; therefore, Standards Rule 1-2(e) applies.” By stating unambiguously the subject of the appraisal is “real property not intangibles,” the answer implies that above-market leases are part of real property.

Leases-in-place and above- and below-market leases are part of real property and should be considered in any estimate of the value of real property rights. That’s not to say that above-market contract rents should be used to estimate fee-simple value. If above-market contract rents are used to estimate value, the result would be the value of the leased-fee interest. If fee-simple value is sought, market rents should be utilized.

Goodwill

Goodwill rarely comes up in real estate assessments, but in some cases it is reported in purchase price allocations that are submitted as part of a property tax appeal. Goodwill is defined in *The Dictionary of Real Estate Appraisal* (Appraisal Institute 2015) as follows:

1. Unidentifiable intangible assets
2. The amount by which the acquisition price exceeds the fair value of identified assets
3. That intangible asset arising as a result of name, reputation, customer loyalty, location, products, and similar factors not separately

identified (American Institute of Certified Public Accountants et al. 2015)

4. That intangible asset arising as a result of elements such as name, reputation, customer loyalty, location, products and related factors not separately identified and quantified. (ASA 2009)

As the second definition above suggests, goodwill appears only after all other assets have been separately identified and quantified. It is usually attributed to an entity's name, reputation, or similar factor that has not been separately identified. It is probably worth noting the term *goodwill* has also been used in the past to describe business value. Similar to the term *blue sky*, it was used generically to describe the value of a business. This is an incorrect application of the term. Although goodwill is somewhat ambiguous, it represents only one potential component of a going-concern and should not be confused with the overall value of a business.

Goodwill exists only as part of a business or going-concern. If the real property being appraised or assessed is not being valued as a going-concern, then goodwill is not relevant to the assignment. For most properties, assessors need only value the sticks and bricks, so intangible value, going-concern value, and goodwill are irrelevant. For some property types, however, estimating the value of the real property requires consideration of the going-concern. This occurs when revenue from the business is used to estimate the value of the real property. In addition, sale price sometimes includes consideration for both real property and an ongoing business. In those cases, intangible value may exist and that intangible value could include goodwill.

The issue of goodwill arose in the assessment appeal of the Ritz Carlton Half Moon Bay Hotel in California. In that case, the hotel had sold in 2004 for \$124,350,000, and the taxpayer appealed

the assessment on the basis the price included intangible assets, which are not assessable under California law. The hotel appealed the assessment, claiming it erroneously included \$16,850,000 worth of nontaxable intangible assets, including \$14,150,000 of goodwill. During the board hearing, the taxpayer's appraiser explained the calculation of goodwill as follows:

... from an accounting perspective ... there is some type of premium being paid or value being asserted to a property based on whether it is the flag [i.e., brand], whether it's the location, whatever it might be. We think there's something there. So essentially that's how we got that [\$14,150,000], because again it's a residual with all the other numbers combined, and deducted off the purchase price. (SHC Half Moon Bay, LLC v. County of San Mateo 2014)

The assessor valued the hotel using the Rushmore approach and argued that any value attributed to goodwill had been accounted for within the management fee. The court ruled that the Rushmore approach did not go far enough in removing intangible assets, but it did agree with the assessor that the deduction of the management and franchise fees did, however, exclude the intangible asset of goodwill.

Typically, the issue of goodwill arises for assessors when properties are purchased and the price has been allocated. For accounting purposes, goodwill has no basis unless it is purchased as part of a business. In the purchase of a business, value is usually assigned to goodwill when the price has been allocated to all other known assets, and there is still some amount of the purchase price remaining. Although goodwill is a valid intangible asset, it is often an elusive characteristic of a going-concern and difficult to isolate and value (even for business appraisers). Because goodwill is not specifically identified and courts have ruled the value of goodwill is reflected in a management

fee, it is safe to say that applying the management fee technique in an income approach effectively removes any goodwill value in the estimate of real property.

Go-Dark Valuation

There is no official definition of *go-dark valuation*, but it basically means *as if vacant*. In this theory, a property is assumed to be vacant, even if it is fully occupied and rents are stabilized. The value is estimated via the income approach by including the cost to lease up the property to full stabilization, assuming market rent. The technique is sometimes used in purchase price allocations to estimate the value of leases-in-place—an intangible asset for financial reporting purposes.

Although the go-dark valuation might be appropriate for accounting purposes, it is not used in estimating the fee-simple value of the real property. Fee-simple ownership includes all rights and benefits in a property, free of encumbrances such as above- and below-market leases. A property's occupancy is a condition of the property that should be recognized, as noted, no differently from its physical condition. Assuming a property is vacant when it is actually occupied is a hypothetical condition that results in liquidation value. The *Appraisal of Real Estate* cautions appraisers about this approach, stating,

A lender or other client may request a value opinion for real property as if it were not occupied by the business, which is commensurate with the liquidation premise, although the highest and best use is continued operation as a going-concern. In those cases, the value of the real property as if it were not occupied by the business should be treated as a hypothetical condition to avoid misleading the user of the report. (Appraisal Institute 2013, 715)

Some practitioners argue that because some definitions of fee-simple include the word *unencumbered*, the value should be estimated assuming the property is

vacant. They suggest if there is a lease in place, the property is encumbered and therefore cannot be fee-simple. In other words, unencumbered is equated with being vacant. This is a misinterpretation of the definition of fee-simple and not aligned with market behavior. Buyers, sellers, brokers, appraisers, and lenders treat fee-simple interest as a property leased at prevailing market rents and occupancy. If a property is suffering from high vacancy, a lease-up adjustment might be appropriate, but if the property is fully occupied, an adjustment for lease-up is not necessary.

In a case involving an owner-occupied office building in Kansas, the taxpayer argued the property should be valued as vacant, even though it was fully occupied. The court rejected that approach and called it a “suspension of reality,” saying,

This Court understands that it may be proper appraisal practice to include a lease-up discount in addition to a stabilized vacancy allowance in cases where the property is experiencing a below stabilized vacancy position. This is not such a case, however, as the evidence here indicates the subject property's highest and best use is its actual use as a fully owner-occupied facility. Applying a lease-up discount in this tax appeal would require a suspension of reality and an acceptance of conditions not borne out by the evidence. While Williams appropriately applied a lease-up discount in the income approach in appraising this fully occupied property based upon extraordinary assumptions and hypothetical conditions prescribed by his client, Chase Bank, no such extraordinary assumptions or hypothetical conditions are called for under Kansas property tax law. (In the Matter of the Equalization Appeals of Yellow Equipment and Terminals, Inc. et al. 2012)

Fee-simple value does not require a property to be vacant, because there is no market support for that premise.

Although a go-dark valuation might be an appropriate business valuation approach, it is a not an appropriate technique in real property appraisal to achieve fee-simple value.

The Business Enterprise Value Approach

In the property tax assessment context, the term *business enterprise value (BEV) approach*, also known as the TAB (tangible assets backing) approach and the BEA approach, refers to a method of valuing real property in which intangibles are involved. This method is not described in any current real estate appraisal or business appraisal texts.

The BEV approach first emerged in the property tax arena in the 1990s. A series of articles and court cases emerged involving the proper treatment of intangibles in shopping centers, malls, and hotels. In the early days, the BEV approach represented the broader argument that some properties included intangible value, including regional malls. An example can be seen in a case involving the Merle Hay Mall in Des Moines, Iowa, in which the court described the BEV theory as follows:

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 such as trade names, franchises, and agreements, that have been assembled to make a business a viable entity. (Merle Hay Mall v. Board of Review 1997)

The mall owner argued the value of these intangible assets should be removed from the mall's assessment. The Iowa Supreme Court rejected the BEV theory in part because it had not been embraced by the appraisal community, stating,

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. Also, 'It is undisputed that this method was designed in the late 1980s by a group of shopping mall owners in cooperation with real estate appraisers and real estate professors in a group called SCAN (shopping center assessment network).' (Merle Hay Mall v. Board of Review 1997)

In a case involving the assessment of a 1.2-million-square-foot training center (WXIII/Oxford-DTC Real Estate, LLC v. Board of Supervisors of Loudoun County 2004), a Virginia court embraced the BEV approach (calling it the Course 800 approach). The BEV approach was argued again in the assessment of the Saddle Brook Marriott in New Jersey in 2005. In that case the taxpayer's appraiser suggested the Rushmore approach used by the assessor required additional adjustments to completely remove any intangible value. Those adjustments included an additional deduction for the value of personal property, Marriott flag, goodwill, and start-up costs. The court rejected those adjustments, stating:

