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Court of Special Appeals of Maryland

No. 1276

September Term, 2019

MDEC No. CSA-REG-1276-2019

SHELTER SENIOR LIVING IV, LLC,
Appellant,

v.

BALTIMORE COUNTY, MARYLAND, *et al.*,
Appellees.

Appeal from the Circuit Court for Baltimore County in Case No. 03-C-18-009042 consol. with No. 03-C-18-012380 (Hon. Keith Truffer, Judge)

BRIEF OF AMICI CURIAE AMERICAN SENIORS HOUSING ASSOCIATION, HEALTH FACILITIES ASSOCIATION OF MARYLAND, MARYLAND CHAMBER OF COMMERCE, LIFESPAN NETWORK, AND NAIOP MARYLAND CHAPTERS IN SUPPORT OF APPELLANT'S BRIEF

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INTEREST OF AMICI CURIAE

Amici curiae ("Amici") are the American Seniors Housing Association ("ASHA"), Health Facilities Association of Maryland ("HFAM"), LifeSpan Network, Maryland Chamber of Commerce, and NAIOP Maryland Chapters.

ASHA represents the interests of more than 500 companies involved in finance, development, and operation of the full spectrum of housing and services for seniors, including independent living, assisted living, memory care, and continuing care communities. HFAM has been a leader and advocate for Maryland's long-term and post-acute care provider community for more than 70 years and represents every type of long-term care provider throughout Maryland. LifeSpan Network is the largest senior care provider association in the Mid-Atlantic, representing more than 250 senior care provider organizations in Maryland and Washington, D.C. Maryland's long-term care provider community directly supports approximately $3.7 billion in State economic activity and serves as a major job-creator and economic engine. Long-term care is a leading employment center and health care employment training hub in communities across Maryland.

The Maryland Chamber of Commerce is Maryland's only statewide business advocacy organization and is dedicated to making Maryland work better for all Marylanders. NAIOP is the nation's leading advocate for companies involved in commercial construction, land development, brokerage, and property management. Its Maryland Chapters represent more than 700 companies involved in commercial, industrial, and mixed-use real estate.

Amici, representing the Maryland senior housing industry and the Maryland business community more globally, have special expertise and extensive experience buying and selling businesses consisting of real property and other assets. Amici are uniquely interested because the decision below completely upends how recordation and transfer taxes have historically been assessed when senior living businesses—or indeed any business in which intangible personal property, including goodwill, is a component—are sold in Maryland. How are companies supposed to predict and plan for the costs of a potential transaction when recordation and transfer taxes cannot be accurately calculated? Obviously, they cannot, and with unpredictably higher costs they may choose to avoid doing business in Maryland.

The situation here is all the more egregious because every relevant law disallows the result that the Maryland Tax Court's ruling imposed. Boiled down, if this Court does not reverse the Maryland Tax Court's unsupported holding, the cost of buying and selling senior living businesses in Maryland will be substantially and improperly increased, and the Maryland senior living development business and other businesses may be unnecessarily jeopardized, as transactions slow or even halt. This in turn may decrease senior living options, and likely will have other unintended and harmful consequences on economic development in this State.

STATEMENT OF THE CASE

Amici adopt the Statement of the Case in Appellant's Brief (p. 1).

QUESTION PRESENTED

Amici adopt the question presented in Appellant's Brief (pp. 1-2).

STATEMENT OF FACTS

Amici adopt the Statement of Facts in Appellant's Brief (pp.2-5), but restate the most pertinent facts here:

The owners of senior living facilities in Rockville, Towson, and White Marsh (the "Sellers") sold three facilities in July 2014 for a total of $93,400,000. E.298-308. Of that amount, the deeds presented for recordation (the "Deeds") showed that the consideration for the real property (*i.e.*, land and improvements) was $40,142,200 (E.234-252). The amended and restated closing statements also showed this and that $3,143,579 was for tangible personal property (E.253-288, 298-308) and the remainder, $50,114,221, was for other assets including intangibles, which includes the goodwill of the businesses (E. 298, 302, 305) (goodwill being a universally recognized type of intangible personal property).

As is typical, the Sellers tendered recordation and transfer taxes based solely on the consideration for the real property stated in the Deeds, $40,142,200. The clerks in Baltimore and Montgomery Counties, however, refused to record the Deeds unless the Sellers paid taxes on $90,256,421 ($40,142,200 for real property plus $50,114,221 for intangible personal property including goodwill). E.94, 234-252, 298-308. This was shocking and a complete surprise to the Sellers as goodwill and other intangible personal property historically has **never** been subject to recordation and transfer taxes; such taxes are limited to the value of real property conveyed and do not include any type of tangible or intangible personal property like goodwill. The Sellers paid the amounts demanded under protest (E.94), thereby increasing their tax burden by over a million dollars. Appellant's Brief at 1.

