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BOARD OF EQUALIZATION
KEY AGENCY ISSUE

- [ ] Board Meeting
- [ ] Business Taxes Committee
- [ ] Customer Services Committee
- [ ] Legislative Committee
- [x] Property Tax Committee
- [ ] Other

DISCUSSION RELATING TO INTANGIBLE ASSETS AND RIGHTS IN ASSESSORS' HANDBOOK SECTION 502, ADVANCED APPRAISAL

I. Issue

Which version of the section relating to the treatment of intangible assets and rights should the Board adopt for inclusion in Assessors' Handbook Section 502, *Advanced Appraisal* (AH 502)?

II. Staff Recommendation

[Assessors concur with staff recommendation.]

To ensure that its instruction to county assessors is consistent with current law, the Board should adopt staff's version of the section of AH 502 that relates to the treatment of intangible assets and rights. (See Attachment 1.)

III. Other Alternative(s) Considered

1. Adopt industry's version of the section relating to the treatment of intangible assets and rights. (See Attachment 2.)

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IV. Background

The Assessors' Handbook is a series of manuals, issued by the Board, that are aimed at providing uniform instruction to the state's 58 county assessors. In 1997 the Board directed staff to prepare a new manual for inclusion in the handbook. The new manual, Assessors' Handbook Section 502, *Advanced Appraisal* (AH 502), is to encompass advanced appraisal practices and theories.

Among the most controversial subjects to be addressed in AH 502 is the treatment of intangible assets and rights. The controversy, which has been ongoing in the courts for several decades, involves the practical implications of the two-pronged legal mandate to (1) exempt from taxation all intangible assets and rights that are not inherent in the ownership of taxable property, but (2) assess taxable property by assuming the presence of any intangible assets and rights that are needed to put the property to productive use.

Under this legal concept, "intangibles" associated with the property itself, such as permits and licenses, are not themselves taxable. However, to the extent that such intangibles contribute to the value of taxable property by, for example, enabling its profitable use, that effect on value is properly reflected in the assessment of the property. Thus, in assessing property at its full value as required by the state Constitution, assessors do not directly tax intangibles; neither, however, do they disregard the presence of otherwise non-taxable intangibles that contribute to the full value of taxable property.

Generally, assessors estimate value by analyzing market data on sales of similar properties (the comparable sales approach); by estimating replacement costs (the replacement cost approach); or by converting (i.e., capitalizing) the net income from the property into a present value sum (the income approach). Further, the courts have held that since no one of these methods alone can be used to estimate the value of all property, the assessor, subject to requirements of fairness and uniformity, may exercise his discretion in using one or more of them.

In an income-based appraisal, the use of income derived from rental of the property is generally preferred over the use of income derived from its operation, since the latter is more likely to be influenced by managerial skills or to come from sources other than the taxable property. Despite the preference in favor of rental income, however, for many types of properties data on rental income is unavailable. For some of these properties, income derived from their operation may lawfully form the basis of a valid indicator of value.

In the valuation of these properties, the application of the legal concepts governing the treatment of intangible assets and rights becomes difficult, and disputes between taxpayers and assessors—or the Board—often ensue. From the standpoint of appraisal theory, the disputes involve the proper application of the "principle of unit valuation." Under this concept, which is typically used by the Board in carrying out its constitutional duty to collectively value all of a public utility's operating property, a sale of a whole company—or a capitalization of the company's expected operating earnings—is sometimes used as evidence of the aggregated value of the company's taxable property. The principle of unit valuation is applied infrequently in appraisals of locally assessed property.

Regardless of whether the disputes involve state assessed property or locally assessed property, taxpayers usually assert that some portion of either the income used (in an appraisal based on the income approach) or the sale price relied upon (in an appraisal based on a sale of an entire company) is attributable to non-taxable intangible assets and rights whose presence is *not* necessary to the productive use of the taxable property. Conversely, assessors and Board staff have often adopted the position that the intangible(s) whose presence is asserted by the taxpayer would not even exist apart from the taxable property, and that any value conferred by such intangibles is therefore properly included in the assessment.

In 1995 the Legislature adopted statutory amendments aimed at clarifying the treatment of intangible assets and rights. The amendments, which were accomplished in legislation sponsored by industry, added subdivisions (d), (e), and (f) to section 110 of the Revenue and Taxation Code. In *American Sheds, Inc.* v. *County of Los Angeles* 66 Cal.App.4th 384 (August 1998) the court said that the amendments reflect preexisting law.

Despite the amendments, the controversy over the application of the fundamental legal concept remains. In fact, the respective views of industry and Board staff on this issue are so divergent that in the course of developing AH 502, industry prepared its own version of the chapter on the treatment of intangibles, intended to replace staff's version in its entirety. In addition, the California Assessors' Association, which concurs with staff's recommended version for AH 502, has submitted a position paper on the treatment of intangibles. At the request of the assessors group, the position paper is attached to this document. (See Attachment 3.)

V. Staff Recommendation

A. Description of the Staff Recommendation

In general, staff's version of the chapter on intangibles gives recognition to the longstanding legal principle that (1) exempts from taxation all intangible assets and rights that are not inherent in the ownership of taxable property, but (2) requires that an assessment of taxable property be made by assuming the presence of any intangible assets and rights that are needed to put the property to productive use. Further, staff's version acknowledges the conjecture that is often inherent in attempts to explicitly segregate from the value of taxable property some intangibles that may *not* be needed to put the property to productive use. Thus, staff's version advises that where the non-taxable value of such an intangible cannot logically be established, an appraiser should account for the presence of the intangible by giving a particular approach to value more or less weight depending, primarily, on the extent to which the activities of the business that is operating the taxable property are entwined with, or integrally related to, the property's use.

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B. Pros of the Staff Recommendation

1. *Staff's version lawfully addresses concerns about the improper taxation of intangibles.*
Taxpayers who own property that is valued by reference to earnings from the property's operation—or by reference to a sale of the business entity that is operating the property—often assert that the resulting assessment includes the value of non-taxable intangibles. Staff's version of the chapter on the treatment of intangible assets and rights addresses these concerns by instructing that (1) a value indicator based on operating earnings, or on a sale of the business entity operating the property, should be used only where the facts indicate that the earnings of the business can be ascribed primarily to the taxable property; (2) the market values of any non-taxable intangibles whose separate value can logically be established should be deducted from such an indicator; and (3) an appraiser should give greater weight to the indicator(s) that are less likely to include the value of non-taxable intangibles whose separate value *cannot* logically be established.

2. *Staff's version recognizes both the Board's and an assessor's lawful discretion in applying the traditionally sanctioned approaches to value.*
Staff's version would recognize both the Board's and an assessor's authority to use any or all of the income, comparative sales, or cost approaches to value. Without such discretion, the Board—or an assessor—could in some cases be forced to use an approach that, considering all factors on the valuation date, may not be relevant to the current value of the property.

3. *Adopting staff's version would ensure that the Board's guidance on this controversial subject is consistent with current law.*
Staff's version is consistent with current law on the treatment of intangible assets and rights. Thus, for example, in *American Sheds, Inc. v. County of Los Angeles* 66 Cal.App.4th 384 (August 1998) the court affirmed that in a valuation based on operating earnings, it is proper to account for non-taxable values by imputing to the taxable property that portion of the earnings which is attributable to the property itself. Thus, in that case, it was not necessary for the assessor to establish the separate values of all of the non-taxable intangibles; instead, an income-based valuation method, designed to capture only the value of the taxable property, was deemed proper.

   This holding by the court, which analyzed the issues in light of the 1995 statutory amendments, is consistent not only with specific language in staff's draft (see page 18), but also with staff's general advice that, for some non-taxable intangibles, it may not be logically possible to establish their separate values. Thus, staff's draft is consistent with current law in ensuring that an assessor or the Board is able to use judgment both in valuing taxable property and in accounting for some non-taxable intangibles.

C. Cons of the Staff Recommendation

[The following text was provided by industry.]

1. *Inaccurate Representation of Current Law.* The conclusions drawn in the staff draft regarding the treatment of intangible assets and rights for property tax purposes have been rejected by the courts, the Legislature and the Board itself. It is at odds with the *Michael Todd* case, *Shubat* case, and inconsistent with *GTE Sprint*, and several of the cable television cases.

2. *Conflicts with Past BOE Decisions.* The approach followed in the BOE staff draft is also in direct conflict with many decisions of the BOE over the past several years, which reflect and were made pursuant to current California law.

3. *Unfounded Concepts.* The staff draft introduces concepts that are completely new and unique having no basis in appraisal theory or statutory or decisional California law.

4. *Incorrectly Attributes Income and Value.* The staff draft incorrectly attributes all net income to taxable property. The staff approach also has the net impact of loading the value of most intangible assets and rights into the value of taxable property – a result clearly contrary to current law.

5. *Permits Taxation of Intangible Assets and Rights.* The staff draft permits the direct taxation of intangible assets and rights, which violates state law, numerous court decisions and BOE decisions.

6. *Allows Taxation of Business Value.* The staff draft equates business value with taxable property value, resulting in the overvaluation of taxable property.

D. Statutory or Regulatory Change

None

E. Administrative Impact

None

F. Fiscal Impact

1. Cost Impact

None

2. Revenue Impact

None, since staff's version reflects current law.

G. Taxpayer/Customer Impact

Adopting staff's version of the chapter on the treatment of intangible assets and rights would promote fairness and uniformity by providing clarification as to the application of existing law.

H. Critical Time Frames

Approval of the final draft of AH 502, *Advanced Appraisal*, is scheduled for the Property Tax Committee meeting of November 17, 1998.

VI. Alternative 1

A. Description of the Alternative

In general, industry's version of the chapter on the treatment of intangibles emphasizes the difficulty that is inherent in attempts to segregate the value of some non-taxable intangibles from the value of taxable property. In doing so, industry's version strongly favors a valuation approach based on replacement cost. Thus, under industry's version, for property used in a business operation, other approaches to value (e.g., an approach based on operating earnings) would be considered valid only under very limited circumstances.

B. Pros of the Alternative

[Instead of providing arguments in favor of their version, industry opted to submit an outline that highlights their main points. (See Attachment 4.)]

C. Cons of the Alternative

1. *The guidance contained in industry's version fails to recognize either the Board's or an assessor's lawful discretion in the use of the traditionally sanctioned approaches to value.*
   Industry's version would effectively preclude the use of an approach based either on income from a property's operation or—in the case of the Board's collective valuation of all of a public utility's operating property—on a sale of an entire company. Accordingly, under industry's version an assessor's discretion (or the Board's) could be constricted such that the assessment of some properties would have to be based on a cost approach alone. Further, while industry's version would purport to allow the use of other approaches under certain circumstances, it would also effectively instruct that, for all practical purposes, those circumstances could never exist.

2. *Depending on prevailing economic conditions, this constriction on either an assessor's or the Board's discretion in using one or more of the traditionally*

sanctioned approaches to value could lead to both overassessments and underassessments.
In an appraisal of any particular property, the relevance of the traditionally sanctioned approaches to value can vary depending on economic conditions prevailing on the valuation date. Thus, in general, where an estimate based on replacement costs would indicate a *lower* value than one based on another approach, industry's version may lead to *under*assessments. In contrast, where an estimate based on replacement costs would indicate a *higher* value than one based on another approach, industry's version may lead to *over*assessments.

3. *Industry's version materially misstates several points of law.*
On page 6 of their draft, industry makes note of the statutory requirement to remove the fair market value of any intangible assets or rights from an indicator arrived at under the principle of unit valuation. The draft goes on to infer that this requirement "raises significant issues relating to the availability and reliability of data concerning the value of intangible rights and assets." Their draft then draws the conclusion that "[i]f an appraiser does not have access to appropriate data concerning the identification and/or value of intangible assets and rights, then it will not be possible to remove the value of those intangible assets and rights as required…, and a different valuation approach [i.e., a cost approach] should be considered."

There is no basis either for industry's inference about the "significant issues" that are allegedly raised by the referenced statutory language or, more importantly, for their conclusion that the specter of these issues precludes the use of one or more approaches to value. These misstatements of law run contrary to the longstanding rule in this state that, as circumstances warrant, an assessor may exercise discretion in using one or more approaches to value.

As an additional example of a material misstatement of law, on page 5 of their draft industry cites *Michael Todd Co. v. County of Los Angeles* 57 Cal.2d 684 (1962) as support for their contention that the meaning of the statutory language that requires taxable property to be valued by assuming the presence of intangible assets and rights necessary to put the property to productive use is, simply, that it is inappropriate to value the property as "scrap." In citing *Michael Todd*, however, industry has not only misinterpreted the court's holding, but they have also misstated what the court actually said.

Thus, in footnote 6 on page 5 of their draft, industry erroneously states that the court acknowledged that the value of copyrighted movie negatives based on their potential earning power of many millions of dollars was greater than the value of the negatives themselves. The court's actual statement, however, was that the negatives "…cost some $5,000,000 to produce and had a potential earning power of many millions of dollars…" (p. 696). Nowhere did the court address the question of whether a valuation based on earning power would have been appropriate.

071.

More importantly, the court did not conclude, as industry's draft asserts, that the concept of assuming the presence of certain "intangibles" in a valuation of taxable property means, simply, that the property may not be valued as scrap. To the contrary, the court reaffirmed the principle that property must be valued for assessment purposes by assuming that it is being put to productive use. Thus, the assessor's valuation, which was based on production costs, was upheld because "[t]he sole beneficial or productive use of the negative film of a motion picture is for making prints thereof for exhibition, whether such prints be sold or leased." In effect, the court held that while the copyright was not itself taxable, it was proper for the assessor to assume the presence of the copyright in determining the value of the negatives for tax purposes.

D. Statutory or Regulatory Changes

None

E. Administrative Impact

None

F. Fiscal Impact

1. Cost Impact

None

2. Revenue Impact

Enclosed

G. Taxpayer/Customer Impact

Adopting industry's version could subject taxpayers to unfair and non-uniform assessment practices, by providing to county assessors instruction that is inconsistent with current law.

H. Critical Time Frames

Same as under staff's recommendation.

Prepared by: Property Taxes Department; Policy, Planning, and Standards Division

Current as of November 4, 1998

7.2.

TREATMENT OF INTANGIBLE ASSETS AND RIGHTS

INTRODUCTION

To properly value a business entity's taxable property, an appraiser has to ensure that the final value indicator does not include any non-taxable value. A business entity's non-taxable value may consist of tangible items (e.g., licensed vehicles), intangible assets and rights (e.g., commercial franchises), and value attributable to enterprise activity. This chapter discusses the treatment of intangible assets and rights.

In California, the property tax treatment of intangible assets and rights is governed by two fundamental principles. The first of these is that intangible assets and rights which are not an integral part of the bundle of rights (e.g., use, enjoyment, and possession) conveyed with the ownership of real and personal property are exempt from taxation. That is, while the state Constitution authorizes taxation of most real and personal property, there is no such authority with respect to intangible assets and rights which are not inherent in the ownership of taxable property.

Even though many intangible assets and rights are exempt, the second fundamental principle states that taxable property should nonetheless be assessed and valued by assuming the presence of those intangible assets and rights that, although not inherent in the ownership of taxable property, are necessary to put the taxable property to beneficial or productive use. Under this principle, an appraiser valuing taxable property must assume the presence of any intangible assets or rights necessary to the beneficial or productive use of the property being valued. The "beneficial or productive use" is equivalent to the highest and best use of the property.[1]

These two principles, expressly stated in the Revenue and Taxation Code, have been established over several decades of California case law. Applying the principles has, however, proved more difficult than enacting them. Thus, the purpose of this chapter is to aid assessors in the uniform application of these established principles by providing (1) a discussion of relevant terms and concepts; (2) a legal and theoretical framework within which to treat intangible assets and rights in the course of appraising taxable property; and (3) examples that illustrate the application of that treatment.

DISCUSSION OF RELEVANT TERMS

AH 501, Chapter 3, discusses some of the terms and concepts related to the appraisal treatment of intangible assets and rights. That discussion introduces the term "going concern value," the principle of unit valuation, and the statutory scheme that governs the treatment of intangible assets and rights in the appraisal of tangible property. In addition, earlier sections of the present manual have touched on the need to account for intangible assets and rights both in defining an appraisal problem and in solving it.

[1] For a detailed discussion of the concept of highest and best use, see AH 501, Chapter 4.

Intangible Rights

All property, both real and personal, is composed of interests, benefits, and rights associated with its ownership. These, by their very nature, are intangible. The value of property is based upon these "intangibles." Insofar as such intangible assets and rights contribute to the real property's value (for example by enabling its profitable use) they must be taken into account in determining fair market value for assessment purposes.

Every business needs certain "intangible rights." The character and value of the intangible rights held will vary with the nature and scope of the business's operations. Thus, while the owner of a small retail shop might have only a routinely acquired business license issued by local government, a large public utility possesses a varied and valuable collection of intangible rights, such as those conferred by government franchises and operating and use permits.

Intangible rights may be created by law, and they may or may not represent an owner's economic contribution to the productivity of his or her taxable property. For example, zoning laws and district or municipal boundary service areas may create intangible rights in real property without the owner of the property having to make any independent economic contribution.[2] Such intangible rights are inherent in the ownership of the property itself, and thus effectively add to the aggregate of property rights that compose the taxable property.

Government Permits

Other intangible rights, such as government permits to use property for particular purposes, usually represent potential economic benefits that could accrue to property owners. The holder of a special use permit, for example, has obtained the right to make a substantial income from the operation authorized on the property. While the operator has generally made a substantial expenditure to obtain this intangible right to use his or her property for a purpose which, absent such right, would be illegal on every other property in the county, the permit itself represents an intangible right that cannot be separately assessed for property tax purposes. The special use permit, however, is site specific and does authorize a more productive use of taxable property. Since it contributes to the value of the real property, the presence of the permit must be assumed or considered in an appraisal of that taxable property.[3]

Private Contract Rights

An intangible right may also be created by private contract. An example of such an intangible right is the contractual right to operate a particular chain restaurant pursuant to the terms of a

[2] Where the owner has expended time and effort to obtain a change in an existing zoning regulation, however, the rights created by the change represent an economic contribution by the owner to the productivity of the taxable property.

[3] See *American Sheds, Inc.* v. *County of Los Angeles* 66 Cal.App.4th 384 (August 1998) wherein the court upheld the county board's finding that governmental permits authorizing a taxpayer's landfill operation "are site specific and under California law, their contributory value to real property may be assessed." The court discounted the taxpayer's argument that the permits were in fact operator-specific, noting that the permits "authorize operations at this specific property, and contain terms and conditions about how that property must be arranged, maintained, and utilized. The [county board's] finding recognizes this, and refers to the practical connection between the permits and the property, and vice versa."

commercial franchise. This type of intangible right represents an economic contribution by the owner, who generally has paid a substantial sum as consideration for the franchise contract. Whereas the special use permit described above relates directly to the use of taxable property, however, the right to operate a valuable commercial franchise relates primarily to the business entity's enterprise-related activities. Thus, a franchisee's rights under a valuable commercial franchise are examples of intangible rights whose primary purpose is not to authorize a more productive use of taxable property, but rather to authorize the use of a trade name or other legally protected intellectual property in the conduct of a business entity's enterprise-related activities.

Intangible Assets

An "intangible asset" is similar to an intangible right in that it may authorize a particular use of tangible property. Indeed, intangible assets often create intangible rights. However, an intangible asset is also distinct from an intangible right in that, for income tax purposes, an intangible asset is often assigned an allocated value for purposes of depreciation or *amortization* over an estimated useful life.

Any intangible rights conferred by an intangible asset may or may not be directly related to the use of taxable property. As discussed above, a valuable commercial franchise is an example of an intangible asset that confers substantial rights (and may thus represent great value to a business) but which does not relate directly to the use of taxable property. Similarly, a superior workforce in place, highly skilled management, or an extraordinary customer base may create value in the business entity that cannot be ascribed to the property. That is, such intangible assets would not be considered necessary to the beneficial or productive use of the property to the extent that they make a contribution to income or value beyond that which would normally be anticipated from a typically skillful or prudent operator of the property.[4]

Intangible Attributes of Real Property

Section 110(f) expressly provides that the value of "intangible attributes of real property" shall be reflected in the value of the real property. The section provides that such intangible attributes of real property include "zoning, location, and other attributes that relate directly to the property involved." In this definition of "attributes" are two characteristics of property which the Legislature has classified as "intangible," and whose value, therefore, must be reflected in the value of the property. The first is government zoning, which by statutory scheme includes the General or Specific Plan designation, special use, industrial park, planned unit development or other use classification. The second is location, which inherently encompasses all of the physical attributes of the property, such as view, water availability, soil quality, and proximity to services and amenities.

In addition to the characteristics identified in subdivision (f), it is proper to consider as "intangible attributes of real property" any intangible rights which are in the nature of property

[4] Rule 8, subsection (c), provides that in the income approach to value, the amount of income to be capitalized is the net return that the property would yield under "prudent management." Further, subsection (e) recognizes that income derived from operating earnings is "more likely to be influenced by managerial skills and may arise in part from nontaxable property or other sources."

rights—that is, rights inherent in the ownership of an item of tangible property, including the rights to sell, hold, use, occupy, encumber, dispose of, or otherwise determine the status of the tangible item.

Related Business and Appraisal Terms

Several of the terms that come into play in a discussion about the proper treatment of intangible assets and rights have been used in more than one context. This variability in usage can be found both in the law and in the appraisal literature. Below, several of these terms are discussed in their varying contexts.

Going Concern Value

The term *going concern value* is most often used in a sense that encompasses all of the value of a business entity. Often, however, the term is used to refer to an increment of the total value of a business entity that cannot be attributed to identifiable items of tangible property or intangible assets or rights.

In AH 501 "going concern value" was defined as referring to "the total value of an operating business enterprise."[5] In this context, the term is said to include not only the value of all of the tangible property of the enterprise, but also the value of all of the intangible assets and rights held by the business entity (i.e., the "going concern"). Under this usage, which is often associated with valuations made under the principle of unit valuation, "going concern value" refers to a figure that is based on an appraisal of all of a business entity's operating property functioning as a unit. Although in practice this usage is most often used in reference to state-assessed public utilities, the concept of defining and assessing property as a functioning appraisal unit is no less applicable to certain locally assessed property.

In contrast, section 107.7, which governs the valuation of cable television interests, uses "going concern value" in a sense that is meant to convey the idea of an increment of the total value of the business entity (i.e., the cable television system) which is not otherwise attributable to either tangible property or otherwise identifiable intangible assets or rights.

California statutes impose an equivocal prohibition against assessing the value of intangible assets and rights relating to the going concern value of a business using taxable property. That is, such valuations are prohibited except to the extent that the presence of the intangible assets or rights is necessary to put the taxable property to beneficial or productive use. In this context, "going concern value" refers to that portion of the value of a business entity that exceeds the fair market value of the business entity's tangible property put to beneficial or productive use. However, for property tax purposes, this difference in value is more accurately classified as "enterprise value" and should be treated as such (see below).

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[5] AH 501, 7.

Business Enterprise Value

"Business enterprise value" (or "enterprise value") is another term that is used differently depending on the context. In one context, this term connotes value based on the business operations conducted on tangible property rather than value attributable to the property itself. However, in another context, the term may be used to refer to the value of the entire operating enterprise, including the value of tangible property and intangible assets and rights held by the business entity. As previously indicated, for property tax purposes, "enterprise value" should be defined as that portion of the value of a business entity that exceeds the fair market value of the business entity's tangible property put to beneficial or productive use.

Goodwill

Goodwill has also eluded uniform usage. The term has been variously associated with (1) the expectation of continued customer patronage of a business, (2) the presence of "excess earnings," or earnings in excess of those required to provide a fair return for all tangible and identifiable intangible property of the business, and (3) the residual value or "gap" in value that is represented by the difference between the value of the business entity as a whole and the value of the otherwise identifiable assets.[6] For property tax purposes the second definition for goodwill mentioned above is the most appropriate and actually constitutes a form of non-taxable "enterprise value."

Principle of Unit Valuation

The AH 501 provides an introductory discussion of the principle of unit valuation. It is noted there that the principle of unit valuation is based on the concept that the appraisal unit should be the unit most likely to be bought and sold in the market. This concept recognizes that market participants value certain properties according to the benefits that will be generated by the entire operating unit rather than the sum of the estimated values of the individual parts that compose the operating unit. AH 501 notes further that while the principle of unit valuation is usually associated with appraisals of large industrial operations or state-assessed utilities and railroads, the concept of the appraisal unit is more often referred to in the context of appraising locally assessed properties that comprise several parcels.[7]

The principle of unit valuation carries with it at least two implications for the treatment of intangible assets and rights. First, since the traditional application of the principle of unit valuation begins with an appraisal of an entire operating property, including both taxable property and non-taxable intangible assets and rights, adjustments will have to be made for any non-taxable intangible assets and rights that may exist. As discussed later in this chapter, such adjustments are expressly required by section 110(d)(2).

The second implication stems from the legal connection between the principle of unit valuation and the assessment, on a going concern basis, of property operated by certain public utilities.

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[6] Gordon V. Smith and Russell L. Parr, *Valuation of Intellectual Property and Intangible Assets* (John Wiley & Sons, Inc., 1989), 88-89.
[7] AH 501, 11.