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 2005)

In an interesting case involving the Wolfchase Galleria Mall in Memphis, Tennessee, the administrative judge reversed his own prior decision after learning the Appraisal Institute did not endorse the BEV approach used by the taxpayer's appraiser. The confusion

originated because of an Appraisal Institute course titled, “Separating Real and Personal Property from Intangible Business Assets” (Course 800). In its earlier decision, the court mistakenly assumed that techniques taught in the course were endorsed by the Appraisal Institute. Similar to the *Saddle Brook* decision, this case illustrates the importance of market acceptance of an appraisal methodology. In making that point, the court said,

The administrative judge finds that the Essex House must initially be re-examined because one of the key findings that was the basis for the decision has been shown in this appeal to be incorrect. In particular, page 7 of the initial decision and order stated that [taxpayer’s appraiser’s] methodology had been endorsed by the Appraisal Institute. The administrative judge finds the proof in this case established that the Institute is impartial with respect to the particular methodology that should be utilized for separating real and personal property from intangible business assets. (In Re: Wolfchase Galleria Ltd. Partnership v. Shelby County 2005)

Despite the setback from the Merle Hay Mall case in the late 1990s, mall owners continued to pursue property tax reductions based on intangible value into the late 2000s. In a case involving the Maine Mall in Portland, Maine, the court rejected arguments based on intangible value, stating,

In other words, the reductions for the values of certain assets taken by GGP based on the PGH Consulting, LLC appraisal report under the BEV and TAB theories were inappropriate because all of such values are inextricably intertwined with the value. (GGP-Maine Mall, LLC v. City of South Portland 2008).

In a case involving a Red Roof Inn hotel in Jessup, Maryland, the court rejected the BEV approach on the basis that it was academic in nature, stating,

The Court finds that the [taxpayer’s appraiser’s] approach includes impermissible adjustments to the Rushmore approach, which were either duplicative or not supported by the market place. Consequently, the Court must reject [taxpayer’s appraiser’s] appraisal as his theories and methodologies are academic constructs unsubstantiated by the market. Respondent’s appraisal closely reflects the Rushmore methodology, which is market driven and tested. (RRI Acquisition Company, Inc. v. Supervisor of Assessments of Howard County 2006)

These cases are not an exhaustive list. There have been others that have both rejected and embraced the BEV approach. The courts have mostly disallowed the BEV approach for various reasons. In its current form, the BEV approach is essentially the Rushmore approach with start-up costs, assembled workforce, and return on FF&E adjustments. Previous comments and court cases related to start-up costs and assembled workforce are relevant.

As the court in the Red Roof Inn case described, the Rushmore approach has been “market driven and tested.” Unlike the Rushmore approach, the BEV approach has not been embraced by market participants. This shortcoming is significant, and appraisers and assessors should be cautious about supplanting the actions of market participants with academic concepts and unproven theories.

Excess Earnings and Parsing Income Methods

In Section 3, the management fee method (Rushmore approach) for excluding intangibles in an income approach was explained and endorsed. There are other income approach methods for addressing intangibles, including the excess earnings method and parsing income method. These methods are known by other names, including the excess profits method, formula method,

and proxy rent method. Regardless of the name, the approaches are similar. The going-concern's income is allocated to the real property, personal property, and intangible assets.

The excess earnings method was developed by the U.S. Department of the Treasury in 1920 when breweries and distilleries had to determine lost goodwill value due to prohibition (IRS Appeals & Revenue Memorandum 34). In 1968, the IRS reaffirmed the excess earnings approach with IRS Revenue Ruling 68-609. From an accounting perspective, the excess earnings method is often used to estimate the value of goodwill.

The steps required to perform the excess earnings approach are as follows:

1. Estimate a company's total earnings.
2. Estimate the value of the company's tangible assets (often based on financial statements or other techniques)
3. Multiply the tangible asset value by a rate of return to calculate the earnings attributable to the company's tangible assets.
4. Subtract the tangible asset earnings from total earnings to arrive at excess earnings.
5. Divide the remaining excess earnings by an appropriate capitalization rate to calculate the value of goodwill and other intangible assets.

Interestingly, one of the first steps in the excess earnings method is to estimate the value of the tangible assets, free of any intangible value. That is exactly the goal of most assessors in estimating the market value of real and personal property. Presumably, an assessor could stop at that step since the aim of most assessors is a market value free of intangible value.

The courts have allowed the use of the excess earnings method, particularly in divorce cases or partnership buyouts. In *Dixon v. Crawford, McGillian, Peterson & Yelish* (2011), the court accepted the

method to determine the value of a law firm's goodwill in a partnership dispute. In *Marriage of Hall* (1984), the court allowed the use of the excess earnings method (among other methods) to establish the goodwill value of a physician's practice in a divorce.

Although the excess earnings method is relatively simple, it does have its shortcomings and critics. In fact, the IRS has suggested that it should be used only as a last resort, stating, "it should not be used if there is better evidence available from which the value of intangibles can be determined" (IRS Revenue Ruling 68-609). Despite this disclaimer, the excess earnings method is still used today (primarily by business appraisers).

In the text *Going Concern Valuation*, the authors comment on some of the difficulties in applying the excess earnings method:

The Excess Profits technique is applicable to all types of property; however, valuing the components is extremely difficult and complex. Doing so requires the real estate appraiser to have the knowledge and experience in personal property appraising, business valuation, and some knowledge in accounting practices. Personal property appraising experience is needed to value the equipment, not to mention other items. Accounting experience is needed to formulate the correct income and expense statements, as well as to normalize those statements. Business valuation knowledge and experience is needed in order to develop the business component capitalization rate. Lastly, it is exceptionally difficult to develop market-based returns on the individual components. (Wilson and Wilson 2012, 90).

A variation of the excess earnings method is the parsing income method. In this method, the total revenue of the going-concern is allocated to real property, personal property, and any intangible assets. The steps in performing the parsing income method are as follows:

1. Allocate a going-concern's net income between real property, personal property, and intangible assets.
2. Apply separate capitalization rates to the net income of each component to arrive at a value estimate for each component, real property, personal property, intangible assets.

The Appraisal Institute addresses the parsing income method in *The Appraisal of Real Estate*, stating,

When using the parsing income method, it is critical to ensure that any allocation of the income and expenses correctly identifies the contribution of the income to the total assets from tangible and intangible personality. If the allocation is not done properly, it is unlikely that the residual value of the value for any asset class will be correct. (Appraisal Institute 2013)

The parsing income method does have its challenges. For example, there is often little market evidence for rates of return for tangible assets of a going-concern or a supportable capitalization rate for the intangible assets. The Appraisal Institute noted this and other challenges of applying the parsing income method by describing what critics have said about the approach:

Critics state that this methodology is flawed because the identification of an appropriate capitalization rate to convert the residual income to different asset classes can be difficult. This method has also been criticized for using a percentage deduction from income to quantify the value of both the franchise and residual intangibles. Further criticism is leveled at the deductions for a return on the various components of the going concern, which create an opportunity for double-counting unless caution is exercised by the appraiser. (Appraisal Institute 2013)

The courts have generally rejected the parsing income method for property tax purposes. In a case involving the assessment of a Marriott Hotel in Saddlebrook, New Jersey, the court rejected the parsing of the income approach from both a theoretical and an empirical perspective (*Chesapeake Hotel LP v. Saddle Brook Township* 2005). In a British Columbia court decision, the court struggled with the income parsing method because the court found it difficult to attribute a hotel's superior revenue per available room (RevPAR) solely to intangible value. In that case, the court commented on the challenge of isolating the intangible revenue, saying,

We question how the appraisers can be sure how much of the RevPAR differential enjoyed by the Empress over the other eight hotels is related to the character and quality of the land and improvements, and how much is related to brand or business goodwill. (Fairmont Hotels v. Area 01 2005)

The excess earnings and parsing income methods have a theoretical basis, but unfortunately the data necessary to perform them correctly are often lacking. Although these methods are valid when performed correctly, they are not the preferred income approach method recommended by this committee.