The Sellers filed for refunds, which were denied. E.94, Appellant's Brief at 1. The Sellers appealed to the Maryland Tax Court, which—in an order that cites no authority whatsoever—flatly ruled that $50,114,221 allocated by the parties as goodwill is subject to recordation and transfer taxes. E.143-144. The Circuit Court for Baltimore County affirmed. E.15.

SCOPE AND STANDARD OF REVIEW

Amici adopt the Scope and Standard of Review section of Appellant's Brief (pp. 5-7).

ARGUMENT

I. RECORDATION AND TRANSFER TAXES ARE IMPOSED BY STATUTE, AND THE APPLICABLE STATUTES PROVIDE THAT THOSE TAXES ARE APPLIED TO THE VALUE OF THE REAL PROPERTY CONVEYED AND NOT TO GOODWILL.

The seminal question here is whether recordation and transfer taxes are due on the value of intangible personal property, including goodwill, transferred in a business sale when recorded deeds evidence only conveyance of real property. Based on the well-reasoned arguments in Appellant's Brief—with which Amici fully agree—Amici respectfully assert that this Court should vacate the Tax Court's decision to include goodwill in the calculation of recordation and transfer taxes. Failure to do so will damage the Maryland senior housing and business communities going forward by locking in an erroneous and unauthorized process for assessing recordation and transfer taxes on goodwill that Maryland law simply does not permit and will paint Maryland as an "anti-business" state.

Four straightforward and complementary statutory tax structures—(1) the Maryland recordation tax, (2) the Maryland transfer tax, (3) the Baltimore County transfer tax, and (4) the Montgomery County transfer tax—govern whether recordation or transfer taxes, or both, are due when a deed is presented for recordation in Baltimore or Montgomery Counties, and, if a tax is due, how it is calculated. All of these statutes plainly and unambiguously impose taxes **solely** on the consideration for real property conveyed by a recorded deed. None even remotely permits taxation on any type of intangible personal property, and at least two expressly prohibit taxing intangible personal property like goodwill.

A. Maryland Recordation Tax Applies to Real Property Conveyed and Not to Goodwill.

Section 12-102 of Md. Code Tax-Property Article ("Tax-Prop.") provides in part "recordation tax is imposed on an instrument of writing: (1) recorded with the clerk of the circuit court for a county." The key term here is "instrument of writing." Tax-Prop. §12-101 defines that term as follows:

> (j)(1) "Instrument of writing" means a written instrument that:
> (i) conveys title to or creates or gives notice of a security interest in real property; . . .

The recordation tax rates are determined by each county and Baltimore City and are applied to the consideration paid for the instrument of writing. Tax-Prop. §§12-103(a)(1) and 12-103(b)(1).

Another provision in Title 12, Tax-Prop. §12-117(b), strongly supports the conclusion Amici advance—that recordation taxes are based solely on the value of the real property conveyed. As a matter of background, until 2008, instead of selling real property by deed, and incurring recordation and transfer taxes, sellers would sometimes sell the equity interests of the landowning entities. This produced essentially the same result—a new entity controlled the underlying real estate—but without any obligation to pay recordation or transfer taxes. In Chapter 3 of the 2007 Special Session, the General Assembly imposed the same recordation and transfer taxes on transfers of controlling interests in real property entities as are due on deeds for the real property. Tax-Prop. §§12-117(b)(1) and 13-103(b)(1).

To confirm the General Assembly's intent that recordation taxes are based solely on the value of real property, Tax-Prop. §12-117(b)(2)(iii) expressly states, "The consideration to which the recordation tax applies is reduced by the amount allocable to the assets of the real property entity other than real property." In other words, if such a transaction includes personal property, the consideration paid for that personal property is not included when computing recordation taxes.

As the recordation tax statute confirms, the Tax Court's holding here that recordation taxes were due on the goodwill—which is not real property—ignores the statute's plain meaning by adding in a category—intangible personal property—that is utterly absent from the words of the statute. *See Kushell v. Dep't of Nat'l Res*., 385 Md. 563, 576-77 (2005) ("In construing the plain language, a court may neither add nor delete language so as to reflect an intent not evidenced in the plain and unambiguous language of the statute . . . .").

Furthermore, Maryland has long accepted the doctrine of *expressio unius est exclusio alterius,* meaning that “the expression of one thing is the exclusion of another.” *Comptroller of the Treasury v. Blanton*, 390 Md. 528, 537-538 (2006) (*citing Baltimore Harbor Charters, Ltd. v. Ayd*, 365 Md. 366, 385 (2001), and *Biggus v. Ford Motor Credit Co.*, 328 Md. 188, 214 (1992)); *see also Houghton v. Forrest*, 412 Md. 578, 590 (2010), and *Newell v. Runnels*, 407 Md. 578, 643 (2009).

