TEC Industries Current Property Tax Issues and USPAP Update

National Association of Property Tax Representatives –
Transportation, Energy, Communications

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Robert Reilly has been a managing director of Willamette Management Associates for about 25 years. Willamette Management Associates provides business and intangible asset valuation, forensic analysis, and financial opinion services for transaction, financing, taxation, bankruptcy, litigation, and planning purposes. Robert frequently provides unit valuation, intangible asset valuation, and functional and economic obsolescence analysis opinions related to property tax compliance and litigation. Robert has testified in both federal and state courts related to property taxation and other disputes.

Robert holds a BA degree in economics and an MBA degree in finance, both from Columbia University. He is a certified public accountant, accredited in business valuation, and certified in financial forensics. He is also a chartered financial analyst, chartered global management accountant, certified management accountant, certified business appraiser, certified valuation analyst, certified real estate appraiser, certified review appraiser, and state certified general appraiser in several states.

Robert is the co-author of 12 books, including *Guide to Intangible Asset Valuation* (revised edition published by the AICPA in 2014) and *Practical Guide to Bankruptcy Valuation* (published by the American Bankruptcy Institute in 2013).

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Discussion Outline

- Introduction
- USPAP update issues
- Issues related to other property tax professional standards
- TEC industries current property tax issues
- Questions and discussion

USPAP Update Issues

- How and why USPAP changes over time
  - The Appraisal Standards Board (ASB) generally updates USPAP every two years
  - The current version is the 2014-2015 edition; the 2016-2017 USPAP edition has been issued
  - The ASB issues several exposure drafts each cycle and both requests and considers written comments from any interested parties
  - Send your comments regarding USPAP changes to The Appraisal Foundation (TAF) in Washington, D.C.
  - All comments are available for public inspection
  - The ASB holds public hearings and adopts final USPAP changes by a public vote of ASB members at a public hearing

USPAP Update Issues (cont.)

- USPAP is intended to encourage consistency in appraisal practice and encourage public confidence in the appraisal profession
- USPAP changes are made when old provisions become obsolete and new provisions are needed to encourage consistency of practice
- The ASB receives its authority from TAF. TAF receives its authority from the Appraisal Subcommittee (ASC). ASC is a subcommittee of the Federal Financial Institutions Examination Council (FFIEC). FFIEC receives its authority by federal law: the Financial Institutions Reform Recovery and Enforcement Act (FIRREA).

Three Major USPAP Update Issues

- Standards Rules (SR) 4 and 5 were retired
  - SR 4 and 5 addressed real property appraisal consulting development and reporting
  - SR 4 and 5 were retired because of confusion and misuse
  - Advisory Opinion 21 was expanded to explain how to complete assignments other than appraisal or appraisal review
  - The term "appraisal consulting" was eliminated from USPAP

Three Major USPAP Update Issues (cont.)

- New report options in SR 2, 8 and 10
  - USPAP previously had three report options for RP and PP appraisals:
    - self-contained appraisal report
    - summary appraisal report
    - restricted use appraisal report
  - USPAP now has two report options for RP and PP appraisals:
    - appraisal report
    - restricted appraisal report
  - These two options are similar to previous SR 10 BV appraisal report options
  - All "restricted use" appraisal reports are now restricted appraisal reports

Three Major USPAP Update Issues (cont.)

- SR 3 review appraisal report content revised to be consistent with other appraisal reports

<u>Standards Rule 3-5</u>

The content of an appraisal review report must be consistent with the intended use of the appraisal review and, at a minimum:

(a) state the identity of the client and any intended users, by name or type;

(b) state the intended use of the appraisal review;

(c) state the purpose of the appraisal review;

(d) state information sufficient to identify:

(i) the work under review, including any ownership interest in the property that is the subject of the work under review;

(ii) the date of the work under review;

(iii) the effective date of the opinions or conclusions in the work under review; and

(iv) the appraiser(s) who completed the work under review, unless the identity is withheld by the client.

Three Major USPAP Update Issues (cont.)