6. Summary

In most U.S. jurisdictions, intangible assets are not taxable as part of a real property assessment. For that reason, assessors must ensure the value of intangible assets is excluded. This is particularly important when properties sell with intangible assets included in a sale price or when business income is used in an income approach to value a property. In those cases, the property typically constitutes a going-concern, which includes land, buildings, personal property, and potentially intangible

assets. This guide highlights many property types that potentially include intangible assets, such as hotels, senior care facilities, and properties with valuable trade names and franchises.

There are typically two circumstances in which assessors come across intangible assets. In the first instance, a property sells as a going-concern, such as a hotel with a franchise agreement in place or a restaurant with a well-known name sold as part of the real estate. In the second, revenue from a business is used to value real property in an income approach.

Various professions are involved in identifying and valuing intangible assets. Accountants, consultants, corporate finance executives, business appraisers, assessors, and real estate appraisers may all come into contact with intangible assets. The methods used for estimating the value of intangible assets can vary widely depending on who is performing the valuation and allocation and the purpose for deriving the value estimate. This variation in methods has resulted in a disconnect between how buyers and sellers perceive the value of intangible assets, how accountants report intangible assets, and how assessors, taxpayers, and property tax professionals measure intangibles. Often the methods used by accountants and other financial professionals are different and not appropriate for property tax assessments.

Assessors are often challenged with determining whether something even rises to the level of an intangible asset. To help determine whether something is an intangible asset, the following four-part test can be applied:

1. An intangible asset should be identifiable.
2. An intangible asset should have evidence of legal ownership, that is, documents that substantiate rights.
3. An intangible asset should be capable of being separate and divisible from the real estate.

4. An intangible asset should be legally transferrable.

Intangible assets may be *intertwined* with the real estate, making it difficult to value them independently. This four-part test can assist the assessor in determining whether an intangible asset is actually something the assessor should consider. If an asset doesn't possess all four characteristics, then it probably is not an intangible asset.

In addition to property tax, there are many reasons intangible assets need to be identified and valued separately from other assets, including for accounting purposes, business-related purposes, and real estate purposes. The most common purposes are for accounting and financial reporting. The techniques accountants use to identify and allocate intangible assets are established by the FASB, the IASB, and the IRS. The classification and methods used for estimating and allocating intangible value for accounting purposes are not necessarily the same as those for property tax purposes. In fact, even the type of value typically estimated for accounting purposes (fair value) is different from that for property tax purposes (typically market value).

There are numerous methods for estimating and allocating the value of intangible assets. The reason there are so many methods is the many different professionals who estimate intangible value. Business appraisers and accountants use methods that tend to value the intangible asset independently. The skill and knowledge required to apply those methods are typically those of a professional business appraiser or accountant. However, there are methods for estimating the value of real property that effectively exclude the value of intangible assets. These are the methods most appropriate for assessors who seek to simply exclude the value of intangible assets, not directly value them.

The cost approach is one of the easiest approaches for ensuring any intangible

value is excluded in an assessment. It is very familiar to assessors and appraisers, and the data necessary to complete the approach are readily available. The cost approach is often criticized because depreciation/obsolescence may be difficult to estimate and market participants do not always use the cost approach in making pricing decisions. Although the cost approach may have weaknesses, it is often the simplest approach for assessors and appraisers to apply, and it is free of influences from going-concern or other intangible assets.

The sales comparison approach can also be applied in estimating the value of real property that potentially includes intangible assets. The most common technique is the market survey method. Conducting market surveys includes sale verification and review of public financial reports, purchase price allocations, and other documents in which buyers and sellers have reported the price paid for real estate, versus personal property and intangibles. Sale verification can determine whether the allocation was considered in the pricing decision.

The income approach can also be utilized to ensure intangible value is excluded from an estimate of the value of the real property. The management fee approach is based on the concept that intangible value arising from a going-concern can be measured by capitalizing the management fee necessary to compensate a third party to run the business. Critics of the management fee approach argue that 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. Proponents of this approach say that, because the management fee is based on a percentage of revenue, good management is rewarded with

higher revenues and higher intangible value. Poor management results in lower revenues and lower intangible value.

Taxpayers and their representatives have suggested the presence of intangible assets due to other sources, including a skilled and assembled workforce, business start-up costs, goodwill, and leases-in-place, among others. These intangible assets are often applicable in the accounting world but are not necessarily valid for real property valuation. Similarly, some alternative approaches have been suggested for isolating intangible value, such as go-dark valuation, which assumes a property is vacant for purposes of estimating the value of leases-in-place. Again, this is a valid accounting approach, but it is not suggested for estimating the value of real property.

The identification and valuation of intangible assets have been debated for many years in the appraisal and assessment community. This guide is intended to assist assessors in understanding and addressing intangible assets in property tax valuation. Although many practitioners have proposed various methods for estimating and allocating intangible asset value, ultimately the real estate marketplace determines whether intangibles are included or excluded in verified sale prices of real property transactions. The cornerstone of developing an accurate market value is for the appraiser/assessor to verify the components of the price with a knowledgeable party to the transaction. If in the verification process the buyer, seller, or another knowledgeable participant indicates little or no value was allocated to intangibles, then the appraiser should acknowledge that. If the appraiser assumes a different allocation from what was agreed upon at the time of sale, then the appraiser is likely not estimating market value.

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Policy Statement

This guide is being provided to the IAAO membership to assist in identifying intangible assets and exclude them from real property assessments. This guide was developed by the IAAO Special Committee on Intangibles for informational purposes only. The statements made or opinions expressed by the authors of this report do not necessarily represent a policy position of IAAO. The guidance in this paper is also not meant to replace state and local laws or court decisions.

There are many ways to value and allocate intangible assets. This guide addresses the techniques that are applicable for the most common situations encountered by assessors. Selected alternative methods are discussed in Section 5, Special Topics. However, there are many other methods not covered that may be valid or applicable for certain properties. This guide briefly addresses the treatment of intangible value for telecommunications, railroads, and public utility properties. For those and other complex properties, an assessor or appraiser would be wise to research additional guidance and methods that go beyond the scope of this guide.

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Appendix A. Selected Property Types and Intangible Assets

This appendix discusses various property types in relation to intangible value. In determining whether a property type is likely to have intangible assets associated with it, three questions must be answered. First, in the valuation of the property, is the rent derived from a business or from the real estate? Second, is the property typically bought and sold as a going-concern or real property alone? Third, if there is an *intangible* associated with a property, does it pass the four-part test to rise to the level of an asset?

Amusement and Theme Parks

These property types rarely sell, but when they do, it is possible the sale was part of a going-concern transaction in which the buyer purchased both the business and the real property. Sale verification can help the appraiser or assessor determine exactly what was included in the price.

Apartments

Apartment properties derive their revenue from space rental. When these properties sell, the price is typically based on the ability of the real estate to generate rent. These properties are not typically considered going-concerns that include a business. For this reason, there is typically no intangible value for the appraiser or assessor to consider.

In some cases, property owners have argued that rent subsidies represent an intangible value. In a case involving an apartment complex with subsidized Section 8 rents, the court rejected that argument, stating,

Here what was taken into account in reaching true cash value was the rental subsidy provided by the federal government. This subsidy was no more intangible than the actual rents paid by the tenants. A review of the regulatory agreement does not reveal any use restrictions on the rental subsidies, beyond their use as a method for making mortgage loan and other payments due MSHDA [Michigan State Housing Development Authority]. The substance of the subsidy as it pertains to the project was rental income. (Dowagiac Limited Dividend Housing Association. v. City of Dowagiac 1987)

Auto Dealerships and Auto Repair Facilities

Auto dealerships are typically special-purpose properties designed and built specifically for the sales and repair of automobiles. These properties are generally owner-occupied and purchased for their utility, rather than their ability to generate rental income. When occupied new auto dealerships sell, they often include land, buildings, personal property, inventory, and intangible assets. The intangible assets can include sales and service franchise agreements, noncompete agreements, and other intangible assets depending on the property. The appraiser should exercise caution in valuing these facilities, because franchise agreements are typically not assumable as a matter of right by a buyer of a dealership.

Business appraisers value auto dealerships using methods such as a price-to-earnings multiple. Cash flows generated by the sale and service of automobiles are a primary factor in business valuation of these properties. However, real estate appraisers and assessors generally ignore the business income and focus on the tangible assets. All three valuation approaches can be applied to auto dealerships; however, if improved sales are used, the appraiser should carefully verify these sales to determine what was included in the price.

