

POER *Insights*



Your source for information on property tax issues. www.mfpoer.com

Don't Pay Taxes on Business Enterprise Value

By Scott Donald, Vice President, Marvin F. Poer and Company

For the last 25 years, business enterprise value (BEV) has been one of the most controversial issues in the appraisal community. The following white paper discusses the issues behind BEV, the complexities of identifying and quantifying BEV, and the approaches necessary to make sure you Don't Pay Taxes on Business Enterprise Value.



Scott Donald

FOR THE LAST 25 YEARS, business enterprise value (BEV) has been a hot topic of discussion. It has been, and continues to be one of the most controversial issues in the appraisal community. A wide range of opinion exists regarding how to best to deal with it and very little progress has been made in establishing protocols for resolving areas of dispute. ¹

The debate is important for business property owners because intangible assets such as BEV should not be assessed for ad valorem tax purposes. By identifying and subtracting items relating to BEV, taxes can be substantially reduced.

A BUSINESS IS A GOING CONCERN

BEV is just one portion of a business property's "going con-

cern." There is also the real estate (land and building) and the personal property (furniture, fixtures and equipment) as illustrated in Figure 1.

Problems arise when the lines are blurred between intangible value, personal property and the "bricks and dirt."

DEFINING BEV

There are various definitions for business enterprise value and the term has evolved over time. In 1933, the U.S. Supreme Court ini-

tially defined BEV in a ruling involving a public utility.

This court has declared it to be self-evident that there is an element of value in an assembled and established plant, doing business and earning money over one not thus advanced and that this element of value is a property right which should be considered in determining the value of the property upon which the owner has a right to make a fair return. ²

The *Dictionary of Real Estate Appraisal* describes business enterprise value as "a value enhancement that results from items of intangible personal property such as marketing and management skills, an assembled workforce, working capital, trade names, franchises, patents, trademarks, non-realty related contracts/leases, and some operating agreements." ³

Figure 1 - Typical Assets of a Going Concern

Tangible Property		Intangible Property	
Land	Improvements Building Laundry Facilities Maintenance Facilities Landscaping Parking/Driveways	Personal Property Furnishings Washers & dryers Maintenance Equipment Computers Inventory	BEV Business name Assembled Workforce Contractual guarantees Non-realty contracts Goodwill due to reputation

The 12th edition of *The Appraisal of Real Estate* calls BEV, “the existence of a residual intangible personal property component in certain properties.”⁴ When the 13th edition is released later this summer, the definition will most likely be updated.

WHAT KINDS OF PROPERTIES HAVE BEV?

In most management-intensive businesses, BEV plays a major role. These businesses are not a real estate business; they are an operating business that just happens to take place in real estate.⁵

Since all realty-based properties must be managed, Robert Owens contends there is an element of business enterprise value present in virtually all types of real estate.

While varying levels of business expertise (enterprise) are required to run individual properties and in various types of business situations, it is difficult to propose a standard that would differentiate in this regard. For example, it may be argued that it requires greater owner/manager expertise to rent and maintain a rental house in an over-supplied housing market than to operate and manage a new, mid-rise office building in a popular area of a city. Regardless of a person’s position on this, it is noteworthy that neither single-family rental units nor large office buildings are typically men-

Figure 2 - Direct Capitalization Method

Income			
Rooms	ADR	\$302.00	\$25,070,350
Food & Beverage			\$18,623,850
Telephone	Occupancy	56.00%	\$1,292,750
Other Income			\$4,803,800
Total Revenues	No.of Rooms	398	\$49,790,750
Operating Expenses			
Departmental Expenses			
Rooms		\$8,923,050	
Food & Beverage		\$16,127,550	
Telephone		\$553,500	
Rentals, Conference Services & Other Income		\$2,378,400	
Total Departmental Expenses		\$27,982,500	
Undistributed Expenses			
Administrative and General, H.R. & Security		\$4,438,650	
Marketing		\$2,507,350	
Maintenance		\$2,664,750	
Energy		\$1,949,750	
Total Administrative & Housing Expenses		\$11,560,500	
Fixed Expenses			
Property Tax		\$0	
Insurance		\$547,708	
Other Expense		\$355,300	
Real Property Reserves (3 % of Room Revenue)		\$752,111	
Total Fixed Expenses		\$1,655,118	
Total Operating Expenses			\$41,198,118
Net Operating Income From Operations			\$8,592,632
Total Income Attributable to Personal Property			\$1,700,000
Total Income Attributable to Going Concern			\$2,258,252
Net Income Attributable To Real Property			\$4,634,380
Tax Adjusted Cap Rate	7.60%		
Value Estimate of Real Property			\$60,978,680

tioned as candidates for BEV consideration, suggesting that the level of owner/manager expertise may not be an adequate discriminator for BEV identification.⁶

