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## **EXCLUDING INTANGIBLES FROM PROPERTY**

The title of this presentation suggests that an exclusion of intangibles from property will necessarily include a determination of the tangible portion of real estate. Since this determination is usually made on the basis of the property owner's interest or in the interest of the appraisal district, the opportunity for disagreement is apparent. The Dictionary of Real Estate Appraisal, Appraisal Institute, 3rd Addition, defines these terms as follows:

### Intangible Property -

1. Non-physical items of personal property, e.g., franchises, trademarks, patents, copyrights, goodwill
2. Deferred items such as a development or organization expense

### Tangible Property -

1. Property than can be perceived with the senses; includes land, fixed improvements, furnishings, merchandise, cash, and other items of working capital used in an enterprise.

The Texas Property Tax Code defines as follows:

“Tangible personal property” means personal property than can be seen, weighed, measured, felt, or otherwise perceived by the senses, but does not include a document or other perceptible object that constitutes evidence of a valuable interest, claim, or right and has negligible or no intrinsic value.

“Intangible personal property” means a claim, interest (other than an interest in tangible property), right, or other thing that has value but cannot be see, felt, weighed, measured, or otherwise perceived by the senses, although its existence may be evidenced by a document. It includes a stock, bond, note or account receivable, franchise, license or permit, demand or time deposit, certificate of deposit, share account, share certificate account, share deposit account, insurance policy, annuity, pension, cause of action, contract, and goodwill.

There seems to be only minor debate that other properties such as golf courses, hotels, motels, and health care facilities, have recognized intangible value. Regional shopping centers frequently are the battleground in ad valorem tax cases.

Since, for ad valorem tax purposes, these factors must be defined and valued separately, the methodology of evaluation has also had equal opportunity for disagreement. In order to present an understanding of the evaluation methods, a review of the legal foundation for the exclusion of intangibles follows:

### Constitutional and Statutory Framework

Under the Texas Constitution, all real property and all tangible personal property is taxable, unless specifically exempted by the

constitution. TEX.CONST.art VIII,§ 1(b). The constitution authorizes, but does not mandate, taxation of intangible property. TEX.CONST.art.VIII, § 1(c).

The legislature elected to not tax intangible property. TES. TAX CODEANN. § 11.02 (Vernon 1992).

Taxpayers and tax authorities are taking a keen interest in the valuation of intangibles. Because the value of intangible personal property is not taxable, when its value is intertwined with the value of taxable property, the value of the intangible property must be excluded. *Gregg County Appraisal District v. Laidlaw*.

Moreover, the statutory standards for appraisal practice in Texas require that the value of intangibles be recognized and quantified. USPAP --. The USPAP was adopted by the Texas Legislature in 1991 and its use is required in all appraisals.

Thus, this paper examines how to identify, quantify, and exclude the value of intangible property in valuing property that is otherwise taxable.

Some recent cases include:

1. Simon Property Texas, L.P. vs. Travis Central Appraisal District
- 2.
- 3.
- 4.

### Excluding Intangibles - Two Schools of Thought

Some of the arguments against recognizing business value are as follow:

- Mall land prices uniquely make up the difference between sales price and the depreciated replacement cost of the buildings and other improvements because the sites are monopolistic and unrelated to surrounding retail site prices.

- Appraisers and investors have traditionally not recognized shopping malls as businesses.
- Mall businesses have not been sold, exchanged or valued outside of a tax appeal assignment.
- Mall management does not conduct itself in a manner separate from a specialized real estate management team, is unlicensed, and doesn't consider itself as a taxable revenue entity.
- Malls are really only comprised of a large group of individual businesses and as such are only a means for these businesses to succeed and contribute to the economic health of the community.<sup>1</sup>

Others argue that any excess of contract rental over market rental is an intangible. This is supported by Standard Rule 1-2(e), USPAP.

Shopping Center, Appraisal and Analyses, Appraisal Institute, 1st Edition, 1993, discusses the business value component and presents the opinions of noted appraisers that have concluded that business value does indeed exist in the shopping malls as well as those commonly thought to be combined with business value.

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<sup>1</sup> Arthur E. Ginney, MAI, "Conflict at the Mall: The Tax Reduction Solution", Appraisal Views, a quarterly newsletter published by Schultz, Carr, Bissette & Atwater/VNI

## Valuation - Excluding Intangibles

1. Intangible Value will be the difference between the Market Value and the Depreciated Cost of the real estate.

Calculation of Business Enterprise Value by Extraction		
Total market value of subject property (as indicated by the income and/or sales comparison approaches)		\$54,500,000
Less real property value		
Land (by cost approach)	\$7,500,000	
Building and site improvements (by cost approach)	\$37,500,000	
Total		-\$45,000,000
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Indicated business enterprise value		\$9,500,000

Valuation - Excluding Intangibles

2. Intangible Value will be the difference in value of the income stream capitalized by a market rate not subject to operating agreements and a typical rate for shopping malls.