Here, this tenet of statutory construction means that because intangible property like goodwill is not listed as a taxable category in the recording statute, it is necessarily excluded. The Tax Court’s holding requiring the Seller to pay taxes on $50,000,000 of goodwill and other intangible property is therefore incorrect as a matter of law. Failure to reverse this erroneous decision will needlessly jeopardize the senior living business in Maryland.

B. <u>Maryland Transfer Tax Applies to Real Property Conveyed and Not to Goodwill.</u>

Pursuant to Tax-Prop. Title 13, State transfer tax applies to the consideration payable for an instrument of writing. Tax-Prop. §13-203.

In Title 13, the term “instrument of writing” is defined even more narrowly than under Title 12; under Title 13 “instruments of writing” are limited to documents that convey title to or leasehold interest in real property. Tax-Prop. §13-101(e)(1) and (2). The rate of the State transfer tax is 0.5% of the consideration payable for the instrument of writing. Tax-Prop. §13-203(a). Under this statutory framework, when a deed granting real property is presented for recordation, the State transfer tax is easily determinable—it is based on the consideration paid for real property conveyed by the deed.

Based on the plain meaning of this statute as well, the Tax Court erred as a matter of law in rewriting the transfer tax statute to add intangible personal property, including goodwill, to the stated definition of "instrument in writing." *Kushell*, 385 Md. at 576; *Blanton*, 390 Md. 537. Goodwill is a category of intangible personal property. As such, it is patently different from the real property described in the Deeds—and falls far outside the taxable boundaries.

C. <u>**Baltimore County Transfer Tax Applies to Real Property Conveyed and Not to Goodwill.**</u>

Tax-Prop. §13-402.1 authorizes counties to impose transfer taxes on an "instrument of writing." This section incorporates the definition of "instrument of writing" in Tax-Prop. §13-101(e)(1)—"a written instrument that conveys title to, or a leasehold interest in, real property."

Accordingly, Baltimore County Code §11-3-201 defines an "instrument of writing" in the same way as Tax-Prop. §13-101(e)(1). Under §11-3-203, Baltimore County's transfer tax is imposed only on instruments of writing recorded with the Clerk of the Circuit Court. Section 11-3-203(b) provides that the Baltimore County transfer tax is imposed at the rate of 1.5% of the consideration for the conveyance effectuated by the instrument of writing. Again, because only real property is transferred by an instrument of writing, the Baltimore County transfer tax excludes the value of any type of tangible or intangible personal property, including goodwill.

Furthermore, §11-1-102(c)(1) of the Baltimore County Code expressly limits the County's taxing powers: "The county may not impose taxes on . . . (ii) intangible personal property." This provision could not be any more clear—it says that Baltimore County transfer tax cannot be applied to any type of intangible personal property, which of course includes goodwill.

Consequently, and quite consistently with the Maryland transfer tax formulation, the plain meaning of the Baltimore County Code prohibits Baltimore County from imposing taxes on goodwill or any other intangible property. Yet, that is precisely what happened here, and precisely why the Tax Court erred as a matter of law in allowing Baltimore County to unilaterally change the wording of the governing statute and wrongly collect transfer taxes on goodwill. *See, e.g., Kushell*, 385 Md. at 576; *Blanton*, 390 Md. 537.

D. Montgomery County Transfer Tax Applies to Real Property Conveyed and Not to Goodwill.

Of the four taxes at issue here, only Montgomery County's transfer tax law does not use the defined term "instrument of writing." Nonetheless, the Montgomery County transfer tax law, like the other three laws, applies only to documents that convey real property. Montgomery County Code §52-31 imposes a tax on the transfer of fee simple interests in real property. No Montgomery County Code section authorizes a transfer tax on the transfer of personal property, including goodwill.

Additionally, just like in the Baltimore County Code, the Montgomery County Code provides that the Montgomery County Council "shall not have the power to impose any tax upon any . . . intangible personal property . . . ." M. Co. Code §52-17(b). Thus, under the Montgomery taxation rubric, taxation on the transfer of intangible personal property, including goodwill, is prohibited.

Goodwill is neither an interest in real property nor subject to taxation under the Montgomery County Code. Baltimore and Montgomery Counties' brazen insistence on collecting these taxes, and the Tax Court's imprimatur on the imposition of the taxes, violates multiple canons of statutory construction and creates needless uncertainty for those contemplating the sale of senior living facilities and other businesses.

E. <u>The History of the State Recordation and Transfer Taxes Establishes They do Not Apply and Never Have Applied to Transfers of Goodwill.</u>

The State recordation tax was first enacted in 1937. 1937 Md. Laws Sp. Sess., Ch. 11. In 1984, it applied to "every instrument of writing conveying title to real or personal property." *See Dean v. Pinder*, 312 Md. 154, 159 (1988). Pursuant to Chapter 8 of the Laws of Maryland of 1985, the General Assembly changed the recordation tax law so that it now applies only to the transfer of real property. Thus, the General Assembly excluded transfers of any sort of personal property, including goodwill, from the recordation tax 35 years ago.