From an appraisal standpoint, that legal connection suggests that there will be few required adjustments for intangible assets and rights where the only significant intangible assets and rights present are those necessary to put the taxable property to beneficial and productive use. As discussed later in this section, section 110(e) requires that taxable property be assessed and valued by assuming the presence of those intangible assets or rights necessary to the taxable property's beneficial and productive use. Appraisers are required to remove or make adjustments for only those intangible assets and rights whose presence is not required to be assumed.[8]

Components of a Going Concern[9]

Monetary Assets

Monetary assets are generally liquid assets directly or indirectly involved in the operation of a going concern. As an example, a business entity needs "working cash" in order to cover expenses that are typically paid prior to the time that receivables have been collected.

Real Property

Real property is defined in section 104 as "the possession of, claim to, ownership of, or right to the possession of land." Real property includes all the interests, benefits, and rights associated with the ownership of a particular property. Under the principle of unit valuation, all of the real property owned by a business entity that is necessary to provide the primary utility or product of the business entity constitutes a component of the going concern. This real property may be referred to as the unitary real property or the operating real property. Real property that is not part of the operating unit is not part of the going concern. This concept of unitary real property or operating real property is based on the logical premise that all of a business entity's functionally-related operating assets, including real property, would be transferred together in a sale of the business entity.

Tangible Personal Property

While all tangible property, both real and personal, is generally subject to ad valorem taxation, some types of tangible personal property are exempt. Accordingly, adjustments must be made by the appraiser when such exempt personal property is established as a component of the appraisal unit. Examples include motor vehicles, certain vessels, and assets located in federal enclaves.

Intangible Assets and Rights

When assessing or valuing property under subdivisions (e) and (f) of section 110, the appraiser should assume the presence of only (1) those intangible assets or rights necessary to put the property to beneficial or productive use and (2) intangible attributes of real property as provided in subdivision (f). To the degree that these items contribute to the value of the real property, they

[8] Section 110(f), which requires that the value of "intangible attributes of real property" be reflected in the value of the real property, provides another self-evident exception to the requirement to adjust for intangible assets and rights.
[9] As used in the remainder of this manual, except as otherwise noted, the terms "going concern," "business entity," and "business concern" all refer to an operating business enterprise, including all its tangible property and its intangible assets and rights functioning as unit.

must be considered in an appraisal of the taxable property. While some intangible assets, such as working cash, are clearly unrelated to the productive use of the property, others, such as building permits, are directly related to the use of the property. Most intangible assets and rights, however, fall somewhere in between these two ends of the spectrum.

STATUTORY AND JUDICIAL FRAMEWORK

Under article XIII, section 2 of the California Constitution, only the specific intangible personal property listed in that section may be subject to property tax. Further, the Legislature may provide for the property taxation of these items of intangible personal property, which include notes, debentures, shares of capital stock, bonds, solvent credits, deeds of trust, mortgages, and any legal or equitable interest therein. The Legislature may not, however, provide for the property taxation of any other type of intangible personal property.

Under section 212, the Legislature has determined not to tax the intangible personal property listed in article XIII, section 2 of the California Constitution. Thus, except as set forth in subdivisions (e) and (f) of section 110, all intangible assets and rights—including intangible personal property—which are not specifically listed in that section are exempt from property taxation.

The California Courts of Appeal have identified intangible assets and rights in certain property tax cases. These intangible assets and rights include, among others, governmental permits (including liquor licenses, cable television franchises, and airport rental car and stadium concessions), stock exchange seats, press association memberships, memberships in social, professional and fraternal clubs, patents, copyrights, goodwill, judgments, causes of action, insurance policies, enterprise value, going concern value, favorable franchise rights, customer lists, the right to do business, marketing and programming contracts, management and operating systems, and work force in place.[10] In addition, section 107.7(d) provides a list of certain nontaxable intangible assets and rights specifically related to cable television systems. Finally, certain tangible personal property is specifically limited as to the property rights to be appraised.[11]

Section 212 states the principle that intangible assets and rights are exempt from property taxation and that the value of intangible assets and rights shall not enhance or be reflected in the value of taxable property. However, this principle is subject to the last sentence of section 212(c), which states that "taxable property may be assessed and valued by assuming the presence of intangible assets or rights necessary to put the taxable property to beneficial or productive use." Taken together, these provisions are consistent with numerous court cases over the years. In a

[10] See, *Roehm* v. *County of Orange*, 32 Cal. 2d 280 (1948); *County of Orange* v. *Orange County Assessment Appeals Board*, 13 Cal. App. 4th 524 (1993); *Shubat* v. *Sutter County Assessment Appeals Board*, 13 Cal. App. 4th 794 (1993); *GTE Sprint Communications Corp.* v. *County of Alameda*, 26 Cal. App. 4th 992 (1994); *De Luz Homes, Inc.* v. *County of San Diego*, 45 Cal. 2d 546 (1955); *County of Los Angeles* v. *County of Los Angeles Assessment Appeals Board*, 13 Cal. App. 4th 102 (1993); *Service America Corp.* v. *County of San Diego*, 15 Cal. App. 4th 1232 (1993).

[11] Some examples are storage media for computer programs (section 995); business records (section 997); motion pictures (section 988); certain works of art (section 986); and timeshare estate amenities (section 998).

recent case, a court of appeal pointed out the consistency of the case law with the constitutional and statutory provisions, as follows:

> The leading decision regarding property tax consideration of intangibles associated with real property is *Roehm* v. *County of Orange* (1948) 32 Cal.2d 280 (Roehm) (per Traynor, J.). *Roehm* held that a liquor license, being an intangible asset, did not constitute taxable personal property, under constitutional and statutory provisions. However, the court explained, "Intangible values...that cannot be separately taxed as property may be *reflected* in the valuation of taxable property. Thus, in determining the value of property, assessing authorities may take into consideration earnings derived therefrom, *which may depend on the possession of intangible rights and privileges* that are not themselves regarded as a separate class of taxable property." (Id. At p. 285, italics added.) 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.[12]

Subdivisions (d), (e) and (f) of section 110 provide similar guidance regarding the property tax treatment of intangible assets and rights. Subdivision (d) provides that:

1. The value of intangible assets and rights relating to the going concern value of a business using taxable property shall not enhance or be reflected in the value of the taxable property;

2. If the principle of unit valuation is used to value properties that are operated as a unit and the unit includes intangible assets and rights, then the fair market value of the taxable property contained within the unit shall be determined by removing from the value of the unit the fair market value of the intangible assets and rights contained within the unit; and,

3. The exclusive nature of a concession, franchise or similar agreement, whether *de jure* or *de facto*, is an intangible asset that shall not enhance the value of taxable property, including real property.

The going concern value referred to in subdivision (d)(1) is that portion of the value of a business entity that exceeds the fair market value of the business entity's tangible property put to beneficial or productive use. This difference may be referred to as "enterprise value."

These three provisions contained within subdivision (d), however, are subject to subdivision (e), which states that "taxable property may be assessed and valued by assuming the presence of intangible assets or rights necessary to put the property to beneficial or productive use."[13] Finally,

[12] See *American Sheds, Inc., supra.*

[13] See *American Sheds, Inc., supra,* in which the court stated: "A useful explanation of the rules embraced in these statutes appears in a September 15, 1995 letter to the Secretary of the Senate by Senator Ken Maddy, author of the amendments. According to Senator Maddy, 'The bill provides that the intangible assets and rights relating to the going concern...are not to be reflected in the value of property. However, under subdivision (e) of Section 110...as added by the bill, property may be valued assuming the existence of intangible assets necessary to put the property to

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section 110(f) provides that for purposes of determining the full cash value or fair market value of real property, intangible attributes of real property shall be reflected in the value of the real property. These intangible attributes include zoning, location and other such attributes that relate directly to the real property involved. In this context, subdivision (d)(3) above refers to the exclusive nature of an agreement that does not grant the right to use real property and which is not an attribute of real property.

VALUATION ISSUES

The valuation question for the appraiser is a practical one. That is, where property is operated by a business entity, what method or methods does an appraiser employ to ensure that the market values of all non-taxable intangible assets and rights are excluded from the final value indicator for the taxable property? Section 110(d)(2) outlines the answer to that question where (1) the principle of unit valuation is used and (2) the unit includes both non-taxable intangible assets and rights. Specifically, subdivision (d)(2) provides that when both of those conditions are present, the fair market value of the taxable property must be determined by removing from the value of the unit the fair market value of any non-taxable intangible assets and rights.

However, subdivision (d)(2) stops short of prescribing a specific method for accomplishing this adjustment. Instead, from a practical standpoint subdivision (d)(2), subdivisions (e) and (f), as well as section 212, establish for the appraiser two clearly identifiable boundaries. At one end, these provisions imply that tangible property should not be valued at salvage value (i.e., the value of property at the end of its economic life in its present use) merely because the accompanying intangible assets and rights themselves cannot be taxed. At the other end, the statutory provisions can be interpreted to mean that the value of the tangible property used in a business entity does not necessarily, as a matter of law, equal the value of the business entity itself. In this context, and as part of the normal appraisal process, appraisers should consider all of the traditional approaches to value and reconcile those indicators to determine the proper value.

From a conceptual standpoint, the boundaries are consistent with the fundamental appraisal principle which states that an owner of taxable property will follow a course of action that produces the highest rate of return, on a risk-adjusted basis, and that results in the highest and best use of the property.[14] As a practical matter, an appraiser's task is to apply the appropriate valuation methodologies to determine the value of the tangible assets within the two boundaries. Further, the value so determined should reflect the values of intangible assets and rights only to the extent that such intangible assets and rights constitute attributes of real property or are necessary to put the tangible property to its highest and best use.

In short, the two boundaries establish opposite extremes for the valuation of taxable property used in a business. Thus, under normal circumstances, an appraiser would use a method that

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productive use....For example, under the terms of the bill, an assessor could not use a liquor license to enhance the value of taxable property. However, the assessor may assume the presence of a license so that a bar's taxable property may be taxed as a bar and not at salvage value (i.e., as a warehouse).'"

[14] See AH 501, 52.

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avoids any result that approaches either salvage value, or at the other extreme, the value of the business entity.

When deciding whether the appraisal unit includes non-taxable intangible assets and rights in a business operation, a determination must be made as to whether earnings are largely derived from enterprise activity, or if they are derived from taxable property. It is less likely that adjustments will be necessary where the appraisal unit possesses the following characteristics:

1. The taxable property is integrally related to the business operation.
2. The focus of the business is to maximize the use of the property.
3. Earnings are not largely derived from enterprise activity.
4. If the property were sold the right must necessarily transfer with the land.

Under these conditions, some level of enterprise activity is required to operate and maintain the property; however, such activity is ultimately directed towards maximizing the beneficial and productive use of the property; consequently, in the income approach it is properly accounted for by treating it as an operating expense. As long as income and expenses are properly accounted for, the net earnings are appropriately attributable to the taxable property.

Analyzing the Relationship Between the Business Entity Operation and the Taxable Property

As emphasized above, the focus here is the appraiser's evaluation of the extent of the relationship between the business operation and the use of the taxable property. In analyzing this relationship, the appraiser should seek to answer the following questions:

First, does the business use the property as an integral part of an operating unit or going concern? The issue is whether the earnings of the business can be ascribed to the use of the taxable property. If the answer is no, then the appraiser should place little or no weight on an indicator derived from an approach to value which is based either on the earnings of the business or on a sale of the business in toto.

Second, if the earnings of the business can be ascribed to the use of taxable property, to what extent do the business's earnings depend on a sale or service activity that uses the property only incidentally in carrying out such activity? In the reconciliation process, the answer to this question will guide the appraiser in the decision to place more or less relative weight on particular indicators. When making this judgment the appraiser should consider the extent to which the earnings of the business depend on either (1) the possession of a valuable commercial franchise or (2) a level of human skill or entrepreneurship that is atypical for the type of property operation which involves the subject taxable property. Ideally, the appraiser should develop a method of valuation which captures or imputes an income that excludes earnings of the business not attributable to the taxable property.

Consider the type of business whose earnings are clearly dependent upon human skill or entrepreneurship. A physician's practice is a good example, since the doctor's earnings are dependent not on the instruments in her medical bag, but rather on her acquired training, skill, and license to use those instruments in the practice of medicine. Thus, even though the doctor uses valuable tangible property (e.g., instruments, equipment, and specially designed offices), the use of that property is only incidental to the doctor's earnings from the practice of medicine.

This apparently incidental relationship between the use of taxable property and the doctor's earnings is made even more obvious if one considers what the tangible property would sell for apart from the medical practice as a going concern. Clearly, the earnings of the practice would have little bearing on the price that the tangible property would command in such a sale, since the primary force behind those earnings is not the tangible property, but rather intangible factors such as the doctor's human skill. A similar analysis applies to businesses whose earnings are primarily dependent on the sale of personal property and the provision of personal services.

In contrast to a physician's practice, consider an apartment house as an example of a business whose earnings are dependent on the use of taxable property. Although the ownership and operation of an apartment house is a business (i.e., the owner manages the property in order to make a profit on his investment), the earnings of that business clearly can be ascribed to the use of the taxable property. Thus, even though the owner of the apartment house exercises some personal effort in the course of managing the apartment house, that effort is generally only incidental to the business's earnings, which are derived almost entirely from rentals of the taxable property. Indeed, each rental of an individual apartment is tantamount to a short-term purchase of the rights to use a portion of the taxable property.

This integral relationship between the earnings of the apartment house and the use of taxable property is further illustrated by the scenario that would play out upon the sale of the taxable property apart from the existing business. Unlike the doctor's tangible property, the price commanded by the apartment house would be determined by reference to the earnings of the business. More importantly, investors typically would evaluate the prospective earnings of the apartment house based not on an analysis of the prior operator's acumen in managing the property, but rather on an evaluation of factors such as the location, quality of construction, and remaining useful life of the physical property. A similar analysis applies to other businesses whose earnings are primarily dependent upon the use of taxable property, including electricity-producing dams, ski slopes, bowling alleys, golf courses, many public utilities, and hotels and motels that do not benefit from extraordinary reputations for service or quality or from associations with unusually valuable franchises.

The examples of the medical practice and the apartment house represent opposite ends of the range of property uses made in business operations. Property used by businesses falling near either of these two extremes is easy to identify as either a good candidate for an approach to value based on either a sale of the business or the earnings of the business (the apartment house) or a poor candidate for such an approach (the medical practice). However, most businesses fall somewhere in between the two extremes, and this fact may introduce into the appraiser's analysis an ambivalence that, in some cases, cannot logically be resolved by any prescribed formula.

Determining the Presence of Intangible Assets and Rights, Not Covered by Subdivisions (e) and (f), that Relate to the Going Concern Value of a Business Entity

Where an appraiser can logically establish the fair market value that an intangible not covered by subdivisions (e) or (f) of section 110 would have apart from its existence within the business entity, it will be possible to explicitly remove that value from a unitary value indicator that is based either on the earnings of the business entity or on a sale of the business entity. In calculating an indicator of value based on the income approach, it will sometimes be possible to remove from the income stream to be capitalized any revenues that cannot be ascribed to the operating property.

Where the separate value of an intangible asset or right that is not covered by subdivision (e) or (f) of section 110 cannot logically be established, however, an explicit removal may not be possible. This difficulty is most likely to arise where the activities of the business entity are integrally related to the use of taxable property. In such cases, it may be impossible to even approximate the point at which the taxable property ends and the non-taxable intangible asset or right begins, and an attempt to explicitly remove the value of the "intangible" may represent an attempt to separate from the value of the taxable property the very thing which gives rise to that value in the first place. Thus, it may be more logical for the appraiser to account for such intangible assets and rights implicitly, and impute an amount of income, which would solely account for the taxable property. Whenever possible the appraiser should compare this resulting indicator of value with results from other approaches and, in the reconciliation process, place appropriate weight on the indicator(s) that are less likely to include any value other than the fair market value of the taxable property being appraised.

Valuation of Taxable Property by Assuming the Presence of Intangible Assets and Rights Necessary to Put the Taxable Property to Beneficial and Productive Use

As discussed above, the law establishes that taxable property must be valued assuming the presence of those intangible assets and rights which are necessary for the beneficial or productive use of the property. Put another way, this means that an appraiser valuing taxable property must not hypothecate the absence of such intangible assets and rights. From either viewpoint, this principle implies at least three things for the appraiser.

First, and most obviously, the principle implies that the "beneficial or productive use" under consideration by the appraiser is the property's highest and best use. To interpret the principle as allowing an appraiser to assume a lesser use would be to allow for a valuation at less than full cash value.

Secondly, the principle implies that the intangible assets and rights needed for the beneficial or productive use of the taxable property do not have to be currently in place in order for the appraiser to assume their presence. Thus, an appraiser valuing taxable property must assume the presence of those intangible assets or rights that would be necessary to the highest and best use of the taxable property. Whether the current owner of the property actually possesses those intangible assets and rights is not important, since the current owner may not be making the highest and best use of the property.

Thirdly, and most importantly, if the presence of intangible assets and rights must be assumed by law because they are necessary for the beneficial or productive use of the property, then two requirements must be met: (1) no additional value should be added to the fair market value on account of their presence,[15] and (2) the appraiser should not attempt to adjust the value indicators to remove their value or influence from the fair market value. These requirements would apply in the examples previously noted, including the case of the special use permit necessary to use property for the operation of a solid waste disposal facility. Likewise, the requirements would apply to the presence of a workforce in place that is minimally necessary for the operation of, for example, a large resort hotel.

ADJUSTMENT OF VALUE INDICATORS

Once an appraiser has determined that the earnings of the business can be ascribed primarily to the use of taxable property, and having proceeded with a calculation of a unitary indicator or indicators based upon the earnings of the business or upon a sale of the business, he or she should proceed to deduct from those indicators the market values of any non-taxable intangible assets and rights not covered by subdivisions (e) or (f).

These are intangible assets and rights that would have a reasonably ascertainable fair market value apart from the business. As discussed below, such intangible assets and rights include all of the financial assets listed under section 212, and—perhaps—trademarks, copyrights, patents, or other intellectual properties.

Intangible Assets

Financial Assets

As discussed above, there are certain intangible assets whose separate value can reasonably be ascertained. The financial assets listed in subdivisions (a) and (b) of section 212—notes, debentures, shares of capital stock, solvent credits, bonds, deeds of trust, mortgages, and money kept on hand to be used in the ordinary and regular course of the business—represent such intangible assets. These are intangible assets and rights whose value generally can be explicitly removed in the course of an appraisal of the taxable property of an operating enterprise. The preferred method of estimating the fair market value of these intangible assets and rights is by reference to their cash equivalent values or separate sales of similar assets.

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[15] However, note that under the principle of substitution it may be proper, in arriving at a *cost*-based indicator of value, to add amounts for entrepreneurial services, advertising, recruiting and training employees, or other costs incurred in placing the taxable property into profitable operation. (See rule 6.)

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In some cases, however, there will be no reliable market data as to the separate value of an intangible asset. In that event, the appraiser may be able to refer to sales contracts and agreements, asset lists attached to those agreements, and cash flow analyses used to develop the sales price. These documents may provide evidence of the values that a buyer and a seller assigned to particular assets, including intangible assets and rights.[16]

Items Based on Relationships between the Business Entity and Employees, Customers, or Suppliers

For income tax purposes, an assessee who is able to prove that a particular intangible asset can be valued and that it has a limited useful life may depreciate its value over its useful life.[17] Thus, for income tax purposes businesses often assert separate valuations for intangible assets—including those based on relationships between the business and its employees, customers, or suppliers—that would not otherwise be regarded as having any independent existence. However, while the U.S. Supreme Court has upheld particular taxpayers' claims for depreciation of such intangible assets, it has also noted that it will often be too difficult to prove that such assets can be separately valued.[18]

If it is difficult in the income tax arena to prove the separate value of intangible assets and rights that are based on business relationships, it will be even more difficult in the property tax arena. This is because, as discussed throughout this chapter, for property tax purposes the presence of certain intangible assets and rights is to be assumed to the extent that they are necessary to the taxable property's beneficial or productive use. For example, as indicated above, while the presence of a typically skilled workforce or management team or a minimally necessary customer base creates value in a business entity that cannot be ascribed to the property, those "intangible assets and rights" are necessary to put the property to beneficial and productive use. On the other hand, a superior workforce or management team, or an exceptional customer base, are intangible assets and rights that go beyond that which would typically be anticipated as necessary to put the property to productive use.

Therefore, in valuing unitary or unit properties such as shopping centers or hotels, the appraiser should assume the presence of those intangible assets and rights which are normal or typically necessary to put such property to beneficial or productive use. The normal or typically necessary intangible assets and rights constitute the workforce, management, and customer base, without which an operating property may not be able to generate a normal level of revenues. However, when the workforce, management, or customer base is superior or atypical, and it can be demonstrated that it creates additional value in the business entity above and beyond the value of the operating property, an adjustment is necessary.[19] Data supporting such superior or atypical

[16] In contrast, the appraiser should be cautious of appraisals made for income tax purposes; such valuations are made after the fact, and tend to be motivated by a new owner's desire to minimize prospective income tax liabilities.
[17] *Newark Morning Ledger Co.* v. *United States*, 113 S. Ct. 1670
[18] 113 S. Ct. at 1681.
[19] The same reasoning and resultant adjustment should apply in circumstances where the workforce, management, or customer base are inferior, creating a decrease in the value of the business entity below that which would otherwise prevail.

assets and rights, requested from the business entity operating the property, should be analyzed quantitatively to determine the nature of the adjustment warranted.

Intangible Rights

Rights to Use Property

Building permits, special use permits, leases, rental agreements, or other items that enable the beneficial or productive use of taxable property will typically come within the scope of section 110(e). Accordingly, the presence of such intangible rights should be assumed, and no adjustment is necessary.

Commercial Franchises and Intellectual Property Rights

Commercial franchises and intellectual property rights (e.g. copyrights, patents, and trademarks) generally have an ascertainable market value apart from the business entity that holds them. In that event, the discussion above relating to the treatment of financial assets applies here as well. When such intangible assets and rights are not covered by subdivision (e) or (f) of section 110, the preferred method of adjusting for such intangible assets and rights is by reference to market data, or, if such data is unavailable, to sales contracts, asset lists, cash flow analyses, and other documents used to develop the sales price of the business. For commercial franchisees, there are, for example, frequent franchise- or enterprise-related activities, such as promotional campaigns, merchandising, or specialized marketing by the business entity. These are activities that go above and beyond the enterprise-related activities of a typical business entity in that same sales or service category.

ADJUSTMENTS IN THE THREE APPROACHES TO VALUE

Comparative Sales Approach

Traditionally, in the comparative sales approach the appraisal unit consists of only taxable property. That is, the adjustment of the sales prices of the comparable properties do not include adjustments for non-taxable intangible assets and rights that are part of an operating unit. However, when the appraisal unit consists of an entire business entity (i.e., when the principle of unit valuation is used) adjustments may be required for the purpose of excluding any value that is not properly included in the fair market value of the taxable property.

Income Approach

Under rule 8, income derived from rental of properties is preferred to income derived from their operation, since the latter is the more likely to be influenced by managerial skills and may arise in part from non-taxable property or other sources. Nevertheless, under a traditional application of the principle of unit valuation, operating income—not rental income—will be the starting point of the appraiser's analysis.

Depending on the business, the operating income may include income attributable to selling merchandise, the provision of personal services, or to intangible assets or rights that are not covered by subdivision (e) or (f) of section 110. It is for these items that the appraiser must make adjustments in order to arrive at the income attributable to the taxable property.

These adjustments can be made by adding appropriate amounts to the operating expenses that are used to reduce total operating income to a net income that can then be attributed to the taxable property. Thus, the cost of goods sold, employee salaries, and the costs associated with maintaining a superior customer base are examples of items that could be added. Alternatively, for intangible assets and rights whose market values can be estimated by reference to separate sales of similar intangible assets and rights, lump sum adjustments should be made to the income-based value indicator.

Generally, if the anticipated net income for a typical operator of the real property either cannot be estimated with reasonable accuracy, or cannot be ascribed to the real property, then a reasonable portion of the anticipated net income may be allocated or imputed to the real property. If there is no reasonable, sound and practical basis for allocation or apportionment, then an economic rent, based on a reasonable return on the real property may be used as the basis for the valuation of the real property.

Cost Approach

The treatment of intangible assets or rights should not be an issue except where an appraiser has relied on an approach to value that is based either on a sale of the business in toto or on the net earnings of the business. Properly employed, an approach based on replacement costs does not give rise to disputes over the treatment of intangible assets and rights. Thus, except as may be otherwise required by subdivisions (e) or (f) of section 110, in the replacement cost approach an appraiser should not add amounts reflecting the costs of acquiring non-taxable intangible assets and rights, since to rely on an indicator so derived would be to implicitly (if not directly) assess those intangible assets and rights.[20]

[20] However, note that under the principle of substitution it may be proper to add amounts for entrepreneurial services, advertising, recruiting and training employees, or other costs incurred in placing the taxable property into profitable operation. (See rule 6.)

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AH 502 DRAFT DATED JUNE 1998
Chapter 6. Special Topics
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INDUSTRY DRAFT
(August 5, 1998)

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AH 502 DRAFT DATED JUNE 1998
Chapter 6, Special Topics
Treatment of Intangible Assets and Rights
INDUSTRY DRAFT
(August 5, 1998)

Chapter 6. Treatment of Intangible Assets and Rights.

