Understanding Intangible Assets and Real Estate: A Response to the IAAO Committee's Guide

By Cris K. O'Neall & C. Stephen Davis[1]

This paper responds to the guide issued by the IAAO Special Committee on Intangibles relating to the handling of intangible assets and real estate in property tax valuation and assessment. The response supports use of appraisal methods which directly appraise and remove the full value of identified non-taxable intangible assets in the valuation and assessment of taxable real property. The response also addresses some of the methods discussed in the IAAO Committee's guide and identifies concerns with the legal authorities cited in the guide.

In early 2017 the International Association of Assessing Officers (IAAO) Special Committee on Intangibles issued a white paper addressing the scope of the intangible asset exemption: "Understanding Intangible Assets and Real Estate: A Guide for Real Property Valuation Professionals,"[2] hereafter the "IAAO Guide" or "Guide." The IAAO describes the purpose of the IAAO Guide as follows: "This guide is intended to assist assessors in understanding and addressing intangible assets in property tax valuation" and "to assist in identifying intangible assets and exclude them from real property assessments." [3] The Guide purports to describe the legal and appraisal requirements for removing the value of intangible assets and rights in the assessment of real estate for property tax purposes. However, the Guide advocates appraisal methods that do not remove the value of intangible assets from assessment, omits essential appraisal authority, mis-cites court decisions, and ignores controlling law. This paper exposes the unbalanced nature of and errors in the Guide, including techniques which purportedly minimize or eliminate the value of intangible assets from assessment and other omissions.

I. *THE QUALIFIED NATURE OF THE IAAO GUIDE*

Not all IAAO publications have equal weight. The IAAO Guide expressly provides the following self-limiting disclosure immediately below the title of the paper: "This guide was developed by the IAAO Special Committee on Intangibles for informational purposes only and does not necessarily represent a policy position of IAAO. This guide is not a Technical Standard and was developed for the benefit of assessment professionals."[4]

An IAAO "technical standard" represents an official position of the IAAO: "International Association of Assessing Officers (IAAO) maintains technical standards that reflect the *official position of IAAO* on various topics related to property tax administration, property tax policy, and valuation of property including mass appraisal and related disciplines. *These standards are adopted by the IAAO Executive Board*. IAAO assessment standards represent a consensus in the assessing profession."[5] The IAAO Guide is not an IAAO technical standard, so it has not been approved by the IAAO Executive Board and cannot be described as endorsing a "consensus" in the assessing profession.

II. *EXCLUDING THE VALUE OF INTANGIBLE ASSETS: ISSUES RAISED IN THE IAAO GUIDE*

The IAAO Guide correctly acknowledges that in "the majority of jurisdictions, intangible assets are not taxable, at least not as part of the real estate assessment. As a result, assessors must ensure their real estate assessments are free of any intangible value" and that "the value of intangible assets is excluded." The Guide also says "assessors seek methods that measure the value of the real property but exclude any intangible asset value" and "[assessors] must utilize methods to ensure the value of intangible assets is excluded from real estate assessments."[6]

The question is whether the IAAO Guide actually proposes methods that meet this standard. The bare assertion that all of the intangible assets have been removed from an assessment must be tested: if the appraisal methodology is recognized to encompass non-taxable intangible assets, then it must demonstrate exactly how intangibles are removed and what value was ascribed to each of those removed intangibles. The methods advocated by the Guide can be evaluated by asking whether a particular method of appraisal subsumes intangible assets and, if so, what those intangibles are, their values, and whether those values are actually excluded.

A fundamental question raised by any assessment or appraisal method is whether it is likely to include intangible assets. Capitalizing operating revenue very likely means that business enterprise, and/or business enterprise components such as assembled workforce, working capital, licensing rights or such, are included in the assessment. If the cost indicator includes a line item for operating permits or environmental emission credits, then an intangible asset is being assessed. If the sales price is paid for a rental property, and that price is based on an above market lease in place and/or fails to account for lease-up costs and delay, then intangible assets are implicated. Thus, an initial question is whether the nature of the property at issue and the appraisal method implicates intangible assets.

There are a number of issues addressed in the IAAO Guide which are accepted in the appraisal profession as being consistent with correct methods for handling the identification, segregation and removal of intangibles. For example, several paragraphs in the Guide point out that the Cost Approach, as applied to the tangible real and personal property, "inherently excludes" the value of non-taxable intangible assets and rights.[7] The Guide also states that when the Sales Comparison Approach or the Income Approach are used to value going-concern type properties, it is likely that non-taxable intangibles are subsumed in the going-concern value conclusion, and those intangibles that were captured need to be identified and their values excluded.[8] In addition, the Guide cautions that sales prices for real property sold along with a business may include intangibles' values.[9] Therefore, from an introductory perspective, the Guide satisfactorily identifies those situations in which intangibles may be implicated in an appraisal.

There are other issues addressed in the IAAO Guide which are not accurately or correctly discussed. The *first* is the "separability" criteria for identifying intangibles. The *second* is the role of ownership in the intangibles exclusion process. The *third* is the use of accounting and tax records to allocate value to intangible assets. And the *fourth* is the efficacy of the Rushmore "Management Fee" method for removing the value of non-taxable intangibles. Each of these issues is addressed below.

A. Separability Is Not Necessary for the Identification of Intangible Assets

1. *The Issue*

The IAAO Guide asserts that "separability" is necessary for identification of intangibles because some intangible assets are "intertwined" in that one intangible is dependent upon another and the intangibles "are not easily separated." The Guide also states "the question is whether the business . . . could be separated from the real estate" or, more broadly, "[i]f the real estate [could] be sold without the intangible."[10]

2. *The Response*

An intangible asset need not "be capable of being separate and divisible from real estate" as the IAAO Guide contends for the intangible to be recognized, and the "separability test" is unnecessary. No reason is given for separability in the IAAO's list of requirements for identifying intangibles. In fact, so long as there is adequate data available for placing a value on an intangible, even one that is not easily separated from real estate, the ability to divide the intangible from the real estate is irrelevant.