Comment: If the identity of the appraiser(s) in the work under review is withheld by the client, that fact must be stated in the appraisal review report.

(e) state the effective date of the appraisal review and the date of the appraisal review report

(f) clearly and conspicuously:

- state all extraordinary assumptions and hypothetical conditions; and
- state that their use might have affected the assignment results

Other USPAP Update Issues

- Change in assignment results and scope of work definitions
  - The term “assignment results” includes all opinions—not just opinions of value
  - The scope of work must be disclosed in both appraisal and review appraisal assignments
- Change in USPAP preamble – when USPAP applies
  - Preamble language revised to clarify USPAP rules and standards apply when either the service or the appraiser is required to apply by law, regulations, or agreement with the client or intended user
  - Individuals may choose to comply with USPAP any time
- Change in the competency rule
  - Previously, the appraiser must be competent
  - Adds: “In all cases, the appraiser must perform competently when completing the assignment.”

Other USPAP Update Issues (cont.)

- Change in the ethics rule
  - Appraiser must disclose any services (performed as an appraiser or in any capacity) regarding the subject property within the three year period immediately prior to accepting the current assignment
- No new SR issued
  - No new statements issued
  - Statements will be eliminated in the 2016-2017 edition USPAP
  - No new advisory opinions issued
- Expanded illustrations of "hypothetical condition" and "extraordinary assumption"
  - Hypothetical condition—assumption that is contrary to what is known by the appraiser or the date of the assignment, but that is used for analysis purposes
  - Extraordinary assumption—an assumption that if found to be false as of the date of the assignment could alter the appraiser's opinions or conclusion

Consideration of Other Property Tax Professional Standards

- In the property tax arena, some organizations or groups may create ad hoc professional standards.
- Let's consider the authority or legitimacy of such other so-called standards.
- Let's consider two hypothetical sets of property-tax-related valuation standards. Let's call these hypothetical standards:
  - Wholly Sinister Assemblage of Tax Assessors (WSATA) standards and
  - Nefarious Cohort of Unfair Valuation States (NCUVS) standards

Purpose and Objective of Any Professional Standards

- Many professional organizations and agencies promulgate professional standards.
- Examples of professions that are subject to professional standards include appraisers, accountants, and legal counsel.
- Some of the purposes and objectives of professional standards include the following:
  - promote the ethical behavior of the organization’s members
  - improve the consistency and quality of practice among the organization's members
  - educate the organization’s members and the public
  - ensure the public trust of those parties relying on the work of the organization’s members
  - enhance the quality of the work of the organization's members
- Let’s consider if the hypothetical WSATA or NCUVS standards achieve these public interest purposes and objectives.

Authority of Professional Standards

- Most professional organizations or agencies that promulgate professional standards do so under the following authority:
  - statutory law
  - regulation (indirect law)
  - agreement of the regulated members
- For example, the FASB is authorized to promulgate GAAP by the SEC, which is authorized by the Securities Act of 1933.
- For example, the IRS (through the U.S. Treasury) promulgates tax regulations when the Internal Revenue Code (passed by Congress and signed by the President) authorizes "the Secretary to issue regulations that . . ."
- For example, CPAs are subject to the AICPA professional standards when they agree to become members of the AICPA.

Authority of Professional Standards (cont.)

- Some of the organizations or agencies that promulgate valuation-related professional standards include:
  - TAF ASB – promulgates USPAP
  - American Society of Appraisers – membership standards
  - Institute of Business Appraisers – membership standards
  - Appraisal Institute – membership standards
  - National Association of Certified Valuators and Analysts – membership standards
  - American Institute of Certified Public Accountants – membership standards
  - International Association of Assessing Offices – membership standards
- Let's consider if the hypothetical WSATA or NCUVS standards have any authority or legitimacy