This chapter is intended to assist appraisers in identifying and properly handling intangible assets and rights during the appraisal process. Intangible assets and rights consist of all of the elements of a business enterprise that exist in addition to monetary and tangible assets.[1/] Intangible assets and rights are not subject to ad valorem taxation. [2/]While intangible assets and rights often do not appear on a company's balance sheet, they are almost always present in one form or another in appraisals of commercial and industrial properties. Some examples of intangible assets and rights include franchises, subscriber contracts, management and operating systems, a work force in place, going concern, and goodwill.[3/]

Because taxing jurisdictions only assess the value of real property and tangible personal property, appraisers should plan the appraisal to isolate and value only taxable property as the appraisal unit. When appraisers are called upon to value intangible assets and rights and to remove the value of those intangible assets and rights from the value of the appraisal unit, the appraiser will find that intangible assets and rights may be difficult to identify and value. Any recognized valuation method may be appropriate depending on the facts and circumstances of the appraisal problem. However, appraisers should utilize valuation methods which value only the taxable property, and should use extreme caution if employing a valuation method which captures more than the value of the taxable property and requires the additional step of removing the value of the intangible assets and rights.

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Smith and Parr, Valuation of Intellectual Property and Intangible Assets, 2d ed., p. 83 (1994).

2/

Revenue and Taxation Code §212.

3/

Revenue and Taxation Code §107.7. See, Appraisal Standards Board, Uniform Standards of Professional Appraisal Practice, p. 9 (1998). A more exhaustive list of intangible assets and rights can be found in Pratt, Reilly and Schweihs, Valuing a Business, 3rd edition, p. 546 (1996), and Smith, Corporate Valuation, pp. 145-154 (1988). A list of some of the intangible assets and rights identified in California statutes and cases can be found in Appendix 1.

A. Legal Framework.

1. Revenue and Taxation Code Sections 110 and 212

Under Article XIII, Section 2 of the California Constitution only the specific intangible personal property listed in that section may be subject to property tax. Also, under Article XIII, Section 2, the Legislature may provide for the property taxation of these items of intangible personal property, which include notes, debentures, shares of capital stock, bonds, solvent credits, deeds of trust, mortgages, and any legal or equitable interest therein. The Legislature may not provide for the property taxation of any other type of intangible personal property. Under Section 212 of the Revenue and Taxation Code, the Legislature has determined not to tax the intangible personal property listed in Article XIII, Section 2 of the California Constitution. All intangible assets and rights, including intangible personal property, which are not specifically listed in Article XIII, Section 2 are immune from property taxation.

Under California law, only real property and tangible personal property may be subject to property tax. Intangible assets and rights, which are not subject to property tax, include, but are not limited to, the types of items set forth in Article XIII, Section 2 of the Constitution. Revenue and Taxation Code Section 107.7(d) also provides a list of certain nontaxable intangible assets and rights. In addition, the California Courts of Appeal have identified intangible assets and rights in certain property tax cases.[4/] Finally, certain tangible personal property is specifically limited in the property rights to be appraised.[5/]

Revenue and Taxation Code Section 212 states the general rule that intangible assets and rights are exempt from property taxation and that the value of intangible assets and rights shall not enhance or be reflected in the value of taxable property. However, this general rule is subject to the last sentence of Section 212(c), which states that "taxable property may be assessed and valued by assuming the presence of intangible assets or rights necessary to put the taxable property to beneficial or productive use."

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See, Roehm v. County of Orange, 32 Cal. 2d 280 (1948); County of Orange v. Orange County Assessment Appeals Board, 13 Cal. App. 4th 524 (1993); Shubat v. Sutter County Assessment Appeals Board, 13 Cal. App. 4th 794 (1993); GTE Sprint Communications Corp. v. County of Alameda, 26 Cal. App. 4th 992 (1994); De Luz Homes, Inc. v. County of San Diego, 45 Cal. 2d 546 (1955); County of Los Angeles v. County of Los Angeles Assessment Appeals Board, 13 Cal. App. 4th 102 (1993); Service America Corp. v. County of San Diego, 15 Cal. App. 4th 1232 (1993).

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Some examples are storage media for computer programs (Rev. & Tax. Code § 995); business records (Rev. & Tax. Code § 997); motion pictures (Rev & Tax. Code § 988); certain works of art (Rev & Tax. Code § 986); and timeshare estate amenities (Rev & Tax. Code § 998).

Subdivisions (d), (e) and (f) of Section 110 of the Revenue and Taxation Code also provide guidance regarding the property tax treatment of intangible assets and rights. Subdivision (d) provides that: (1) the value of intangible assets and rights relating to the going concern value of a business using taxable property shall not enhance or be reflected in the value of the taxable property, (2) if the principle of unit valuation is used to value properties that are operated as a unit and the unit includes intangible assets and rights, then the fair market value of the taxable property contained within the unit shall be determined by removing from the value of the unit the fair market value of the intangible assets and rights contained within the unit, and (3) the exclusive nature of a concession, franchise or similar agreement, whether de jure or de facto, is an intangible asset that shall not enhance the value of taxable property, including real property. These three provisions contained within Section 110(d) are subject to Section 110(e), which states that "taxable property may be assessed and valued by assuming the presence of intangible assets or rights necessary to put the property to beneficial or productive use". Finally, subdivision (f) of Section 110 provides that for purposes of determining the "full cash value" or "fair market value" of real property, intangible attributes of real property shall be reflected in the value of the real property. These intangible attributes include zoning, location and other such attributes that relate directly to the real property involved.

To interpret Sections 110(e) and 212(c) it is necessary to determine the meaning of the statement repeated in both of those sections -- "taxable property may be assessed and valued by assuming the presence of intangible assets or rights necessary to put the taxable property to beneficial or productive use." This language originates from cases where taxpayers attempted to obtain a scrap valuation for tangible assets by assuming those assets would not be used in a productive business in association with related intangible assets and rights. The courts concluded in those cases that a scrap valuation was not appropriate.[6/]

Sections 110(e) and 212(c) may be illustrated by the following example. A "McDonald's" sign typically is valued for property tax purposes based on the cost approach. Assuming the sign is used in an operating McDonald's business, a taxpayer may not obtain a scrap value for the sign on the grounds that, absent a McDonald's franchise, the sign would have only a scrap value. On the other hand, assuming the sign (and the franchise it represents) helps attract business, it would not be appropriate to equate the value of the sign with the difference between the value of the business

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AH 501, p. 14 (1997). For example, in Michael Todd v. County of Los Angeles, 55 Cal. 2d 684 (1962) the taxpayer argued that a movie negative should be valued at scrap value because a negative would have a scrap value without the nontaxable intangible copyright. In Michael Todd the court concluded that the value of the movie negative, when put to beneficial and productive use, could be determined by using a cost valuation approach. The court in Michael Todd also acknowledged that the value of the copyrighted movie negative based on its potential earning power of many millions of dollars was greater than the value of the movie negative itself. However, it is apparent that valuing the potential earning power of the copyrighted movie would have resulted in the improper taxation of the copyright.

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enterprise and the value of the other tangible assets --that approach attributes the entire intangible business enterprise value to the sign.

Sections 110(e) and 212(c) do not authorize adding an increment to the value of taxable property to reflect the value of intangible assets and rights necessary to put the taxable property to beneficial or productive use. For example, a business which owns taxable property may need working capital in order for the taxable property to be put to beneficial and productive use. However, the value of the taxable property should not be increased by the value of the working capital used in the business (or any portion thereof). Similarly, businesses owning taxable property may need customers, tax-exempt software, patents or other assets not subject to property tax in order to put the taxable property to beneficial and productive use. Again, the value of the taxable property should not be increased by the value of those nontaxable assets (or by any portion thereof). Accordingly, in valuing taxable property, Sections 110(e) and 212(c) indicate that it is appropriate to assume the presence of the intangible assets and rights which are necessary to put taxable property to beneficial or productive use, but these sections do not authorize first valuing the taxable property and then adding an increment of additional value to reflect the presence of intangible assets.[7/] Under appraisal theory, the fair market value of any taxable property cannot be more than the cost to procure a reasonable substitute.

Section 110(d)(1) states that the value of intangible assets and rights relating to the going concern value of a business using taxable property shall not enhance or be reflected in the value of the taxable property. This language is derived from court decisions where the court rejected a valuation approach which equated business enterprise value with taxable asset value.[8/] Those cases indicate that it would be illegal to simply add the value of intangible assets and rights to the value of taxable property or to assume that the value of intangible assets and rights are somehow subsumed within the value of the taxable assets of a business enterprise.

Section 110(d)(2) indicates that if the principle of unit valuation is used to value taxable property, then the fair market value of any intangible assets or rights contained within the unit must be removed. This rule recognizes that a business enterprise value typically will contain many intangible assets and rights. This rule also raises significant issues relating to the availability and reliability of data concerning the value of intangible rights and assets. If an appraiser does not have access to appropriate data concerning the identification and/or value of intangible assets and rights, then it will not be possible to remove the value of those intangible assets and rights as required by this rule and a

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See, American Society of Appraisers, Appraising Machinery and Equipment, pp. 80-1 (1989).

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See, GTE Sprint Communications Corp. v. County of Alameda, 26 Cal. App. 4th 992 (1st Dist. 1994); Shubat v. Sutter County Assessment Appeals Board, 13 Cal. App. 4th 794 (3d Dist. 1993).

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different valuation approach should be considered. Issues concerning the availability and reliability of data should be addressed in connection with the identification of the appropriate value approach for an appraisal assignment.

In summary, Revenue and Taxation Code Sections 110 and 212 confirm the basic principle contained in the California Constitution that intangible assets and rights are not subject to property tax. These sections also reflect the holdings of several Court of Appeal decisions. These holdings briefly can be summarized as follows.

(1) When valuing taxable property, it is appropriate to assume the presence of intangible assets or rights that are necessary to put the taxable property to the beneficial or productive use defined in the appraisal. It would be inappropriate to use a scrap valuation based on the removal of the associated intangible assets or rights required for the highest and best use.

(2) It is not appropriate to add intangible asset values to tangible asset values or to assume that intangible asset values are subsumed within the tangible asset values.

(3) A business enterprise (or unit) value can include many significant intangible assets or rights. If a business enterprise is being valued as part of the appraisal process, then the intangible assets and rights contained within that appraisal unit must be removed in order to avoid the improper taxation of those intangible assets and rights.

B. Discussion of Relevant Terms.

1. Intangible Assets and Rights.

When appraising commercial and industrial property, the appraiser must identify the intangible assets and rights that may be present in order to safeguard their exclusion from property tax. While only real property or tangible personal property can be assessed, the term to be applied to all of the other items of value has been an evolving one. The source of this other value (that is, value not attributable to real property or tangible personal property) has been described by various terms, such as intangible value, franchise value, going concern value, enterprise value, and goodwill. More recently, these broad categories of non-assessable items have been broken down into sub-categories of intangible assets and rights, and have been identified separately within the business enterprise.

Many appraisers may be more familiar with the term "intangible personal property." Intangible personal property may be best thought of as a subset of "intangible assets and rights." Assets are things which have value. All forms of property -- real, tangible personal and intangible personal -- are assets. Thus intangible assets and rights includes all types of intangible personal property. But an item cannot be assessed

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unless it is real or tangible personal property. For that reason, the term "intangible personal property" may not convey the full range of non-assessable items.

Intangible assets and rights include all intangible assets and rights relating to or arising in connection with a business operation conducted on, or with, real property and tangible personal property. Intangible assets and rights are not subject to property tax and are not part of the property to be assessed.[9/] As neither intangible assets nor intangible rights are taxable, there is no need for an appraiser to distinguish between them. Intangible assets and rights generally relate to the business being conducted rather than solely to the real property and tangible personal property used in the conduct of that business. Intangible assets and rights are to be contrasted with intangible attributes of real property described below.

Many intangible assets and rights, though they clearly exist, will not be shown on a company's books unless they were purchased. Examples include such items as vendor relationships, brand recognition, customer loyalty, and the cumulative effect of prior year's advertising and marketing. Moreover, even if intangible assets and rights are shown on a company's books, the company's balance sheet may not reflect the fair market value of those intangible assets and rights. Goodwill, patents, copyrights, and certain licenses or franchises are examples of such intangible assets and rights.

Other intangible assets and rights may be identifiable but not necessarily capable of segregation from the value of the business enterprise. As an example, the company which manufactures Thomas' English Muffins can obtain a higher price for its product over generic English muffins. However, the trademark could normally not be sold separate from the business because the buyer would also have to purchase the muffin formula, the manufacturing know-how, and the packaging design if the buyer were to command the higher price. The fact that the trademark cannot be separated from the business does not prevent the recognition of the value of the trademark.[10/]

Many intangible assets and rights, such as patents and copyrights, are not tied to a particular physical location, however there are intangible assets and rights related to some businesses (such as the professional reputation of congregate care operators) which cannot be readily transferred to another location but which are not related to the physical plant itself.[11/]

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Revenue and Taxation Code §§ 110, 212.

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Smith, "Tangible Ways to Value Intangible Assets," Journal of Property Tax Management, p. 35 (Winter 1991).

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Rabianski, "Going-Concern Value, Market Value, and Intangible Value," The Appraisal Journal, p. 184 (April 1996).

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Some intangible rights are perhaps better described as intangible assets, because they belong to the holder of the right and may be valuable to him. For example, in the case of a retail clothing business, the company's policies and procedures with respect to customer service and the integration of those policies and procedures into the training of the sales force are essential to the business's survival, and thus are a valuable intangible asset. Also, Revenue and Taxation Code Section 110(d)(3) specifically identifies the exclusive nature of a concession, franchise, or similar agreement, whether de jure or de facto, as an intangible asset.

Similarly, a company's relationship with its work force is a valuable business asset, as any company suffering the effects of a strike can attest. Yet a work force itself is not the property of the company to be freely bought, sold or traded as the business managers see fit. Still, for example, when a production or refinery business is purchased as a going operation, there is a separate value that can be placed on the company's relationship with its work force that comes with the business. That value is an intangible asset associated with the business operations and is not part of the real property value. However, having a work force does impact the value of the real property. Without a work force in place (and a business to employ it), the plant or refinery real property would be worth only what it could be sold for to an entrepreneur in a start-up mode, or in liquidation as scrap.

2. Intangible Attributes of Real Property.

Real property, defined in Section 104 of the Revenue and Taxation Code, consists of the physical property and intangible attributes of the physical property. Inherent in the ownership of real property are the rights of possession and rights to use the property. Intangible attributes of real property include zoning, location, and other such attributes that relate directly to the real property involved.[12/] Section 110(f) of the Revenue and Taxation Code states that intangible attributes of real property, in contrast to intangible assets and rights that may be used in connection with the real property, are to be reflected in the value of the real property.

Real property value is largely driven by its location. Indeed, many intangible attributes of real property can be subsumed in the single concept of "location." Location is a broad concept encompassing both physical attributes — an appraiser can go to the corner of 10th and Main Streets and see the size, shape, and topography of the property situated there — and intangible attributes — zoning is generally determined by a property's location within a community and in relation to neighboring properties.

Thus, the zoning of real property for commercial use is an intangible attribute of that real property which must be reflected in the appraisal whether the property is used to

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Intangible attributes of real property do not include licenses, franchises, and other rights to do business that are exercised in connection with the use of the real property.

house a grocery store, a dress shop, a bar or a liquor store. Moreover, whether a property has an ocean view, is close to a sewage treatment plant, or has adequate access to public infrastructure (e.g., freeways) or services (e.g., garbage collection) may be considered intangible attributes of the real property that will affect its value. These items also will be inherent in the physical location of the property.

One intangible attribute of real property that may be unrelated to location but that still may be inherent in the physical attributes of the real property is architecture. Thus, the fact that a building was designed by Frank Lloyd Wright may make the real property more valuable than if the designing architect was merely a follower of Mr. Wright's style.

It is important to distinguish between enforceable land use restrictions, such as public access requirements for ocean front property or government imposed rent or price restrictions that are an integral part of the real property being appraised, and intangible assets and rights that relate to the business use of the property and must not be assessed.[13/] Section 110 of the Revenue and Taxation Code and Property Tax Rule 2 require that an assessor take into account the adverse effects of government imposed restrictions rights of possession or use. Some examples of enforceable land use restrictions that must be considered in valuing real property are set forth in Section 402.1.

In contrast to intangible attributes of real property, intangible assets and rights of the business operation utilizing the real property cannot enhance or be reflected in the value of the real property. That there is a liquor license associated with the current use of the real property as a bar or liquor store is not an intangible attribute of the real property, but is a non-taxable intangible asset or right of the business operation. Franchises, permits and licenses to operate a cable television system likewise are non-assessable intangible rights and assets, and not assessable attributes of the physical property used to conduct the cable television business.[14/] Similarly, validation rights issued by the federal Food and Drug Administration are not assessable attributes of the real property to which they are associated, but are non-assessable assets of the business operation. Validation rights permit the business to sell, as a pharmaceutical, the product manufactured at the plant. Even in the absence of a validation permit, the plant still may be used to manufacture product, and the product still may be sold for non-regulated uses.

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AH 501, pp. 65-66 (1997).

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Revenue and Taxation Code § 107.7.

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3. Related Business and Appraisal Terms.

There are several terms related to intangible assets and rights with which the appraiser should be familiar.

a. Business Enterprise Value and Enterprise Value.

The term "business enterprise value" refers to the value of the entire business enterprise and includes all tangible assets and all intangible assets and rights.[15] In the property tax context, the separate term "enterprise value" is a broad concept that often encompasses all elements that give value to a business operation over and above the value of the tangible assets of a business organization.[16] Thus, for example, trade names, logos, systems of operations, advertising, customer and distribution relationships, and work force are all components of enterprise value that create value separate and apart from any value inherent in the tangible assets.
Thus, while it may appear as though a semiconductor plant owned by Company X is more valuable than a similar plant owned by Company Y based solely on capacity used, the appraiser must exercise care. If Company X has favorable "take or pay" contracts with customers locked in place and is making products at a price which the marketplace would not otherwise absorb, the appraiser should not attribute that value to the assessable real property. That value is part of the enterprise value and is attributable to the favorable contracts. Similar semiconductor plants should have similar economic returns, and thus similar fair market values.

b. Going Concern Value.

"Going concern value" is one term that can and has caused confusion for some appraisers. In fact, more than one definition of the term "going concern value" or of some variation of that term can be found in appraisal literature. Also, there are different meanings for California property tax purposes and more than one meaning even within California property tax law.

The description of "going concern value" set out in Assessors' Handbook Section 501, *Basic Appraisal*, is a description of what constitutes the value of an entire business enterprise, i.e. the total value of a going business or concern, including both taxable

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A "business enterprise" is defined as a "commercial, industrial or service organization pursuing an economic activity." Appraisal Standards Board, Uniform Standards of Professional Appraisal Practice, p. 9 (1998).

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Rabianski, "Going-Concern Value, Market Value, and Intangible Value," The Appraisal Journal, p. 184 (April 1996); Pratt, Reilly and Schweihs, Valuing a Business, 3rd edition, p. 19 (1996); California Portland Cement v. State Board of Equalization, 67 Cal. 2d 578 (1967).

and non-taxable elements.[17] Of course, only property which is taxable under California law may be assessed.

Going concern value is itself an intangible asset or right and is not assessable for California property tax purposes. As noted, "going concern value" is a term generally used in an appraisal of an entire established business operation. In that context, "going concern value" is an increment of value in excess of the value of the identifiable tangible property and intangible assets and rights used in that business operation. It is a value distinct from the value of the assessable property. Thus, Section 107.7(d) lists "going concern value" as a separately identified intangible asset or right that cannot be assessed. While Section 107.7(d) is written in terms of cable television systems, its non-exclusive list of intangible assets and rights is not peculiar to cable television.

Outside the property tax arena, going concern appraisals are commonly conducted for hotels and motels, restaurants, bowling alleys, industrial enterprises, shopping centers, retail stores, and similar business operations using real property. Generally, the real property is considered an integral part of the business operation. Without an allocation among the various elements contributing value to the business operation, however, such an appraisal is not appropriate for California property tax purposes. The value of the physical real and tangible personal property assets to be assessed must be segregated from the total value of the business.

Where the unit principle of valuation is used, it has been said that the assessable property is valued as a going concern. This means only that the taxable property of the business should be valued as if put to beneficial or productive use. It does not mean that the entire value of the business can be assessed or that the going concern value is assessable.[18]

c. Goodwill Value.

Goodwill is a term used to encompass value in excess of the value of identifiable tangible property and intangible assets and rights used in the business operation. As additional increments of value, enterprise value, goodwill and going concern value can co-exist and may not capture the same value or basket of assets and rights. Goodwill is a recognized business asset based on reputation.[19] Thus a hotel chain's reputation for quality and luxury that will bring customers to a new hotel stems from the mix of amenities in the package of services provided in its other hotel operations. However,

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AH 501, p. 7 (1997).

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Revenue and Taxation Code Section 110(d).

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Goodwill is a separate property interest under California law. Civil Code § 655.

the value generated for the hotel business from its system of operations -- its recipe for success -- does not inhere in the buildings and furnishings. Rather it accrues to the hotel chain's trade name, reputation and goodwill.

C. Valuation Issues.

1. All Taxable Property is to be Valued At Its Highest and Best Use.

In valuing taxable property, an appraiser must value the property at its highest and best use.[20] This does not mean that taxable property has an assessed value over and above its market derived value due to the presence of the intangibles necessary to productively deploy the taxable property. In almost every situation one can imagine, taxable property must have associated intangible assets and rights in order to be used in an ongoing business enterprise. An owner of a restaurant business likely needs a business license to operate the restaurant. An owner of a motion picture negative needs the copyright, or at least partial rights to it (i.e., a license) in order to exploit the film negative.[21] The value of such intangible assets and rights does not enhance and is not to be reflected in the value of taxable property.[22] The appraiser must also be mindful of the principle of substitution, which holds that no one would pay more for the subject property than the cost to procure a reasonable substitute without undue delay, sets a ceiling on the appraiser's determination of fair market value.[23]

2. Selecting the Appropriate Appraisal Unit

a. If the Appraiser Can Reliably Limit the Appraisal Unit to Taxable Property Only, He or She Should Do So.

In the vast majority of instances, the threshold issue of selecting the proper appraisal unit merits only a small amount of the appraiser's time because the most logical

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American Society of Appraisers, Appraisal of Machinery and Equipment, p. 80 (1989) ("this premise implies that the assets are installed, operating, and an integral part of the entity in which they are employed."); Revenue and Taxation Code §110(e).

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Michael Todd Co. v. County of Los Angeles, 57 Cal. 2d 684 (1962).

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Revenue and Taxation Code §110(d)(1).

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The Appraisal of Real Estate, 11th edition, p. 336 (1996); AH 501, p. 56 (1997); American Society of Appraisers, Appraising Machinery and Equipment, pp. 81-2 (1989); Pratt, Reilly and Schweihs, Valuing a Business, 3rd edition, pp. 267, 548 (1996).

101.

appraisal unit consists only of the taxable property.[24] It is axiomatic that all other things being equal (including reliability of data), it is better to select the valuation method which requires the fewest adjustments.[25] If the appraisal unit consists only of taxable property, the appraiser does not have to remove nontaxable assets and rights, including intangible assets and rights.[26] For example, if an appraiser is assigned the task of assessing the taxable property of a local photocopy business, he or she may choose to rely upon audited business property statement costs, properly trended and depreciated, as the basis for the assessment. The appraiser is less likely to require information on the income of the photocopy business or the market prices for photocopy businesses because development of those income and market value indicators for the business requires the further step of removing the value of nontaxable assets and rights, and introduces an unnecessary level of uncertainty.

b. <u>If the Assessee is Engaged in a Business Whose Revenues are Generated Principally from Enterprise Activity, the Appraiser Should Not Use the Business as the Appraisal Unit.</u>

In those few instances where the taxable property cannot readily be valued by itself, the appraiser should ascertain the nature of the business of the assessee to determine if that business generates revenues principally from enterprise activity.

Enterprise activity occurs when a business engages in the sale of goods or services.[27] Income attributable to enterprise activity may not be ascribed to taxable property. A retail store operated by the property owner involves at least two activities. One is the ownership of the real and tangible personal property, and the other is the business (i.e., enterprise activity) of selling merchandise at the property.[28] The income attributed to the retail store's enterprise activity may not be assessed. However, the presence of

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American Society of Appraisers, <u>Appraising Machinery and Equipment</u>, p. 7 (1989). Appraisers should be mindful of the requirement in Property Tax Rule 461(d) to separate appraisal units in certain circumstances. For real property, Revenue and Taxation Code Section 51(d) states that the appraisal unit is one that is commonly bought and sold as a unit in the marketplace, or that is normally valued separately.

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<u>See</u>, <u>e.g.</u>, <u>The Appraisal of Real Estate</u>, 11th edition, pp. 604-5 (1996).

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The cost approach does not typically capture the value of intangible assets and rights because the appraisal unit only includes the subject property. Rabianski, "Going-Concern Value, Market Value and Intangible Value," <u>The Appraisal Journal,</u> p. 185 (April, 1996).

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A "business enterprise" is a "commercial, industrial or service organization pursuing an economic activity." Appraisal Standards Board, <u>Uniform Standards of Professional Appraisal Practice</u>, p. 9 (1998).

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AH 501, p.97 (1997).