State transfer taxes were first imposed by Chapter 403 of the Laws of Maryland of 1969 to raise money for open space and recreational opportunities. Then, as now, the transfer tax was imposed only on instruments conveying title to, or a leasehold interest in, real property. Simply put, State transfer taxes have never been imposed on the transfer of any tangible or intangible personal property. Appellees (the "Taxing Authorities") cannot unilaterally make their own changes to long-existing statutes by adding goodwill to the tax base, thereby making Maryland senior housing and commercial real estate transactions even more costly, without the General Assembly formally amending the law to allow such a dramatic change.

F. No Case Law Changes the Clear Meaning of the Tax Statutes; Cases Cited Below do Not Apply Here.

In the 83-year history of the recordation statute and the 51-year history of the State transfer tax statute, not a single reported case has imposed a recordation or transfer tax on the transfer of any kind of intangible personal property, including goodwill. Nonetheless, the Tax Court's ruling-imposed taxes on the goodwill being sold, and the Circuit Court affirmed that mistaken decision.

In its Memorandum Opinion, the Circuit Court for Baltimore County cited *Pritchett v. Kidwell*, 55 Md. App. 206 (1983), and *Dean v. Pinder* for the proposition that consideration payable, and the amount on which taxes are calculated, may include more than cash paid. E.10-14. Neither case addresses whether recordation and transfer taxes can be imposed on deeds for the value of, or consideration paid for, goodwill. Rather, these cases relate only to the transfer of real property and consider only whether, or how much, to tax such transfers.

Specifically, *Pritchett v. Kidwell* involved the transfer for $60,000 by two partners of their interests in a parcel of real property used by their partnership. The buyers agreed to hold the sellers harmless from loss arising from a mortgage on the property, for which all of the partners were liable. The Court of Special Appeals held that the indemnity and relinquishment of claims for contribution were elements of the consideration for the conveyance of the real property, and that recordation and transfer taxes were payable on them. Taxation on the transfer of goodwill or other intangible personal property was not at issue, was not mentioned, and was not analyzed.

In *Dean v. Pinder* the Court of Appeals framed the question before it as:

> [W]hether the statutorily required 'actual consideration' for the imposition of [recordation and transfer] taxes exists when the owners of real property transfer the title of that property to a corporation of which they are the sole shareholders.

312 Md. 156.

In answering this question—which again makes no mention of taxing intangible personal property—the Court held that recordation and transfer taxes were due because the value of the corporation's stock increased upon the conveyance.

As noted, neither case even remotely analyzed whether goodwill or other intangible personal property can be taxed under Maryland recordation and transfer laws, much less supports the Taxing Authorities' unfounded position.

II. THE EXISTENCE AND VALUATION OF GOODWILL IS ESTABLISHED AND REGULATED BY FEDERAL AND MARYLAND TAX LAW AND IS ROUTINELY DETERMINED BY APPRAISERS.

The Taxing Authorities' fundamental argument below was that "Neither the State nor [Baltimore or Montgomery Counties] impose a tax on intangible property, because intangible property is an accounting fiction and ripe for abuse." (Answering Memorandum in Support of the Decision of the Maryland Tax Court, pp. 14-15). This statement is not only erroneous but also astounding. In acknowledging that the State and counties do not tax intangible property, the Taxing Authorities concede their whole case and admit that the Tax Court ruling is wrong and must be reversed as a matter of law.

The Taxing Authorities then double down and state that "it is almost as if [Sellers] chose a purchase price and then worked backwards to fill in the amounts for intangible personal property." (*Id.* at 15.) As explained next, this is the exact process a taxpayer must undertake when buying and selling a business with goodwill. Thus, the Taxing Authorities fault Appellant for simply fulfilling obligations under federal and Maryland income tax law.

Goodwill is an intangible asset that can be valued. In *BAA, PLC v. Acacia Mut. Life Ins. Co*., 400 Md. 136, 164 n.24 (2007), the Court of Appeals cited the Supreme Court case *Old Dearborn Distrib. Co. v. Seagram–Distillers Corp.,* 299 U.S. 183, 194, 57 S. Ct. 139, 144–145, 81 L.Ed. 109, 119 (1936) (". . . good will is property in a very real sense, injury to which, like injury to any other species of property, is a proper subject for legislation"), and *Gilmore Ford, Inc. v. Turner*, 599 So.2d 29, 31 (Ala. 1992) ("[g]oodwill is property of an intangible nature which constitutes a valuable asset of the business of which it is a part . . . . It is well settled that goodwill, being property, is transferable and may be bought and sold in connection with the sale of a business . . . ."). *See also Skrabak v. Skrabak*, 108 Md. App. 633, 641–42 (1996); *Strauss v. Strauss*, 101 Md. App. 490, 502 (1994); and *Prahinski v. Prahinski*, 321 Md. 227, 233 (1990).