Process of Setting Professional Standards

- The process of promulgating professional standards should be fair, transparent, and in the public interest
- For example, let's consider how the TAF ASB promulgates USPAP:
  - The ASB members are known to the public
  - The ASB holds periodic public meetings throughout the year
  - The ASB requests input and suggestions from the public
  - The ASB requests input from subject matter experts, who are volunteers from appraisers and parties who rely on appraisers
  - The ASB issues USPAP exposure drafts—usually 3 or more each update cycle
  - The public responds in writing; such responses become public information
  - The ASB holds public meetings and solicits public comments
  - The ASB members vote on the final USPAP changes in public meetings
- Let's consider if the process of promulgating the WSATA and NCUVS standards is open, transparent, and in the public interest

Final Thoughts on Other Property Tax Professional Standards

- This discussion does not consider technical issues with regard to the hypothetical WSATA or NCUVS standards' valuation approaches, methods, and procedures
- This discussion does consider the following issues with regard to any taxation-related or valuation-related professional standards
  - Are the purpose and objective of the standards in the public interest?
  - What is the organization's or the agency's authority to promulgate such standards?
  - Is the process for promulgating such standards fair, transparent, and in the public interest?

Three TEC Current Property Tax Issues

- Identification and valuation of identifiable intangible assets
  - Are there generally accepted intangible assets?
  - Are there generally accepted intangible asset valuation methods?
  - Can goodwill be valued separately from the taxpayer other assets?
- Discount rate and capitalization rate issues
  - MCAPM variables
  - Growth rate determination considerations
  - Income tax rate and related variables
- Economic obsolescence analysis issues
  - Common measurement methods
  - WACC vs. ROI "income shortfall" method
  - Affect of intangible assets on economic obsolescence

Identification and Valuation of Intangible Assets

- Intangible assets and intangible personal property (IPP) are not "intangibles"
- Generally accepted lists of intangible assets
- Intangibles that are not IPP
- Generally accepted intangible asset valuation approaches methods and procedures
- Goodwill valuation approaches methods and procedures

Examples of Intangible Assets: FASB ASC 805

- Marketing-related intangible assets
  - Trademarks, trade names, service marks, collective marks, certification marks
  - Trade dress (unique color, shape, package design)
  - Newspaper mastheads
  - Internet domain names
  - Noncompetition agreements
- Customer-related intangible assets
  - Customer lists
  - Order or production backlog
  - Customer contracts and related customer relationships
  - Noncontractual customer relationships

Examples of Intangible Assets: FASB ASC 805 (cont.)

- Artistic-related intangible assets
  - Plays, operas, and ballets
  - Books, magazines, newspapers, and other literary works
  - Musical works such as compositions, song lyrics, and advertising jingles
  - Pictures and photographs
  - Video and audiovisual material, including motion pictures or films, music videos, and television programs

Examples of Intangible Assets: FASB ASC 805 (cont.)

- Contract-based intangible assets
  - Licensing, royalty, and standstill agreements
  - Advertising, construction, management and service or supply contracts
  - Lease agreements (whether the acquiree is the lessee or the lessor)
  - Construction permits
  - Franchise agreements
  - Operating and broadcast rights
  - Servicing contracts such as mortgage servicing contracts
  - Employment contracts
  - Use rights such as drilling, water, air, timber cutting, and route authorities

Examples of Intangible Assets: FASB ASC 805 (cont.)

- Technology-based intangible assets
  - Patented technology
  - Computer software and mask works
  - Unpatented technology
  - Databases, including title plants
  - Trade secrets, such as secret formulas, processes, and recipes

Examples of Intangible Assets: Internal Revenue Code Section 197

- Goodwill
- Going-concern value
- Any of the following intangible items:
  - Workforce in place including its composition and terms and conditions (contractual or otherwise) of its employment
  - Business books and records, operating systems, or any other information base (including lists or other information with respect to current or prospective customers)
  - Any patent, copyright, formula, process, design, pattern, knowhow, format, or other similar item
  - Any customer-based intangible
  - Any supplier-based intangible
  - Any other similar item

Examples of Intangible Assets: Internal Revenue Code Section 197

- Any license, permit, or other right granted by a governmental unit or an agency or instrumentality thereof
- Any covenant not to compete (or other arrangement to the extent such arrangement has substantially the same effect as a covenant not to compete) entered into in connection with an acquisition (directly or indirectly) of an interest in a trade or business or substantial portion thereof
- Any franchise, trademark, or trade name
- Other Internal Revenue Code sections (e.g., Sections 482 and 936) include other lists of intangible assets

What is Not an Intangible Asset?