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that enterprise activity may be assumed so that a typical business owner would be able to pay the economic rent for the taxable real property. A motel also has a business whose business generates its revenues principally from enterprise activity. The intangible assets and rights which may be present in a motel include developed procedures, implemented marketing, advertising, promotion, and preopening expenses, financial relationships, franchise affiliations, advanced telephone reservations system, and sources of supply.[29/] Relying on a capitalization of the enterprise income would be "inappropriate and misleading" in that circumstance.[30/]

If the appraiser determines that the assessee is engaged in a business whose revenues are generated principally from enterprise activity, the appraiser should value the taxable property directly, and should avoid the use of appraisal methods which require appraisal of the entire business.[31/] In most instances the income and market approaches will produce an unreliable result either because there is insufficient income or market data, or because the process of adjusting the value of the business down to the taxable property requires subjective judgments which render the result meaningless.[32/] However, in some instances the subject property has suffered significant physical depreciation or functional or economic obsolescence. In those instances the income approach is the preferred approach because it will disclose the presence of depreciation or obsolescence which may not be detected by other valuation methods.[33/]

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Nelson, Messer and Allen, "Hotel Enterprise Valuation," The Appraisal Journal, pp. 167-8 (April 1988); Appraisal of Real Estate, 11th edition, p. 481 (1996).

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Madonna v. County of San Luis Obispo, 39 Cal. App. 3d 57, 61 (1974).

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Property Tax Rule 6(a) calls for use of the cost approach when there is no reliable income or market data available for the taxable property. The most universally applied approach for property tax purposes is the cost approach. AH 501, p. 73 (1997). See, Kelly and Byrnes, "The Valuation of Landfills for Ad Valorem Assessment Purposes," Journal of Property Tax Management, pp. 6-7 (Summer 1995).

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For example, assume that the assessee is a medical practice which lacks reliable accounting records to allow the appraiser to perform a historical cost approach. The appraiser should ascertain the replacement costs of the taxable property (e.g. office furniture and medical instruments), and then apply appropriate depreciation factors, rather than attempt to value the entire medical practice using an income or market approach, and then removing the value attributable to the patient (customer) relationships, work force in place, and goodwill.

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Property Tax Rule 8; See, Rabianski, "Going-Concern Value, Market Value, and Intangible Value," The Appraisal Journal, p. 188 (April 1996). If the income approach indicates a value higher than that indicated by other approaches, the value indicated by the income approach may include a non-realty or business enterprise value component. The Appraisal of Real Estate, 11th edition, p. 602 (1996).

c. If the Appraiser is Unable to Value the Taxable Property Directly, and the Assessee is not Engaged in a Business Whose Revenues are Generated Principally from Enterprise Activity, the Appraiser May Choose to Use the Assessee's Business as the Appraisal Unit Provided Reliable Data Are Available.

In those rare instances where (i) the appraiser is unable to value the taxable property directly, and (ii) the assessee is not engaged in a business whose revenues are generated principally from enterprise activity, the appraiser may choose to use the assessee's business as the appraisal unit and to remove the value of the nontaxable assets and rights from the appraisal unit provided there are reliable data available concerning the identity and value of those nontaxable assets and rights.[34/]

d. Appraising the Assessee's Business.

If the appraiser finds it necessary to appraise the assessee's business, and then remove the value of the intangible assets and rights, the appraiser should consider collecting and analyzing the following data in appraising the business:

- the nature and history of the business;
- financial and economic conditions affecting the business, its industry, and the general economy;
- past results, current operations, and future prospects of the business;
- past sales of ownership interests in the business being appraised;
- sale of similar businesses; and
- prices, terms, and conditions affecting past sale of comparable business assets.[35/]

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Revenue and Taxation Code §110(d)(2); AH 501, p. 12 (1997). Under the Uniform Standards of Professional Appraisal Practice, Standards Rule 1-2(e), an appraiser must "identify and consider the effect on value of any personal property, trade fixtures or intangible items that are not real property but are included in the appraisal. . . [s]eparate valuation of such items is required when they are significant to the overall value."

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AH 501, pp. 60-61 (1997); Appraisal Standards Board, Uniform Standards of Professional Appraisal Practice, Standard Rule 9-4, pp.56-7 (1998).

Most of this information may be publicly available through documents filed with the Securities and Exchange Commission and business and trade periodicals.

e. Removing Intangible Assets and Rights from the Appraisal Unit.

Intangible assets and rights can be valued using a variety of valuation methods, all of which are derived from the three generally accepted approaches -- cost, market and income.[36/]

Methodologies under the cost approach include depreciated replacement cost, depreciated reproduction cost, recreation cost, creation cost, and a one-time cost savings or avoidance.[37/] These methods attempt to quantify the current cost of generating a perfect substitute for the subject intangible assets and rights in terms of functionality, utility, usefulness, and remaining life.[38/] A work force in place is an intangible asset which can be valued using a cost approach where the cost to recreate the asset is used. An appraiser can determine the cost of locating, interviewing and training employees, as well as the cost of the probable advertising and placement fees.[39/]

In many instances, an intangible asset may produce an identifiable income stream, such as a stream of royalties for the use of intellectual property, the income stream from a customer relationship, or a greater than market price for goods or services.[40/] The income stream can be estimated and discounted to present value to arrive at an income approach value indicator.[41/] An appraiser may also quantify a stream of cost savings as

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Pratt, Reilly and Schweihs, Valuing a Business, 3rd edition, p. 56 (1996). A demonstration appraisal can be found in Reilly, "Allocating Value in Location-Dependent Businesses," Journal of Property Tax Management, pp. 1-17 (Spring 1993).

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Rabe and Reilly, "Valuation of Intangible Assets," National Public Accountant, p. 45 (Spring 1992).

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Cesta and Davis, "Extracting the Value of Intangible Assets from the Unit Assessment Method," Assessment Journal, p. 56 (Sept./Oct. 1996).

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Smith and Parr, Valuation of Intellectual Property and Intangible Assets, 2d ed., pp. 302-3 (1994).

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Smith, "Tangible Ways to Value Intangible Assets," Journal of Property Tax Management, p. 38 (Winter 1991); Koch, "Defending a Customer List Amortization Deduction," Journal of Property Tax Management, p. 24 (Spring 1991).

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Smith and Parr, Valuation of Intellectual Property and Intangible Assets, 2d ed., pp. 300-1 (1994).

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a result of ownership of the intangible asset or right.[42] The duration of the income stream or cost savings must also be determined. The appraiser should consider limiting factors on the life of an intangible asset or right, such as the length of the contract which may create the asset or right (e.g., a favorable lease), legal restrictions on the asset or right (e.g., a patent), and actuarial mortality (e.g., a customer relationship).[43]

Some intangible assets and rights, such as a liquor license, may be bought and sold by themselves on the open market. These open market sales may provide the basis of a reliable comparable sales approach. However, the market approach will rarely be used due to a lack of comparable sale data.[44]

Goodwill, going concern value, and similar intangible assets typically are valued using a residual technique. For an ongoing business enterprise, the appraiser will value all of the tangible assets and as many intangible assets and rights as possible using direct valuation methods. The difference between the sum of the values of the tangible and intangible assets and rights and the value of the entire business enterprise can be ascribed to goodwill, going concern, or similar intangible assets. This difference often arises because the principle of substitution sets a ceiling on the values of the identifiable tangible and intangible assets and rights. In a sense, the residual method is really an excess earnings method, because the residual value represents the earnings of the business enterprise over and above the earnings attributable to the identifiable assets.[45]

The value of intangible assets and rights cannot be removed by merely deducting the related expenses from the income stream to be capitalized.[46] Allowing a deduction for

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Pratt, Reilly and Schweihs, Valuing a Business, 3rd edition, p. 552 (1996).

43/

Rabe and Reilly, "Valuation of Intangible Assets," National Public Accountant, p. 45 (Spring 1992).

44/

Smith, "Tangible Ways to Value Intangible Assets," Journal of Property Tax Management, p. 37 (Winter 1991).

45/

Smith and Parr, Valuation of Intellectual Property and Intangible Assets, 2d ed., p. 94 (1994); Mobley, "Defining and Allocating Going-Concern Value Components," The Appraisal Journal, pp. 325-6 (October 1997).

46/

Property Tax Rule 8(e) ("[w]hen income from operating a property is used, sufficient income shall be excluded to provide a return on working capital and other nontaxable operating assets and to compensate unpaid or underpaid management."). See, AH 501, p.95 (1997) for a discussion of Property Tax Rule 8(e).

the associated expense does not allow for a return on the capital expenditure.[47] For example, allowing the deduction of wages paid to a skilled work force does not remove the value of the work force in place from the income indicator, because the amount of the wages paid does not necessarily represent a return of and on the work force in place, and further bear no relationship to the costs associated with locating, interviewing, training and otherwise acquiring the work force. Similarly, the deduction of a management fee from the income stream of a hotel does not recognize or remove the value attributable to the business enterprise that operates the hotel.[48]

3. Adjustment of Value Indicators.

Regardless of the method used, the appraiser should remove the value of all intangible assets and rights from each value indicator before the value indicators are reconciled. Moreover, only the taxable property in place on the lien date is assessable. If the value of the business is included in the value indicator, the appraiser may have captured a value associated with the value of property to be acquired in the future to maintain the predicted income stream or to support the market value of the business. The appraiser must remove the value associated with property to be acquired in the future.[49] Set forth below is a discussion of the three valuation methods, and observations regarding the removal of the value of intangible assets and rights from those indicators.

a. Comparative Sales Approach.

When using the comparative sales approach, the comparable properties are often sold in a transaction which includes intangible assets and rights. The value of those intangible assets and rights, as well as the value of assets other than the comparable property, must be removed from the sale price before the sale is compared to the subject property.[50] The appraiser is free to use any of the three traditional approaches -- cost, income, and market -- to value those nontaxable intangible assets and rights. If the subject property was part of the sale of a business enterprise, the appraiser may wish to examine transaction documents which may contain an allocation of the purchase price to the various component assets. The appraiser should be aware that

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Investors demand both a return of their investment (a recapture of the investment) and return on their investment (a yield on the investment). AH 501, p. 98, 101-2 (1997). The yield on the investment must compensate the business for the risk above a safe rate of return. Smith and Parr, Valuation of Intellectual Property and Intangible Assets, 2d ed., p. 244 (1994).

48/
Dowell, "Hotel Investment Analysis: In Search of Business Value," Journal of Property Tax Management, p. 11 (Fall 1997).

49/
Union Pacific R.R. Co. v. State Board of Equalization, 49 Cal. 3d 138, 150 (1989).

50/
AH 501, p. 91 (1997).

this allocation may or may not be made based upon the fair market value of the various component assets.

b. Income Approach.

If the income stream used by the appraiser is in part generated by intangible assets and rights, the appraiser must either (a) attribute sufficient income to provide a return of and on the intangible assets and rights,[51] or (b) remove the value of the intangible assets and rights from the income indicator (using any acceptable valuation method) after the income stream has been capitalized or discounted to present value. A business may have valuable intangible assets and rights (e.g., customized computer software, patents, copyrights) even though the business may not generate sufficient income to produce an adequate rate of return of and on the subject property.

c. Cost Approach.

Since the appraisal unit for the cost approach typically includes only the subject property, the appraiser generally is not faced with the exclusion of the value of intangible assets and rights. In those circumstances where intangibles may be present within the appraisal unit, the appraiser may either (a) isolate the cost of the intangible assets and rights and subtract those costs before applying price trending and depreciation factors or (b) determine the fair market value of the intangible assets and rights using any acceptable valuation method.

4. Reconciliation.

The final step in the appraisal process is to reconcile the value indicators. In theory, each approach to value should yield the same indication of value.[52] In practice, it is rare for each value indicator to be identical. Variations occur because of the lack of adequate, reliable data to perform each approach to value, the subjectivity of the adjustments to be made in the appraisal process, and the inclusion of (and failure to remove) the value of nonassessable tangible property and intangible assets and rights within the appraisal unit. It is essential that an appraiser's value indicators relate to the same property. For example, if the value indication derived from income capitalization is substantially higher than an indication based on the cost approach, the income capitalization value may include a non-realty or business enterprise value component.[53]

51/

Property Tax Rule 8(e), AH 501, p. 95 (1997).

52/

AH 501, p. 61 (1997).

53/

The Appraisal of Real Estate, 11th edition, p. 602 (1996).

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The appraiser should bear the following guidelines in mind when giving weight to his or her valuation approaches:

- If reliable market data for sales prices of property comparable to the subject property are available, the comparative sales approach is generally preferred. If reliable market data for sales prices of business enterprises are available, which business enterprises include properties comparable with the subject property, then the comparable sales approach may be utilized if the value of the assets other than the comparable property, including intangible assets and rights present in the business, are removed from the sales price before the sale is compared to the subject property. Under these circumstances, the greater the proportion of assets other than the comparable property, including intangible assets and rights contained within the business enterprise, the less reliable the data becomes.

- If reliable market data are not available, the income approach is preferred if the appraiser can identify a discrete income stream attributed to the subject property only. If the appraiser can identify a discrete income stream attributed to the business enterprise which includes the subject property, then the income approach may be utilized if the value of the intangible assets and rights present in the business enterprise is removed. Under these circumstances, the greater the proportion of intangible assets and rights contained within the business enterprise, the less reliable the data becomes.

- If reliable market and income data are not available, and the property has experienced relatively little depreciation or obsolescence, the cost approach is preferred because it typically values only the subject property.

- Valuation approaches with the most reliable data are favored over approaches with less reliable data.

- Valuation approaches requiring the fewest adjustments are generally favored.

- Valuation approaches which value only the subject property are generally favored over approaches which value the business enterprise that contains the subject property.

An example illustrating these principles is set forth in Appendix 2.

Appendix 1

Examples of Intangible Assets and Rights

Causes of action
Copyrights
Covenants not to compete
Customer lists
Deferred, startup, or prematurity costs
Enterprise value
Favorable franchise rights
Going concern value
Goodwill
Governmental permits (including liquor licenses, cable television franchises, and airport rental car and stadium concessions)
Insurance policies
Judgments
Management and operating systems
Marketing and programming contracts
Memberships in social, professional and fraternal clubs
Nonreal property lease agreements
Patents
Press association memberships
Right to do business
Sanitary landfill operating permits
Stock exchange seats
Subscriber contracts
Validation permits
Work force in-place

Appendix 2

XCORP is engaged in the widget business. XCORP owns all of its tangible plant and equipment and has invested $40,000,000 in that tangible plant and equipment. XCORP currently has a customer base of 100,000 customers, and purchased or acquired those customers over time. The XCORP business currently is operating at capacity and generating a profit.

Information concerning the original cost, replacement cost and depreciation of XCORP's tangible assets is considered reasonably accurate. The replacement cost new less depreciation value for XCORP's taxable tangible property calculated in accordance with Property Tax Rule 6 is $30,000,000. An income approach value of $54,000,000 was calculated and was based on the income anticipated for the existing XCORP business consisting of plant, equipment, customer base and other associated assets in perpetuity. The income capitalized was the gross income less expenses and capital expenditures required to develop and maintain the estimated income (other than amortization, depreciation, debt retirement, interest, property taxes, corporation net income taxes, and corporate franchise taxes measured by net income). XCORP's expenses and capital expenditures required to develop and maintain the estimated income include expenses relating to the maintenance of XCORP's customer base. In determining the business enterprise value of $54,000,000 under the income approach, XCORP's gross income was not reduced by a return on the value of the customer base asset or any other nontaxable asset.

XCORP's customer base of 100,000 customers is a valuable intangible asset that is not subject to property tax. Market data relating to sales of customers by or to companies in the widget business and XCORP's internal data concerning the costs to acquire customers shows that XCORP's customer base is worth approximately $15,000,000.

Revenue and Taxation Code Section 110(d) requires that the value of intangible assets and rights be removed from a unit value indicator, such as an income approach. In addition, Property Tax Rule 8(e) requires that "when income from operating a property is used, sufficient income shall be excluded [from the amount to be capitalized] to provide a return on ... nontaxable operating assets." Since Rule 8(e) contemplates adjusting the cash flow for such a return before capitalizing the income stream, if an appraiser does not make that adjustment, then the appraiser must remove the value of the nontaxable operating assets from the value of the unit (pursuant to Revenue and Taxation Code Section 110(d)(2)). In this case, the income approach value of $54,000,000 is reduced by $15,000,000 to yield a value of $39,000,000 in order to remove the value of the customer base.

XCORP has other nontaxable assets, such as working capital, goodwill, assembled work force, and other intangible assets. The value of these other nontaxable assets also must be removed from the income approach value either (i) by adjusting the income to capitalize or (ii) by removing the value of the asset from the capitalized income value. The appraiser is able to quantify working capital and the value of the assembled work force, however, reliable data is not available to quantify the value of XCORP's other intangible assets and rights as they relate to the income being capitalized.

Based on market transactions involving the purchase and sale of businesses similar to XCORP, it appears that the value of the XCORP business enterprise may approximate $60,000,000. However, that value includes the value of XCORP's nontaxable assets and rights as well as expectations about future growth and expansion which would require significant additional investment in plant and equipment. Given the lack of available data concerning all of the components of the XCORP business value of approximately $60,000,000, it is not feasible to determine the value of the taxable property by identifying and valuing every intangible asset and right and then reducing the value of the business enterprise by the value of all of the intangible assets and rights.

Under these circumstances, where there is not reliable income or market data concerning the tangible property itself, the replacement cost new less depreciation value approach is the most reliable value approach and accordingly it should be used in place of the income or market approach. Based on the foregoing, the value of XCORP's taxable tangible assets is approximately $30,000,000.

CALIFORNIA ASSESSORS ASSOCIATION

AD-HOC COMMITTEE

POSITION PAPER ON INTANGIBLES

The purpose of this paper is to express the position of the California Assessors Association on the issue of intangible personal property as it relates to real property assessments. Opinions contained herein should provide guidance to Assessors and businesses alike in determining when "intangibles" should or should not be considered in the valuation of real property, for purposes of meeting the constitutional mandate that real property be assessed at "full cash value."[1] This paper also discusses appropriate methods for assessing real property when intangible business personal property is involved and the earnings of the business are derived in whole or part from the beneficial or productive use of the real property itself. In essence, the California Assessors Association's objective is to maintain uniformity of assessment practice in this complex area.

"Intangibles" have become an issue because a small group of taxpayers have alleged that nontaxable intangibles have sometimes been included in real property assessments. These allegations have led to litigation, as well as recent enactment of legislation intended to limit the consideration of intangibles in the valuation of real property for taxation purposes. A Section on "Intangibles" has been drafted for inclusion in Assessors Handbook 502, Advanced Appraisal.

Any attempt to clarify the issue of "intangibles" should be prefaced by a brief discussion of salient principles of property taxation. Section 103 of the California Revenue and Taxation Code defines "property" as "all matters and things, real, personal, and mixed, capable of private ownership." Therefore, by legal definition, there are only two types of property, real and personal. Personal property includes all property except real property.[2] Personal property is either tangible or intangible. Examples of tangible personal property include physical assets such as equipment and motor vehicles; whereas examples of "intangible personal property" include such incorporeal assets as trademarks, patents, copyrights and liquor licenses.

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[1] *See* Article XIII A, Sections 1 and 2, of the California Constitution. Sec. 1 states, "The maximum amount of any ad valorem tax on real property shall not exceed one (1%) of the full cash value of such property." Both Subsection (a) of 110 and (a) of 110.1 of the Revenue and Taxation Code define "full cash value as "fair market value." Section 110.1 elaborates on the definition of "fair market value" as that term applies to the 1975 lien date and to changes of ownership and new construction thereafter. Subsection (f) of 110.1 states that for each lien date after the lien date in which the full cash value is determined, the full cash value of real property including possessory interests in real property, shall be adjusted by an inflation factor which shall be determined as provided in subdivision (a) of Section 51. *See also,* De Luz Homes, Inc. v. County of San Diego (1955) 45 Cal. 2d 546.

[2] Revenue and Taxation Code, Section 106.

Although there is no such thing as "intangible real property," real property is comprised of all intangible interests, benefits and rights inherent to the ownership of land and improvements. Implicit in the tenets of real property law and appraisal theory is the principle that the value of real property lies in the bundle of (intangible) rights associated with it. It is the right to benefit from the ownership, possession and use of real property that gives it value. Although real property may be comprised of various intangible interests, benefits and rights, it is considered to be tangible property. For property tax purposes it is these interests, benefits and rights of tangible real property which are valued.

All real property is taxable under the Constitution unless expressly exempted. The Constitution has not conferred upon the legislature the power to exempt real property. However, Article XIII, Section 2 grants the legislature the authority to exempt tangible and intangible personal property from taxation if it so chooses.[3] While the courts have interpreted the Constitution and statutes thereunder as having exempted all intangible personal property from property taxation,[4] the Courts have also held repeatedly that to properly assess taxable property at its full value as required by the Constitution, the assessor must value the property assuming the presence of whatever intangible assets are necessary to put the property to beneficial or productive use.[5] Because the

[3] Article XIII, Section 2 reads in part as follows: "The Legislature may provide for property taxation of all forms of tangible personal property, shares of capital stock, evidences of indebtedness, and any legal or equitable interests therein not exempt under any other provision of this article. The Legislature, two-thirds of the membership of each house concurring, may classify such personal property for differential taxation or for exemption...."

[4] In Roehm v. County of Orange, 32 Cal. 2d 280 (1948) the Court indicated that the Legislature is not empowered to provide for taxation of any intangible assets other than those listed in Article XIII, Section 2 (i.e. shares of capital stock, evidences of indebtedness, and any legal or equitable interests therein). Of those intangibles for which the Legislature may provide taxation, Revenue and Taxation Code, Section 212 expressly exempts "[n]otes, debentures, shares of capital stock, solvent credits, bonds, deeds of trust, mortgages, and any interest in such property." In other words, the constitution provides only a short list of intangibles from which the legislature may choose to tax or not. Any intangibles not specified in that list are nontaxable.

[5] In County of Stanislaus v. County of Stanislaus Assessment Appeals Board and Post Newsweek Cable, Inc. (1989) 213 Cal.App.3d 1445 (involving the assessment of a cable television possessory interest and the assessment of intangibles where the assessments were based primarily upon the sales price of the system without specifically identifying a possessory interest as part of the value), the taxpayer argued that the cable franchises were exempt intangible assets. Upholding the recently decided Cox Case the Court at page 1452 found that cable television franchises "...consist of two basic components: the right to use the public streets to lay the cables and the right to charge a fee to subscribers for their use of the cable facilities." At page 1454 the court explained that the first component is an assessable possessory interest, but the "intangible right to do business is not assessable" for property tax purposes. Nonetheless, the Court went on to say, "Our conclusion that the intangible right to do business is not assessable for ad valorem tax purposes, however, does not mean the value of Post-Newsweek's intangible rights may not be considered in assessing the value of the possessory interests. " Citing Roehm v. County of Orange at page 285, the Court continued, "'Intangible values ... that cannot be separately taxed as property may be reflected in the valuation of taxable property. Thus in determining the value of [taxable] property, assessing authorities may take into consideration earnings derived therefrom, which may depend upon the possession of intangible rights and privileges that are not themselves regarded as a separate class of taxable property.' " Accord, Michael Todd Co. v. County of Los Angeles, 57 Cal.2d 684, 693-694 (1962); Western Title Guaranty Co. v. County of Stanislaus, 41 Cal.App. 3d 733, 741. *See also,* Cox Cable San Diego, Inc. v. County of San Diego, 185 Cal.App.3d 368 (1986). Section 212(c) of the Revenue and Taxation Code states, "Taxable property may be

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Legislature has no power to exempt real property from taxation, and its authority to exempt (or tax) property is limited to personal property, statutes addressing the issue of intangibles must be narrowly drafted and construed as only applying to such personal property, the value of which is unrelated to and severable from the real property (or the earnings derived from its use). Value attributed to an intangible interest, benefit or right arising from the ownership, possession and use of real property is included in the taxable value of the real property and cannot be exempted by the legislature, a property tax rule or a handbook.

Recent changes to Sections 110 and 212 of the California Revenue and Taxation Code, while attempting to delineate when intangibles should not be included in the valuation of real property, have added confusion to the principles enunciated above, and may prove unconstitutional if they contradict the mandate that real property must be valued at "full cash value," or if they conflict with court decisions pertaining to the valuation of real property. In fact, Section 110(d) may conflict with the reiteration of case law in subsection (e) which states: "Taxable property may be assessed and valued by assuming the presence of intangible assets or rights necessary to put the taxable property to beneficial or productive use." Section 110(d) provides:

> (1) The value of intangible assets and rights relating to the going concern value of a business using taxable property shall not enhance or be reflected in the value of the taxable property.
>
> (2) If the principle of unit valuation is used to value properties that are operated as a unit, then the fair market value of the taxable property contained within the unit shall be determined by removing from the value of the unit the fair market value of the intangible assets and rights contained within the unit.
>
> (3) The exclusive nature of a concession, franchise, or similar agreement is an intangible asset that shall not enhance the value of taxable property, including real property.

Subsections (1) and (2), if interpreted as applying to intangible assets and rights that are inextricably related to the value of the property itself or to earnings that are derived from the use of the property, could violate the principle that taxable property may be assessed by assuming the presence of intangible assets or rights necessary to put the taxable property to beneficial or productive use. Both Subsection (1) of 110(d) and Section 107.7(d), by precluding the consideration of going concern value in the valuation of real property, may contradict the principle that market value for assessment

assessed and valued by assuming the presence of intangible assets or rights necessary to put the taxable property to beneficial or productive use."