Under both federal and Maryland income tax law, the buyer and seller of assets constituting a trade or business must allocate the purchase price among acquired assets using the "residual method," under which the assets are divided into distinct classes, and report the allocation of the purchase price to the Internal Revenue Service on Form 8594. 26 U.S.C.A. §1060 and related Treasury Regulations. *See* Md. Code, Tax-General Article, §10-203, which conforms Maryland tax law to federal tax law. Two of these classes include such intangible assets as goodwill, going concern value, and covenants not to compete. 26 U.S.C.A. §197.

Such allocation and delineation of property is an exact and necessary process because asset classes receive different tax treatment. For example, most intangible assets, including goodwill, are amortized by buyers over a 15-year period pursuant to 26 U.S.C.A. §197, while sellers generally recognize capital gain upon the sale of goodwill.

Not only does tax law recognize the existence of intangible assets including goodwill, it provides guidance on how to value or appraise such assets. The IRS states that it is almost always possible to make a separate appraisal of tangible and intangible assets and specifies a formula to be used to value intangible assets, such as goodwill. Rev. Rul. 65-193, 1965-2 C.B. 370; Rev. Rul. 68-609, 1968-2 C.B. 327.

Professional guidelines and standards about the valuation of businesses, and particularly seniors housing facilities, recognize goodwill as a business asset and discuss how goodwill should be valued. *See, e.g.,* Appraisal Institute, The Appraisal of Real Estate (14th ed. 2013), page 704 (recognizing the existence of goodwill in assets such as assisted-living facilities); William H. Beazley, *Valuation of Real Estate Within Senior Living Facilities*, 19 Seniors Housing & Care J. 23–33 (2011) ("The task facing most analysts is that seniors housing properties are bought and sold as going concerns with residents in-place. The going concern includes all tangible and intangible personal property in the sales transaction. . . . . Intangible personal property includes . . . goodwill . . . .”); National Association of Certified Valuators and Analysts (NACVA) Professional Standards, 2017, page 7, available at: https://www.nacva.com/standards (Valuators must determine whether or not the enterprise has goodwill or other intangible value).

Consequently, experts uniformly agree that goodwill is a standard component of senior housing assets and must be independently valued. Federal and State tax laws have rules directing how to do just that. The Taxing Authorities are wrong when they argue that goodwill can be ignored and taxed as if it were real property.

CONCLUSION

When parties buy or sell senior living facilities and commercial real estate properties generally in Maryland, they should have the absolute right to rely on the plain meaning of the State and county recordation and transfer tax statutes to predict the costs associated with their transactions. Here, despite the plain meaning of those statutes, the Taxing Authorities forced the Sellers to pay over a million dollars in transfer and recordation taxes that were simply not due. The Tax Court then refused to refund those taxes to the Seller.

For the reasons stated herein and for those in Appellant’s Brief, Amici respectfully request that the Court reverse the Tax Court’s decision, remand the case, and direct that recordation and transfer taxes shall not be imposed on the value of goodwill or any other type of personal property. Any other result will allow an impermissible sea change in the imposition of taxes in senior living and other business transactions in Maryland and will jeopardize economic development in Maryland.

Dated June 15, 2020

Respectfully submitted,

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CERTIFICATION OF WORD COUNT AND COMPLIANCE WITH RULE 8-112

1. This brief contains 3,881 words, excluding the parts of the brief exempted from the word count by Rule 8-503.

2. This brief uses thirteen (13) point Times New Roman font and the body of the text is double spaced. This brief complies with the font, spacing, and type size requirements stated in Rule 8-112.

/s/Diane Festino Schmitt
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CERTIFICATE OF SERVICE

I HEREBY CERTIFY that on this 15th day of June, 2020, a copy of the foregoing Brief of Amici Curiae was sent via the Court's Electronic Filing System, served eight copies on the Clerk of the Court via hand-delivery, and two copies on the following via postage prepaid, first class U.S. mail:

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MD Code, Tax - General, § 10-203

§ 10-203. Adjusted gross income of an individual

Except as provided in Subtitle 4 of this title, the Maryland adjusted gross income of an individual is the individual's federal adjusted gross income for the taxable year as adjusted under this Part II of this subtitle.

MD Code, Tax - Property, § 13-402.1

§ 13-402.1. Tax on written instruments permitted

Home rule powers; transfer tax

(a) The governing body of a county that has adopted home rule powers under Article XI-F of the Maryland Constitution may impose a transfer tax on an instrument of writing:

(1) recorded with the clerk of the circuit court for the county; or

(2) filed with the Department.