Auto repair facilities (outside a dealership) can also be valued using all three approaches, depending on the availability of data. In some cases, these facilities are part of a national chain. Tire centers

are also included in this category. These properties can sell as a going-concern or while under lease. If the contract rent exceeds market rent, the value of the leasehold estate is negative and the value of the leased-fee estate exceeds the value based on market rent. Meanwhile, the sum of the value of the two interests equals the value of the fee-simple estate. There is no intangible value.

Big-Box Stores

A big-box store is a physically large retail establishment typically occupied by a corporate chain, such as Walmart, Target, Home Depot, Lowe's, and others. These chains typically develop their stores in a built-to-suit arrangement and sometimes sell them in sale-leaseback transactions. They can be appraised and assessed using all three approaches.

Big-box stores do not sell as going-concerns but often sell as leased-fee investment properties. Leased-fee sale prices can exceed fee-simple value when the rent being paid by the tenant is above market or the investor seeks benefits above and beyond the value of the sticks and bricks. Above-market leases are treated as an intangible in the accounting world. In most jurisdictions, the legal requirement for assessment is fee-simple market value. Under this premise, market rent is utilized—not actual rent. So whether above-market leases are classified as intangible assets is usually irrelevant. The same can be said for below-market leases, which in the assessment world are typically ignored in favor of market rent.

For big-box stores, all three approaches to value can be applied. Sales of big-box stores usually take three forms: sale-leasebacks in which investors purchase occupied stores, investor-to-investor purchases, or sales of vacant stores, often called dark stores. Sale-leaseback transactions are complicated by leased-fee issues, and dark store sales are problematic because they typically represent a different highest and best

use. In addition, many big-box stores place deed restrictions on their future use, which exclude competing market participants from purchase or lease. These issues complicate the sales comparison and income approaches. Big-box chains acquire most of their properties by purchasing land and constructing improvements. Those actions are best reflected in the cost approach. The cost approach inherently excludes encumbrances such as leases and also excludes intangible value that may result from above-market sale prices.

The Ohio Supreme Court acknowledged that fact in a court case involving the assessment of a Meijer store, stating,

Indeed, the owner by purchasing the land and constructing the building evidences a market need for such a property. Therefore, the costs of purchase and construction evidence that a prospective purchaser was willing to pay at least the costs of the property as newly constructed. (Meijer Stores LP v. Franklin County Board of Revision 2009)

Sometimes, taxpayers and their agents argue that big-box stores suffer from functional obsolescence, as reflected by the sales of dark stores (often with deed restrictions in place). In a very recent case concerning the assessment of a Menard's big-box store, the Michigan Court of Appeals recognized the impact of restrictions on big-box stores when it rejected the sales comparison approach in which restricted dark stores were used. The court also rejected the functional obsolescence argument, stating,

There was no evidence in the record of any deficiency in the subject premises that would inhibit its ability to properly function as an owner-occupied freestanding retail building. The functional obsolescence to which Menard refers appears to be the fact that, due at least in part to self-imposed deed restrictions that prohibit competition, such freestanding retail buildings are rarely bought and sold on

the market for use as such but are instead sold to and bought by secondary users who are required to invest substantially in the buildings to convert them into other uses, such as industrial use. (Menard, Inc. v. City of Escanaba 2016)

Many of the issues concerning big-box store valuation are discussed in an article titled, “Thinking Outside the Big Box” (Wilmath and Alesandrini 2015). In that article, the authors address many common appeal issues, including the threat to brick-and-mortar stores from online retailing, the smaller store prototypes, leased-fee versus fee-simple sales, dark store sales, and highest and best use.

Bowling Alleys

Bowling centers and other entertainment properties are often bought and sold as going-concerns. After the bowling boom of the 1960s, the industry struggled through a long decline. Changing demographics hurt the industry as families moved away from urban areas where bowling centers previously existed to the suburbs. The number of bowling centers dropped from its peak of more than 12,000 in the mid-1960s to fewer than 5,200 nationwide today. To reverse the declining trend, many bowling center owners have added new features such as computerized lights-and-music systems and upscale bowling lounges, which cater to young adults and corporate functions. These boutique bowling centers feature sophisticated lighting and audiovisual systems, comfortable seating, enhanced architectural designs, and high-quality food and drinks.

These properties sometimes sell as going-concerns. Given the declining state of the bowling industry, a price premium for intangible value is unlikely. Sale verification can determine whether the property sold with the business and how much, if any, may have been allocated to intangible business value.

Car Washes

Car wash properties, both full-service and coin-operated, are typically sold based on the potential income generated by the going-concern. Typically a price includes the real estate, the personal property, and the business. If a car wash has a successful location with a steady customer base, revenues are likely to be high, resulting in value to the business. If the car wash is closed or not being managed well, the value of the business may be zero.

When the sale of a property is based on the income generated by a going-concern, as with a car wash, rather than on the rent paid by tenants, such as an office building or shopping center, there is a potential for business value. When valuing a car wash, the appraiser or assessor should consider the cost approach, because it inherently excludes any business or intangible value. Sales of car wash properties should also be considered, with careful verification to determine whether there was any business value included in the transaction. It is more likely the value of a car wash business is inextricably intertwined with the value of the real property because the business cannot be sold separate and apart from the real estate.

Casinos

Like hotels, casinos are sometimes valued based on the amount of revenue they generate. In Las Vegas, home of many casinos, state law mandates the use of the cost approach. However, in other jurisdictions, such as Atlantic City, the income approach is the preferred method of valuation. When the income approach is used, it is necessary to exclude any intangible value that may exist as a result of the going-concern.

One casino operator, Penn National Gaming, Inc., operates 26 facilities in 17 states. In 2013, it spun off its real estate assets into a REIT, Gaming and Leisure Properties, Inc. Of significance is the

fact that Penn National retained all its casino licenses; hence no *intangible* was transferred to the REIT. This did not stop its subsidiary, HC Bangor LLC, from challenging the City of Bangor, Maine's, assessment as improperly including the value of *intangibles*, such as the gaming license (Belanger 2015).

In a 2013 court case involving the property tax assessment of the Borgata Casino, the New Jersey Tax Court approved the use of the Rushmore approach by the taxpayer's appraiser for excluding intangibles (*Marina District Development Co., LLC v. City of Atlantic City* 2013).

Convenience Stores/Gas Stations

Often convenience stores and gas stations sell as a going-concern in which the sale price includes land, building, personal property, inventory, and a business. Sometimes the real property alone sells in a sale-leaseback transaction, which can be complicated by the terms of the lease and may or may not be arm's-length. However, in some cases convenience stores and gas stations sell as land and improvements only. Sale verification can determine what was included in the price.

The potential inclusion of business value in a convenience store valuation was noted in the Appraisal Institute's text on convenience store valuation, in which the author stated,

Many real estate appraisers are unfamiliar with business valuation. ... However, it is critical for the convenience store appraiser to recognize that the value of a convenience store may include values other than that of the real property. (Bainbridge 2012)

Branded convenience stores in good locations can be very successful and produce significant amounts of revenue. It is often difficult to determine how much success is due to location or reputation and brand. All three approaches to value

can be applied to convenience stores or gas stations. The cost approach is desirable because it includes only the value of the real property. The sales comparison approach may be complicated by the inclusion of a business, personal property, or inventory. The income approach can also be challenging because valid rental data may be difficult to find.

Corporate Headquarters

In some cases, corporate headquarters transfer in sale-leaseback transactions, in which a corporation sells its headquarters but remains as a tenant. Some argue that investors pay a premium in this type of transaction because of the creditworthiness of the tenant and that premium represents intangible value. Others contend the quality of the location and the superior characteristics of the land and improvements attract the creditworthy tenant and reflect real property, not intangibles. There is nothing improper about considering a sale-leaseback transaction between unrelated parties, each seeking to benefit their own interest. The seller wants to maximize the purchase price, while the purchaser seeks to minimize it; the seller wants to minimize the rent paid to the buyer, while the buyer seeks to maximize it (*AEI Net Lease Fund v. Erie County* 2008). Careful sale verification can determine whether the quality of the tenant caused the buyer to pay an above-market price for the property.