Examples include:

1. High market share
2. High profitability or high profit margin
3. Lack of regulation
4. A regulated (or protected) position
5. Monopoly position (or barriers to entry)
6. Market potential
7. Breadth of customer appeal
8. Mystique
9. Heritage
10. Competitive edge
11. Life-cycle status
12. Uniqueness
13. Discount prices (or full prices)
14. Positive image
15. First to market
16. Technological superiority
17. Consumer confidence or trustworthiness
18. Creativity
19. High growth rate
20. High return on investment
21. Size
22. Synergies
23. Economies of scale
24. Efficiencies
25. Longevity

Real Property Intangible Attributes:

- There are also intangible attributes that influence the value of industrial, commercial, residential, and mixed-use real estate
- These attributes are not intangible assets
- These attributes typically cannot be separated from the value of the subject real estate
- Examples include:
  1. view
  2. neighborhood
  3. proximity to transportation
  4. proximity to downtown
  5. easements, rights of way
  6. access
  7. zoning
  8. air, water, etc., rights
  9. subsurface rights
  10. construction, development permits
  11. leases, tenants
  12. favorable rental rates

Generally Accepted Intangible Asset Valuation Approaches and Methods

- Cost approach methods
  - Reproduction cost new less depreciation method
  - Replacement cost new less depreciation method
  - Trended historical cost less depreciation method
- Market approach methods
  - Relief from royalty (RFR) method
  - Comparable uncontrolled transactions (CUT) method
  - Comparable profit margin (CPM) method
- Income approach methods
  - Differential income (with/without) method
  - Incremental income (before/after) method
  - Profit split (or residual profit split) method
  - Residual (or excess) income method

Goodwill Valuation Approaches, Methods, and Procedures

- Income approach methods
  - present value of expected future income (after CAC) from expected future customers (as the current customers retire)
  - capitalized excess earnings method (CEEM)—after a fair rate of return on all other business operating assets is subtracted from the entity NCF
- Market approach
  - residual from transaction purchase price
  - residual from business enterprise (unit) value
- Cost approach
  - opportunity cost method—capitalized lost income during expected period to hypothetically recreate all of the subject business enterprise tangible property and IPP

Discount Rate and Capitalization Rate Issues - MCAPM

- Use of the modified capital asset pricing model (MCAPM) to estimate the cost of equity capital in the WACC discount rate:

$$ke = Rf + \beta\ (Rm - RF) + Sp + CSRp$$

- Issues include:
  - What is the appropriate risk free rate?
  - What is the appropriate source/calculation of beta?
  - Is there a size adjustment equity risk premium?
  - How does one calculate a company-specific equity risk premium?

Discount Rate and Capitalization Rate Issues - Growth

- The direct capitalization rate may be calculated as:

  the discount rate – long-term growth rate =
  the direct capitalization rate

- What is the appropriate expected long-term growth rate?
  - It is an expected future rate
  - It is a blended rate over many future periods
  - It is the expected growth rate in the income measure to be capitalized (not the revenue growth rate)
  - It should be sustainable (based on expected capx and expected other investments)
  - It should be consistent with the other unit valuation variables
  - It should be consistent with the bundle of operating assets subject to valuation (e.g., not including future M&A activity)

Discount Rate and Capitalization Rate Issues – Tax Rate

- The income tax rate used in an income approach analysis should be the sustainable tax rate for market participants in the taxpayer industry
- Special income tax attributes of the subject taxpayer may transfer over to (or have any value to) the "willing buyer" market participants in the subject industry; for example:
  - zero percent (or low) current tax rate
  - NOL carryforward
- The income tax rate used in the discount/capitalization rate should be consistent with the income tax rate used to calculate the income metric subject to capitalization

Economic Obsolescence Issues

- Economic obsolescence is one component of external obsolescence that should be considered in any cost approach analysis
- To the extent that the taxpayer experiences economic obsolescence, it should impact the cost approach value of all RE and TPP—and of all cost approach IPP
- Do not use the "residual from income approach value" method to measure economic obsolescence
  - this is not a generally accepted method
  - this analysis is conceptually flawed
- There are various economic obsolescence methods and measures

Economic Obsolescence Issues (cont.)