California's State Board of Equalization (SBE) addressed the issue of "separability" when it approved *Assessors' Handbook* Section 502 in December 1998.[11] In Issue Paper Number 98-031, which was released prior to approving *Assessors' Handbook* Section 502, the California SBE considered the question of separability.[12] On December 7, 1998, the California SBE's Property Tax Committee determined that separability was not necessary in order to recognize an intangible asset or right for purposes of removing the intangible's value in the property tax assessment of taxable real and personal property.[13] Based on this decision, the California SBE included language in *Assessors' Handbook* Section 502, Chapter 6 (entitled "Treatment of Intangible Assets and Rights") stating that while some intangible assets and rights may be identifiable but not capable of segregation, the inability to separate an intangible "does not prevent recognition of the value" of the intangible.[14] The California SBE's guidance is consistent with that of Reilly and Schweihs issued ten years later: "[T]here is absolutely no requirement that the intangible asset has to be transferable separately from other assets. In other words, the subject commercial intangible asset may be sold with other tangible assets and/or with other intangible assets."[15]

The IAAO Guide is unclear about what types of intangibles must be found separable. The example provided is the "historical significance" of the Waldorf Astoria Hotel in New York City.[16] The Guide then refers to other types of "real property attributes" that are intangible in nature and cannot be sold without the real property, such as view, proximity (location), prestige and appeal.[17] Later, the Guide refers to "real property intangibles" such as zoning and air rights.[18] All of these intangible attributes of real property are properly tied to the real property because they are integral to the property (just as a property's layout, design, or architectural style is integral to the property). These intangible real property attributes are taxable under California *Revenue and Taxation Code* section 110(f) and the California Supreme Court's guidance: "[I]ntangible attributes of real property" include location, proximity, zoning, view, architecture and other attributes that "are an integral part of" the real property, but "intangible attributes" do not include rights exercised in connection with the use of real property.[19] But aside from this limited set of intangible real property attributes, the value of all other intangible attributes, even those closely aligned with the real property, must be removed.

B. Ownership Is Not Relevant in the Intangibles Value Exclusion Process

1. *The Issue*

The IAAO Guide states that "the sale of a hotel with a franchise and management agreement in place does not include the value of those assets [the agreement]" because the value of the agreement inures to the hotel management company and not the hotel owner. The first sentence of the paragraph in which this statement appears provides the context: "a property sells and the intangible assets are included in the price." Another place in the Guide says that the "intangible assets owned by others, such as the franchisor or third-party management agreement [of a hotel]," need not be excluded even if they were included in the purchase price for the sale of a going-concern that includes real estate, personal property and an ongoing business. In the Income Approach context, the Guide also asserts that management and franchise are owned by the management or franchise company.[20]

2. *The Response*

In the circumstance where a purchase price is paid for a going-concern consisting of real property, personal property *and* intangible assets, that purchase price must be allocated to all of the assets that were included in the purchase. While the IAAO Guide generally concurs with this, the Guide also singles out hotel management and franchise agreements as not being subject to this standard. But when intangible assets are included in the purchase price paid for a hotel property, a portion of that price must be allocated to those assets, i.e., the management/franchise agreement. Likewise, when the management/franchise agreement generates revenues for a going-concern, a portion of that going-concern's value must be allocated to the intangible. That is so *regardless* of who owns the agreement because the benefits flowing from that intangible agreement accrue to *both* the hotel manager *and* the hotel owner. Those benefits accrue to the manager and the owner because they share the *legal rights to use* (a) the real property and (b) the intangible assets/rights under the management/franchise agreement. This issue is discussed in more detail in the "Management Fee" method section below.

Similar misdirection appears in the IAAO Guide's discussion of assembled workforce: "Typically, the management company of a hotel, not the owner, hires the managers and workers. Therefore any value of the *assembled workforce* belongs to the management company."[21] Again, the issue is not who "owns" the workforce, but who *benefits* from the presence of the workforce and who holds the legal right to use and benefit from that workforce. Both the hotel manager *and* the hotel owner benefit from a hotel's workforce—the manager earns a management fee, and the owner makes revenues. (Moreover, even if the manager hires the workforce, the hotel owner pays the salaries and wages of the managers and workers in that workforce.)

C. Accounting/Tax Records Should Not Be Used to Allocate Value to Intangibles

1. *The Issue*

In the context of analyzing property sales, particularly sales of going-concern properties which include intangibles, the IAAO Guide encourages assessors to consider sales price allocations appearing in financial reports and accounting documents as well as filings under *Internal Revenue Code* section 1060.[22] However, the Guide also counsels assessors not to rely on accounting valuations because "[t]he classification and method for estimating and allocating intangible value for accounting purposes are rarely the same [as those] for property tax purposes," and not to rely on financial reporting information because "the type of value required for financial reporting [accounting purposes] is typically fair value. . . . The definition of fair value is different from that for property tax purposes (typically market value)."[23]

2. *The Response*

The instructions on Page 47 of the IAAO Guide are proper. Reliance on valuations performed for accounting or tax reporting purposes are nearly always irrelevant and inappropriate for use in property tax assessment appraisals. This is demonstrated by the Guide's citation to the decision in *Hilliard City Schools Board of Education v. Franklin County Board of Revision,*[24] where the Ohio Supreme Court declined to use accounting information in favor of an appraisal.[25] Similarly, the use of value allocations made for federal tax purposes was rejected by the California Court of Appeal:

> [T]he proposition that a sales price is prima facie evidence of fair market value . . . holds . . . true with respect to an arm's length, open market sale . . . with the proviso that the probative value of such sale may be displaced by a variety of factors, including the influence of *tax* and other business considerations. . . . [P]laintiffs' contractual allocation of the purchase price . . . minimized the value of the [real] property as compared with

> the business assets [intangibles]. These allocations largely reflected plaintiffs' own construction of the values, and at least one of them was specifically made for *federal tax purposes*.[26]

The IAAO Guide's discussion of this topic concludes: "Valuation and allocation for accounting purposes *may* be different from, and *possibly* not applicable to, the value of real property in a property tax assessment scenario. . . . Although accounting documents may not prove or disprove the presence or value of intangible assets, they do represent another piece to the puzzle that *could* assist the appraiser or assessor in reaching a supportable estimate of value."[27] The equivocating nature of these statements casts doubt on accounting (or tax) reporting documents, and such information should not be used for purposes of allocating value to intangibles in the property tax assessment of real property.