<b>Determining Value of Intangibles by Difference in Capitalization Rate</b>	
Net Operating Income	\$5,000,000
Capitalization Rate = (Based on analysis of the market for typical shopping centers)	10%
<b>INDICATED VALUE</b>	<b><u>\$50,000,000</u></b>
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Net Operating Income	\$5,000,000
Capitalization Rate = (Based on analysis of the market for typical mall shopping centers)	7.5%
<b>INDICATED VALUE</b>	<b><u>\$66,666,000</u></b>
<b>INDICATED INTANGIBLE VALUE</b>	<b>\$16,666,000</b>

### Valuation - Excluding Intangibles

3. Intangible Value is excluded by deducting from the net income the specific amount attributable to the value of the business.

An additional deduction is made for the return on and of personal property.

Estimation of Business Enterprise Value by Residual Income Allocation		
Net operating income to subject property		\$3,000,000
Less return on hotel business 0.05 x \$30,000,000 business revenue	\$1,500,000	
Less return on personal property 0.11 x \$1,500,000	\$165,000	
Less return of capital in personal property with estimated remaining economic life of 10 years 1/10 x \$1,500,000	\$150,000	
<u>Total</u>		<u>-\$1,815,000</u>
Income allocated to hotel real property Capitalized at indicated market rate for real property only		\$1,185,000
\$1,185,000/.105		\$11,285,000

## ADDENDA

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1. Uniform Standards of Professional Appraisal Practice 1996 Edition
2. "Measuring Intangible Value: Valuation Framework for Shopping Centers", The Appraisal Journal, Spring 1996, pp 25-35
3. "Anchor Stores vs. Developers: The Valuation Battle Continues", The Appraisal Journal, Spring 1996, pp. 16-24
4. "Making Connections: Code Section 197, Intangible Asset Valuation, and Shopping Malls", The Appraisal Journal, Spring 1996, pp. 36-48
5. "Going-Concern Value, Market Value, and Intangible Value". The Appraisal Journal, April 1996, pp. 183-194
6. "Segregating Real Estate Value from Nonrealty Value in Shopping Centers", The Appraisal Journal, January 1996, pp. 1-13
7. "Business Enterprise Value: The Debate Continues", The Appraisal Journal, January 1995, pp. 33-40
8. "The Business Value of Super-Regional Shopping Centers and Malls", The Appraisal Journal, October 1992, pp. 453-462
9. "Does Shopping Mall Development Create Business Value?", The Appraisal Journal, July 1991, pp. 303-313
10. "Operational Items to Consider when Valuing a Regional Mall", The Appraisal Journal, October 1991, pp. 553-556

- 11."Shopping Centers Are a Business Too", The Appraisal Journal, January 1989, pp. 57-64
- 12."The Valuation of Regional and Super-regional Malls", Assessment Digest, September-December 1991, pp. 2-13
- 13."Valuing the Real Estate of Regional Shopping Centers Independently of Operating Business Value Components: A Review of Recent Research", Presented at White Paper Educational Session AIREA Annual Meeting, Chicago, Illinois by Dr. William N. Kinnard, Jr., MAI, SREA, CRE, Real Estate Counseling Group of Connecticut, Inc., May 3, 1990
- 14."The Operation of a Regional or Super Regional Shopping Center: Management-Intensive Operational Business Entrepreneurialship", Presented at SREA 22nd Annual Symposium, San Antonio, Texas by Stephen R. Wheelock, CRE, MAI and Dr. K. Edward Atwood, September 13, 1990
- 15."The Business Enterprise Value Component of Operating Properties: The Example of Shopping Malls", Presented at The American Real Estate and Urban Economics Association Annual Meeting by Jeffrey D. Fisher, Ph.D. and William N. Kinnard, Jr., Ph.D, MAI, SREA, December 28, 1989
- 16."Appraising Golf Courses for Ad Valorem Tax Purposes", The Appraisal Journal, October 1993, pp. 611-616
- 17."Myths about Hotel Business and Personality Values", The Appraisal Journal, October 1993, pp. 608-611
- 18."Considerations in the Valuation of Hotels", The Appraisal Journal, July 1993, pp. 348-356

- 19."Understanding the Unique Aspects of Hotel Property Tax Valuation", The Appraisal Journal, January 1993, pp. 9-27
- 20."The Determination of Hotel Value Components for Ad Valorem Tax Assessment", The Appraisal Journal, July 1993, pp. 342-347
- 21."Mixed Business and Real Estate Components in Hotel Valuation", The Appraisal Journal, July 1996