When REITs purchase corporate office buildings, they often allocate the fair value of intangibles to leases-in-place, above- or below-market leases, or both. These allocations are typically done after the pricing decision for financial reporting or accounting purposes and are permitted under accounting and IRS rules. But leases-in-place and above- or below-market leases are not valid intangible assets in estimating the market value of the fee-simple interest. Above- or below-market leases do not create an intangible asset; they create leased-fee and

leasehold interests. (Refer to Section 5, Special Topics, under the heading “Go-Dark Valuation.”)

The Iowa Supreme Court examined the proper way to value an office campus property in a property tax case involving the 600,000-square-foot corporate headquarters of Wellmark in Des Moines. In that case, the court considered arguments pertaining to functional obsolescence, intangibles, and the proper approach to value these types of properties. Ultimately, the court rejected arguments related to intangibles and functional obsolescence and embraced the cost approach as the appropriate valuation methodology, stating,

Based on our de novo review of the record, we conclude that the cost approach provides the best mechanism for determining market value. There is no dispute that the building is appropriate as a corporate headquarters for an insurance company. There is also no dispute that the actual cost of the building was in the neighborhood of \$150 million and that there had been very little physical deterioration of the structure as of the date of the assessment. Courts have often applied the cost approach in determining the value of a single-tenant corporate headquarters property when comparable sales were not available. (Wellmark v. Polk County Board of Review 2016)

Drugstores

Modern drugstores are typically occupied by chains such as Walgreens, CVS, and Rite Aid. These chains typically develop their stores in a built-to-suit arrangement and sometimes sell them in sale-leaseback transactions. They can be appraised or assessed using all three approaches.

Drugstore properties do not sell as going-concerns, but they often sell as leased-fee investment properties. Leased-fee sale prices can exceed fee-simple value, typically when the rent being paid by the tenant is above market.

Accountants treat above-market leases as an intangible asset. In most jurisdictions, the legal requirement for assessment is fee-simple market value. Under that premise, market rent—not contract rent—is utilized. So whether above-market leases are classified as intangible assets is irrelevant. The same can be said for below-market leases, which in the assessment world are typically ignored in favor of market rent.

For drugstores, all three approaches to value can be applied. Drugstore chains acquire most of their properties by purchasing land and constructing improvements. Those actions are best reflected in the cost approach. A Florida judge acknowledged that fact in a court case involving the assessment of CVS stores, saying,

It is logical that, should a drug store chain decide what to pay for one of these properties, the drug store would look to the costs involved in building a new store on a competing corner. As noted by [CVS representative], CVS itself weighs the costs and benefits of building their own stores when it comes to the decision to acquire an existing store or chain of stores. (CVS Corporation Divisions and Affiliates v. Rob Turner, Property Appraiser for Hillsborough County, Florida, et al. 2013)

The market and income approaches can also be applied to drugstores; however, sales of operating drugstores are typically leased-fee transactions that may require an adjustment to arrive at fee-simple prices. The income approach can also be applied if actual lease rates for operating drugstores can be obtained.

Fitness Centers

Fitness centers are often sold as a going-concern. All three valuation approaches can be applied to fitness centers and similar sports-related facilities. The cost approach is appealing because it isolates only the value of the real property. The sales comparison approach may be

complicated by the inclusion of business value and personal property. The income approach can also be difficult because of the lack of reliable rental data.

Funeral Homes

Funeral homes can sell as real property, a going-concern, or both. Many consider them special-purpose property. Often when these properties sell, the price includes the land, buildings, personal property, and intangible value. The intangible value can arise from the trade name, prepaid funeral deposits, or both. Often funeral homes are located in buildings that have been converted from a different use, such as dwellings, office buildings, and stores.

All three approaches can be applied to funeral homes, although reliable sale comparables and lease comparables are scarce. In valuing the real property, the most reliable approach to value may be the cost approach.

Golf Courses

When golf courses sell, the price often includes land, buildings, personal property, and often the business. The sale prices of golf courses are typically driven by their ability to generate income. If the going-concern of the golf course is able to generate a profit, the price will likely exceed that of one that does not. The difficulty for assessors is developing approaches to value that reflect the different course types (private, semiprivate, public) and the various sources of income present in golf course operations (golf cart rental, pro-shop income, memberships, greens fees, and so on).

All three approaches to value can be applied to golf courses. The income approach is used most by market participants in setting prices for golf courses. However, revenue can vary dramatically depending on the type of course and the services offered. If the revenues from the going-concern are used to estimate the

value of the real estate, intangible assets related to the going-concern must be considered.

In the Appraisal Institute's text on appraising golf courses, the authors offer several methods for dealing with intangible assets. Suggested techniques include the excess profits technique, analysis of sales of golf course business opportunities, the residual/segregated value technique, and the management fee technique, among others (Hirsh 2016).

Similar to hotels, any value of intangible assets in going-concern appraisals can be measured in the income approach by applying a management fee appropriate for running the business; this effectively removes any intangible value in the income approach. In the sales comparison approach, consideration should be given to each golf course's revenue-generating capability.

The cost approach can be applied to golf courses. However, the golf industry is in transition, because fewer courses are being developed and the number of golfers is declining. The replacement cost of a golf course may not reflect the fee-simple market value without consideration for obsolescence. Although golf courses may sell as going-concerns, the declining nature of the industry casts doubt on significant intangible value associated with these properties.

Hotels, Resorts, and Bed & Breakfast and Other Lodging Facilities

Property types most commonly associated with intangible assets are lodging facilities. These property types often utilize intangible assets to allow the real and personal property to achieve its highest and best use. For example, management and franchise agreements are often necessary for a lodging property to compete in the market.

As described in Section 3, the Rushmore approach has been widely accepted

by the courts, has been embraced by most assessment jurisdictions, and reflects observable and verifiable market behavior in the transaction market. For lodging properties and casinos, the Rushmore approach is the recommended method for excluding intangible value from real property valuations.

Industrial Properties

The many types of industrial properties range from distribution warehouses to mini-storage facilities. Most represent the general industrial category in which they are bought and sold based on their ability to generate rent, with little if any intangible value. However, in some rare cases, specialized industrial properties may be sold as a going-concern with the business included in the purchase price. This usually involves company buyouts or mergers. These situations are rare, but sale verification can determine whether any nonrealty items were included in a price.

Landfills

A landfill operation includes real estate to store waste, operating permits and contracts, waste transport equipment, and management to run the business. Together these components make up a going-concern. The right of a business to store waste on a site typically requires a nontransferable permit from a government agency, and those rights typically do not run with the land. That permit could be considered an intangible asset. Although the permit itself should be excluded in estimating the fee-simple value of the real property, the assumption of its existence under highest and best use of the property is permitted.

It seems contrary to estimate value utilizing landfill revenue only achievable by virtue of a nontransferable permit, when the value of the permit itself must be excluded from value. The courts have recognized this paradox in cases involving landfill assessments. In

a case involving a landfill in Kenosha, Wisconsin, the courts gave considerable weight to the ability of the land to generate landfill revenue and assumed competent management would obtain the proper permits (*Waste Management of Wisconsin, Inc. v. Kenosha County Board of Review* 1994). Although the permit was considered an intangible asset and excluded from the assessment, the land was valued assuming the presence of the permit.

A California court made a similar ruling in a landfill case, noting,

In short, in a real property case, intangibles associated with the realty, such as zoning, permits, and licenses, are not real property and may not be taxed as such. However, insofar as such intangibles affect the real property's value, for example by enabling its profitable use, they may properly contribute to an assessment of fair market value. (American Sheds, Inc. v. County of Los Angeles 1998)

Marinas

When marinas sell, the price typically includes land, buildings, personal property, and often the marina business. Sale prices are typically driven by the marina's ability to generate income. The value of marinas is often determined by the revenue generated by the various profit centers of a marina—boat repair, dry storage, slip rental, gasoline and retail sales, and other services. The operation of a marina requires expertise, and its success is dependent on competent management.

All three approaches to value can be applied to a marina. The income approach is used most often by market participants when purchasing a marina, by using revenues from the various profit centers. If the revenues from the business are used to estimate the value of the real estate, intangible assets related to the going-concern must be considered.

Mobile Home Parks and RV Parks

Mobile home parks and RV parks derive their revenue from space rental. When these properties sell, the price is typically based on the ability of the real estate to generate rent. These properties are not typically considered going-concerns that include a business. For this reason, there is typically no intangible value for the appraiser or assessor to consider.