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purposes results from the use to which it (real property) is put and varies with the profitableness of that use, present and prospective, actual and anticipated. Based upon sound appraisal theory it is generally true that property which is operational is more valuable than it would be if idle. In short, all of these legislative provisions could result in the wholesale exemption of taxable real property.

Subsection (3) is especially troublesome and appears to be a circumvention of the holdings in County of Stanislaus v. Assessment Appeals Board and Post-Newsweek Cable, Inc. 213 Cal. App.3d 1445 (1989), ITT World Communications, Inc. v. County of Santa Clara Cal. App.3d 246 (1980) and Cox Cable San Diego v. County of San Diego 185 Cal. App.3d 368 (1986). In Stanislaus the issue before the court was whether a cable television franchise is subject to real property tax. The Court held that while the franchisee's right to charge a fee and to make a profit from the operation of the business is a constitutionally protected nontaxable asset, the assessor may take into consideration the presence of the franchise in valuing the taxable property of the cable system. Citing Western Title Guaranty Co. v. County of Stanislaus, 41 Cal. App. 3d 733, at p.741, the Court said," '[T]he propriety of including nontaxable intangible values in the valuation of otherwise taxable property has been asserted by the courts in a variety of contexts, and market value for assessment purposes is the value of property when *put to beneficial or productive use.*'" In ITT World (involving a state-assessed property where the Board-adopted values were based primarily on the income (capitalized earnings approach) and were substantially higher than the cost approach indicators), the taxpayer argued that its property could not lawfully be assessed higher than RCNLD (reproduction cost new less depreciation) and that any assessment above that constituted a tax upon its franchise. While the Court agreed that intangible personal property (which includes corporate franchises of public utilities, excepting special franchises) is exempt from taxation, it pointed out at p. 254, "Although appellant's franchise cannot be assessed and directly subjected to property taxation, the assessment of its taxable property may take into account earnings from that property that depend upon appellant's possession of a franchise. Such an assessment would properly reflect the effect of the intangible value of possession of the franchise on the value of the tangible taxable property."[6] The Cox Cable case distinguished between franchises that are a separate class of intangible personal property that are

[6] ITT World is notable for several reasons. First, it reaffirmed the position taken in previous decisions that taxable, tangible property may be valued by using an income approach. Second, it found that an assessment based on earnings may properly reflect the effect of intangibles. And third, it decided that reproduction cost new less depreciation is not the upper limit of value.

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not taxable by the assessor and franchises that are "indissolubly annexed" to real property and therefore are taxable.[7]

A careful reading of Section 110(d)(3) of the Revenue and Taxation Code seems to suggest that heretofore taxable possessory interests that are dependent upon an exclusivity factor can no longer be assessed, or can be assessed at only nominal value if they are subject to a franchise. The reason for this inference lies in Section 107(a) of the Revenue and Taxation Code which requires for the existence of a possessory interest the attributes of independence, durability and exclusivity. It is a franchise that confers the exclusive right to use public real property in a specific manner not enjoyed by members of the public at large. Also, under subsection (d)(3) it is not clear how one "intangible," i.e. the exclusive nature of the franchise, can be removed from another, i.e. the franchise itself, if the latter is necessary to put the taxable property to beneficial or productive use.

The California Assessors Association does not believe that there is a widespread or pervasive assessment problem surrounding intangibles. All Assessors are aware that specific intangible personal property has been exempted from direct taxation through statute, case law and assessment practice. Examples of such intangible personal property are, but not limited to notes, debentures, shares of capital stock, bonds, deeds of trust, liquor licenses, patents, copyrights, accounts receivable, prepaid expenses, trade names, and franchises which do not grant the right to use real property. Arguments that nontaxable intangibles have been included in the assessment of real property frequently fail to distinguish between intangible interests, benefits or rights ensuing from the ownership of real property, and intangible personal property that is not related to the ownership of real property or necessary to put real property to beneficial or productive use. In fact, these distinctions are often ignored or obfuscated.

Adding to the confusion is the deliberate or inadvertent commingling of terminology from two separate disciplines: financial accounting and real property appraisal. For example, a cable television franchise is a depreciable "intangible asset" for accounting and income tax purposes, but for property tax purposes it conveys a taxable possessory interest in land. An existing customer base can be a depreciable "intangible asset" for accounting and income tax purposes; however, in the valuation of an income producing property, the established customer base represents one of the property's going concern attributes. Also, because Federal income tax law allows amortization of

[7] Quoting from Stockton Gas etc. Co. v. San Joaquin Co., 148 Cal. 313, 321, the Court in Cox Cable said, "[D]iscussing the issue of where property must be assessed under the constitutional requirement that property must be assessed where it is situated, the court did say the similar franchise 'is indissolubly annexed to the street of a city in and upon which it is exercised...an easement appurtenant to such streets. This being so, it necessarily, as real property, has a *situs* in the city where it is exercised, and, under the constitutional provision with reference to the assessment of property, must be assessed there.'" See also footnote 5.

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only those intangible assets that can be separately identified and valued, it is in the taxpayer's economic interest to classify all of its intangible assets as something other than goodwill or going concern value.[8] Consequently, through ingenuity, numerous new items of "intangible personal property" have been created for income tax amortization purposes. Unfortunately, they are now being imported into the law of property tax assessment.[9] Financial accounting terminology and methodology, developed for income tax application, is not relevant to real property appraisal.

The California Assessors Association seriously doubts that nontaxable intangibles are being included in the assessment of real property. The very methodologies employed to value property ensures that they are not. In making an appraisal, the appraiser first analyzes the relationship between the business operation and the real property, and determines whether the activities (and therefore the earnings) of the business are integrally related to the use of the real property or whether they are incidental to that use. If the earnings are derived in large measure from the use of the property, then a methodology based upon those earnings (e.g. an income approach) or the sales price of the property may be the best indicator of value. Conversely, if the business and the property are only incidentally related, the earnings of the business result largely from entrepreneurship (i.e. human skills), and then the earnings should be accorded little weight in the appraisal process (e.g. medical or legal practices where the earnings are derived from the skills of their operators and not from the real property).

Most commercial property assessments pose few problems with regard to intangibles. Property appraisers value the vast majority of commercial properties utilizing economic rents and comparable sales of equivalent real property. In the process the appraiser looks to the market place whenever possible to determine the "highest and best use" of the property being appraised. Although a business may be utilizing property at its highest and best use, the activity of the business is incidental to the use of the taxable property. It is the real property that is being valued, not the business that is using it. In such cases, the earnings of the business come from human enterprise activity and are not integrally related to the real estate. While the location, zoning, quality and condition of the property may affect the earnings of the business utilizing it, the effect of these variables on property value is measured by the market

[8] *See*, The Effect of Intangibles on Property Value (A draft paper prepared by the Assessment Standards Division for presentation to the California State Board of Equalization on January 7, 1992.)

[9] Compare the small list of intangible personal property mentioned in Article XIII, Sec.2 of the California constitution (i.e. notes, debentures, shares of capital stock, bonds, solvent credits, deeds of trusts, and mortgages) with those set forth in the Revenue and Taxation Code under Section 107.7 pertaining to the nontaxable intangible assets or rights of a cable television system. These intangible assets or rights, include: franchises or licenses to construct, operate, and maintain a cable television system for a specified franchise term (excepting the possessory interest portion of the franchise) subscribers, marketing, and programming contracts, nonreal property lease agreements, management and operating systems, a work force in place, going concern value, deferred, startup, or prematurity costs, covenants not to compete, and goodwill.

rent commanded by the real property and the sales of comparable real property. Most commercial property is bought and sold by investors for the income generated from the real estate. The appraiser's only task is to find the income for the real property that excludes all appropriate expenses necessary to maintain the income stream. The use of economic rents based upon an analysis of the open market to appraise rental properties eliminates any issue of nontaxable intangibles, as the rent is solely attributable to the taxable property.

There are types of multi-residential, commercial and industrial real properties where the property and business are totally integrated. The business in these instances is to maximize the highest and best use of the real property. For these properties, the earnings of the business result primarily from the attributes of the property and the direct use of the property for the specific purpose for which the property was developed. Examples of such properties are: mines, quarries, geothermal power plants, co-generation power plants, hydroelectric power plants, golf courses, ski resorts, oil fields and refineries, cable television systems and public utilities. There are no market rents for most of these special use type properties, and true comparable sales, if any, are rare. The value of these properties can be attributed to special permitted uses, unique physical characteristics, or extremely limited availability. The best indicator of market value for such a property is its capitalized earning capability. The selling price of such a property is believed to represent the present value of projected future earnings, and therefore its market value, because the business is inextricably coupled with the operation of real property. Property Tax Rules 8(e) and 25(b) provide for capitalizing the net income from the operation of these types of properties. This income approach requires that all operating expenses, costs of goods sold, an allowance for typical management and a provision for a return on working capital and other nontaxable operating assets be excluded in determining the net income to be capitalized.

When a property is valued by capitalizing the net income from its operation, care must be taken not to capitalize income that is not attributable to the taxable property. Property Tax Rule 8(e) cautions that income derived from the operation of a property may be influenced by managerial skills, and may arise in part from sources other than the property itself. The California Supreme Court has opined that: "Income derived in large part from enterprise activity [may not] be ascribed to the property being appraised; instead, it is the earnings from the [taxable] property itself or from the beneficial use thereof which are to be considered...." [10]

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[10] *See*, California Portland Cement Co. v. State Board of Equalization, 67 Cal.2d 578 (1978) at Page 584; *See also*, County of Stanislaus, (Supra in Footnote 5). In California Portland Cement, the Court held that information sought by the State Board (sales volumes and income, costs of production, and production volume) was relevant to the appraisal of plaintiff's property which consisted of a limestone quarry and adjacent cement mill, notwithstanding plaintiff's argument that the data sought was related to the value of the business and not the property. The Court

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No court decision or statute has explicitly defined nontaxable "enterprise" value. However, cautionary language from numerous court cases warning against using "earnings derived in large part from enterprise activity" in arriving at an indicator of value for real property, leads one to the conclusion that nontaxable "enterprise" value consists of the capitalized net earnings which are derived in large measure from human enterprise activity rather than from real property interests or attributes.

When deciding whether real property can be valued by capitalizing net income from its operation, the appraiser must determine whether earnings are largely derived from enterprise activity or whether they are derived from the attributes of the property. It is appropriate to capitalize net income from the operation of a property to determine taxable value under the following circumstances:

(1) The taxable property is integrally related to the business operation.

(2) The maximum business profit requires the use of the property to the extent permitted.

(3) Earnings are not largely derived from human enterprise activity.

(4) If any net earnings are derived from human enterprise activity, they are sufficiently identifiable and quantifiable to be removed.

Some level of enterprise activity is required to operate and maintain the special use properties listed above; however, this activity is ultimately directed towards maximizing the beneficial or productive use of the property, and consequently, is accounted for by its removal as an operating expense. As long as income and expenses are properly accounted for, the net earnings are appropriately attributable to the taxable property.

The term "enterprise value" is elusive. Depending upon the source, the definition varies considerably. Enterprise value is defined in some contexts as the value of a business in its entirety, encompassing all tangible and intangible assets.[11] Taxpayers sometimes use this term as an umbrella for a laundry list of intangible factors that cannot be segregated in order to avoid a valuation based upon an income or sales

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found that the Board did not have sufficient data for a comparative sales approach and was, therefore, warranted in using an income approach. Nonetheless, the Court warned against capitalizing enterprise profits and quoting from the De Luz case stated that " 'a method may be employed which imputes an appropriate income to the property.'" This case is significant because the court, despite its caveats, approved an income approach for a property that was not rented. It found that "The taxpayers whose property has been valued by the capitalization of income method, as in De Luz, Palm-Ramon, etc. may likewise be viewed as engaging in the 'business' of using, managing or developing the property or its products, hopefully for a profit."

[11] *See* Jackson, William B., "Removing Intangible Assets from the Selling Price of a Going Concern," 1987. "Business enterprise value" is also defined as "a value enhancement that results from items of intangible personal property such as marketing and management skill, an assembled work force, working capital, trade names, franchises, patents, trademarks, non-realty related contracts or leases, and some operating agreements," Appraisal Institute, *The Appraisal of Real Estate, 11th ed., 1996, 578.*

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approach. In many of these instances the taxpayer contends that a cost approach is the only appropriate appraisal methodology for valuing the property even though there is an integral relationship between its business and the real property. This so-called "bricks and mortar approach" may result in an appraisal value far below market or a value substantially lower than that generated by an analysis of the economic income from the property or from similar properties. The courts have rejected the notion that a property can only be assessed at scrap value.[12] The appraiser should be wary of alleged intangibles of an amorphous character, which cannot be consistently defined, much less quantified. In this context, and as part of the normal appraisal process, appraisers should consider all the traditional approaches to value and the reconciliation of those value indications to determine the proper value.

Enterprise value must not be confused with going concern value. In general, an established income producing property will possess a greater value than an otherwise similar property that is idle and not yet productive. This is because a fully developed property provides immediate earnings. A similar undeveloped property, however, may necessitate large capital outlays to establish income earning capability. Indirect costs such as advertising, promotion, professional services, income losses and other start up costs incurred after physical construction, may be necessary to put the tangible property to productive use. The increment in value, commonly referred to as "going concern value," is part of the taxable market value of a developed income producing property, free of any time delay necessary to develop earning power. Valuing income producing real property as a going concern simply accounts for the fact that when such a property can be acquired free of any time delay in earning income, it is more valuable than an identical property sitting idle.

Issues involving "intangibles" are most likely to be encountered in a situation where the real property is an integral part of the business. The appraiser must make an initial determination as to whether the criteria are met (supra) that make it appropriate to value the taxable property by capitalizing the net income from its operation. Then it must be determined if intangible personal property exists for which income must be imputed and excluded. Any value attributable to the previously specified intangible

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[12] In Michael Todd Co. v. County of Los Angeles, 55 Cal.2d 684 (1962) (Involving the film negatives for the movie "Around the World in Eighty Days"), the assessor used a depreciated cost approach appraisal and enrolled a value of $1,526,900. The plaintiff argued that the assessor had valued the copyright and that the negatives had a salvage value of $1,000 without the copyright. Although the court agreed that the copyright was a distinct intangible property interest and not subject to taxation of itself, the court held at page 696: "But 'market value' for assessment purposes is the value of the property when put to beneficial or productive use; it is not merely whatever residual value may remain after the property is demolished, melted down, or otherwise reduced to its constituent elements." In ITT World Communications (supra) the court said at page 256: "It cannot be said that, as an absolute rule of appraisal practice, and as an intrinsic attribute of tangible property, RCNLD is a ceiling on value. Thus, it cannot be said that, as a matter of law, an assessment in excess of RCNLD is necessarily arbitrary, in excess of discretion, or in violation of standards prescribed by law."

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personal property must be excluded from any real property assessment (e.g. notes, debentures, shares of capital stock, bonds, deeds of trust liquor licenses, patents, copyrights, accounts receivable, prepaid expenses, trade names, and franchises which do not grant the right to use real property). None of these examples of intangible personal property is an interest, benefit or right arising from the ownership of real property. None of them are necessary to put real property to beneficial or productive use.

All of the exempt intangible personal property mentioned above, the value of which must be excluded from any real property assessment, possess specific characteristics:

(1) Each is identifiable (legally recognized)

(2) Each is capable of private ownership (An attribute of all property)

(3) Each is marketable (capable of being sold separately from the tangible property.)

(4) Each possesses value.

Intangible personal property possessing the above listed characteristics do not constitute an interest, benefit, or right arising from the ownership of real property and are not necessary to put real property to beneficial or productive use. If alleged intangible personal property does not possess these four characteristics, and simply identifies entrepreneurial achievement or development that represents a stage of production in putting the real property to beneficial or productive use, then the value of such an intangible benefit cannot be excluded in the valuation. Examples of such intangible benefits or interests may include, but are not limited to, a workforce in place, an established customer base, a monopolistic market position for the property's products or service and the going concern stage of production.

The courts in California have concluded that "[I]n determining the value of property, assessing authorities may take into consideration earnings derived therefrom, which may depend upon the possession of intangible rights and privileges that are not themselves regarded as a separate class of taxable property," *Roehm v. County of Orange,* 32 Cal.2d 280, 285. If any statute is interpreted as requiring the exemption of an intangible interest, benefit or right arising from the ownership of real property, such an interpretation results in an unconstitutional exemption of real property.

(7/31/98)

AH 502
"TREATMENT OF INTANGIBLE ASSETS AND RIGHTS"
OUTLINE OF INDUSTRY DRAFT

1. Basic Principles

   - Value attributable to real property and tangible property may be assessed
   - Intangible attributes of real property inherent in its physical location may be valued
   - Value attributable to most other intangible assets and rights may not be assessed
   - Intangibles are present in most commercial and industrial properties
   - Intangibles usually relate to the business itself rather than to real property or tangible personal property used to conduct that business
   - Intangibles are nontaxable even if they are not severable from the business enterprise and sold separately.
   - Some intangibles are bought and sold by themselves in the open market

2. Characterizing Intangible Property Interests

   - Going concern is the value of an established business enterprise in excess of identifiable tangible and intangible property interests used in the business operation
   - Business enterprise value typically includes all elements that confer value, separate and apart from value inherent in tangible assets of a business organization
   - Exclusive nature of a concession or franchise is an intangible asset that shall not enhance the value of taxable property, including real property

3. Constitutional and Statutory Framework

   - Intangibles not specifically identified in Constitution are immune from property tax
   - Under Rev. & Tax. Code, taxable property may be valued by assuming presence of intangibles necessary to put property to beneficial use; under Code, intangible attributes or

real property may be reflected in the value of that property

- Value of most other intangibles may not be reflected in value of taxable property

- Code does not authorize adding an increment to value of taxable property to reflect the value of intangibles necessary to put the taxable property to productive use
- Value of separately identified intangibles relating to going concern value of a business shall not be reflected in the value of the taxable property of that business
- It is impermissible to equate business enterprise value with taxable asset value

4. Valuation Considerations

- Assessors should employ the valuation method which requires the fewest adjustments
- Valuation methods that *only* capture taxable property are preferable to other methods
- Value associated with intangibles must be isolated and removed from the appraisal unit
- If an appraiser does not have access to reliable data concerning the identity and value of intangibles, a different valuation approach should be considered
- Value of real and tangible personal property must be segregated from total value of business
- Appraiser should avoid use of methods which require valuation of entire business; income attributable to enterprise activity may not be ascribed to taxable property
- Difference between total value of tangible and intangible assets *and* value of business enterprise usually should be ascribed to going concern and goodwill
- Under the income approach, the value of intangibles cannot be removed merely by deducting related expenses from the income stream to be capitalized
- Reconciliation must not take place until the value of all intangibles is removed from value indicators

AH 502 DRAFT DATED JUNE 1998
Chapter 6. Special Topics
Treatment of Intangible Assets and Rights
INDUSTRY DRAFT
(August 5, 1998)

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AH 502 DRAFT DATED JUNE 1998
Chapter 6, Special Topics
Treatment of Intangible Assets and Rights
INDUSTRY DRAFT
(August 5, 1998)

Chapter 6. Treatment of Intangible Assets and Rights.

This chapter is intended to assist appraisers in identifying and properly handling intangible assets and rights during the appraisal process. Intangible assets and rights consist of all of the elements of a business enterprise that exist in addition to monetary and tangible assets.[1/] Intangible assets and rights are not subject to ad valorem taxation. [2/]While intangible assets and rights often do not appear on a company's balance sheet, they are almost always present in one form or another in appraisals of commercial and industrial properties. Some examples of intangible assets and rights include franchises, subscriber contracts, management and operating systems, a work force in place, going concern, and goodwill.[3/]

Because taxing jurisdictions only assess the value of real property and tangible personal property, appraisers should plan the appraisal to isolate and value only taxable property as the appraisal unit. When appraisers are called upon to value intangible assets and rights and to remove the value of those intangible assets and rights from the value of the appraisal unit, the appraiser will find that intangible assets and rights may be difficult to identify and value. Any recognized valuation method may be appropriate depending on the facts and circumstances of the appraisal problem. However, appraisers should utilize valuation methods which value only the taxable property, and should use extreme caution if employing a valuation method which captures more than the value of the taxable property and requires the additional step of removing the value of the intangible assets and rights.

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Smith and Parr, Valuation of Intellectual Property and Intangible Assets, 2d ed., p. 83 (1994).

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Revenue and Taxation Code §212.

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Revenue and Taxation Code §107.7. See, Appraisal Standards Board, Uniform Standards of Professional Appraisal Practice, p. 9 (1998). A more exhaustive list of intangible assets and rights can be found in Pratt, Reilly and Schweihs, Valuing a Business, 3rd edition, p. 546 (1996), and Smith, Corporate Valuation, pp. 145-154 (1988). A list of some of the intangible assets and rights identified in California statutes and cases can be found in Appendix 1.

A. Legal Framework.

1. Revenue and Taxation Code Sections 110 and 212

Under Article XIII, Section 2 of the California Constitution only the specific intangible personal property listed in that section may be subject to property tax. Also, under Article XIII, Section 2, the Legislature may provide for the property taxation of these items of intangible personal property, which include notes, debentures, shares of capital stock, bonds, solvent credits, deeds of trust, mortgages, and any legal or equitable interest therein. The Legislature may not provide for the property taxation of any other type of intangible personal property. Under Section 212 of the Revenue and Taxation Code, the Legislature has determined not to tax the intangible personal property listed in Article XIII, Section 2 of the California Constitution. All intangible assets and rights, including intangible personal property, which are not specifically listed in Article XIII, Section 2 are immune from property taxation.

Under California law, only real property and tangible personal property may be subject to property tax. Intangible assets and rights, which are not subject to property tax, include, but are not limited to, the types of items set forth in Article XIII, Section 2 of the Constitution. Revenue and Taxation Code Section 107.7(d) also provides a list of certain nontaxable intangible assets and rights. In addition, the California Courts of Appeal have identified intangible assets and rights in certain property tax cases.[4/] Finally, certain tangible personal property is specifically limited in the property rights to be appraised.[5/]

Revenue and Taxation Code Section 212 states the general rule that intangible assets and rights are exempt from property taxation and that the value of intangible assets and rights shall not enhance or be reflected in the value of taxable property. However, this general rule is subject to the last sentence of Section 212(c), which states that "taxable property may be assessed and valued by assuming the presence of intangible assets or rights necessary to put the taxable property to beneficial or productive use."

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See, Roehm v. County of Orange, 32 Cal. 2d 280 (1948); County of Orange v. Orange County Assessment Appeals Board, 13 Cal. App. 4th 524 (1993); Shubat v. Sutter County Assessment Appeals Board, 13 Cal. App. 4th 794 (1993); GTE Sprint Communications Corp. v. County of Alameda, 26 Cal. App. 4th 992 (1994); De Luz Homes, Inc. v. County of San Diego, 45 Cal. 2d 546 (1955); County of Los Angeles v. County of Los Angeles Assessment Appeals Board, 13 Cal. App. 4th 102 (1993); Service America Corp. v. County of San Diego, 15 Cal. App. 4th 1232 (1993).

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Some examples are storage media for computer programs (Rev. & Tax. Code § 995); business records (Rev. & Tax. Code § 997); motion pictures (Rev & Tax. Code § 988); certain works of art (Rev & Tax. Code § 986); and timeshare estate amenities (Rev & Tax. Code § 998).

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Subdivisions (d), (e) and (f) of Section 110 of the Revenue and Taxation Code also provide guidance regarding the property tax treatment of intangible assets and rights. Subdivision (d) provides that: (1) the value of intangible assets and rights relating to the going concern value of a business using taxable property shall not enhance or be reflected in the value of the taxable property, (2) if the principle of unit valuation is used to value properties that are operated as a unit and the unit includes intangible assets and rights, then the fair market value of the taxable property contained within the unit shall be determined by removing from the value of the unit the fair market value of the intangible assets and rights contained within the unit, and (3) the exclusive nature of a concession, franchise or similar agreement, whether de jure or de facto, is an intangible asset that shall not enhance the value of taxable property, including real property. These three provisions contained within Section 110(d) are subject to Section 110(e), which states that "taxable property may be assessed and valued by assuming the presence of intangible assets or rights necessary to put the property to beneficial or productive use". Finally, subdivision (f) of Section 110 provides that for purposes of determining the "full cash value" or "fair market value" of real property, intangible attributes of real property shall be reflected in the value of the real property. These intangible attributes include zoning, location and other such attributes that relate directly to the real property involved.

To interpret Sections 110(e) and 212(c) it is necessary to determine the meaning of the statement repeated in both of those sections – "taxable property may be assessed and valued by assuming the presence of intangible assets or rights necessary to put the taxable property to beneficial or productive use." This language originates from cases where taxpayers attempted to obtain a scrap valuation for tangible assets by assuming those assets would not be used in a productive business in association with related intangible assets and rights. The courts concluded in those cases that a scrap valuation was not appropriate.[6]

Sections 110(e) and 212(c) may be illustrated by the following example. A "McDonald's" sign typically is valued for property tax purposes based on the cost approach. Assuming the sign is used in an operating McDonald's business, a taxpayer may not obtain a scrap value for the sign on the grounds that, absent a McDonald's franchise, the sign would have only a scrap value. On the other hand, assuming the sign (and the franchise it represents) helps attract business, it would not be appropriate to equate the value of the sign with the difference between the value of the business

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AH 501, p. 14 (1997). For example, in Michael Todd v. County of Los Angeles, 55 Cal. 2d 684 (1962) the taxpayer argued that a movie negative should be valued at scrap value because a negative would have a scrap value without the nontaxable intangible copyright. In Michael Todd the court concluded that the value of the movie negative, when put to beneficial and productive use, could be determined by using a cost valuation approach. The court in Michael Todd also acknowledged that the value of the copyrighted movie negative based on its potential earning power of many millions of dollars was greater than the value of the movie negative itself. However, it is apparent that valuing the potential earning power of the copyrighted movie would have resulted in the improper taxation of the copyright.