Rate and application

(b) A transfer tax imposed under this section:

(1) may not exceed 0.5%; and

(2) does not apply to an instrument of writing exempt from the State transfer tax under § 13-207 of this title.

26 U.S.C.A. § 197

§ 197. Amortization of goodwill and certain other intangibles
Effective: October 23, 2004

(a) General rule.--A taxpayer shall be entitled to an amortization deduction with respect to any amortizable section 197intangible. The amount of such deduction shall be determined by amortizing the adjusted basis (for purposes of determining gain) of such intangible ratably over the 15-year period beginning with the month in which such intangible was acquired.

(b) No other depreciation or amortization deduction allowable.--Except as provided in subsection (a), no depreciation or amortization deduction shall be allowable with respect to any amortizable section 197 intangible.

(c) Amortizable section 197 intangible.--For purposes of this section—

(1) In general.--Except as otherwise provided in this section, the term "amortizable section 197 intangible" means any section 197 intangible—

(A) which is acquired by the taxpayer after the date of the enactment of this section, and

(B) which is held in connection with the conduct of a trade or business or an activity described in section 212.

(2) Exclusion of self-created intangibles, etc.--The term "amortizable section 197 intangible" shall not include any section 197 intangible—

(A) which is not described in subparagraph (D), (E), or (F) of subsection (d)(1), and

(B) which is created by the taxpayer.

This paragraph shall not apply if the intangible is created in connection with a transaction (or series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof.

(3) Anti-churning rules.—

For exclusion of intangibles acquired in certain transactions, see subsection (f)(9).

(d) Section 197 intangible.--For purposes of this section—

(1) In general.--Except as otherwise provided in this section, the term "section 197 intangible" means—

(A) goodwill,

(B) going concern value,

(C) any of the following intangible items:

(i) workforce in place including its composition and terms and conditions (contractual or otherwise) of its employment,

(ii) business books and records, operating systems, or any other information base (including lists or other information with respect to current or prospective customers),

(iii) any patent, copyright, formula, process, design, pattern, knowhow, format, or other similar item,

(iv) any customer-based intangible,

(v) any supplier-based intangible, and

(vi) any other similar item,

(D) any license, permit, or other right granted by a governmental unit or an agency or instrumentality thereof,

(E) 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, and

(F) any franchise, trademark, or trade name.

(2) Customer-based intangible.—

(A) In general.--The term "customer-based intangible" means--

(i) composition of market,

(ii) market share, and

(iii) any other value resulting from future provision of goods or services pursuant to relationships (contractual or otherwise) in the ordinary course of business with customers.

(B) Special rule for financial institutions.--In the case of a financial institution, the term "customer-based intangible" includes deposit base and similar items.

(3) Supplier-based intangible.--The term "supplier-based intangible" means any value resulting from future acquisitions of goods or services pursuant to relationships (contractual or otherwise) in the ordinary course of business with suppliers of goods or services to be used or sold by the taxpayer.

(e) Exceptions.--For purposes of this section, the term "section 197 intangible" shall not include any of the following:

(1) Financial interests.--Any interest--

(A) in a corporation, partnership, trust, or estate, or

(B) under an existing futures contract, foreign currency contract, notional principal contract, or other similar financial contract.

(2) Land.--Any interest in land.

(3) Computer software.--

(A) In general.--Any--

(i) computer software which is readily available for purchase by the general public, is subject to a nonexclusive license, and has not been substantially modified, and

(ii) other computer software which is not acquired in a transaction (or series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof.

(B) Computer software defined.--For purposes of subparagraph (A), the term "computer software" means any program designed to cause a computer to perform a desired function. Such term shall not include any data base or similar item unless the data base or item is in the public domain and is incidental to the operation of otherwise qualifying computer software.

(4) Certain interests or rights acquired separately.--Any of the following not acquired in a transaction (or series of related transactions) involving the acquisition of assets constituting a trade business or substantial portion thereof:

(A) Any interest in a film, sound recording, video tape, book, or similar property.

(B) Any right to receive tangible property or services under a contract or granted by a governmental unit or agency or instrumentality thereof.

(C) Any interest in a patent or copyright.

(D) To the extent provided in regulations, any right under a contract (or granted by a governmental unit or an agency or instrumentality thereof) if such right--

(i) has a fixed duration of less than 15 years, or

(ii) is fixed as to amount and, without regard to this section, would be recoverable under a method similar to the unit-of-production method.

(5) Interests under leases and debt instruments.--Any interest under--

(A) an existing lease of tangible property, or

(B) except as provided in subsection (d)(2)(B), any existing indebtedness.

(6) Mortgage servicing.--Any right to service indebtedness which is secured by residential real property unless such right is acquired in a transaction (or series of related transactions) involving the acquisition of assets (other than rights described in this paragraph) constituting a trade or business or substantial portion thereof.