Movie Theaters

Movie theaters can be categorized into traditional, multiplex, megaplex, drive-ins, and IMAX. Movie theaters are typically valued using the rent for the facility, not the revenue from ticket sales. In some cases it may be possible a buyer purchased a going-concern, instead of the real estate alone. In most cases, movie theaters are sold as real estate only. Sale verification can indicate what was included in a sale price.

Office Buildings

Office buildings are bought either for investment purposes or for owner occupancy. When these properties sell, they sell either for their ability to generate rent or, in the case of owner-occupied properties, their ability to provide utility.

In some cases, single-occupant office buildings and corporate campus properties sell in a sale-leaseback transaction, in which a corporation sells the property and remains as a tenant. Some argue the sale price in a sale-leaseback transaction may be influenced by the creditworthiness of the tenant. The argument suggests that a price premium paid to obtain a creditworthy tenant is intangible value. Others contend the quality of the location and the superior characteristics of the land and improvements attract the creditworthy tenant and reflect real property, not intangibles. Careful sale verification can determine whether the quality of the tenant caused the buyer to pay an above-market price for the property.

When REITs purchase office buildings, they often allocate the fair value of intangibles to leases-in-place, above- or below-market leases, or both. These allocations are typically done for financial reporting or accounting purposes after the pricing decision and are permitted under accounting rules. But leases-in-place and above- or below-market leases are not valid intangible assets in estimating market value of the fee-simple interest. Above- or below-market leases do not create an intangible asset; they create leased-fee and leasehold interests.

Racetracks

Horse- and dog-racing facilities typically consist of the track itself, a clubhouse or grandstand, barns, and other support areas. A racetrack can be valued as a going-concern by utilizing the actual revenues from operations (including gambling revenues, often called *the handle*) the facility generates. Racetracks can also be valued as real property only, with the focus on the land and improvements. Often racetracks are valued as a going-concern; then the total value is allocated to the land, building, personal property, and intangible value. In their text about the valuation of pari-mutuel racetracks, Nelson and Messer cite the cost approach as the best way to allocate the real property value, noting,

A racetrack is basically a business property (a going-concern) with strong real estate foundations, but it is also one with considerable risks. ... Appraisers are generally called on to allocate various aspects of the enterprise value. One method of allocating value is to go to a conventional cost approach. (Nelson and Messer 1989)

In a court case involving the West Flagler Kennel Club in Miami, Florida, the court upheld the assessor's income approach value because the appraiser made an allowance for the pari-mutuel license (*Hecht v. Dade County, Florida et al.* 1970). In a Florida case involving

the Tropical Park horse track, the court considered the pari-mutuel license intangible property, stating,

The trial court simply found that the income or profit of the race track business was not assignable to the real estate but rather to the intangible rights which have been granted the owner by the state in the form of a license to conduct pari-mutuel wagering. We think there is evidence to support this conclusion. (Metropolitan Dade County v. Tropical Park Inc. 1970)

Regional Malls and Shopping Centers

Arguments for the presence of intangible assets in shopping centers and malls include superior management, optimal tenant mix, cart and stroller rental income, monopoly value, above-market rent, percentage rents, start-up costs, and others. The courts have mostly rejected arguments related to intangible value in retail properties (*Merle Hay Mall v. Board of Review* 1997; *Eden Prairie Mall, LLC v. County of Hennepin* 2009; *State ex rel. N/S Associates by JMB Group Trust v. Board of Review of the Village of Greenview* 1991). In a court case involving the Merle Hay Mall in Des Moines, Iowa, the court stated,

Further, the business enterprise value concept seems to be used almost exclusively in tax assessment cases; it is not used in all mall appraisals. Significantly, one appraiser who had used the theory several times in tax assessment cases testified that he had never used it when a mall requested an appraisal for the purpose of obtaining a mortgage loan. Apparently, no assessor in Iowa applies this theory, and there is no uniformly accepted methodology to do so. (Merle Hay Mall v. Board of Review 1997)

For hotels, senior care properties, and some other property types, the value of the real property is often based on the revenue generated by the business occupying the real estate. This is not true for most retail properties, in which the

value of the real property is measured by the rent for the property. Regional malls, shopping centers, and other retail properties derive their income from rent paid by tenants, not from business income. Even though successful shopping centers and regional malls are operated by businesses, their value is measured by their ability to generate rent. Further, the absence of intangibles in mall transactions is well documented by appraisers who routinely value regional mall properties.

A Wisconsin court recognized the nuance that intangible assets must be separable from the real estate in its ruling on the assessment of the Southridge Mall. In that case, the court stated,

Southridge Mall's raison d'être—namely, the leasing of space to tenants and related activities such as trash disposal, baby stroller rentals, etc.—is a transferrable value that is inextricably intertwined with the land and 'all buildings and improvements thereon, and all fixtures and rights and privileges appertaining thereto,' sec. 70.03, Stats., just as the transferrable value of a farm—the growing of crops—is inextricably intertwined with the property from which the farm operates. (State ex rel. N/S Associates by JMB Group Trust v. Board of Review of the Village of Greenview 1991)

In essence, malls, shopping centers and similar properties comprise land, buildings, and personal property. Income is generated by renting space and other services, which are tied to the real property. In some cases, market participants may be willing to pay above-market prices for creditworthy tenants, but in almost every case, there is no intangible value associated with retail properties when market rent is used to value the property.

Restaurants

Restaurants, both fast food and full service, often sell as going-concerns that could include intangible value. In

fact, restaurant businesses often sell independent of real estate. The most common intangible asset associated with restaurants is the business name. A well-run restaurant with a popular following can achieve a level of success that similar properties do not enjoy. That success can translate into an intangible asset. However, success is often achieved through the efforts of specific ownership or management and cannot be transferred to a new buyer or successor. Similarly, the identity of a restaurant is often tied to its location. When appraising the property as a going-concern, an appraiser should be mindful that not all success is transferable.

Business appraisers value restaurants using EBITDA multipliers and other methods in which revenue is based on business receipts. Real estate appraisers value restaurants using all three approaches and in the income approach utilize revenue based on the rental of the property. In reality, both techniques can be applied to the same property—one arriving at the value of the business and the other at the value of the real property.

Sometimes a restaurant in a full-service hotel may achieve revenues significantly higher than typical food and beverage revenue for most hotel restaurants. That difference may be attributed to brand or reputation, but may not be something a new hotel owner can achieve through location alone. A comparison of food and beverage revenue as a percentage of total revenue should be made against benchmarks published in industry reports.

All three approaches can be used to value restaurants, although market participants rarely use the cost approach. When restaurants sell as a going-concern, with real property, personal property, and intangible value, verification should assist the appraiser or assessor in determining how much of the price was allocated to real property. If the income approach is used to value the real property, revenue should be based on the rental of the

property, not the business income. There are exceptions to this, such as restaurants located within full-service hotels, whose contributory value is often estimated using food and beverage revenue.

Senior Care Facilities

Senior care facilities include nursing homes, assisted living facilities, independent living facilities, and continuing care retirement communities (CCRCs), among others. These properties differ from typical multi-family properties, because they offer services over and above the real estate. Services can include beauty salons, cleaners, medical services, transportation, meals, and so on. These services are provided by the business operating inside the real estate.

Senior care facilities are often bought and sold based on the revenue from business operations, which can include a combination of rental income and services income. Included in the price are real property, personal property, intangible assets associated with the business, and licenses and permits that allow the facility to operate. For example, nursing homes require a certificate of need.

The Appraisal of Nursing Facilities addresses the need to allocate the value between tangible and intangible assets as follows:

The methods for allocating the going-concern of a health care facility are the subject of an on-going debate. There is no sure, single technique to separate the real estate value from the value of the business enterprise. The cost approach may be the best indicator of the value of the tangible assets. This is especially true when the facility is newer. However, the cost approach is ineffective when the total value of the business or going-concern is less than the value indicated from the cost approach. (Tellatin 2009)

In the case of CCRCs, the courts have leaned heavily on the cost approach because of the complexities of the income

approach for these property types. In a court case in Oregon, the court noted that newly built facilities are evidence that investors base their decisions on the cost approach, stating,

Here, the objective is to value tangible real property, not going-concern or business value. A CCRC is a going-concern that provides many services for which income is received. Consequently, there is some danger of overvaluing or undervaluing the real property due to inability to separate income for services from income for use of the property. ... The cost approach eliminates this danger by avoiding any going-concern value or value attributable to services. It also eliminates the effects of management and management policies that affect the income earned by the property. Where the property is reasonably new construction, the cost approach can provide a good indication of a base value. (Linus Oakes, Inc., fka Parkway Medical Buildings, Inc. v. Department of Revenue, State of Oregon, et al. 2000)

All three approaches can be used to value senior care facilities, although the courts have strongly favored the cost approach for CCRC properties. When the sale price of a senior care facility includes real property, personal property, and intangible value, verification should assist the appraiser or assessor in allocating the purchase price.