D. The "Management Fee" Method Does Not Remove the Value of Intangibles

1. *The Issue*

The Rushmore "Management Fee" method asserts generally that deducting a management and/or franchise fee or other operating costs accounts for (removes) the value of intangible assets from assessment: "Rushmore's assertion is that, by deducting the costs associated with intangible value . . . from a property's operating expenses, the remaining NOI is for the real property only."[28] Put another way:

> The management fee approach is based on the premise that any intangible value arising from a going-concern can be measured by capitalizing the management fee necessary to compensate a third party to run the business. . . . Theoretically, under this method, any value arising from the management of the business has been excluded. Under the theory of substitution, no one would pay more for a business or building than the presumed cost to replace it.[29]

The IAAO Guide contends that "hotels usually sell with the intangibles excluded from the transaction price through [management fee] deductions in the pricing decision that represent business-related intangible assets."[30] Finally, the Guide also asserts that when an income approach is used, the Rushmore "Management Fee" method is the "best method for excluding intangible value in an income approach" and "is the most valid approach for excluding intangible assets in an income approach."[31]

2. *The Response*

i. <u>*The Relationship between the Hotel Owner and Hotel Operator under the Management/Franchise Agreement*</u>

When an income capitalization approach is used to value a property and the income used in the approach is generated by all forms of property in use, including real property, personal property, and intangible property, the resulting value represents the value of *all forms of property* that generated the income, including the real property, personal property and intangible property. The general appraisal principle is set forth in a decision by the California Court of Appeal: "When the capitalization-of-income approach is used as a basis for an opinion of or considered in determining the market value of an operating enterprise, the result is a determination of the total value of all of the items of property which are a part of that enterprise."[32]

The Rushmore "Management Fee" method assumes that a hotel owner and a hotel manager have entered into a hotel management or franchise agreement under which the manager will operate a hotel on the hotel owner's behalf. Under this agreement, the hotel owner provides a hotel facility for the hotel manager to operate. In return, the hotel manager provides to the hotel owner the benefits of the hotel manager's management expertise as well as the benefits relating to the hotel manager's name or "brand."

The intangible contractual rights of the hotel owner and the hotel manager, and the interests created by those rights, are aligned under the management/franchise agreement because the owner and manager are both engaged in an ongoing hotel enterprise using the same tangible and intangible property, and their mutual success depends on how well the hotel performs financially. Success under the management/franchise agreement comes in two parts. First, the hotel manager succeeds if it receives a management fee as called for in the contract. Because the management fee is usually a percentage of revenues generated, the fee is tied to the hotel's performance. (The IAAO Guide asserts that any return to the business from a management/franchise agreement arises from this percentage of revenues element.[33] But because the *entire* percentage management fee is paid to the manager, and not the hotel owner, the percentage fee does *not* capture any of the value of the management/franchise agreement to the owner.) And second, the hotel owner succeeds if the hotel produces revenues sufficient to pay the hotel manager's fee *and* the hotel produces incremental additional revenue over and above the fee paid to the hotel manager, which revenue goes to the hotel owner.

ii. <u>*"Return of" and Return on" the Management/ Franchise Agreement*</u>

The Management Fee method deducts the management or franchise fee as a regular operating expense in a standard income capitalization analysis: "the management fee approach can be applied by including a going-concern management fee as an operating expense."[34] The deduction of the management/ franchise fee in the Management Fee method amounts to the hotel owner's repayment of the fee to the hotel manager. It is, in the strictest sense, the cost to the hotel owner for having a management company or franchisee operate the owner's hotel. As such, it literally represents the "return of" the management fee to the hotel manager. Referring back to a portion of the IAAO Guide cited above, it represents the "cost to replace" the management agreement under the "theory of substitution."[35]

The Management Fee method's contention that the deduction of the management fee represents the full value of the intangible non-taxable hotel management/franchise agreement is short-sighted and misleading. First, no hotel owner would hire a hotel manager if doing so did not produce additional revenue to the hotel owner. Why would a hotel owner pay a hotel manager a management/franchise fee if, at the end of the year, the revenue brought in by the hotel manager's efforts was only enough to pay the management/ franchise fee to the manager? All of the revenue attributable to hiring the hotel manager would be paid to the manager, and the hotel owner would be no better off than if he had not hired the manager in the first place.

Clearly, the hotel owner will only hire a hotel manager if the manager will increase the hotel's revenue by more than the amount of the management/franchise fee paid to the manager. In other words, the hotel owner will not hire a hotel manager if there is only a "return of" the management/franchise agreement through payment of the management/franchise fee. There also has to be a "return on" the management/franchise agreement to the hotel owner, meaning that as a result of hiring the hotel manager and entering into the management/franchise agreement, the hotel owner receives additional revenue *over and above the fee* paid to the hotel manager.

An example is in order. Assume a hotel owner can make $10 million per year operating a hotel by himself. Alternatively, the owner can engage a hotel manager to operate the hotel under a management agreement which requires payment of a four percent (4%) management fee (or $400,000). For the owner to pay the manager the management fee and make the same $10 million as before, the manager's efforts have to increase the hotel's revenues by the amount of the management fee (4% or about $400,000) to $10.4 million. However, at this level of operating revenue the hotel owner only nets $10 million after paying the management fee to the manager (the "return of" the management fee), and so the owner will be ambivalent about whether or not to retain the manager. The hotel owner will only hire a manager (enter into a management agreement) if the manager's efforts *increase the hotel's revenues by more than 4%* (more than $400,000) so that the hotel owner receives a "return on" his investment in the hotel management agreement over and above the "return of" the management fee to the manager.

This is where the second fallacy in the Management Fee method arises. The Management Fee method asserts that the hotel management company holds all of the rights to the management/franchise agreement or, stated another way, that all of the benefits and value of that agreement resides with the manager. But such is not the case for two reasons: (a) the hotel owner has obtained access to the rights held by the manager/franchisor by virtue of the management/ franchise agreement (as described above, the hotel owner and manager are essentially partners or joint venturers in the hotel enterprise by virtue of the management/franchise agreement); and (b) although the management fee ("return of") may be paid to the manager/franchisor, the additional revenue earned by the hotel as a result of the management/ franchise agreement over and above the management fee, the "return on," *belongs to the hotel owner* based on the allocation of intangible contractual rights under the management/ franchise agreement. The manager does not receive the additional revenue generated by the management/franchise agreement over and above the management fee, only the hotel owner does. It is this "return on" which arises from the manager's and owner's shared rights in the management/ franchise agreement which the Management Fee method fails to take into consideration.