(7) Certain transaction costs.--Any fees for professional services, and any transaction costs, incurred by parties to a transaction with respect to which any portion of the gain or loss is not recognized under part III of subchapter C.

(f) Special rules.—

(1) Treatment of certain dispositions, etc.--

(A) In general.--If there is a disposition of any amortizable section 197 intangible acquired in a transaction or series of related transactions (or any such intangible becomes worthless) and one or more other amortizable section 197 intangibles acquired in such transaction or series of related transactions are retained--

(i) no loss shall be recognized by reason of such disposition (or such worthlessness), and

(ii) appropriate adjustments to the adjusted bases of such retained intangibles shall be made for any loss not recognized under clause (i).

(B) Special rule for covenants not to compete.--In the case of any section 197 intangible which is a covenant not to compete (or other arrangement) described in subsection (d)(1)(E), in no event shall such covenant or other arrangement be treated as disposed of (or becoming worthless) before the disposition of the entire interest described in such subsection in connection with which such covenant (or other arrangement) was entered into.

(C) Special rule.--All persons treated as a single taxpayer under section 41(f)(1) shall be so treated for purposes of this paragraph.

(2) Treatment of certain transfers.--

(A) In general.--In the case of any section 197 intangible transferred in a transaction described in subparagraph (B), the transferee shall be treated as the transferor for purposes of applying this section with respect to so much of the adjusted basis in the hands of the transferee as does not exceed the adjusted basis in the hands of the transferor.

(B) Transactions covered.--The transactions described in this subparagraph are--

(i) any transaction described in section 332, 351, 361, 721, 731, 1031, or 1033, and

(ii) any transaction between members of the same affiliated group during any taxable year for which a consolidated return is made by such group.

(3) Treatment of amounts paid pursuant to covenants not to compete, etc.--Any amount paid or incurred pursuant to a covenant or arrangement referred to in subsection (d)(1)(E) shall be treated as an amount chargeable to capital account.

(4) Treatment of franchises, etc.--

(A) Franchise.--The term “franchise” has the meaning given to such term by section 1253(b)(1).

(B) Treatment of renewals.--Any renewal of a franchise, trademark, or trade name (or of a license, a permit, or other right referred to in subsection (d)(1)(D)) shall be treated as an acquisition. The preceding sentence shall only apply with respect to costs incurred in connection with such renewal.

(C) Certain amounts not taken into account.--Any amount to which section 1253(d)(1) applies shall not be taken into account under this section.

(5) Treatment of certain reinsurance transactions.--In the case of any amortizable section 197 intangible resulting from an assumption reinsurance transaction, the amount taken into account as the adjusted basis of such intangible under this section shall be the excess of--

(A) the amount paid or incurred by the acquirer under the assumption reinsurance transaction, over
(B) the amount required to be capitalized under section 848 in connection with such transaction.

Subsection (b) shall not apply to any amount required to be capitalized under section 848.

(6) Treatment of certain subleases.--For purposes of this section, a sublease shall be treated in the same manner as a lease of the underlying property involved.
(7) Treatment as depreciable.--For purposes of this chapter, any amortizable section 197 intangible shall be treated as property which is of a character subject to the allowance for depreciation provided in section 167.
(8) Treatment of certain increments in value.--This section shall not apply to any increment in value if, without regard to this section, such increment is properly taken into account in determining the cost of property which is not a section 197 intangible.
(9) Anti-churning rules.--For purposes of this section--
(A) In general.--The term "amortizable section 197 intangible" shall not include any section 197 intangible which is described in subparagraph (A) or (B) of subsection (d)(1) (or for which depreciation or amortization would not have been allowable but for this section) and which is acquired by the taxpayer after the date of the enactment of this section, if--
(i) the intangible was held or used at any time on or after July 25, 1991, and on or before such date of enactment by the taxpayer or a related person,
(ii) the intangible was acquired from a person who held such intangible at any time on or after July 25, 1991, and on or before such date of enactment, and, as part of the transaction, the user of such intangible does not change, or
(iii) the taxpayer grants the right to use such intangible to a person (or a person related to such person) who held or used such intangible at any time on or after July 25, 1991, and on or before such date of enactment.

For purposes of this subparagraph, the determination of whether the user of property changes as part of a transaction shall be determined in accordance with regulations prescribed by the Secretary. For purposes of this subparagraph, deductions allowable under section 1253(d) shall be treated as deductions allowable for amortization.

(B) Exception where gain recognized.--If--

(i) subparagraph (A) would not apply to an intangible acquired by the taxpayer but for the last sentence of subparagraph (C)(i), and

(ii) the person from whom the taxpayer acquired the intangible elects, notwithstanding any other provision of this title--

(I) to recognize gain on the disposition of the intangible, and

(II) to pay a tax on such gain which, when added to any other income tax on such gain under this title, equals such gain multiplied by the highest rate of income tax applicable to such person under this title, then subparagraph (A) shall apply to the intangible only to the extent that the taxpayer's adjusted basis in the intangible exceeds the gain recognized under clause (ii)(I).