Ski Resorts

Ski resorts consist of land (including a mountain slope), lodging facilities, ski lifts, equipment to groom the ski runs, snowmaking equipment, and typically a rental/retail shop. Ski lodges offer various services that are part of a business and not necessarily part of the real property.

When ski resorts sell, the price may include land, buildings, personal property, and often the business. Sale prices of ski resorts are typically driven by their ability to generate income. When either

the real estate or the business is being valued, it is necessary to analyze the number of skiers who patronize a facility. Resort demand will assist the appraiser or assessor in determining highest and best use of the property.

The difficulty in separating the real estate from the ski resort business was recognized by the Oregon Supreme Court in the assessment of a ski resort on Mt. Bachelor near Bend, Oregon (*Mt. Bachelor, Inc. v. Department of Revenue* 1975). In that case, the court approved an income approach that included revenue from ski lift tickets.

All three approaches to value can be applied to ski resorts. If the revenues from the business are used to estimate the value of the real estate, consideration for intangible assets related to the going-concern must be considered. A ski resort is an income-producing business intertwined with the real estate. It is often difficult to separate the value of the business from the real estate. Similar to hotels, any value to intangible assets in going-concern appraisals can be measured in the income approach by applying a management fee appropriate for running the business; this effectively removes any intangible value.

Telecommunications, Railroads, and Public Utilities

Telecommunications properties, railroads, and public utilities are sometimes valued at a state level using a technique called *unit valuation* or referred to as being *centrally assessed*. This method values an entire company and then allocates that value to multiple jurisdictions, which can be local, countywide, or even statewide. Unit valuation methods are often applied in the assessment of communications, transportation (railroads and airlines), water, gas, wastewater, and electric utilities, as well as oil and gas pipeline companies.

The unit approach is used to value these types of property because it is considered

more efficient than attempting to value the individual parts located in each jurisdiction. The premise is that the individual assets, such as railroad tracks, train cars, and train stations, have more value as an integrated operating unit than as separate assets and assessing them as a whole and then allocating them to each jurisdiction ensures uniformity.

Because the entire business is valued, the unit valuation involves appraising the going-concern and allocating that value to the various components of land, building, personal property, and intangible assets. Valuing the intangibles is what attracts the most appeals related to the value of these properties. The going-concern value of these types of properties represents the individual values of land, building, and personal property but, because these properties are valued as a going-concern, may include intangible assets.

A California court ruled in favor of the assessor in a property tax appeal involving the telephone company PacTel. In that case, the taxpayer argued that the company's license issued by the Federal Communications Commission was an intangible asset that should have been excluded from the assessment. The court stated,

What PacTel fails to appreciate sufficiently is that although 'intangible property' is exempted from property taxation, such property may enhance the value of tangible personal property (Los Angeles SMSA Limited Partnership v. State Board of Equalization et al. 1992).

A property tax case involving the unit approach occurred in Florida in the early 1990s. In that case, the court rejected the railroad's argument that management skills and quality of service delivered by its employees was an intangible value that should have been excluded from the assessment (*Florida East Coast Railway Company v. Department of Revenue* 1993).

The unit approach is not always applied to telecommunications, railroads,

and public utility properties. For many industries, such as telecommunications, much of the value lies in personal property and intangible assets. These properties are sometimes assessed locally. The real estate for these types of property can often be minimal in comparison to the personal property and intangible assets. In these situations, the cost approach is the best approach since it is the preferred approach for personal property and the cost approach inherently excludes intangible value.

A recent case from California addressed the issue of intangible assets in the property tax assessment of the Elk Hills Power Plant (*Elk Hills Power, LLC v. Board of Equalization et al.* 2013). In that case, the taxpayer argued that emission reduction credits (ERCs) are intangible assets that should have been excluded from the company's property tax assessment. An ERC is a credit earned by a company when it reduces air emissions beyond what is required. It can be used by the owner of a business or sold to other companies that need emission offsets. Elk Hills had purchased approximately \$10 million in ERCs to obtain the permits it needed to build its power plant. The assessor had included the value of the ERCs in Elk Hills' assessment, and litigation ensued. The court rejected the assessor's reasoning that the ERCs were taxable because they were necessary to put the taxable property to its productive use. The California Supreme Court ruled that the ERC's were intangible property that should be excluded from the assessment.

California law is interesting in that the state *Assessors' Handbook* allows intangible assets to be assumed in estimating the value of tangible assets, but they must be excluded from that value. The handbook states,

The value of such intangible assets and rights does not enhance and is not to be reflected in the value of taxable property (California State Board of Equalization 1998, 159).

That distinction was important in *Elk Hills* because clearly the company needed the ERCs to build the power plant, and without them the power plant would not be able to operate and would be virtually worthless. But the California Assessors' Handbook and courts make a clear distinction between assuming the presence of an intangible asset for a tangible asset to achieve its highest and best use, versus actually including the value of that intangible asset in the assessment.

All three approaches can be applied in a unit valuation approach. The cost approach is typically applied in an aggregate method, versus an asset-by-asset basis. Accounting book value is often used as a substitute for replacement cost and trended for time. In the income approach, some practitioners use the stock-and-debt method, which measures value using a company's stock. The income approach typically utilizes the capitalization of earnings to measure value in the unit approach.

Appendix B. Glossary

Permission to reproduce the following excerpts from The Dictionary of Real Estate Appraisal, 6th edition, was generously provided by the Appraisal Institute. The Appraisal Institute was not involved in the development, preparation, or review of “Understanding Intangible Assets and Real Estate: A Guide for Real Property Valuation Professionals.” The views and opinions expressed therein are not endorsed or approved by the Appraisal Institute as policy unless adopted by the Board of Directors pursuant to the Bylaws of the Appraisal Institute.

Air rights—The right to undisturbed use and control of designated air space above a specific land area within stated elevations. Air rights may be acquired to construct a building above the land or building of another or to protect the light and air of an existing or proposed structure on an adjoining lot. Air rights do not always include developmental rights.

Big-box store—A single-use store, typically between 10,000 and 100,000 square feet or more, such as a large bookstore, office supply store, pet store, electronics store, or toy store (ICSC 2012).

Blue sky—The process of qualifying an issue (e.g., a real estate syndication) under a state securities act.

Bundle of Rights theory—The concept that compares property ownership to a bundle of sticks with each stick representing a distinct and separate right of the property owner, e.g., the right to use real estate, to sell it, to lease it, to give it away, or to choose to exercise all or none of these rights.

Business Enterprise Value—The value contribution of the total intangible assets of a continuing business enterprise such as marketing and management skill, an assembled workforce, working capital, trade names, franchises, patents, trademarks, contracts, leases, customer base, and operating agreements.

Business start-up costs—Pre-opening expenses necessary to turn completed real

estate into an operating business; can include initial operating losses, operating capital, advertising and promotions, assembling a workforce, training, etc.

Certificate of Need—A written document issued by a governmental body (e.g., the State Department of Health) to an individual or organization proposing to construct or modify a health facility, or to offer a new or different service.

Condemnation—The act or process of enforcing the right of eminent domain.

Credit tenant—A tenant in a retail, office, or commercial property with a long history in business, strong financial statements, or a large market presence that could be rated as investment grade by a rating agency. Because of the likelihood of honoring their leases, credit tenants are considered less risky to lease to, and developments with credit tenants as anchors are considered less risky investments for lenders.

Deed restriction—A provision written into a deed that limits the use of land. Deed restrictions usually remain in effect when title passes to subsequent owners.

Eminent domain—The right of government to take private property for public use upon the payment of just compensation. The Fifth Amendment of the U.S. Constitution, also known as the takings clause, guarantees payment of just compensation upon appropriation of private property.