Note that this analysis is not dependent on who "owns" the rights under the management/franchise agreement (in fact, there is an allocation of rights under that agreement). If the total revenues generated by the hotel are being used in an Income Approach to value the hotel, the resultant business enterprise value includes return to both the hotel owner and the hotel manager. In this circumstance, the full value of the management/franchise agreement must be removed, i.e., return of and return on, and the ownership of the agreement is irrelevant.

Investors demand both a return of their investment (a recapture of the investment) and return on their investment (a yield on the investment). Thus, "return of" and "return on" are always required if an investor is to undertake any form of investment. This is true both for investments in real property as well as investment in a hotel management/ franchise agreement. The California SBE has recognized the "return on" requirement in its *Assessors' Handbook* Section 502: "An investor's expected return must include both an economic reward and a recovery of invested capital. The economic reward is the *return on* capital, ..."[36] The "return on" concept was explicitly applied to the Management Fee method by the California SBE:

> The value of intangible assets and rights cannot be removed by merely deducting the related expenses from the income stream to be capitalized. Allowing a deduction for the associated expense does not allow for a *return on* the capital expenditure. . . . 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*.[37]

This is consistent with California Property Tax Rule 8(e) relating to the Income Approach which states: "When income from operating a property is used, sufficient income shall be excluded to provide a *return on* working capital and other nontaxable operating assets [i.e., intangible assets and rights] and to compensate unpaid or underpaid management."[38] Rule 8(e) has the force of law in California.

The IAAO Guide asserts: "whether a deduction of a management fee and related brand expenses adequately removes business or other intangible asset values in a hotel valuation by a real property appraiser should be based on verified market behavior."[39] Quoting Elgonemy: "Appraisers should value hotels the same way that investors analyze deals."[40] If investors demand a return of *and* a return on their investment in a hotel management/franchise agreement, then the "Management Fee" method, which only provides a return of, is not "consistent with the observed market behavior" of hotel investors in the "transaction market [which] is the primary source of appropriate valuation methodology to replicate in any appraisal."[41] It is noteworthy that the Guide provides no statements from hotel investors as to how they treat intangibles in hotel investment decisions.

iii. <u>*California's Court of Appeal Has Disapproved the "Management Fee" Method*</u>

The application of the Rushmore "Management Fee" method to a major resort hotel was expressly disapproved by the California Court of Appeal in 2014:

> We disagree with the County's claim that "the intangible value was removed by deducting the management and franchise fee." The Assessor . . . did not explain how that deduction captured the "majority" of intangible property. . . . The Assessor's reliance on the deduction of the management and franchise fee—and its refusal to identify and value certain intangible assets—is akin to paying "lip service to the concept of exempting intangible assets from taxation," a practice condemned in *GTE Sprint* [*Communications Corp. v. County of Alameda* (1994)] 26 Cal.App.4th at p. 1005.[42]

In the final analysis, the Rushmore "Management Fee" method capitalizes operating revenues into a going concern value. The fact that the management/franchise fee is deducted does not prevent that result. That being the case, there is no difference between the Management Fee method and a standard income capitalization approach that arrives at a business enterprise value. Furthermore, if the operating revenue being capitalized is generated in part from the presence of intangible assets, but nothing is removed from the resulting indication of value by the income approach for those intangibles, the resulting value will necessarily subsume the value of intangible assets.

To sum up, the IAAO Guide states: "Rushmore's assertion is that, by deducting the costs associated with intangible value . . . from a property's operating expenses, the remaining NOI is for the real property only."[43] Thus, a standard income approach, without any other adjustment, does not include the value of intangible assets. But, as the appellate court said in *SHC Half Moon Bay*, there is no explanation provided as to how the deduction of a management or franchise fee removes the *value* of the intangible rights embodied in the management/franchise agreement. The Guide afforded the IAAO an opportunity to address this and related questions in a non-litigation context. While IAAO Committee documented their awareness of these issues in the Guide, they did not address them in any meaningful way.

iv. <u>*The Rushmore "Management Fee" Method Is Not Widely Embraced by Courts*</u>

The IAAO Guide asserts that the Rushmore Management Fee method is "widely embraced by the courts" and lists judicial decisions in support of this view.[44]

Careful review of those decisions reveals the following. The Guide cites thirteen cases in support of the Rushmore Management Fee method (fourteen cases are discussed, but the Maryland decision, *RRI Acquisition Company, Inc. v. Supervisor of Assessments of Howard County*,[45] is cited twice). Of those thirteen cases, six were issued by the New Jersey Tax Court. The two Michigan decisions were issued by the Michigan Tax Tribunal, which is not a court (although the Guide refers to the Michigan Tax Tribunal as court), and one of those decisions contains some criticism of the Rushmore method. The Guide cites two decisions from the District of Columbia, both relating to the same hotel property. The 2015 decision was issued by a trial court (Superior Court). The 2009 District of Columbia decision is not reported, so the specific tribunal and the content of the decision cannot be confirmed. Finally, the Guide cites to the 2013 California Court of Appeal decision in *EHP Glendale, LLC v. County of Los Angeles* (*EHP II*),[46] even though that decision was subsequently decertified and depublished by the California Supreme Court.

Regarding New Jersey, two of the cited decisions contain the following language:

> This decision is based upon the consideration of the reasoning and supporting data addressed in the record of this case for the particular adjustments proposed. It should not be understood as a definitive pronouncement on appraisal practices designed to extract real estate value from the assets of a business or as binding precedent with respect to adjustments of the kind proposed here, should they be offered in other cases with different records.[47]

The second case, *BRE Prime Properties, LLC v. Borough of Hasbrouck Heights*,[48] has not been certified for publication by the New Jersey Tax Court Committee on Opinions. And in a third case, the New Jersey Superior Court Appellate Division found that the taxing jurisdiction's opinion of value under the income approach did not account adequately for the value of the intangible business assets in the valuation of a casino-hotel.[49]

To summarize, the IAAO Guide reports that the Rushmore Management Fee method has been embraced by courts in only six states. Six of the thirteen decisions cited are from New Jersey, but three of those decisions do not unequivocally approve the Rushmore method. Two of the thirteen decisions were not issued by a court but by the Michigan Tax Tribunal and so have limited precedential value. The two decisions from the District of Columbia pertain to the same property, although the citation to one of those decisions cannot be located, and the other decision is by a lower court. And the California decision cited by the Guide has been decertified and depublished by the California Supreme Court. In light of the above, it is difficult to support the Guide's assertion that the Rushmore method "has been widely embraced by the courts." Moreover, there is at least one case disapproving the Management Fee Method: *SHC Half Moon Bay LLC v. County of San Mateo*.