In addition to management expertise, other examples of BEV can be found in the following:

- **Hospitality** – franchise, contracts, labor agreements, historic elements
- **Healthcare** – return on personal property, merger and

acquisition activity, non-realty contracts

- **Shopping Malls** – location, tenant mix, customer lists
- **Restaurants** – business name, liquor license, clientele
- **Manufacturing Facilities** – design, product, innovations

THE BIG PICTURE

The value for the total going concern of the business must be determined before the BEV can be extracted. Figure 2 shows how the

going concern of a hotel property can be calculated in a simplistic but palatable presentation to the tax assessor. It is a hybrid of a two-year averaged direct capitalization. Figure 3 provides the types of assumptions employed in the direct capitalization, as well as the calculation of income attributable to personal property and the going concern.

The direct capitalization method rolls forward an historic look at the hotel’s income stream

and demonstrates its potential direction. The return of the personal property is usually accounted for in the subtraction of the existing assessment. However, this leaves not only the return on the assets that contribute to the business but also accounts for a floor value, which ignores potential write offs and fair market value of the actual assets.

The income attributable to the going concern takes into account the return of and on the management and franchise fees. Often, only the expense of these two accounts is measured and the full impact of their worth to the entity is overlooked.

THE DEVIL'S IN THE DETAILS

Even when there's agreement that BEV conceptually exists, figuring out the portion of a property's total going concern that might be identified as BEV is still no easy task. There are divergent methods of estimating BEV and no single technique is universally accepted.⁷

Knowledge of the property type is critical in identifying and calculating intangible business enterprise value. Just as important is the understanding of the industry and its place in the local economy. Key Performance Indicators (KPI) can help define, measure and assess the state of the business. These are not goals or business drivers; they are used to value unique attributes such as the benefits of leadership, service and client satisfaction. When used

Figure 3 - Assumptions & Calculations to Direct Cap

Assumptions			
Personal Property Value	\$7,000,000	Book Value	Number
Capitalization Rate	6.50%	Per Room	of Rooms
Tax Adjusted Cap Rate	7.60%	\$17,588	398
Calculation of Personal Property Income			
1. Reserves for Replacement of Personal Property			
Cost Basis	Recapture Rate	Total Allocation	Useful life
\$7,000,000	14.29%	\$1,000,000	7 Yrs.
2. Return on Personal Property			
Cost Basis	Return On PP	Total Allocation	Mtg. Rate of Real Estate + Chattel
\$7,000,000	10.00%	\$700,000	8% 2%
Total Income Attributable to Personal Property			\$1,700,000
Calculation of Income Attributable to Going Concern			
1. Management Contract: (Management Fee & Franchise Fee)			
Mgmt. Contract	Base Cap Rate	Enterprise Value	
\$1,931,400	6.50%	\$29,713,846	
2. Adjusted Management Fee:			
Enterprise Value	Cap Rate	Adj. Mgmt Fee	
\$29,713,846	7.60%	\$2,258,252	\$2,258,252

by professionals in risk management or business performance, this useful data can help analyze and segregate the BEV from the going concern.

WHAT'S THE BEST APPROACH?

The most common method of BEV analysis is the *income approach*. This is due in large part to the obvious. Since businesses are measured in terms of profit, the income approach is easily the most applicable yardstick available. Depending on the type of property and the availability of data, a simple income approach methodology is the use of variables. These multipliers are based on industry standards and applied to annual cash flow, total gross revenue, total net revenue

and/or some other desired income basis.

Another approach is a cost analysis of a business that is either new, unique or has a dearth of historical operating data.

A *sales or market data approach* is applicable where enough data from transactions in regulated industries is available, such as healthcare facilities and specific manufacturing plants.

CALCULATING BEV

The income associated with BEV can be calculated in a variety of ways by various components. Some condensed examples are:

- **Direct Cap** – A cash flow is developed, which accounts for the income stream along with the direct and indirect charges. It extracts allocated income (treated in essence as an

expense to this cash flow) for the return on and of the business, as well as a return on and of the contributing furniture, fixtures and equipment.