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enterprise and the value of the other tangible assets --that approach attributes the entire intangible business enterprise value to the sign.

Sections 110(e) and 212(c) do not authorize adding an increment to the value of taxable property to reflect the value of intangible assets and rights necessary to put the taxable property to beneficial or productive use. For example, a business which owns taxable property may need working capital in order for the taxable property to be put to beneficial and productive use. However, the value of the taxable property should not be increased by the value of the working capital used in the business (or any portion thereof). Similarly, businesses owning taxable property may need customers, tax-exempt software, patents or other assets not subject to property tax in order to put the taxable property to beneficial and productive use. Again, the value of the taxable property should not be increased by the value of those nontaxable assets (or by any portion thereof). Accordingly, in valuing taxable property, Sections 110(e) and 212(c) indicate that it is appropriate to assume the presence of the intangible assets and rights which are necessary to put taxable property to beneficial or productive use, but these sections do not authorize first valuing the taxable property and then adding an increment of additional value to reflect the presence of intangible assets.[7/] Under appraisal theory, the fair market value of any taxable property cannot be more than the cost to procure a reasonable substitute.

Section 110(d)(1) states that the value of intangible assets and rights relating to the going concern value of a business using taxable property shall not enhance or be reflected in the value of the taxable property. This language is derived from court decisions where the court rejected a valuation approach which equated business enterprise value with taxable asset value.[8/] Those cases indicate that it would be illegal to simply add the value of intangible assets and rights to the value of taxable property or to assume that the value of intangible assets and rights are somehow subsumed within the value of the taxable assets of a business enterprise.

Section 110(d)(2) indicates that if the principle of unit valuation is used to value taxable property, then the fair market value of any intangible assets or rights contained within the unit must be removed. This rule recognizes that a business enterprise value typically will contain many intangible assets and rights. This rule also raises significant issues relating to the availability and reliability of data concerning the value of intangible rights and assets. If an appraiser does not have access to appropriate data concerning the identification and/or value of intangible assets and rights, then it will not be possible to remove the value of those intangible assets and rights as required by this rule and a

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See, American Society of Appraisers, Appraising Machinery and Equipment, pp. 80-1 (1989).

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See, GTE Sprint Communications Corp. v. County of Alameda, 26 Cal. App. 4th 992 (1st Dist. 1994); Shubat v. Sutter County Assessment Appeals Board, 13 Cal. App. 4th 794 (3d Dist. 1993).

different valuation approach should be considered. Issues concerning the availability and reliability of data should be addressed in connection with the identification of the appropriate value approach for an appraisal assignment.

In summary, Revenue and Taxation Code Sections 110 and 212 confirm the basic principle contained in the California Constitution that intangible assets and rights are not subject to property tax. These sections also reflect the holdings of several Court of Appeal decisions. These holdings briefly can be summarized as follows.

> (1) When valuing taxable property, it is appropriate to assume the presence of intangible assets or rights that are necessary to put the taxable property to the beneficial or productive use defined in the appraisal. It would be inappropriate to use a scrap valuation based on the removal of the associated intangible assets or rights required for the highest and best use.
>
> (2) It is not appropriate to add intangible asset values to tangible asset values or to assume that intangible asset values are subsumed within the tangible asset values.
>
> (3) A business enterprise (or unit) value can include many significant intangible assets or rights. If a business enterprise is being valued as part of the appraisal process, then the intangible assets and rights contained within that appraisal unit must be removed in order to avoid the improper taxation of those intangible assets and rights.

B. <u>Discussion of Relevant Terms</u>.

1. <u>Intangible Assets and Rights</u>.

When appraising commercial and industrial property, the appraiser must identify the intangible assets and rights that may be present in order to safeguard their exclusion from property tax. While only real property or tangible personal property can be assessed, the term to be applied to all of the other items of value has been an evolving one. The source of this other value (that is, value not attributable to real property or tangible personal property) has been described by various terms, such as intangible value, franchise value, going concern value, enterprise value, and goodwill. More recently, these broad categories of non-assessable items have been broken down into sub-categories of intangible assets and rights, and have been identified separately within the business enterprise.

Many appraisers may be more familiar with the term "intangible personal property." Intangible personal property may be best thought of as a subset of "intangible assets and rights." Assets are things which have value. All forms of property -- real, tangible personal and intangible personal -- are assets. Thus intangible assets and rights includes all types of intangible personal property. But an item cannot be assessed unless it is real or tangible personal property. For that reason, the term "intangible personal property" may not convey the full range of non-assessable items.

Intangible assets and rights include all intangible assets and rights relating to or arising in connection with a business operation conducted on, or with, real property and tangible personal property. Intangible assets and rights are not subject to property tax and are not part of the property to be assessed.[9/] As neither intangible assets nor intangible rights are taxable, there is no need for an appraiser to distinguish between them. Intangible assets and rights generally relate to the business being conducted rather than solely to the real property and tangible personal property used in the conduct of that business. Intangible assets and rights are to be contrasted with intangible attributes of real property described below.

Many intangible assets and rights, though they clearly exist, will not be shown on a company's books unless they were purchased. Examples include such items as vendor relationships, brand recognition, customer loyalty, and the cumulative effect of prior year's advertising and marketing. Moreover, even if intangible assets and rights are shown on a company's books, the company's balance sheet may not reflect the fair market value of those intangible assets and rights. Goodwill, patents, copyrights, and certain licenses or franchises are examples of such intangible assets and rights.

Other intangible assets and rights may be identifiable but not necessarily capable of segregation from the value of the business enterprise. As an example, the company which manufactures Thomas' English Muffins can obtain a higher price for its product over generic English muffins. However, the trademark could normally not be sold separate from the business because the buyer would also have to purchase the muffin formula, the manufacturing know-how, and the packaging design if the buyer were to command the higher price. The fact that the trademark cannot be separated from the business does not prevent the recognition of the value of the trademark.[10/]

Many intangible assets and rights, such as patents and copyrights, are not tied to a particular physical location, however there are intangible assets and rights related to some businesses (such as the professional reputation of congregate care operators) which cannot be readily transferred to another location but which are not related to the physical plant itself.[11/]

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Revenue and Taxation Code §§ 110, 212.

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Smith, "Tangible Ways to Value Intangible Assets," Journal of Property Tax Management, p. 35 (Winter 1991).

11/

Rabianski, "Going-Concern Value, Market Value, and Intangible Value," The Appraisal Journal, p. 184 (April 1996).

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Some intangible rights are perhaps better described as intangible assets, because they belong to the holder of the right and may be valuable to him. For example, in the case of a retail clothing business, the company's policies and procedures with respect to customer service and the integration of those policies and procedures into the training of the sales force are essential to the business's survival, and thus are a valuable intangible asset. Also, Revenue and Taxation Code Section 110(d)(3) specifically identifies the exclusive nature of a concession, franchise, or similar agreement, whether de jure or de facto, as an intangible asset.

Similarly, a company's relationship with its work force is a valuable business asset, as any company suffering the effects of a strike can attest. Yet a work force itself is not the property of the company to be freely bought, sold or traded as the business managers see fit. Still, for example, when a production or refinery business is purchased as a going operation, there is a separate value that can be placed on the company's relationship with its work force that comes with the business. That value is an intangible asset associated with the business operations and is not part of the real property value. However, having a work force does impact the value of the real property. Without a work force in place (and a business to employ it), the plant or refinery real property would be worth only what it could be sold for to an entrepreneur in a start-up mode, or in liquidation as scrap.

2. Intangible Attributes of Real Property.

Real property, defined in Section 104 of the Revenue and Taxation Code, consists of the physical property and intangible attributes of the physical property. Inherent in the ownership of real property are the rights of possession and rights to use the property. Intangible attributes of real property include zoning, location, and other such attributes that relate directly to the real property involved.[12/] Section 110(f) of the Revenue and Taxation Code states that intangible attributes of real property, in contrast to intangible assets and rights that may be used in connection with the real property, are to be reflected in the value of the real property.

Real property value is largely driven by its location. Indeed, many intangible attributes of real property can be subsumed in the single concept of "location." Location is a broad concept encompassing both physical attributes — an appraiser can go to the corner of 10th and Main Streets and see the size, shape, and topography of the property situated there — and intangible attributes — zoning is generally determined by a property's location within a community and in relation to neighboring properties.

Thus, the zoning of real property for commercial use is an intangible attribute of that real property which must be reflected in the appraisal whether the property is used to

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Intangible attributes of real property do not include licenses, franchises, and other rights to do business that are exercised in connection with the use of the real property.

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house a grocery store, a dress shop, a bar or a liquor store. Moreover, whether a property has an ocean view, is close to a sewage treatment plant, or has adequate access to public infrastructure (e.g., freeways) or services (e.g., garbage collection) may be considered intangible attributes of the real property that will affect its value. These items also will be inherent in the physical location of the property.

One intangible attribute of real property that may be unrelated to location but that still may be inherent in the physical attributes of the real property is architecture. Thus, the fact that a building was designed by Frank Lloyd Wright may make the real property more valuable than if the designing architect was merely a follower of Mr. Wright's style.

It is important to distinguish between enforceable land use restrictions, such as public access requirements for ocean front property or government imposed rent or price restrictions that are an integral part of the real property being appraised, and intangible assets and rights that relate to the business use of the property and must not be assessed.[13/] Section 110 of the Revenue and Taxation Code and Property Tax Rule 2 require that an assessor take into account the adverse effects of government imposed restrictions rights of possession or use. Some examples of enforceable land use restrictions that must be considered in valuing real property are set forth in Section 402.1.

In contrast to intangible attributes of real property, intangible assets and rights of the business operation utilizing the real property cannot enhance or be reflected in the value of the real property. That there is a liquor license associated with the current use of the real property as a bar or liquor store is not an intangible attribute of the real property, but is a non-taxable intangible asset or right of the business operation. Franchises, permits and licenses to operate a cable television system likewise are non-assessable intangible rights and assets, and not assessable attributes of the physical property used to conduct the cable television business.[14/] Similarly, validation rights issued by the federal Food and Drug Administration are not assessable attributes of the real property to which they are associated, but are non-assessable assets of the business operation. Validation rights permit the business to sell, as a pharmaceutical, the product manufactured at the plant. Even in the absence of a validation permit, the plant still may be used to manufacture product, and the product still may be sold for non-regulated uses.

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AH 501, pp. 65-66 (1997).

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Revenue and Taxation Code § 107.7.

3. Related Business and Appraisal Terms.

There are several terms related to intangible assets and rights with which the appraiser should be familiar.

a. Business Enterprise Value and Enterprise Value.

The term "business enterprise value" refers to the value of the entire business enterprise and includes all tangible assets and all intangible assets and rights.[15] In the property tax context, the separate term "enterprise value" is a broad concept that often encompasses all elements that give value to a business operation over and above the value of the tangible assets of a business organization.[16] Thus, for example, trade names, logos, systems of operations, advertising, customer and distribution relationships, and work force are all components of enterprise value that create value separate and apart from any value inherent in the tangible assets.
Thus, while it may appear as though a semiconductor plant owned by Company X is more valuable than a similar plant owned by Company Y based solely on capacity used, the appraiser must exercise care. If Company X has favorable "take or pay" contracts with customers locked in place and is making products at a price which the marketplace would not otherwise absorb, the appraiser should not attribute that value to the assessable real property. That value is part of the enterprise value and is attributable to the favorable contracts. Similar semiconductor plants should have similar economic returns, and thus similar fair market values.

b. Going Concern Value.

"Going concern value" is one term that can and has caused confusion for some appraisers. In fact, more than one definition of the term "going concern value" or of some variation of that term can be found in appraisal literature. Also, there are different meanings for California property tax purposes and more than one meaning even within California property tax law.

The description of "going concern value" set out in Assessors' Handbook Section 501, *Basic Appraisal*, is a description of what constitutes the value of an entire business enterprise, i.e. the total value of a going business or concern, including both taxable

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A "business enterprise" is defined as a "commercial, industrial or service organization pursuing an economic activity." Appraisal Standards Board, Uniform Standards of Professional Appraisal Practice, p. 9 (1998).

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Rabianski, "Going-Concern Value, Market Value, and Intangible Value," The Appraisal Journal, p. 184 (April 1996); Pratt, Reilly and Schweihs, Valuing a Business, 3rd edition, p. 19 (1996); California Portland Cement v. State Board of Equalization, 67 Cal. 2d 578 (1967).

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and non-taxable elements.[17] Of course, only property which is taxable under California law may be assessed.

Going concern value is itself an intangible asset or right and is not assessable for California property tax purposes. As noted, "going concern value" is a term generally used in an appraisal of an entire established business operation. In that context, "going concern value" is an increment of value in excess of the value of the identifiable tangible property and intangible assets and rights used in that business operation. It is a value distinct from the value of the assessable property. Thus, Section 107.7(d) lists "going concern value" as a separately identified intangible asset or right that cannot be assessed. While Section 107.7(d) is written in terms of cable television systems, its non-exclusive list of intangible assets and rights is not peculiar to cable television.

Outside the property tax arena, going concern appraisals are commonly conducted for hotels and motels, restaurants, bowling alleys, industrial enterprises, shopping centers, retail stores, and similar business operations using real property. Generally, the real property is considered an integral part of the business operation. Without an allocation among the various elements contributing value to the business operation, however, such an appraisal is not appropriate for California property tax purposes. The value of the physical real and tangible personal property assets to be assessed must be segregated from the total value of the business.

Where the unit principle of valuation is used, it has been said that the assessable property is valued as a going concern. This means only that the taxable property of the business should be valued as if put to beneficial or productive use. It does not mean that the entire value of the business can be assessed or that the going concern value is assessable.[18]

c. Goodwill Value.

Goodwill is a term used to encompass value in excess of the value of identifiable tangible property and intangible assets and rights used in the business operation. As additional increments of value, enterprise value, goodwill and going concern value can co-exist and may not capture the same value or basket of assets and rights. Goodwill is a recognized business asset based on reputation.[19] Thus a hotel chain's reputation for quality and luxury that will bring customers to a new hotel stems from the mix of amenities in the package of services provided in its other hotel operations. However,

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AH 501, p. 7 (1997).

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Revenue and Taxation Code Section 110(d).

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Goodwill is a separate property interest under California law. Civil Code § 655.

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the value generated for the hotel business from its system of operations -- its recipe for success -- does not inhere in the buildings and furnishings. Rather it accrues to the hotel chain's trade name, reputation and goodwill.

C. Valuation Issues.

1. All Taxable Property is to be Valued At Its Highest and Best Use.

In valuing taxable property, an appraiser must value the property at its highest and best use.[20] This does not mean that taxable property has an assessed value over and above its market derived value due to the presence of the intangibles necessary to productively deploy the taxable property. In almost every situation one can imagine, taxable property must have associated intangible assets and rights in order to be used in an ongoing business enterprise. An owner of a restaurant business likely needs a business license to operate the restaurant. An owner of a motion picture negative needs the copyright, or at least partial rights to it (i.e., a license) in order to exploit the film negative.[21] The value of such intangible assets and rights does not enhance and is not to be reflected in the value of taxable property.[22] The appraiser must also be mindful of the principle of substitution, which holds that no one would pay more for the subject property than the cost to procure a reasonable substitute without undue delay, sets a ceiling on the appraiser's determination of fair market value.[23]

2. Selecting the Appropriate Appraisal Unit

a. If the Appraiser Can Reliably Limit the Appraisal Unit to Taxable Property Only, He or She Should Do So.

In the vast majority of instances, the threshold issue of selecting the proper appraisal unit merits only a small amount of the appraiser's time because the most logical

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American Society of Appraisers, Appraisal of Machinery and Equipment, p. 80 (1989) ("this premise implies that the assets are installed, operating, and an integral part of the entity in which they are employed."); Revenue and Taxation Code §110(e).

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Michael Todd Co. v. County of Los Angeles, 57 Cal. 2d 684 (1962).

22/

Revenue and Taxation Code §110(d)(1).

23/

The Appraisal of Real Estate, 11th edition, p. 336 (1996); AH 501, p. 56 (1997); American Society of Appraisers, Appraising Machinery and Equipment, pp. 81-2 (1989); Pratt, Reilly and Schweihs, Valuing a Business, 3rd edition, pp. 267, 548 (1996).

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appraisal unit consists only of the taxable property.[24] It is axiomatic that all other things being equal (including reliability of data), it is better to select the valuation method which requires the fewest adjustments.[25] If the appraisal unit consists only of taxable property, the appraiser does not have to remove nontaxable assets and rights, including intangible assets and rights.[26] For example, if an appraiser is assigned the task of assessing the taxable property of a local photocopy business, he or she may choose to rely upon audited business property statement costs, properly trended and depreciated, as the basis for the assessment. The appraiser is less likely to require information on the income of the photocopy business or the market prices for photocopy businesses because development of those income and market value indicators for the business requires the further step of removing the value of nontaxable assets and rights, and introduces an unnecessary level of uncertainty.

b. If the Assessee is Engaged in a Business Whose Revenues are Generated Principally from Enterprise Activity, the Appraiser Should Not Use the Business as the Appraisal Unit.

In those few instances where the taxable property cannot readily be valued by itself, the appraiser should ascertain the nature of the business of the assessee to determine if that business generates revenues principally from enterprise activity.

Enterprise activity occurs when a business engages in the sale of goods or services.[27] Income attributable to enterprise activity may not be ascribed to taxable property. A retail store operated by the property owner involves at least two activities. One is the ownership of the real and tangible personal property, and the other is the business (i.e., enterprise activity) of selling merchandise at the property.[28] The income attributed to the retail store's enterprise activity may not be assessed. However, the presence of

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American Society of Appraisers, Appraising Machinery and Equipment, p. 7 (1989). Appraisers should be mindful of the requirement in Property Tax Rule 461(d) to separate appraisal units in certain circumstances. For real property, Revenue and Taxation Code Section 51(d) states that the appraisal unit is one that is commonly bought and sold as a unit in the marketplace, or that is normally valued separately.

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See, e.g., The Appraisal of Real Estate, 11th edition, pp. 604-5 (1996).

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The cost approach does not typically capture the value of intangible assets and rights because the appraisal unit only includes the subject property. Rabianski, "Going-Concern Value, Market Value and Intangible Value," The Appraisal Journal, p. 185 (April, 1996).

27/

A "business enterprise" is a "commercial, industrial or service organization pursuing an economic activity." Appraisal Standards Board, Uniform Standards of Professional Appraisal Practice, p. 9 (1998).

28/

AH 501, p.97 (1997).

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that enterprise activity may be assumed so that a typical business owner would be able to pay the economic rent for the taxable real property. A motel also has a business whose business generates its revenues principally from enterprise activity. The intangible assets and rights which may be present in a motel include developed procedures, implemented marketing, advertising, promotion, and preopening expenses, financial relationships, franchise affiliations, advanced telephone reservations system, and sources of supply.[29] Relying on a capitalization of the enterprise income would be "inappropriate and misleading" in that circumstance.[30]

If the appraiser determines that the assessee is engaged in a business whose revenues are generated principally from enterprise activity, the appraiser should value the taxable property directly, and should avoid the use of appraisal methods which require appraisal of the entire business.[31] In most instances the income and market approaches will produce an unreliable result either because there is insufficient income or market data, or because the process of adjusting the value of the business down to the taxable property requires subjective judgments which render the result meaningless.[32] However, in some instances the subject property has suffered significant physical depreciation or functional or economic obsolescence. In those instances the income approach is the preferred approach because it will disclose the presence of depreciation or obsolescence which may not be detected by other valuation methods.[33]

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Nelson, Messer and Allen, "Hotel Enterprise Valuation," The Appraisal Journal, pp. 167-8 (April 1988); Appraisal of Real Estate, 11th edition, p. 481 (1996).

30/

Madonna v. County of San Luis Obispo, 39 Cal. App. 3d 57, 61 (1974).

31/

Property Tax Rule 6(a) calls for use of the cost approach when there is no reliable income or market data available for the taxable property. The most universally applied approach for property tax purposes is the cost approach. AH 501, p. 73 (1997). See, Kelly and Byrnes, "The Valuation of Landfills for Ad Valorem Assessment Purposes," Journal of Property Tax Management, pp. 6-7 (Summer 1995).

32/

For example, assume that the assessee is a medical practice which lacks reliable accounting records to allow the appraiser to perform a historical cost approach. The appraiser should ascertain the replacement costs of the taxable property (e.g. office furniture and medical instruments), and then apply appropriate depreciation factors, rather than attempt to value the entire medical practice using an income or market approach, and then removing the value attributable to the patient (customer) relationships, work force in place, and goodwill.

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Property Tax Rule 8; See, Rabianski, "Going-Concern Value, Market Value, and Intangible Value," The Appraisal Journal, p. 188 (April 1996). If the income approach indicates a value higher than that indicated by other approaches, the value indicated by the income approach may include a non-realty or business enterprise value component. The Appraisal of Real Estate, 11th edition, p. 602 (1996).

c. If the Appraiser is Unable to Value the Taxable Property Directly, and the Assessee is not Engaged in a Business Whose Revenues are Generated Principally from Enterprise Activity, the Appraiser May Choose to Use the Assessee's Business as the Appraisal Unit Provided Reliable Data Are Available.

In those rare instances where (i) the appraiser is unable to value the taxable property directly, and (ii) the assessee is not engaged in a business whose revenues are generated principally from enterprise activity, the appraiser may choose to use the assessee's business as the appraisal unit and to remove the value of the nontaxable assets and rights from the appraisal unit provided there are reliable data available concerning the identity and value of those nontaxable assets and rights.[34/]

d. Appraising the Assessee's Business.

If the appraiser finds it necessary to appraise the assessee's business, and then remove the value of the intangible assets and rights, the appraiser should consider collecting and analyzing the following data in appraising the business:

- the nature and history of the business;
- financial and economic conditions affecting the business, its industry, and the general economy;
- past results, current operations, and future prospects of the business;
- past sales of ownership interests in the business being appraised;
- sale of similar businesses; and
- prices, terms, and conditions affecting past sale of comparable business assets.[35/]

34/ Revenue and Taxation Code §110(d)(2); AH 501, p. 12 (1997). Under the Uniform Standards of Professional Appraisal Practice, Standards Rule 1-2(e), an appraiser must "identify and consider the effect on value of any personal property, trade fixtures or intangible items that are not real property but are included in the appraisal. . . [s]eparate valuation of such items is required when they are significant to the overall value."

35/ AH 501, pp. 60-61 (1997); Appraisal Standards Board, Uniform Standards of Professional Appraisal Practice, Standard Rule 9-4, pp.56-7 (1998).

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Most of this information may be publicly available through documents filed with the Securities and Exchange Commission and business and trade periodicals.

e. Removing Intangible Assets and Rights from the Appraisal Unit.

Intangible assets and rights can be valued using a variety of valuation methods, all of which are derived from the three generally accepted approaches -- cost, market and income.[36]

Methodologies under the cost approach include depreciated replacement cost, depreciated reproduction cost, recreation cost, creation cost, and a one-time cost savings or avoidance.[37] These methods attempt to quantify the current cost of generating a perfect substitute for the subject intangible assets and rights in terms of functionality, utility, usefulness, and remaining life.[38] A work force in place is an intangible asset which can be valued using a cost approach where the cost to recreate the asset is used. An appraiser can determine the cost of locating, interviewing and training employees, as well as the cost of the probable advertising and placement fees.[39]

In many instances, an intangible asset may produce an identifiable income stream, such as a stream of royalties for the use of intellectual property, the income stream from a customer relationship, or a greater than market price for goods or services.[40] The income stream can be estimated and discounted to present value to arrive at an income approach value indicator.[41] An appraiser may also quantify a stream of cost savings as

36/

Pratt, Reilly and Schweihs, Valuing a Business, 3rd edition, p. 56 (1996). A demonstration appraisal can be found in Reilly, "Allocating Value in Location-Dependent Businesses," Journal of Property Tax Management, pp. 1-17 (Spring 1993).

37/

Rabe and Reilly, "Valuation of Intangible Assets," National Public Accountant, p. 45 (Spring 1992).

38/

Cesta and Davis, "Extracting the Value of Intangible Assets from the Unit Assessment Method," Assessment Journal, p. 56 (Sept./Oct. 1996).

39/

Smith and Parr, Valuation of Intellectual Property and Intangible Assets, 2d ed., pp. 302-3 (1994).

40/

Smith, "Tangible Ways to Value Intangible Assets," Journal of Property Tax Management, p. 38 (Winter 1991); Koch, "Defending a Customer List Amortization Deduction," Journal of Property Tax Management, p. 24 (Spring 1991).

41/

Smith and Parr, Valuation of Intellectual Property and Intangible Assets, 2d ed., pp. 300-1 (1994).