III. *THE IAAO GUIDE MIS-CITES PERTINENT LAW AND IGNORES KEY AUTHORITIES*

The IAAO Guide reads like a legal brief, citing 52 cases or administrative decisions. But this legalistic patina is thin. The main problem is that the Guide does not acknowledge the basic hierarchy of authority: a tax tribunal or trial court decision is not binding authority as a general rule, and is not equivalent to a published appellate court decision. The Guide cites many authorities, but the citation-heavy format should not be construed to add credibility. Careful review reveals undisciplined and indiscriminate references to authorities, most of which are not binding, and the omission of authorities which are in fact precedential. Moreover, many of the authorities cited are difficult to obtain because they are opinions by state or provincial boards of review or equalization which have no binding or precedential effect. In some cases, the decisions are not readily accessed, which makes vetting such references impossible without significant additional effort.

A. Skilled and Assembled Workforce

The IAAO Guide's reliance on questionable citations is illustrated by focusing on its discussion of skilled and assembled workforce.[50] The Guide offers five legal citations in support of its advice that the assembled workforce intangible need not be recognized or deducted in valuing real property:

1. *Boise Cascade Corporation v. Department of Revenue*[51]: "The Oregon Tax Court rejected the workforce argument in a case involving the assessment of a veneer mill. In that case, the court said, 'management or work force in place [value] . . . should not be deducted from any estimate of market value.'"

2. *EHP Glendale, LLC v. County of Los Angeles* (*EHP I*)[52]: "The court rejected the workforce argument, stating 'Absent superior management of an exceptional workforce, though, the presence of prudent management and a reasonably skilled workforce are required to put a property to its beneficial and productive use, and no additional value needs to be deducted from the income stream.'"

3. *HC Half Moon Bay, LLC v. County of San Mateo*[53]: "[T]he court determined that the assessor failed to remove the value of the hotel's assembled workforce, stating, '. . . the deduction of the management fee from the hotel's projected revenue stream did not—as required by California law—identify and exclude intangible assets such as the hotel's assembled workforce.'"

4. F*airmont Hotels & Resorts v. Capital Assessor, Area No. 01*[54]: "The court recognized that a trained workforce is intertwined with the real estate, and its frequent turnover negates its value, stating,

> 'With respect to an assembled workforce, while we accept that there must have been an initial investment in hiring and training a workforce, we do not accept that the initial investment necessarily continues to have discreet market value. . . . We find that such value is inextricably intertwined with the realty.'"

5. *CP Hotels Real Estate Corp. v. Municipality of Jasper*[55]: "[T]he court recognized an assembled workforce might not be desired by a potential buyer, saying, 'the assembled workforce may actually be a liability, instead of an asset.'"

Each of these five citations is problematic for the reasons set forth below.

Boise Cascade Corporation. The Oregon Legislature amended Oregon Revised Statutes section 307.020 in 1993 to expressly include assembled workforce within the statutory definition of intangible assets. The IAAO Guide cites as authority a case that was superseded by subsequent legislation.

EHP Glendale, LLC. The language in the IAAO Guide attributed to *EHP I* is not found in that case. The quoted language is actually found in a later 2013 decision by the California Court of Appeal in the same case.[56] *EHP II* was wrongly decided and inconsistent with California law, and the California Supreme Court decertified *EHP II* and ordered it be depublished on December 18, 2013. Depublished cases are not citable authority under California law. The Guide also includes the following statement relating to *EHP II*: "The court approved the Rushmore approach, despite the California State Board of Equalization *Assessors' Handbook*, Section 502, disallowing the use of the management fee approach alone."[57] Plainly, this reference is also invalid. In sum, the Guide cites as authority language from a case that is not citable and not deemed reliable by the California Supreme Court.

SHC Half Moon Bay. The IAAO Guide correctly cites this case, which contradicts the Guide's support for the Rushmore Management Fee method. Contrary to the Guide, there are no "conflicting rulings" relating to workforce in the California Court of Appeal[58] because the *EHP II* decision is not good law. In fact, the Guide fails to cite three other California Court of Appeal cases in accord with *SHC Half Moon Bay*, all holding that assembled workforce is an intangible asset that must be removed from assessment.[59] The Guide also fails to disclose the California SBE's recognition of assembled workforce as an intangible asset (workforce is a component "of enterprise value that create[s] value separate and apart from any value inherent in the tangible assets") and requirement that such value be removed from the assessment.[60] Therefore, the Guide misleads the reader into thinking that California courts have ruled that assembled workforce is not a recognized non-taxable intangible when the opposite is the case.

Fairmont Hotels & Resorts / CP Hotels Real Estate Corp. These are Canadian assessment review board decisions and are not precedential authority. Moreover, the Guide ignores legal authority that is contrary to the remarks contained in *Fairmont Hotels & Resorts* to the effect that if the intangible and tangible assets are "intertwined," then the intangible assets need not be removed from the assessment. The California Supreme Court has expressly explained that even if an intangible asset is "intertwined" so that it is necessary for the "beneficial and productive use" of the real property, the value of such intangible components must still be removed from the assessment:

> [I]f the intangible assets are necessary to the beneficial and productive use of the taxable property, the court must determine whether the plaintiff has put forth credible evidence that the fair market value of those assets has been improperly subsumed in the valuation. If so, then the valuation violates [Revenue and Taxation Code] section 110(d)(1), which prohibits an assessor from using the value of intangible rights and assets to enhance the value of taxable property, and the fair market value of those assets must be removed.[61]

Courts in other states have similarly found that the "inextricably intertwined" argument does not overcome the principle that real property assessments should not be based on business value.[62]

Thus, the Guide identifies *no* citable authority with precedential effect in support of its position on assembled workforce, and the sole valid authority it does cite, *SHC Half Moon Bay*, rejects the premise underlying the Rushmore Management Fee method (deduction of employee salaries and wages as an operating expense removes the value of workforce) and actually requires that the value of an assembled workforce be removed from assessment. This is an example of selective citation intended to advance a particular viewpoint, instead of a balanced consideration of actual authority which is inconsistent with the advocated policy. The important conclusion is the Guide's citation of authority cannot be taken at face value: each assertion must be examined for validity and accuracy before it may be relied upon.