- **Direct Expense and Allocation** – Management and franchise fees are expensed and the personal property assessment is subtracted from the composite capitalized value.
- **Business Residual Technique** – The realty and personalty is extracted from the net operating income in order to capitalize the remaining BEV.
- **Extraction Methodology** – A direct capitalization is applied to the income stream of the real estate and extracted from the purchase price.
- **Variables or Multipliers** – Previously discussed.

There are numerous ways to hybrid the above income approaches to value. The key is to isolate the income applicable to each component and apply an appropriate yield rate to each in whole or part.

CAP RATES

Estimating an appropriate cap rate for intangible assets can be difficult. As Pratt et al. explain:

Net tangible assets provide a measure of safety, that if earnings fail to materialize as expected, then the assets usually can be liquidated for something. On the other hand, intangible assets have no liquidation value in the absence of earnings, since their economic value depends on the ability to generate economic income. Therefore, the risk attached to the intangible portion of the assets would seem to be greater and demand a higher rate of return.⁸

One useful method to determine the appropriate excess income multiplier is to interview knowledgeable market participants, such as buyers and prospective buyers. It may also be possible to extract a BEV cap rate from comparable sales if adequate data is available.⁹

NO EASY ANSWERS

Identifying BEV and properly accounting for it in a property tax appraisal is a complex undertaking. At this time, there isn't a court-anointed methodology on BEV that can be uniformly applied. Conflicts develop when case law, legislation and regulation are inconsistent.

Despite this, appraisers are required to consider BEV. The Uniform Standards of Professional Appraisal Practice mandates an analysis on the effect of intangible value on a going concern if it is part of the property in an appraisal assignment.¹⁰

Many professionals in the valuation industries apply various methods or hybrids of these methods in order to derive a value allocation. Often the approach is dictated by the data available, the specific type of property and the local jurisdictional practice. Until legal precedence is established, a flexible and creative approach is inherent to a successful solution.

BIBLIOGRAPHY

- ¹ Robert W. Owens, "Contemplating the Future of Business Enterprise Value," *The Appraisal Journal*, (Spring 2006), 135-136.
- ² Los Angeles Gas and Electric v. Railroad Commission of California, 289 U.S. 287, 313; 535 S. Ct. 637; 77 L.E. 1180 (1933).
- ³ Appraisal Institute, *Dictionary of Real Estate Appraisal* 3rd ed. (Chicago: Appraisal Institute, 1993), 44.
- ⁴ Appraisal Institute, *Appraisal of Real Estate* 12th ed. (Chicago: Appraisal Institute, 2001), 641.
- ⁵ Maria Wood, "Growing Pains," *Real Estate Forum* (March 1999), 40.
- ⁶ Robert W. Owens, "How Business Enterprise Value Applies in Nearly All Appraisals," *The Appraisal Journal*, (April 1998), 121.
- ⁷ *Ibid*, 117.
- ⁸ Shannon P. Pratt, Robert F. Reilly and Robert P. Schweihs, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*, 3rd ed. (Chicago: Irwin Professional Publishing, 1996), 292-293.
- ⁹ T. Alvin Mobley, "Defining and Allocating Going-Concern Value Components," *The Appraisal Journal*, (October, 1997), 326.
- ¹⁰ The Appraisal Foundation, *Uniform Standards of Professional Appraisal Practice*, SR1-4G, (Washington, D.C.: The Appraisal Foundation, 1999), 16-17.

ABOUT THE AUTHOR

Scott Donald, vice president and managing consultant for Marvin F. Poer and Company, has more than 15 years experience in property valuation, both in the public and private sector. His expertise in real and personal property assessment, combined with a thorough knowledge of local tax practices are major assets to property owners who want proactive tax management.

ABOUT POER

Marvin F. Poer and Company, established in 1964, is the nation's largest independently owned full-service property tax firm. For over four decades, POER has helped clients stay competitive by reducing costs, gaining efficiencies and improving profits.

With 16 local offices and over 200 employees, POER has specialized consultants for every state. Representing properties in all 50 states and Washington DC, POER represents more than 2,000 clients with over 50,000 properties and achieves first year tax savings of over \$200 million for clients every year.



MARVIN F. POER AND COMPANY

12700 HILLCREST ROAD
SUITE 125
DALLAS, TEXAS 75230

POER INSIGHTS is published by Marvin F. Poer and Company, 12700 Hillcrest Road, Suite 125, Dallas, Texas 75230, Daryl Haines, Editor. It is intended for Poer Company clients and other interested parties and its contents are for information only. No specific action is being suggested by this publication for any particular tax case. For additional information you may write to the editor at the aforementioned address or call 972-770-1100.

© 2009 Marvin F. Poer and Company