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a result of ownership of the intangible asset or right.[42] The duration of the income stream or cost savings must also be determined. The appraiser should consider limiting factors on the life of an intangible asset or right, such as the length of the contract which may create the asset or right (e.g., a favorable lease), legal restrictions on the asset or right (e.g., a patent), and actuarial mortality (e.g., a customer relationship).[43]

Some intangible assets and rights, such as a liquor license, may be bought and sold by themselves on the open market. These open market sales may provide the basis of a reliable comparable sales approach. However, the market approach will rarely be used due to a lack of comparable sale data.[44]

Goodwill, going concern value, and similar intangible assets typically are valued using a residual technique. For an ongoing business enterprise, the appraiser will value all of the tangible assets and as many intangible assets and rights as possible using direct valuation methods. The difference between the sum of the values of the tangible and intangible assets and rights and the value of the entire business enterprise can be ascribed to goodwill, going concern, or similar intangible assets. This difference often arises because the principle of substitution sets a ceiling on the values of the identifiable tangible and intangible assets and rights. In a sense, the residual method is really an excess earnings method, because the residual value represents the earnings of the business enterprise over and above the earnings attributable to the identifiable assets.[45]

The value of intangible assets and rights cannot be removed by merely deducting the related expenses from the income stream to be capitalized.[46] Allowing a deduction for

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Pratt, Reilly and Schweihs, Valuing a Business, 3rd edition, p. 552 (1996).

43/

Rabe and Reilly, "Valuation of Intangible Assets," National Public Accountant, p. 45 (Spring 1992).

44/

Smith, "Tangible Ways to Value Intangible Assets," Journal of Property Tax Management, p. 37 (Winter 1991).

45/

Smith and Parr, Valuation of Intellectual Property and Intangible Assets, 2d ed., p. 94 (1994); Mobley, "Defining and Allocating Going-Concern Value Components," The Appraisal Journal, pp. 325-6 (October 1997).

46/

Property Tax Rule 8(e) ("[w]hen income from operating a property is used, sufficient income shall be excluded to provide a return on working capital and other nontaxable operating assets and to compensate unpaid or underpaid management."). See, AH 501, p.95 (1997) for a discussion of Property Tax Rule 8(e).

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the associated expense does not allow for a return on the capital expenditure.[47] For example, allowing the deduction of wages paid to a skilled work force does not remove the value of the work force in place from the income indicator, because the amount of the wages paid does not necessarily represent a return of and on the work force in place, and further bear no relationship to the costs associated with locating, interviewing, training and otherwise acquiring the work force. Similarly, the deduction of a management fee from the income stream of a hotel does not recognize or remove the value attributable to the business enterprise that operates the hotel.[48]

3. Adjustment of Value Indicators.

Regardless of the method used, the appraiser should remove the value of all intangible assets and rights from each value indicator before the value indicators are reconciled. Moreover, only the taxable property in place on the lien date is assessable. If the value of the business is included in the value indicator, the appraiser may have captured a value associated with the value of property to be acquired in the future to maintain the predicted income stream or to support the market value of the business. The appraiser must remove the value associated with property to be acquired in the future.[49] Set forth below is a discussion of the three valuation methods, and observations regarding the removal of the value of intangible assets and rights from those indicators.

a. Comparative Sales Approach.

When using the comparative sales approach, the comparable properties are often sold in a transaction which includes intangible assets and rights. The value of those intangible assets and rights, as well as the value of assets other than the comparable property, must be removed from the sale price before the sale is compared to the subject property.[50] The appraiser is free to use any of the three traditional approaches -- cost, income, and market -- to value those nontaxable intangible assets and rights. If the subject property was part of the sale of a business enterprise, the appraiser may wish to examine transaction documents which may contain an allocation of the purchase price to the various component assets. The appraiser should be aware that

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Investors demand both a return of their investment (a recapture of the investment) and return on their investment (a yield on the investment). AH 501, p. 98, 101-2 (1997). The yield on the investment must compensate the business for the risk above a safe rate of return. Smith and Parr, Valuation of Intellectual Property and Intangible Assets, 2d ed., p. 244 (1994).

48/

Dowell, "Hotel Investment Analysis: In Search of Business Value," Journal of Property Tax Management, p. 11 (Fall 1997).

49/

Union Pacific R.R. Co. v. State Board of Equalization, 49 Cal. 3d 138, 150 (1989).

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AH 501, p. 91 (1997).

this allocation may or may not be made based upon the fair market value of the various component assets.

b. Income Approach.

If the income stream used by the appraiser is in part generated by intangible assets and rights, the appraiser must either (a) attribute sufficient income to provide a return of and on the intangible assets and rights,[51/] or (b) remove the value of the intangible assets and rights from the income indicator (using any acceptable valuation method) after the income stream has been capitalized or discounted to present value. A business may have valuable intangible assets and rights (e.g., customized computer software, patents, copyrights) even though the business may not generate sufficient income to produce an adequate rate of return of and on the subject property.

c. Cost Approach.

Since the appraisal unit for the cost approach typically includes only the subject property, the appraiser generally is not faced with the exclusion of the value of intangible assets and rights. In those circumstances where intangibles may be present within the appraisal unit, the appraiser may either (a) isolate the cost of the intangible assets and rights and subtract those costs before applying price trending and depreciation factors or (b) determine the fair market value of the intangible assets and rights using any acceptable valuation method.

4. Reconciliation.

The final step in the appraisal process is to reconcile the value indicators. In theory, each approach to value should yield the same indication of value.[52/] In practice, it is rare for each value indicator to be identical. Variations occur because of the lack of adequate, reliable data to perform each approach to value, the subjectivity of the adjustments to be made in the appraisal process, and the inclusion of (and failure to remove) the value of nonassessable tangible property and intangible assets and rights within the appraisal unit. It is essential that an appraiser's value indicators relate to the same property. For example, if the value indication derived from income capitalization is substantially higher than an indication based on the cost approach, the income capitalization value may include a non-realty or business enterprise value component.[53/]

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Property Tax Rule 8(e), AH 501, p. 95 (1997).

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AH 501, p. 61 (1997).

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The Appraisal of Real Estate, 11th edition, p. 602 (1996).

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The appraiser should bear the following guidelines in mind when giving weight to his or her valuation approaches:

- If reliable market data for sales prices of property comparable to the subject property are available, the comparative sales approach is generally preferred. If reliable market data for sales prices of business enterprises are available, which business enterprises include properties comparable with the subject property, then the comparable sales approach may be utilized if the value of the assets other than the comparable property, including intangible assets and rights present in the business, are removed from the sales price before the sale is compared to the subject property. Under these circumstances, the greater the proportion of assets other than the comparable property, including intangible assets and rights contained within the business enterprise, the less reliable the data becomes.

- If reliable market data are not available, the income approach is preferred if the appraiser can identify a discrete income stream attributed to the subject property only. If the appraiser can identify a discrete income stream attributed to the business enterprise which includes the subject property, then the income approach may be utilized if the value of the intangible assets and rights present in the business enterprise is removed. Under these circumstances, the greater the proportion of intangible assets and rights contained within the business enterprise, the less reliable the data becomes.

- If reliable market and income data are not available, and the property has experienced relatively little depreciation or obsolescence, the cost approach is preferred because it typically values only the subject property.

- Valuation approaches with the most reliable data are favored over approaches with less reliable data.

- Valuation approaches requiring the fewest adjustments are generally favored.

- Valuation approaches which value only the subject property are generally favored over approaches which value the business enterprise that contains the subject property.

An example illustrating these principles is set forth in Appendix 2.

Appendix 1

Examples of Intangible Assets and Rights

Causes of action
Copyrights
Covenants not to compete
Customer lists
Deferred, startup, or prematurity costs
Enterprise value
Favorable franchise rights
Going concern value
Goodwill
Governmental permits (including liquor licenses, cable television franchises, and airport rental car and stadium concessions)
Insurance policies
Judgments
Management and operating systems
Marketing and programming contracts
Memberships in social, professional and fraternal clubs
Nonreal property lease agreements
Patents
Press association memberships
Right to do business
Sanitary landfill operating permits
Stock exchange seats
Subscriber contracts
Validation permits
Work force in-place

Appendix 2

XCORP is engaged in the widget business. XCORP owns all of its tangible plant and equipment and has invested $40,000,000 in that tangible plant and equipment. XCORP currently has a customer base of 100,000 customers, and purchased or acquired those customers over time. The XCORP business currently is operating at capacity and generating a profit.

Information concerning the original cost, replacement cost and depreciation of XCORP's tangible assets is considered reasonably accurate. The replacement cost new less depreciation value for XCORP's taxable tangible property calculated in accordance with Property Tax Rule 6 is $30,000,000. An income approach value of $54,000,000 was calculated and was based on the income anticipated for the existing XCORP business consisting of plant, equipment, customer base and other associated assets in perpetuity. The income capitalized was the gross income less expenses and capital expenditures required to develop and maintain the estimated income (other than amortization, depreciation, debt retirement, interest, property taxes, corporation net income taxes, and corporate franchise taxes measured by net income). XCORP's expenses and capital expenditures required to develop and maintain the estimated income include expenses relating to the maintenance of XCORP's customer base. In determining the business enterprise value of $54,000,000 under the income approach, XCORP's gross income was not reduced by a return on the value of the customer base asset or any other nontaxable asset.

XCORP's customer base of 100,000 customers is a valuable intangible asset that is not subject to property tax. Market data relating to sales of customers by or to companies in the widget business and XCORP's internal data concerning the costs to acquire customers shows that XCORP's customer base is worth approximately $15,000,000.

Revenue and Taxation Code Section 110(d) requires that the value of intangible assets and rights be removed from a unit value indicator, such as an income approach. In addition, Property Tax Rule 8(e) requires that "when income from operating a property is used, sufficient income shall be excluded [from the amount to be capitalized] to provide a return on ... nontaxable operating assets." Since Rule 8(e) contemplates adjusting the cash flow for such a return before capitalizing the income stream, if an appraiser does not make that adjustment, then the appraiser must remove the value of the nontaxable operating assets from the value of the unit (pursuant to Revenue and Taxation Code Section 110(d)(2)). In this case, the income approach value of $54,000,000 is reduced by $15,000,000 to yield a value of $39,000,000 in order to remove the value of the customer base.

XCORP has other nontaxable assets, such as working capital, goodwill, assembled work force, and other intangible assets. The value of these other nontaxable assets also must be removed from the income approach value either (i) by adjusting the income to capitalize or (ii) by removing the value of the asset from the capitalized income value. The appraiser is able to quantify working capital and the value of the assembled work force, however, reliable data is not available to quantify the value of XCORP's other intangible assets and rights as they relate to the income being capitalized.

Based on market transactions involving the purchase and sale of businesses similar to XCORP, it appears that the value of the XCORP business enterprise may approximate $60,000,000. However, that value includes the value of XCORP's nontaxable assets and rights as well as expectations about future growth and expansion which would require significant additional investment in plant and equipment. Given the lack of available data concerning all of the components of the XCORP business value of approximately $60,000,000, it is not feasible to determine the value of the taxable property by identifying and valuing every intangible asset and right and then reducing the value of the business enterprise by the value of all of the intangible assets and rights.

Under these circumstances, where there is not reliable income or market data concerning the tangible property itself, the replacement cost new less depreciation value approach is the most reliable value approach and accordingly it should be used in place of the income or market approach. Based on the foregoing, the value of XCORP's taxable tangible assets is approximately $30,000,000.

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TREATMENT OF INTANGIBLE ASSETS AND RIGHTS

INTRODUCTION

To properly value a business entity's taxable property, an appraiser has to ensure that the final value indicator does not include any non-taxable value. A business entity's non-taxable value may consist of tangible items (e.g., licensed vehicles), intangible assets and rights (e.g., commercial franchises), and value attributable to enterprise activity. This chapter discusses the treatment of intangible assets and rights.

In California, the property tax treatment of intangible assets and rights is governed by two fundamental principles. The first of these is that intangible assets and rights which are not an integral part of the bundle of rights (e.g., use, enjoyment, and possession) conveyed with the ownership of real and personal property are exempt from taxation. That is, while the state Constitution authorizes taxation of most real and personal property, there is no such authority with respect to intangible assets and rights which are not inherent in the ownership of taxable property.

Even though many intangible assets and rights are exempt, the second fundamental principle states that taxable property should nonetheless be assessed and valued by assuming the presence of those intangible assets and rights that, although not inherent in the ownership of taxable property, are necessary to put the taxable property to beneficial or productive use. Under this principle, an appraiser valuing taxable property must assume the presence of any intangible assets or rights necessary to the beneficial or productive use of the property being valued. The "beneficial or productive use" is equivalent to the highest and best use of the property.[1]

These two principles, expressly stated in the Revenue and Taxation Code, have been established over several decades of California case law. Applying the principles has, however, proved more difficult than enacting them. Thus, the purpose of this chapter is to aid assessors in the uniform application of these established principles by providing (1) a discussion of relevant terms and concepts; (2) a legal and theoretical framework within which to treat intangible assets and rights in the course of appraising taxable property; and (3) examples that illustrate the application of that treatment.

DISCUSSION OF RELEVANT TERMS

AH 501, Chapter 3, discusses some of the terms and concepts related to the appraisal treatment of intangible assets and rights. That discussion introduces the term "going concern value," the principle of unit valuation, and the statutory scheme that governs the treatment of intangible assets and rights in the appraisal of tangible property. In addition, earlier sections of the present manual have touched on the need to account for intangible assets and rights both in defining an appraisal problem and in solving it.

[1] For a detailed discussion of the concept of highest and best use, see AH 501, Chapter 4.

Intangible Rights

All property, both real and personal, is composed of interests, benefits, and rights associated with its ownership. These, by their very nature, are intangible. The value of property is based upon these "intangibles." Insofar as such intangible assets and rights contribute to the real property's value (for example by enabling its profitable use) they must be taken into account in determining fair market value for assessment purposes.

Every business needs certain "intangible rights." The character and value of the intangible rights held will vary with the nature and scope of the business's operations. Thus, while the owner of a small retail shop might have only a routinely acquired business license issued by local government, a large public utility possesses a varied and valuable collection of intangible rights, such as those conferred by government franchises and operating and use permits.

Intangible rights may be created by law, and they may or may not represent an owner's economic contribution to the productivity of his or her taxable property. For example, zoning laws and district or municipal boundary service areas may create intangible rights in real property without the owner of the property having to make any independent economic contribution.[2] Such intangible rights are inherent in the ownership of the property itself, and thus effectively add to the aggregate of property rights that compose the taxable property.

Government Permits

Other intangible rights, such as government permits to use property for particular purposes, usually represent potential economic benefits that could accrue to property owners. The holder of a special use permit, for example, has obtained the right to make a substantial income from the operation authorized on the property. While the operator has generally made a substantial expenditure to obtain this intangible right to use his or her property for a purpose which, absent such right, would be illegal on every other property in the county, the permit itself represents an intangible right that cannot be separately assessed for property tax purposes. The special use permit, however, is site specific and does authorize a more productive use of taxable property. Since it contributes to the value of the real property, the presence of the permit must be assumed or considered in an appraisal of that taxable property.[3]

Private Contract Rights

An intangible right may also be created by private contract. An example of such an intangible right is the contractual right to operate a particular chain restaurant pursuant to the terms of a

[2] Where the owner has expended time and effort to obtain a change in an existing zoning regulation, however, the rights created by the change represent an economic contribution by the owner to the productivity of the taxable property.

[3] See *American Sheds, Inc.* v. *County of Los Angeles* 66 Cal.App.4th 384 (August 1998) wherein the court upheld the county board's finding that governmental permits authorizing a taxpayer's landfill operation "are site specific and under California law, their contributory value to real property may be assessed." The court discounted the taxpayer's argument that the permits were in fact operator-specific, noting that the permits "authorize operations at this specific property, and contain terms and conditions about how that property must be arranged, maintained, and utilized. The [county board's] finding recognizes this, and refers to the practical connection between the permits and the property, and vice versa."

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commercial franchise. This type of intangible right represents an economic contribution by the owner, who generally has paid a substantial sum as consideration for the franchise contract. Whereas the special use permit described above relates directly to the use of taxable property, however, the right to operate a valuable commercial franchise relates primarily to the business entity's enterprise-related activities. Thus, a franchisee's rights under a valuable commercial franchise are examples of intangible rights whose primary purpose is not to authorize a more productive use of taxable property, but rather to authorize the use of a trade name or other legally protected intellectual property in the conduct of a business entity's enterprise-related activities.

Intangible Assets

An "intangible asset" is similar to an intangible right in that it may authorize a particular use of tangible property. Indeed, intangible assets often create intangible rights. However, an intangible asset is also distinct from an intangible right in that, for income tax purposes, an intangible asset is often assigned an allocated value for purposes of depreciation or *amortization* over an estimated useful life.

Any intangible rights conferred by an intangible asset may or may not be directly related to the use of taxable property. As discussed above, a valuable commercial franchise is an example of an intangible asset that confers substantial rights (and may thus represent great value to a business) but which does not relate directly to the use of taxable property. Similarly, a superior workforce in place, highly skilled management, or an extraordinary customer base may create value in the business entity that cannot be ascribed to the property. That is, such intangible assets would not be considered necessary to the beneficial or productive use of the property to the extent that they make a contribution to income or value beyond that which would normally be anticipated from a typically skillful or prudent operator of the property.[4]

Intangible Attributes of Real Property

Section 110(f) expressly provides that the value of "intangible attributes of real property" shall be reflected in the value of the real property. The section provides that such intangible attributes of real property include "zoning, location, and other attributes that relate directly to the property involved." In this definition of "attributes" are two characteristics of property which the Legislature has classified as "intangible," and whose value, therefore, must be reflected in the value of the property. The first is government zoning, which by statutory scheme includes the General or Specific Plan designation, special use, industrial park, planned unit development or other use classification. The second is location, which inherently encompasses all of the physical attributes of the property, such as view, water availability, soil quality, and proximity to services and amenities.

In addition to the characteristics identified in subdivision (f), it is proper to consider as "intangible attributes of real property" any intangible rights which are in the nature of property

[4] Rule 8, subsection (c), provides that in the income approach to value, the amount of income to be capitalized is the net return that the property would yield under "prudent management." Further, subsection (e) recognizes that income derived from operating earnings is "more likely to be influenced by managerial skills and may arise in part from nontaxable property or other sources."

rights—that is, rights inherent in the ownership of an item of tangible property, including the rights to sell, hold, use, occupy, encumber, dispose of, or otherwise determine the status of the tangible item.

Related Business and Appraisal Terms

Several of the terms that come into play in a discussion about the proper treatment of intangible assets and rights have been used in more than one context. This variability in usage can be found both in the law and in the appraisal literature. Below, several of these terms are discussed in their varying contexts.

Going Concern Value

The term *going concern value* is most often used in a sense that encompasses all of the value of a business entity. Often, however, the term is used to refer to an increment of the total value of a business entity that cannot be attributed to identifiable items of tangible property or intangible assets or rights.

In AH 501 "going concern value" was defined as referring to "the total value of an operating business enterprise."[5] In this context, the term is said to include not only the value of all of the tangible property of the enterprise, but also the value of all of the intangible assets and rights held by the business entity (i.e., the "going concern"). Under this usage, which is often associated with valuations made under the principle of unit valuation, "going concern value" refers to a figure that is based on an appraisal of all of a business entity's operating property functioning as a unit. Although in practice this usage is most often used in reference to state-assessed public utilities, the concept of defining and assessing property as a functioning appraisal unit is no less applicable to certain locally assessed property.

In contrast, section 107.7, which governs the valuation of cable television interests, uses "going concern value" in a sense that is meant to convey the idea of an increment of the total value of the business entity (i.e., the cable television system) which is not otherwise attributable to either tangible property or otherwise identifiable intangible assets or rights.

California statutes impose an equivocal prohibition against assessing the value of intangible assets and rights relating to the going concern value of a business using taxable property. That is, such valuations are prohibited except to the extent that the presence of the intangible assets or rights is necessary to put the taxable property to beneficial or productive use. In this context, "going concern value" refers to that portion of the value of a business entity that exceeds the fair market value of the business entity's tangible property put to beneficial or productive use. However, for property tax purposes, this difference in value is more accurately classified as "enterprise value" and should be treated as such (see below).

[5] AH 501, 7.

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Business Enterprise Value

"Business enterprise value" (or "enterprise value") is another term that is used differently depending on the context. In one context, this term connotes value based on the business operations conducted on tangible property rather than value attributable to the property itself. However, in another context, the term may be used to refer to the value of the entire operating enterprise, including the value of tangible property and intangible assets and rights held by the business entity. As previously indicated, for property tax purposes, "enterprise value" should be defined as that portion of the value of a business entity that exceeds the fair market value of the business entity's tangible property put to beneficial or productive use.

Goodwill

Goodwill has also eluded uniform usage. The term has been variously associated with (1) the expectation of continued customer patronage of a business, (2) the presence of "excess earnings," or earnings in excess of those required to provide a fair return for all tangible and identifiable intangible property of the business, and (3) the residual value or "gap" in value that is represented by the difference between the value of the business entity as a whole and the value of the otherwise identifiable assets.[6] For property tax purposes the second definition for goodwill mentioned above is the most appropriate and actually constitutes a form of non-taxable "enterprise value."

Principle of Unit Valuation

The AH 501 provides an introductory discussion of the principle of unit valuation. It is noted there that the principle of unit valuation is based on the concept that the appraisal unit should be the unit most likely to be bought and sold in the market. This concept recognizes that market participants value certain properties according to the benefits that will be generated by the entire operating unit rather than the sum of the estimated values of the individual parts that compose the operating unit. AH 501 notes further that while the principle of unit valuation is usually associated with appraisals of large industrial operations or state-assessed utilities and railroads, the concept of the appraisal unit is more often referred to in the context of appraising locally assessed properties that comprise several parcels.[7]

The principle of unit valuation carries with it at least two implications for the treatment of intangible assets and rights. First, since the traditional application of the principle of unit valuation begins with an appraisal of an entire operating property, including both taxable property and non-taxable intangible assets and rights, adjustments will have to be made for any non-taxable intangible assets and rights that may exist. As discussed later in this chapter, such adjustments are expressly required by section 110(d)(2).

The second implication stems from the legal connection between the principle of unit valuation and the assessment, on a going concern basis, of property operated by certain public utilities.

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[6] Gordon V. Smith and Russell L. Parr, *Valuation of Intellectual Property and Intangible Assets* (John Wiley & Sons, Inc., 1989), 88-89.
[7] AH 501, 11.

From an appraisal standpoint, that legal connection suggests that there will be few required adjustments for intangible assets and rights where the only significant intangible assets and rights present are those necessary to put the taxable property to beneficial and productive use. As discussed later in this section, section 110(e) requires that taxable property be assessed and valued by assuming the presence of those intangible assets or rights necessary to the taxable property's beneficial and productive use. Appraisers are required to remove or make adjustments for only those intangible assets and rights whose presence is not required to be assumed.[8]

Components of a Going Concern[9]

Monetary Assets

Monetary assets are generally liquid assets directly or indirectly involved in the operation of a going concern. As an example, a business entity needs "working cash" in order to cover expenses that are typically paid prior to the time that receivables have been collected.

Real Property

Real property is defined in section 104 as "the possession of, claim to, ownership of, or right to the possession of land." Real property includes all the interests, benefits, and rights associated with the ownership of a particular property. Under the principle of unit valuation, all of the real property owned by a business entity that is necessary to provide the primary utility or product of the business entity constitutes a component of the going concern. This real property may be referred to as the unitary real property or the operating real property. Real property that is not part of the operating unit is not part of the going concern. This concept of unitary real property or operating real property is based on the logical premise that all of a business entity's functionally-related operating assets, including real property, would be transferred together in a sale of the business entity.

Tangible Personal Property

While all tangible property, both real and personal, is generally subject to ad valorem taxation, some types of tangible personal property are exempt. Accordingly, adjustments must be made by the appraiser when such exempt personal property is established as a component of the appraisal unit. Examples include motor vehicles, certain vessels, and assets located in federal enclaves.

Intangible Assets and Rights

When assessing or valuing property under subdivisions (e) and (f) of section 110, the appraiser should assume the presence of only (1) those intangible assets or rights necessary to put the property to beneficial or productive use and (2) intangible attributes of real property as provided in subdivision (f). To the degree that these items contribute to the value of the real property, they

[8] Section 110(f), which requires that the value of "intangible attributes of real property" be reflected in the value of the real property, provides another self-evident exception to the requirement to adjust for intangible assets and rights.
[9] As used in the remainder of this manual, except as otherwise noted, the terms "going concern," "business entity," and "business concern" all refer to an operating business enterprise, including all its tangible property and its intangible assets and rights functioning as unit.

must be considered in an appraisal of the taxable property. While some intangible assets, such as working cash, are clearly unrelated to the productive use of the property, others, such as building permits, are directly related to the use of the property. Most intangible assets and rights, however, fall somewhere in between these two ends of the spectrum.

STATUTORY AND JUDICIAL FRAMEWORK

Under article XIII, section 2 of the California Constitution, only the specific intangible personal property listed in that section may be subject to property tax. Further, the Legislature may provide for the property taxation of these items of intangible personal property, which include notes, debentures, shares of capital stock, bonds, solvent credits, deeds of trust, mortgages, and any legal or equitable interest therein. The Legislature may not, however, provide for the property taxation of any other type of intangible personal property.

Under section 212, the Legislature has determined not to tax the intangible personal property listed in article XIII, section 2 of the California Constitution. Thus, except as set forth in subdivisions (e) and (f) of section 110, all intangible assets and rights—including intangible personal property—which are not specifically listed in that section are exempt from property taxation.