B. Start-up Costs and the Business Enterprise Value Approach

The IAAO Guide contends that business start-up costs are not an intangible that should be recognized in the assessment of properties. The Guide reasons that start-up costs, such as pre-opening marketing and workforce training for a hotel property, only occur at the initial opening of a property. The Guide concludes that because marketing and workforce costs are deducted as operating expenses when existing hotels are appraised, the deduction of start-up expenses as an intangible asset is unnecessary and improper.[63] The start-up costs issue is a subset of the business enterprise value (BEV) approach. The IAAO Guide dismisses the BEV approach because the approach is not broadly accepted in the appraisal community or the market.[64]

The purpose of this response is not to side with those favoring deduction of start-up expenses or those opposed to doing so, or to become involved in the broader dispute between those who support and those who do not support the BEV approach. However, the lack of depth to the legal authorities cited in the IAAO Guide as support for the views opposing deduction of start-up costs and the BEV approach is noteworthy. The IAAO Guide cites eight cases in all relating to start-up costs and the BEV approach. Four of those cases are cited as supporting the Guide's views on both topics.

Five of the cases cited in the IAAO Guide support the "no start-up cost" viewpoint, and one does not. One of those five cases was issued by a trial court.[65] Three other decisions were issued by tax tribunals.[66] These decisions, from the District of Columbia, Maryland, Canada and Maine, are trial court or assessment review board decisions, and some of them have limited precedential impact. The Guide only references one published court decision from New Jersey as opposing the start-up costs position.[67]

The IAAO Guide also cites five decisions that oppose the BEV approach, and one that supports it. The Guide says there are other cases which have "embraced the BEV approach," but does not cite to any of those cases.[68] One such case is a decision by the Appeals Court of Massachusetts which held that the assessor and tax appeal board were required to make deductions for hotel business enterprise value elements.[69] Of the five opposition decisions cited in the Guide, three are from assessment review boards and may have limited precedential effect.[70] One decision was issued by the Iowa Supreme Court twenty years ago; the Guide reports that an Iowa statute required that the court reject the BEV approach in that case because it was not widely accepted by the appraisal community at that time.[71] The only other opposing decision cited by the Guide is once again the New Jersey decision in the *Saddle Brook* Marriott Hotel case.[72] The IAAO Guide puts considerable reliance on this one decision by the New Jersey Tax Court, also citing the case three other times.[73]

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

The IAAO Guide states that fee-simple value for leased properties is found by using market rents, and goes on to say that above-market leases are part of real property and are not intangible.[74] The Guide cites no authority for the latter assertion other than USPAP FAQ 193.[75] The Guide does not cite a conflicting Wisconsin Supreme Court decision which found that above-market leases are not real property or part of fee simple estate property rights.[76] The Guide also does not reference Indiana Tax Court and Kansas Court of Appeals decisions that reached the same conclusion.[77]

D. Goodwill

The IAAO Guide says "Because . . . courts have ruled the value of goodwill is reflected in a management fee, it is safe to say that applying the management fee technique in an income approach effectively removes any goodwill value in the estimate of real property."[78] This conclusion is based solely on the IAAO's incorrect reading of the California Court of Appeal's decision in the *SHC Half Moon Bay* case.

In *SHC Half Moon Bay* the taxpayer identified goodwill as the residual value in a cost segregation appraisal. Because of that, the Court of Appeal found that the taxpayer had failed to present sufficient evidence showing that the deduction of the management fee did not remove goodwill. But this finding must be understood in the context of the review standards used by California appellate courts. In this case, the appellate court determined that the taxpayer had not presented substantial evidence (i.e., facts) showing that the management fee did not remove the value of the hotel's goodwill. However, the court also said that other evidence might have been presented that would show how the management fee failed to remove the value of goodwill: "[t]here *may* be situations where the taxpayer can establish the deduction of a management and franchise fee from a hotel's income stream does not capture the intangible asset of goodwill, but SHC, the taxpayer, has failed to do so here."[79]

The *SHC Half Moon Bay* decision left open the possibility that another taxpayer could demonstrate that goodwill is not removed by the deduction of a management fee. Stated another way, the Court of Appeal did *not* rule as a matter of law, and therefore did not foreclose the possibility that another taxpayer might show, based on different facts, that deduction of a management fee does not in and of itself remove the value of goodwill. Thus, the IAAO's conclusory statement that the management fee technique removes goodwill value was not established as a matter of law in *SHC Half Moon Bay*, but only under the facts of that particular case.

The deduction of goodwill as an intangible asset has been approved by courts in other states.[80] Also, the California SBE says that goodwill is an intangible and that its value should be deducted.[81]

E. Go-Dark Valuation

The IAAO Guide contains a brief discussion of the go-dark valuation issue.[82] Go-dark valuation has engendered significant controversy, and the IAAO has recently issued a "Draft Big Box Position Paper" relating to the "dark store" or go-dark valuation topic.[83] The pejorative terms "go dark" and "dark store theory" have been used by some in the assessment community to refer to the requirement that a leased single tenant retail property be assessed as though vacant and unencumbered by an existing lease. Discussion of go-dark valuation is beyond the scope of this response.

IV. *CONCLUSION: DIRECT VALUATION AND REMOVAL OF IDENTIFIED INTANGIBLES*

The primary purpose of the IAAO Guide is to identify and explain appraisal methods which assessors can use to "effectively exclude" intangibles from property tax assessment without "valuing intangible assets directly."[84] To that end, the Guide asserts that the Rushmore Management Fee method under an income approach is one of the primary ways to remove the value of intangibles when assessing real property.[85] However, as discussed in this response, the Management Fee method is problematic, and the Guide's explanation as to how the method removes intangibles is inadequate. This inadequacy was highlighted by the California Court of Appeal in *SHC Half Moon Bay LLC v. County of San Mateo*. Furthermore, the weaknesses that plague the Guide's explanation of the Management Fee method, including the inaccurate and unbalanced citation to legal authority, also extend to the Guide's discussion of assembled workforce, start-up costs, leases-in-place and goodwill.