- There may be an impact of intangible assets on economic obsolescence measures in the cost approach
- An economic obsolescence measurement is not the same thing as an asset impairment analysis under GAAP FMV accounting
  - ASC 350 (intangible assets) and ASC 360 (PP&E) provide formulaic procedures to test for—and measure—the impairment of FV measures
  - These GAAP asset impairment tests do not relate to the FMV of any asset
  - The unit of testing is different for economic obsolescence analyses than it is for GAAP asset impairment
  - A taxpayer will often experience economic obsolescence and not be allowed to record an asset impairment for GAAP purposes

Measurement of Economic Obsolescence

- Two generally accepted economic obsolescence measurement methods:
  - direct comparison of similar properties with and without external obsolescence; not practical for most TEC properties
  - capitalization of income loss; most commonly used with regard to TEC properties; often called the "income shortfall" method in the vernacular
- When using the capitalization of income loss method, analysts consider several different comparative financial and operational variables, such as:
  - ROA
  - ROE
  - profit margin – gross
  - profit margin – net
  - growth rate in financial metric
  - number of units produced
  - average selling price
  - average COGS
  - revenue per employee
  - growth rate in operational metric

Measurement of Economic Obsolescence

- When using the capitalization of income loss method, consider several different benchmarks
  - time period benchmarks
    - current year vs. 5-year average
    - current year vs. forecast
  - industry benchmarks
    - taxpayer vs. industry average
    - taxpayer vs. selected guideline companies
- One common application of the capitalization of income loss method is the simple comparison of:
  - WACC vs. ROI
  - however, the ROI should be based on the RCNLD, and not on the HCLD

Effect of Intangible Assets on Cost Approach Economic Obsolescence

- Hypothetical Alpha taxpayer fact set

Alpha RE and TPP – based on a cost approach RCNLD analysis	$10,000,000
Alpha IPP – based on a cost approach RCNLD analysis	$4,000,000
Subject net operating income (NOI)	$1,000,000
Required return on investment (ROI)/cost of capital	10%

Effect of Intangible Assets on Cost Approach Economic Obsolescence (cont.)

- Simplified test for identifying economic obsolescence—not considering the Alpha intangible assets

required ROI				10%
actual ROI	$\frac{\text{NOI}}{\text{RE + TPP RCNLD}}$	$\frac{\$1,000,000}{\$10,000,000}$	=	10%
income shortfall/economic obsolescence				0%
value of Alpha RE and TPP (i.e., based on $10,000,000 RCNLD)				$10,000,000

Effect of Intangible Assets on Cost Approach Economic Obsolescence (cont.)

- Simplified test for identifying economic obsolescence—considering the Alpha intangible assets

required ROI				10%
actual ROI	NOI	$1,000,000	=	7.1%
	RE + TPP + IPP RCNLD	$14,000,000		
income shortfall/economic obsolescence =				
(10% - 7.1%) ÷ 10%				29%
value of Alpha RE and TPP				$7,100,000
(i.e., based on $10,000,000 RCNLD – 29% economic obsolescence)				

Summary and Conclusion

- USPAP update issues
  - major USPAP changes
  - other USPAP changes
- Other property tax professional standards
  - assessment of authority and legitimacy
  - assessment of standards-setting process
- TEC industries current property tax valuation issues
  - intangible asset valuation
  - discount rates and capitalization rates
  - economic obsolescence measurement
- Questions and discussion