The California Courts of Appeal have identified intangible assets and rights in certain property tax cases. These intangible assets and rights include, among others, governmental permits (including liquor licenses, cable television franchises, and airport rental car and stadium concessions), stock exchange seats, press association memberships, memberships in social, professional and fraternal clubs, patents, copyrights, goodwill, judgments, causes of action, insurance policies, enterprise value, going concern value, favorable franchise rights, customer lists, the right to do business, marketing and programming contracts, management and operating systems, and work force in place.[10] In addition, section 107.7(d) provides a list of certain nontaxable intangible assets and rights specifically related to cable television systems. Finally, certain tangible personal property is specifically limited as to the property rights to be appraised.[11]

Section 212 states the principle that intangible assets and rights are exempt from property taxation and that the value of intangible assets and rights shall not enhance or be reflected in the value of taxable property. However, this principle is subject to the last sentence of section 212(c), which states that "taxable property may be assessed and valued by assuming the presence of intangible assets or rights necessary to put the taxable property to beneficial or productive use." Taken together, these provisions are consistent with numerous court cases over the years. In a

[10] See, *Roehm* v. *County of Orange*, 32 Cal. 2d 280 (1948); *County of Orange* v. *Orange County Assessment Appeals Board*, 13 Cal. App. 4th 524 (1993); *Shubat* v. *Sutter County Assessment Appeals Board*, 13 Cal. App. 4th 794 (1993); *GTE Sprint Communications Corp.* v. *County of Alameda*, 26 Cal. App. 4th 992 (1994); *De Luz Homes, Inc.* v. *County of San Diego*, 45 Cal. 2d 546 (1955); *County of Los Angeles* v. *County of Los Angeles Assessment Appeals Board*, 13 Cal. App. 4th 102 (1993); *Service America Corp.* v. *County of San Diego*, 15 Cal. App. 4th 1232 (1993).

[11] Some examples are storage media for computer programs (section 995); business records (section 997); motion pictures (section 988); certain works of art (section 986); and timeshare estate amenities (section 998).

recent case, a court of appeal pointed out the consistency of the case law with the constitutional and statutory provisions, as follows:

> The leading decision regarding property tax consideration of intangibles associated with real property is *Roehm* v. *County of Orange* (1948) 32 Cal.2d 280 (Roehm) (per Traynor, J.). *Roehm* held that a liquor license, being an intangible asset, did not constitute taxable personal property, under constitutional and statutory provisions. However, the court explained, "Intangible values...that cannot be separately taxed as property may be *reflected* in the valuation of taxable property. Thus, in determining the value of property, assessing authorities may take into consideration earnings derived therefrom, *which may depend on the possession of intangible rights and privileges* that are not themselves regarded as a separate class of taxable property." (Id. At p. 285, italics added.) 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.[12]

Subdivisions (d), (e) and (f) of section 110 provide similar guidance regarding the property tax treatment of intangible assets and rights. Subdivision (d) provides that:

1. The value of intangible assets and rights relating to the going concern value of a business using taxable property shall not enhance or be reflected in the value of the taxable property;

2. If the principle of unit valuation is used to value properties that are operated as a unit and the unit includes intangible assets and rights, then the fair market value of the taxable property contained within the unit shall be determined by removing from the value of the unit the fair market value of the intangible assets and rights contained within the unit; and,

3. The exclusive nature of a concession, franchise or similar agreement, whether *de jure* or *de facto*, is an intangible asset that shall not enhance the value of taxable property, including real property.

The going concern value referred to in subdivision (d)(1) is that portion of the value of a business entity that exceeds the fair market value of the business entity's tangible property put to beneficial or productive use. This difference may be referred to as "enterprise value."

These three provisions contained within subdivision (d), however, are subject to subdivision (e), which states that "taxable property may be assessed and valued by assuming the presence of intangible assets or rights necessary to put the property to beneficial or productive use."[13] Finally,

[12] See *American Sheds, Inc., supra.*

[13] See *American Sheds, Inc., supra,* in which the court stated: "A useful explanation of the rules embraced in these statutes appears in a September 15, 1995 letter to the Secretary of the Senate by Senator Ken Maddy, author of the amendments. According to Senator Maddy, 'The bill provides that the intangible assets and rights relating to the going concern...are not to be reflected in the value of property. However, under subdivision (e) of Section 110...as added by the bill, property may be valued assuming the existence of intangible assets necessary to put the property to

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section 110(f) provides that for purposes of determining the full cash value or fair market value of real property, intangible attributes of real property shall be reflected in the value of the real property. These intangible attributes include zoning, location and other such attributes that relate directly to the real property involved. In this context, subdivision (d)(3) above refers to the exclusive nature of an agreement that does not grant the right to use real property and which is not an attribute of real property.

VALUATION ISSUES

The valuation question for the appraiser is a practical one. That is, where property is operated by a business entity, what method or methods does an appraiser employ to ensure that the market values of all non-taxable intangible assets and rights are excluded from the final value indicator for the taxable property? Section 110(d)(2) outlines the answer to that question where (1) the principle of unit valuation is used and (2) the unit includes both non-taxable intangible assets and rights. Specifically, subdivision (d)(2) provides that when both of those conditions are present, the fair market value of the taxable property must be determined by removing from the value of the unit the fair market value of any non-taxable intangible assets and rights.

However, subdivision (d)(2) stops short of prescribing a specific method for accomplishing this adjustment. Instead, from a practical standpoint subdivision (d)(2), subdivisions (e) and (f), as well as section 212, establish for the appraiser two clearly identifiable boundaries. At one end, these provisions imply that tangible property should not be valued at salvage value (i.e., the value of property at the end of its economic life in its present use) merely because the accompanying intangible assets and rights themselves cannot be taxed. At the other end, the statutory provisions can be interpreted to mean that the value of the tangible property used in a business entity does not necessarily, as a matter of law, equal the value of the business entity itself. In this context, and as part of the normal appraisal process, appraisers should consider all of the traditional approaches to value and reconcile those indicators to determine the proper value.

From a conceptual standpoint, the boundaries are consistent with the fundamental appraisal principle which states that an owner of taxable property will follow a course of action that produces the highest rate of return, on a risk-adjusted basis, and that results in the highest and best use of the property.[14] As a practical matter, an appraiser's task is to apply the appropriate valuation methodologies to determine the value of the tangible assets within the two boundaries. Further, the value so determined should reflect the values of intangible assets and rights only to the extent that such intangible assets and rights constitute attributes of real property or are necessary to put the tangible property to its highest and best use.

In short, the two boundaries establish opposite extremes for the valuation of taxable property used in a business. Thus, under normal circumstances, an appraiser would use a method that

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productive use....For example, under the terms of the bill, an assessor could not use a liquor license to enhance the value of taxable property. However, the assessor may assume the presence of a license so that a bar's taxable property may be taxed as a bar and not at salvage value (i.e., as a warehouse).'"

[14] See AH 501, 52.

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avoids any result that approaches either salvage value, or at the other extreme, the value of the business entity.

When deciding whether the appraisal unit includes non-taxable intangible assets and rights in a business operation, a determination must be made as to whether earnings are largely derived from enterprise activity, or if they are derived from taxable property. It is less likely that adjustments will be necessary where the appraisal unit possesses the following characteristics:

1. The taxable property is integrally related to the business operation.

2. The focus of the business is to maximize the use of the property.

3. Earnings are not largely derived from enterprise activity.

4. If the property were sold the right must necessarily transfer with the land.

Under these conditions, some level of enterprise activity is required to operate and maintain the property; however, such activity is ultimately directed towards maximizing the beneficial and productive use of the property; consequently, in the income approach it is properly accounted for by treating it as an operating expense. As long as income and expenses are properly accounted for, the net earnings are appropriately attributable to the taxable property.

Analyzing the Relationship Between the Business Entity Operation and the Taxable Property

As emphasized above, the focus here is the appraiser's evaluation of the extent of the relationship between the business operation and the use of the taxable property. In analyzing this relationship, the appraiser should seek to answer the following questions:

First, does the business use the property as an integral part of an operating unit or going concern? The issue is whether the earnings of the business can be ascribed to the use of the taxable property. If the answer is no, then the appraiser should place little or no weight on an indicator derived from an approach to value which is based either on the earnings of the business or on a sale of the business in toto.

Second, if the earnings of the business can be ascribed to the use of taxable property, to what extent do the business's earnings depend on a sale or service activity that uses the property only incidentally in carrying out such activity? In the reconciliation process, the answer to this question will guide the appraiser in the decision to place more or less relative weight on particular indicators. When making this judgment the appraiser should consider the extent to which the earnings of the business depend on either (1) the possession of a valuable commercial franchise or (2) a level of human skill or entrepreneurship that is atypical for the type of property operation which involves the subject taxable property. Ideally, the appraiser should develop a method of valuation which captures or imputes an income that excludes earnings of the business not attributable to the taxable property.

Consider the type of business whose earnings are clearly dependent upon human skill or entrepreneurship. A physician's practice is a good example, since the doctor's earnings are dependent not on the instruments in her medical bag, but rather on her acquired training, skill, and license to use those instruments in the practice of medicine. Thus, even though the doctor uses valuable tangible property (e.g., instruments, equipment, and specially designed offices), the use of that property is only incidental to the doctor's earnings from the practice of medicine.

This apparently incidental relationship between the use of taxable property and the doctor's earnings is made even more obvious if one considers what the tangible property would sell for apart from the medical practice as a going concern. Clearly, the earnings of the practice would have little bearing on the price that the tangible property would command in such a sale, since the primary force behind those earnings is not the tangible property, but rather intangible factors such as the doctor's human skill. A similar analysis applies to businesses whose earnings are primarily dependent on the sale of personal property and the provision of personal services.

In contrast to a physician's practice, consider an apartment house as an example of a business whose earnings are dependent on the use of taxable property. Although the ownership and operation of an apartment house is a business (i.e., the owner manages the property in order to make a profit on his investment), the earnings of that business clearly can be ascribed to the use of the taxable property. Thus, even though the owner of the apartment house exercises some personal effort in the course of managing the apartment house, that effort is generally only incidental to the business's earnings, which are derived almost entirely from rentals of the taxable property. Indeed, each rental of an individual apartment is tantamount to a short-term purchase of the rights to use a portion of the taxable property.

This integral relationship between the earnings of the apartment house and the use of taxable property is further illustrated by the scenario that would play out upon the sale of the taxable property apart from the existing business. Unlike the doctor's tangible property, the price commanded by the apartment house would be determined by reference to the earnings of the business. More importantly, investors typically would evaluate the prospective earnings of the apartment house based not on an analysis of the prior operator's acumen in managing the property, but rather on an evaluation of factors such as the location, quality of construction, and remaining useful life of the physical property. A similar analysis applies to other businesses whose earnings are primarily dependent upon the use of taxable property, including electricity-producing dams, ski slopes, bowling alleys, golf courses, many public utilities, and hotels and motels that do not benefit from extraordinary reputations for service or quality or from associations with unusually valuable franchises.

The examples of the medical practice and the apartment house represent opposite ends of the range of property uses made in business operations. Property used by businesses falling near either of these two extremes is easy to identify as either a good candidate for an approach to value based on either a sale of the business or the earnings of the business (the apartment house) or a poor candidate for such an approach (the medical practice). However, most businesses fall

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somewhere in between the two extremes, and this fact may introduce into the appraiser's analysis an ambivalence that, in some cases, cannot logically be resolved by any prescribed formula.

Determining the Presence of Intangible Assets and Rights, Not Covered by Subdivisions (e) and (f), that Relate to the Going Concern Value of a Business Entity

Where an appraiser can logically establish the fair market value that an intangible not covered by subdivisions (e) or (f) of section 110 would have apart from its existence within the business entity, it will be possible to explicitly remove that value from a unitary value indicator that is based either on the earnings of the business entity or on a sale of the business entity. In calculating an indicator of value based on the income approach, it will sometimes be possible to remove from the income stream to be capitalized any revenues that cannot be ascribed to the operating property.

Where the separate value of an intangible asset or right that is not covered by subdivision (e) or (f) of section 110 cannot logically be established, however, an explicit removal may not be possible. This difficulty is most likely to arise where the activities of the business entity are integrally related to the use of taxable property. In such cases, it may be impossible to even approximate the point at which the taxable property ends and the non-taxable intangible asset or right begins, and an attempt to explicitly remove the value of the "intangible" may represent an attempt to separate from the value of the taxable property the very thing which gives rise to that value in the first place. Thus, it may be more logical for the appraiser to account for such intangible assets and rights implicitly, and impute an amount of income, which would solely account for the taxable property. Whenever possible the appraiser should compare this resulting indicator of value with results from other approaches and, in the reconciliation process, place appropriate weight on the indicator(s) that are less likely to include any value other than the fair market value of the taxable property being appraised.

Valuation of Taxable Property by Assuming the Presence of Intangible Assets and Rights Necessary to Put the Taxable Property to Beneficial and Productive Use

As discussed above, the law establishes that taxable property must be valued assuming the presence of those intangible assets and rights which are necessary for the beneficial or productive use of the property. Put another way, this means that an appraiser valuing taxable property must not hypothecate the absence of such intangible assets and rights. From either viewpoint, this principle implies at least three things for the appraiser.

First, and most obviously, the principle implies that the "beneficial or productive use" under consideration by the appraiser is the property's highest and best use. To interpret the principle as allowing an appraiser to assume a lesser use would be to allow for a valuation at less than full cash value.

Secondly, the principle implies that the intangible assets and rights needed for the beneficial or productive use of the taxable property do not have to be currently in place in order for the appraiser to assume their presence. Thus, an appraiser valuing taxable property must assume the presence of those intangible assets or rights that would be necessary to the highest and best use of the taxable property. Whether the current owner of the property actually possesses those intangible assets and rights is not important, since the current owner may not be making the highest and best use of the property.

Thirdly, and most importantly, if the presence of intangible assets and rights must be assumed by law because they are necessary for the beneficial or productive use of the property, then two requirements must be met: (1) no additional value should be added to the fair market value on account of their presence,[15] and (2) the appraiser should not attempt to adjust the value indicators to remove their value or influence from the fair market value. These requirements would apply in the examples previously noted, including the case of the special use permit necessary to use property for the operation of a solid waste disposal facility. Likewise, the requirements would apply to the presence of a workforce in place that is minimally necessary for the operation of, for example, a large resort hotel.

ADJUSTMENT OF VALUE INDICATORS

Once an appraiser has determined that the earnings of the business can be ascribed primarily to the use of taxable property, and having proceeded with a calculation of a unitary indicator or indicators based upon the earnings of the business or upon a sale of the business, he or she should proceed to deduct from those indicators the market values of any non-taxable intangible assets and rights not covered by subdivisions (e) or (f).

These are intangible assets and rights that would have a reasonably ascertainable fair market value apart from the business. As discussed below, such intangible assets and rights include all of the financial assets listed under section 212, and—perhaps—trademarks, copyrights, patents, or other intellectual properties.

Intangible Assets

Financial Assets

As discussed above, there are certain intangible assets whose separate value can reasonably be ascertained. The financial assets listed in subdivisions (a) and (b) of section 212—notes, debentures, shares of capital stock, solvent credits, bonds, deeds of trust, mortgages, and money kept on hand to be used in the ordinary and regular course of the business—represent such intangible assets. These are intangible assets and rights whose value generally can be explicitly removed in the course of an appraisal of the taxable property of an operating enterprise. The preferred method of estimating the fair market value of these intangible assets and rights is by reference to their cash equivalent values or separate sales of similar assets.

[15] However, note that under the principle of substitution it may be proper, in arriving at a *cost*-based indicator of value, to add amounts for entrepreneurial services, advertising, recruiting and training employees, or other costs incurred in placing the taxable property into profitable operation. (See rule 6.)

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In some cases, however, there will be no reliable market data as to the separate value of an intangible asset. In that event, the appraiser may be able to refer to sales contracts and agreements, asset lists attached to those agreements, and cash flow analyses used to develop the sales price. These documents may provide evidence of the values that a buyer and a seller assigned to particular assets, including intangible assets and rights.[16]

Items Based on Relationships between the Business Entity and Employees, Customers, or Suppliers

For income tax purposes, an assessee who is able to prove that a particular intangible asset can be valued and that it has a limited useful life may depreciate its value over its useful life.[17] Thus, for income tax purposes businesses often assert separate valuations for intangible assets—including those based on relationships between the business and its employees, customers, or suppliers—that would not otherwise be regarded as having any independent existence. However, while the U.S. Supreme Court has upheld particular taxpayers' claims for depreciation of such intangible assets, it has also noted that it will often be too difficult to prove that such assets can be separately valued.[18]

If it is difficult in the income tax arena to prove the separate value of intangible assets and rights that are based on business relationships, it will be even more difficult in the property tax arena. This is because, as discussed throughout this chapter, for property tax purposes the presence of certain intangible assets and rights is to be assumed to the extent that they are necessary to the taxable property's beneficial or productive use. For example, as indicated above, while the presence of a typically skilled workforce or management team or a minimally necessary customer base creates value in a business entity that cannot be ascribed to the property, those "intangible assets and rights" are necessary to put the property to beneficial and productive use. On the other hand, a superior workforce or management team, or an exceptional customer base, are intangible assets and rights that go beyond that which would typically be anticipated as necessary to put the property to productive use.

Therefore, in valuing unitary or unit properties such as shopping centers or hotels, the appraiser should assume the presence of those intangible assets and rights which are normal or typically necessary to put such property to beneficial or productive use. The normal or typically necessary intangible assets and rights constitute the workforce, management, and customer base, without which an operating property may not be able to generate a normal level of revenues. However, when the workforce, management, or customer base is superior or atypical, and it can be demonstrated that it creates additional value in the business entity above and beyond the value of the operating property, an adjustment is necessary.[19] Data supporting such superior or atypical

[16] In contrast, the appraiser should be cautious of appraisals made for income tax purposes; such valuations are made after the fact, and tend to be motivated by a new owner's desire to minimize prospective income tax liabilities.
[17] *Newark Morning Ledger Co.* v. *United States*, 113 S. Ct. 1670
[18] 113 S. Ct. at 1681.
[19] The same reasoning and resultant adjustment should apply in circumstances where the workforce, management, or customer base are inferior, creating a decrease in the value of the business entity below that which would otherwise prevail.

assets and rights, requested from the business entity operating the property, should be analyzed quantitatively to determine the nature of the adjustment warranted.

Intangible Rights

Rights to Use Property

Building permits, special use permits, leases, rental agreements, or other items that enable the beneficial or productive use of taxable property will typically come within the scope of section 110(e). Accordingly, the presence of such intangible rights should be assumed, and no adjustment is necessary.

Commercial Franchises and Intellectual Property Rights

Commercial franchises and intellectual property rights (e.g. copyrights, patents, and trademarks) generally have an ascertainable market value apart from the business entity that holds them. In that event, the discussion above relating to the treatment of financial assets applies here as well. When such intangible assets and rights are not covered by subdivision (e) or (f) of section 110, the preferred method of adjusting for such intangible assets and rights is by reference to market data, or, if such data is unavailable, to sales contracts, asset lists, cash flow analyses, and other documents used to develop the sales price of the business. For commercial franchisees, there are, for example, frequent franchise- or enterprise-related activities, such as promotional campaigns, merchandising, or specialized marketing by the business entity. These are activities that go above and beyond the enterprise-related activities of a typical business entity in that same sales or service category.

ADJUSTMENTS IN THE THREE APPROACHES TO VALUE

Comparative Sales Approach

Traditionally, in the comparative sales approach the appraisal unit consists of only taxable property. That is, the adjustment of the sales prices of the comparable properties do not include adjustments for non-taxable intangible assets and rights that are part of an operating unit. However, when the appraisal unit consists of an entire business entity (i.e., when the principle of unit valuation is used) adjustments may be required for the purpose of excluding any value that is not properly included in the fair market value of the taxable property.

Income Approach

Under rule 8, income derived from rental of properties is preferred to income derived from their operation, since the latter is the more likely to be influenced by managerial skills and may arise in part from non-taxable property or other sources. Nevertheless, under a traditional application of the principle of unit valuation, operating income—not rental income—will be the starting point of the appraiser's analysis.

Depending on the business, the operating income may include income attributable to selling merchandise, the provision of personal services, or to intangible assets or rights that are not covered by subdivision (e) or (f) of section 110. It is for these items that the appraiser must make adjustments in order to arrive at the income attributable to the taxable property.

These adjustments can be made by adding appropriate amounts to the operating expenses that are used to reduce total operating income to a net income that can then be attributed to the taxable property. Thus, the cost of goods sold, employee salaries, and the costs associated with maintaining a superior customer base are examples of items that could be added. Alternatively, for intangible assets and rights whose market values can be estimated by reference to separate sales of similar intangible assets and rights, lump sum adjustments should be made to the income-based value indicator.

Generally, if the anticipated net income for a typical operator of the real property either cannot be estimated with reasonable accuracy, or cannot be ascribed to the real property, then a reasonable portion of the anticipated net income may be allocated or imputed to the real property. If there is no reasonable, sound and practical basis for allocation or apportionment, then an economic rent, based on a reasonable return on the real property may be used as the basis for the valuation of the real property.

Cost Approach

The treatment of intangible assets or rights should not be an issue except where an appraiser has relied on an approach to value that is based either on a sale of the business in toto or on the net earnings of the business. Properly employed, an approach based on replacement costs does not give rise to disputes over the treatment of intangible assets and rights. Thus, except as may be otherwise required by subdivisions (e) or (f) of section 110, in the replacement cost approach an appraiser should not add amounts reflecting the costs of acquiring non-taxable intangible assets and rights, since to rely on an indicator so derived would be to implicitly (if not directly) assess those intangible assets and rights.[20]

[20] However, note that under the principle of substitution it may be proper to add amounts for entrepreneurial services, advertising, recruiting and training employees, or other costs incurred in placing the taxable property into profitable operation. (See rule 6.)

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BOARD OF EQUALIZATION
REVENUE ESTIMATE

ISSUE #98-031

Discussion Relating to Intangible Assets and Rights in Assessors' Handbook Section 502, Advanced Appraisal

Proposal(s)

Board staff is preparing a new manual, *Advanced Appraisal, Assessors' Handbook Section 502 (AH 502)*, dealing with advanced appraisal practices and theories. One of the chapters in the new manual deals with the treatment of intangible assets and rights. The issue paper considers the differing versions of the chapter that have been proposed by staff and industry.

Background, Methodology, and Assumptions

In general, in staff's version of the chapter, taxable property may be valued by assuming the presence of those intangibles necessary to put the taxable property to beneficial or productive use. Where appropriate, this version would allow the use of value indicators based either on (1) income from a property's operation, or (2) a sale of the business entity operating the property. Such valuations are said to be performed according to the "principle of unit valuation."

The alternate version of the chapter proposed by industry effectively precludes the use of such indicators. Instead, in cases where a valuation might otherwise be performed according to the principle of unit valuation, industry's version strongly favors a valuation based on a replacement cost approach alone.

Only a small portion of assessments of state-assessed property and of county-assessed property would be affected by industry's proposal to preclude valuations based on either income from the property's operation or on a sale of a business using the taxable property. An analysis of the 1998-99 Board assessments revealed that total state-assessed values would decrease by $36 million or $360,000 in tax if only replacement cost values were used. This $36 million in value is due to the Board's reliance on a formula for valuing wireless telephone companies that places a 20 percent weight on a capitalized earnings approach (CEA) indicator that excludes reported intangibles.

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Currently, in general, it is Board practice to not place primary reliance on valuation methods based on a property's operating income, or on a sale of the business operating the property unless those methods result in values that are lower than those produced by replacement cost methods.

For locally assessed property, intangibles come into play only in valuing a small percentage of commercial/industrial (C/I) property. The estimated value of commercial/industrial land and structures statewide is $400 billion. If this difference in treatment affected one percent of all C/I properties resulting in an average ten percent reduction in assessed value, the reduction in assessed value would be $400 billion x 1% x 10%, or $400 million. The annual difference in tax would then be $400 million x 1%, or $4 million.

Revenue Summary

If the valuation methods based on either the income from a property's operation or on a sale of the business operating the property are prohibited as in the alternative proposal, property tax revenue from the basic 1 percent property tax rate would decrease by an estimated $4 million annually.

Qualifying Remarks

This analysis assumes that the reliance on valuation approaches based on either operating earnings or on a sale of the business using the property will continue to be limited if the results exceed replacement cost less depreciation and will not change. The usage of these methods has been restricted in recent years in accordance with various settlement agreements. And, under current practice, the values generated under these methods tend to be lower than the values produced using, say, replacement cost methods. This may not hold true in the future since there have been occasions in the past when they resulted in values that were higher than values from other approaches. If market or economic conditions or the judicial or legislative views regarding the taxation of intangibles change, the effect of banning valuation methods that value intangibles may be substantially greater than $4 million in property tax annually.

Preparation

This revenue estimate was prepared by Aileen Takaha Lee, Statistics Section, Agency Planning and Research Division. The estimate was reviewed by Ms. Laurie Frost, Chief, Agency Planning and Research Division; Mr. Richard Johnson, Deputy Director, Property Taxes Department; and
Mr. Ramon Hirsig, Valuation Division, Property Taxes Department. For additional information, please contact Ms. Aileen Takaha Lee at (916) 445-0840.

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