Instead of using methods which claim to "effectively exclude" non-taxable intangibles, such as the Management Fee method, appraisers should value identified intangibles directly and deduct the full value of those intangibles—similar to the "parsing income" technique described in the IAAO Guide.[86] Although the Guide says "[t]he courts have generally rejected the parsing income method for property tax purposes," it only cites *Saddle Brook* and *Fairmont Hotels v. Area 01* to support this assertion.[87] In fact, for over two decades the California Court of Appeal, the California Supreme Court, and the California SBE (in its *Assessors' Handbook* and Property Tax Rule 8(e)) have accepted the method of directly identifying and valuing the separate stream of income associated with an identified intangible asset as a valid method for removing the full value of intangible assets in property tax assessment.[88]

The IAAO Guide says that "the real estate market determines whether intangibles are included or excluded," and that the Management Fee method mimics the market.[89] However, the Guide provides no specific proof that the Management Fee method comports with how market participants evaluate properties. Regardless, most state laws require that the *value* of intangible assets be excluded from *ad valorem* property tax assessments.[90] The Guide does not explain how the Management Fee method, an indirect method for removing intangibles, "effectively excludes" the *full* value of non-taxable intangibles. Directly identifying, valuing and deducting the full value of intangible assets, the method California's appellate courts and the California SBE have followed since the *GTE Sprint Communications Corp.* decision was issued in 1994, is a more effective approach.

ENDNOTES

1. Cris K. O'Neall, Greenberg Traurig, LLP, (949) 732-6610, oneallc@gtlaw.com; C. Stephen Davis, Greenberg Traurig, LLP, (949) 732-6527, daviscs@gtlaw.com. The authors thank attorney Sharon F. DiPaolo of Siegel Jennings Co., LPA in Pittsburgh, PA and attorney Lisa F. Stuckey of Ragsdale, Beals, Seigler, Patterson & Gray, LLP in Atlanta, GA for their assistance in researching some of the legal authorities cited in this article. The authors also thank attorney Jennifer Kim of Greenberg Traurig, LLP for her assistance in preparing this article for publication.

2. International Association of Assessing Officers (IAAO), *Understanding Intangible Assets and Real Estate: A Guide for Real Property Valuation Professionals* (Special Committee on Intangibles, 2017) 14 Journal of Property Tax Assessment & Administration pp. 41-91 <http://www.iaao.org/library/2017_Intangibles_web.pdf> (as of June 18, 2017) (hereafter IAAO Special Committee 2017).

3. *Id*. at pp. 41, 68.

4. *Id*. at p. 41.

5. International Association of Assessing Officers, *Technical Standards*, <http://www.iaao.org/wcm/Resources/Publications_access/Technical_Standards/wcm/Resources_Content/Pubs/Technical_Standards.aspx.> (as of June 18, 2017, italics added).

6. IAAO Special Committee 2017, *supra*, pp. 41, 48, 65.

7. *Id*. at pp. 49-50.

8. *Id*. at pp. 50, 51, 60, 65, 66.

9. *Id*. at pp. 45, 48, 65, 66.

10. *Id*. at pp. 42-45, 66.

11. State Board of Equalization (SBE), Assessor's Handbook Section 502: Advanced Appraisal (Dec. 1998) <http://boe.ca.gov/

proptaxes/pdf/ah502.pdf> (as of June 18, 2017) (hereafter SBE AH 502).

12. State Board of Equalization, Issue Paper Number 98-031 (Nov. 5, 1998) <https://www.boe.ca.gov/proptaxes/pdf/1998.pdf> (as of June 18, 2017).

13. State Board of Equalization, Property Tax Committee Meeting Minutes (Dec. 7, 1998) <http://www.boe.ca.gov/proptaxes/pdf/PTC_Minutes_120798.pdf> (as of June 18, 2017).

14. SBE AH 502, *supra*, p.153.

15. Reilly and Schweihs, Guide to Property Tax Valuation (Willamette Management Associates Partners 2008) p. 326.

16. IAAO Special Committee 2017, *supra*, p. 43.

17. *Ibid*.

18. *Id*. at 59.

19. *Elk Hills Power, LLC v. Bd. of Equalization* (2013) 57 Cal.4th 593, 620-21 (hereafter *Elk Hills Power*).

20. IAAO Special Committee 2017, *supra*, pp. 44-45, 50, 53.

21. IAAO Special Committee 2017, *supra*, p. 56.

22. *Id*. at 50.

23. *Id*. at pp. 47, 66.

24. (Ohio B.T.A. 2007) Nos. 2007-M-277, 2007-M-278, affd. *per curiam* (2011) 128 Ohio St.3d 565.

25. *Id*. at p. 51.

26. *American Sheds, Inc. v. County of Los Angeles* (1998) 66 Cal. App. 4th 384, 394, fn.6. italics added; see also *In re Ames Shopping Plaza Wellsboro Borough* (Pa. Commw. Ct. 1984) 476 A.2d 1001, 1004.

27. IAAO Special Committee 2017, *supra*, p. 51, italics added.

28. *Id*. at p. 52.

29. *Id*. at pp.51-52.

30. *Id*. at p. 55.

31. *Id*. at pp.51, 54.

32. *Los Angeles SMSA Ltd. Partnership v. State Bd. of Equalization* (1992) 11 Cal.App.4th 768, 776, fn.6; *Hershey Entertainment and Resorts Co. v. Dauphin County Bd. of Assessment Appeals* (Pa. Comm. Ct. 2005) 874 A.2d 702.

33. IAAO Special Committee 2017, *supra*, p. 52.

34. *Id*. at p. 51.

35. *Ibid*.

36. SBE AH 502, *supra*, p. 62.

37. *Id*. at p. 162, italics added.

38. Italics added.

39. IAAO Special Committee 2017, *supra*, p. 55.

40. *Id*. at p. 53.

41. *Id*. at p. 55.

42. *SHC Half Moon Bay LLC v. County of San Mateo* (2014) 226 Cal.App.4th 417, 492 (hereafter *SHC Half Moon Bay*).

43. IAAO Special Committee 2017, *supra*, p. 52.

44. IAAO Special Committee 2017, *supra*, pp. 53-54.

45. (Md. T.C.M. 2006) No. 03-RP-HO-0055.

46. (2013), 219 Cal.App.4th 1015 (hereafter *EHP II*).