Fair value—The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (FASB)

Fee-simple estate—Absolute ownership unencumbered by any other interest or estate, subject only to the limitations imposed by the governmental powers of taxation, eminent domain, police power, and escheat.

Financial Accounting Standards Board (FASB)—The agency of the Financial Accounting Foundation that is responsible for establishing financial accounting standards.

Franchise—A privilege or right that is conferred by grant or purchased by an individual or a group of individuals; usually an exclusive right to furnish public services or to sell a particular product in a certain community.

Going-concern—

1. An established and operating business having an indefinite future life.
2. An organization with an indefinite life that is sufficiently long that, over time, all currently incomplete transformations (transforming resources one form to a different, more valuable form) will be completed.

Going-concern value—An outdated label for the market value of all the tangible and intangible assets of an established and operating business with an indefinite life, as if sold in aggregate; more accurately *termed the market value of the going-concern or market value of the total assets of the business.*

Goodwill—Unidentifiable intangible assets.

1. The amount by which the acquisition price exceeds the fair value of identified assets.

2. That intangible asset arising as a result of name, reputation, customer loyalty, location, products, and similar factors not separately identified. (American Institute of Certified Public Accountants et al. 2001)

3. That intangible asset arising as a result of elements such as name, reputation, customer loyalty, location, products and related factors not separately identified and quantified. (ASA 2009)

Hypothetical condition—

1. A condition that is presumed to be true when it is known to be false. (Appraisal Institute 2015)
2. A condition, directly related to a specific assignment, which is contrary to what is known by the appraiser to exist on the effective date of the assignment results, but is used for the purpose of analysis.

Comment: Hypothetical conditions are contrary to known facts about physical, legal, or economic characteristics of the subject property, such as market conditions or trends; or about the integrity of data used in an analysis. (TAF 2016–2017)

Intangible assets—

1. A nonmonetary asset that manifests itself by its economic properties. It does not have the physical substance but grants rights and economic benefits to its owner. (IVSC 2013)
2. A nonphysical asset such as a franchise, trademark, patent, copyright, goodwill, equity, mineral right, security, and contract (as distinguished from physical assets) that grant rights and privileges, and have value for the owner. (ASA 2009).
3. An identifiable nonmonetary asset without physical substance.

An asset is a resource that is controlled by the entity as a result of past events (for example, purchase or self-creation) and from which future economic benefits (inflows of cash or other assets) are expected. [IAS38.8] Thus, the three critical attributes of an intangible asset are:

- identifiability
- control (power to obtain benefits from the asset)
- future economic benefits (such as revenues or reduced future costs). [IFRS Foundation 2014].

Intangible property—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. (TAF 2016–2017)

Leased fee interest—The ownership interest held by the lessor, which includes the right to receive the contract rent specified in the lease plus the reversionary right when the lease expires.

Leasehold interest—The right held by the lessee to use and occupy real estate for a stated term and under the conditions specified in the lease.

Market value—A type of value that is the major focus of most real property appraisal assignments. Both economic and legal definitions of market value have been developed and refined, such as the following:

1. The most widely accepted components of market value are incorporated in the following definition: The most probable price, as of a specified date, in cash, or in terms equivalent to cash or in other precisely revealed terms, for which the specified property rights should sell after reasonable

exposure in a competitive market under all conditions requisite to a fair sale, with the buyer and seller each acting prudently, knowledgeably, and for self-interest, and assuming that neither is under undue duress.

2. Market value is described, not defined in the *Uniform Standards of Professional Appraisal Practice (USPAP)* as follows: A type of value, stated as an opinion, that presumes the transfer of a property (i.e., a right of ownership or a bundle of such rights), as of a certain date, under specific conditions set forth in the definition of the term identified by the appraiser as applicable in an appraisal.

Comment: Forming an opinion of market value is the purpose of many real property appraisal assignments, particularly when the client's intended use includes more than one intended user. The conditions included in market value definitions establish market perspectives for development of the opinion. These conditions may vary from definition to definition but generally fall into three categories:

1. the relationship, knowledge, and motivation of the parties (i.e., seller and buyer);
2. the terms of sale (e.g., cash, cash equivalent, or other terms); and
3. the conditions of sale (e.g., exposure in a competitive market for a reasonable time prior to sale).

Appraisers are cautioned to identify the exact definition of market value, and its authority, applicable in each appraisal completed for the purpose of market value.

USPAP also requires that certain items be included in every appraisal report. Among these items, the following are directly related to the definition of market value:

A | B | C | D | E | F | G | H | I | J | K | L | M | N | O | P | Q | R | S | T | U | V | W | X | Y | Z

- Identification of the specific property rights to be appraised.
- Statement of the effective date of the value opinion.
- Specification as to whether cash, terms equivalent to cash, or other precisely described financing terms are assumed as the basis of the appraisal.
- If the appraisal is conditioned upon financing or other terms, specification as to whether the financing or terms are at, below, or above-market interest rates and/or contain unusual conditions or incentives. The terms of above- or below-market interest rates and/or other special incentives must be clearly set forth; their contribution to, or negative influence on, value must be described and estimated; and the market data supporting the opinion of value must be described and explained.

3. The following definition of market value is used by agencies that regulate federally insured financial institutions in the United States: The most probable price that a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus. Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from seller to buyer under conditions whereby:

- Buyer and seller are typically motivated;
- Both parties are well informed or well advised, and acting in what they consider their best interests;

- A reasonable time is allowed for exposure in the open market;
- Payment is made in terms of cash in U.S. dollars or in terms of financial arrangements comparable thereto; and
- The price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.

(12 C.F.R. Part 34.42(g); 55 *Federal Register* 34696, August 24, 1990, as amended at 57 *Federal Register* 12202, April 9, 1992; 59 *Federal Register* 29499, June 7, 1994)

4. The International Valuation Standards Council defines *market value* for the purpose of international standards as follows: The estimated amount for which an asset or liability should exchange on the valuation date between a willing buyer and a willing seller in an arm's length transaction, after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion. (IVSC 2013)

5. The *Uniform Appraisal Standards for Federal Land Acquisitions* defines *market value* as follows: Market value is the amount in cash, or on terms reasonably equivalent to cash, for which in all probability the property would have sold on the effective date of the appraisal, after a reasonable exposure time on the open competitive market, from a willing and reasonably knowledgeable buyer, with neither acting under any compulsion to buy or sell, giving due consideration to all available economic uses of the property at the time of the appraisal. (Interagency Land Acquisitions Conference 2000)

Personal property—

1. The interests, benefits, and rights inherent in the ownership of tangible objects that are considered by the public as being personal; also called *tangible personal property*.
2. Identifiable tangible objects that are considered by the general public as being “personal”—for example, furnishings, artwork, antiques, gems and jewelry, collectibles, machinery and equipment; all tangible property that is not classified as real estate. (TAF 2016–2017)

Real estate—

1. An identified parcel or tract of land, including improvements, if any. (TAF 2016–2017)
2. Land and all things that are a natural part of the land (e.g., trees, minerals) and things that have been attached to the land (e.g., buildings and site improvements) and all permanent building attachments (e.g., mechanical and electrical plant providing services to a building) that are both below and above the ground. (IVSC 2013)

Real Estate Investment Trust (REIT)—A corporation or trust that combines the capital of many investors to acquire or provide financing for all forms of real property. A REIT serves much like a mutual fund for real property. Its shares are freely traded, often on a major stock exchange. To qualify for the favorable tax treatment currently accorded such trusts, 90% of the taxable income of a REIT must be distributed among its shareholders, who must number at least 100 investors; no fewer than five investors can own more than 50% of the value of the REIT during the last half of each taxable year. The U.S. Securities and Exchange Commission (SEC) stipulates

that REITs with over 300 investors have to make their financial statements public.

Residual techniques—Procedures used to capitalize the income allocated to an investment component of unknown value after all investment components of known values have been satisfied; may be applied to a property’s physical components (land and building), financial interests (mortgage and equity, legal components (leased fee and leasehold interests), or economic components (income and reversion).

Sale-leaseback—A transaction in which real estate is sold by its owner-user, who simultaneously leases the property from the buyer for continued use. Under this arrangement, the seller receives cash from the transaction and the buyer is assured a tenant.

Value in use—The value of a property assuming a specific use, which may or may not be the property’s highest and best use on the effective date of the appraisal. Value in use may or may not be equal to market value but is different conceptually.

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