47. *Chesapeake Hotel LP v. Saddle Brook Township* (N.J. T.C. 2005) 22 N.J.Tax 525, 536-37 (hereafter *Saddle Brooke*); *BRE Prime Properties, LLC v. Borough of Hasbrouck Heights* (N.J. T.C. 2013) Nos. 005271-2010, 005644-2011, unpub. (hereafter *BRE Prime Properties*).

48. *BRE Prime Properties*, *supra*, Nos. 005271-2010, 005644-2011, unpub.

49. *Marina District Development Co., LLC v. City of Atlantic City* (N.J. 2013) 27 N.J. Supp. 469.

50. IAAO Special Committee 2017, *supra*, pp. 55-57.

51. *Boise Cascade Corporation v. Dept. of Revenue* (Or. T.C. 1991) 12 OTR 263.

52. *EHP Glendale, LLC v. County of Los Angeles* (2011) 193 Cal. App.4th 262 (hereafter *EHP I*).

53. *SHC Half Moon Bay LLC*, *supra*, 226 Cal.App.4th 417.

54. *Fairmont Hotels & Resorts v. Capital Assessor, Area No. 01,* [2005] CarswellBC 3760 (Can. Tax. A.B.C.).

55. *CP Hotels Real Estate Corp. v. Municipality of Jasper*, [2005] CarswellAlta 2573 (Can. Tax. A.B.C.).

56. *EHP II*, *supra*, 219 Cal.App.4th 1015.

57. IAAO Special Committee 2017, *supra*, p. 54.

58. IAAO Special Committee 2017, *supra*, p. 57.

59. *GTE Sprint Communications Corp. v. County of Alameda* (1994) 26 Cal.App.4th 992, 1007 (hereafter *GTE Sprint Communications Corp.*); *County of Orange v. Orange County Assessment Appeals Bd.* (1993) 13 Cal.App.4th 524, 533; *Shubat v. Sutter County Assessment Appeals Bd.* (1993) 13 Cal.App.4th 795, 798.

60. SBE AH 502, *supra*, pp.154, 156, 160, fn. 130.

61. *Elk Hills Power,supra*, 57 Cal.4th at p. 615.

62. *Walgreen Co. v. City of Madison* (Wis. 2008) 752 N.W.2d 687, 705; *Gregg County Appraisal District v. Laidlaw Waste Systems, Inc.* (Tex.Ct.App.1995) 907 S.W.2d 12, 19-20.

63. IAAO Special Committee 2017, *supra*, pp. 57-58.

64. *Id*. at pp. 62-63.

65. *CHH Capital Hotel Partners LP v. Dist. of Columbia* (2015 D.C. Super. Ct.) No. 2009 CVT 9455.

66. *RRI Acquisition Co., Inc. v. Supervisor of Assessments of Howard County* (Md. T.C.M. 2006) No. 03-RP-HO-0055 (hereafter *RRI Acquisition*); *CP Hotels Real Estate Corp. v. Municipality of Jasper*, [2005] CarswellAlta 2573 (Can. Tax. A.B.C.); *GGP-Maine Mall, LLC v. City of South Portland* (Me. B.A.R. 2008) No. 2008-1 (hereafter *GGP-Maine Mall*).

67. *Saddle Brook*, *supra*, 22 N.J.Tax 525.

68. IAAO Special Committee 2017, *supra*, p. 63.

69. *Analogic Corporation v. Bd.of Assessors of Peabody* (Mass. Ct.App. 1998) 700 N.E.2d 548, 552-554.

70. *RRI Acquisition*, *supra*, No. 03-RP-HO-0055; *Wolfchase Galleria Ltd. Partnership*, Shelby County (Tenn. S.B.E. Mar. 16, 2005); *GGP-Maine Mall*, *supra*, No. 2008-1.

71. *Merle Hay Mall v. Bd. of Review* (Iowa 1997) 564 N.W.2d 419.

72. *Saddle Brook*, *supra*, 22 N.J.Tax 525.

73. IAAO Special Committee 2017, *supra*, pp. 53, 58, 65.

74. IAAO Special Committee 2017, *supra*, p. 59.

75. The Appraisal Foundation, *Uniform Standards of Professional Appraisal Practice* (2016-2017 ed. 2016) p. 299.

76. *Walgreen Co. v. City of Madison*, *supra*, 752 N.W.2d 687, 700-01.

77. *Grant County Assessor v. Kerasotes Showplace Theatres, LLC* (Ind. T.C. 2011) 955 N.E.2d 876, 882-83; *Shelby County Assessor v. CVS Pharmacy, Inc.*(Ind. T.C. 2013) 994 N.E.2d 350, 354; *In Re Equalization Appeal of Prieb Properties, LLC* (Kan.Ct.App. 2012) 275 P.3d 56, 134-36.

78. IAAO Special Committee 2017, *supra*, pp. 60-61.

79. *SHC Half Moon Bay LLC*, *supra*, 226 Cal.App.4th at p. 493, italics added.

80. *T-Mobile USA, Inc. v. Utah State Tax Comm'n* (Utah 2011) 254 P.3d 752; *GTE Sprint Communications Corp*, *supra*, 26 Cal. App.4th 992; *County of Orange v. Orange County Assessment Appeals Bd.*, *supra*, 13 Cal.App.4th 524.

81. SBE AH 502, *supra*, pp. 154, 157, fn. 118, 157-158, 159, 160, fn. 130.

82. IAAO Special Committee 2017, *supra*, pp. 61-62.

83. International Association of Assessing Officers, *Draft Big Bix Position Paper* (2017) <http://www.iaao.org/media/Exposure/Big_Box_6-1-17.pdf >.

84. IAAO Special Committee 2017, *supra*, pp. 48, 50, 66.

85. *Id*. at pp. 51, 54, 66.

86. IAAO Special Committee 2017, *supra*, pp. 64-65.

87. *Id*. at p. 65.

88. *GTE Sprint Communications Corp.*, *supra*, 26 Cal.App.4th 992; *Elk Hills Power LLC v. Bd. of Equalization*, *supra*, 57 Cal.4th at pp. 617-19; SBE AH 502, *supra*, pp. 161-62.

89. IAAO Special Committee 2017, *supra*, pp. 54, 55, 63, 67.

90. *Id*. at p. 41, 48.