(C) Related person defined.--For purposes of this paragraph--

(i) Related person.--A person (hereinafter in this paragraph referred to as the "related person") is related to any person if--

(I) the related person bears a relationship to such person specified in section 267(b) or section 707(b)(1), or

(II) the related person and such person are engaged in trades or businesses under common control (within the meaning of subparagraphs (A) and (B) of section 41(f)(1)).

For purposes of subclause (I), in applying section 267(b) or 707(b)(1), "20 percent" shall be substituted for "50 percent".

(ii) Time for making determination.--A person shall be treated as related to another person if such relationship exists immediately before or immediately after the acquisition of the intangible involved.

(D) Acquisitions by reason of death.--Subparagraph (A) shall not apply to the acquisition of any property by the taxpayer if the basis of the property in the hands of the taxpayer is determined under section 1014(a).

(E) Special rule for partnerships.--With respect to any increase in the basis of partnership property under section 732, 734, or 743, determinations under this paragraph shall be made at the partner level and each partner shall be treated as having owned and used such partner's proportionate share of the partnership assets.

(F) Anti-abuse rules.--The term "amortizable section 197 intangible" does not include any section 197 intangible acquired in a transaction, one of the principal purposes of which is to avoid the requirement of subsection (c)(1) that the intangible be acquired after the date of the enactment of this section or to avoid the provisions of subparagraph (A).

(10) Tax-exempt use property subject to lease.--In the case of any section 197 intangible which would be tax-exempt use property as defined in subsection (h) of section 168 if such section applied to such intangible, the amortization period under this section shall not be less than 125 percent of the lease term (within the meaning of section 168(i)(3)).

(g) Regulations.--The Secretary shall prescribe such regulations as may be appropriate to carry out the purposes of this section, including such regulations as may be appropriate to prevent avoidance of the purposes of this section through related persons or otherwise.

26 U.S.C.A. § 1060

§ 1060. Special allocation rules for certain asset acquisitions

(a) General rule.--In the case of any applicable asset acquisition, for purposes of determining both--

(1) the transferee's basis in such assets, and

(2) the gain or loss of the transferor with respect to such acquisition, the consideration received for such assets shall be allocated among such assets acquired in such acquisition in the same manner as amounts are allocated to assets under section 338(b)(5). If in connection with an applicable asset acquisition, the transferee and transferor agree in writing as to the allocation of any consideration, or as to the fair market value of any of the assets, such agreement shall be binding on both the transferee and transferor unless the Secretary determines that such allocation (or fair market value) is not appropriate.

(b) Information required to be furnished to Secretary.--Under regulations, the transferor and transferee in an applicable asset acquisition shall, at such times and in such manner as may be provided in such regulations, furnish to the Secretary the following information:

(1) The amount of the consideration received for the assets which is allocated to section 197 intangibles.

(2) Any modification of the amount described in paragraph (1).

(3) Any other information with respect to other assets transferred in such acquisition as the Secretary deems necessary to carry out the provisions of this section.

(c) Applicable asset acquisition.--For purposes of this section, the term "applicable asset acquisition" means any transfer (whether directly or indirectly)--

(1) of assets which constitute a trade or business, and

(2) with respect to which the transferee's basis in such assets is determined wholly by reference to the consideration paid for such assets.

A transfer shall not be treated as failing to be an applicable asset acquisition merely because section 1031 applies to a portion of the assets transferred.

(d) Treatment of certain partnership transactions.--In the case of a distribution of partnership property or a transfer of an interest in a partnership--

(1) the rules of subsection (a) shall apply but only for purposes of determining the value of section 197 intangibles for purposes of applying section 755, and

(2) if section 755 applies, such distribution or transfer (as the case may be) shall be treated as an applicable asset acquisition for purposes of subsection (b).

(e) Information required in case of certain transfers of interests in entities.--

(1) In general.--If--

(A) a person who is a 10-percent owner with respect to any entity transfers an interest in such entity, and

(B) in connection with such transfer, such owner (or a related person) enters into an employment contract, covenant not to compete, royalty or lease agreement, or other agreement with the transferee, such owner and the transferee shall, at such time and in such manner as the Secretary may prescribe, furnish such information as the Secretary may require.

(2) 10-percent owner.--For purposes of this subsection--

(A) In general.--The term "10-percent owner" means, with respect to any entity, any person who holds 10 percent or more (by value) of the interests in such entity immediately before the transfer.

(B) Constructive ownership.--Section 318 shall apply in determining ownership of stock in a corporation. Similar principles shall apply in determining the ownership of interests in any other entity.

(3) Related person.--For purposes of this subsection, the term "related person" means any person who is related (within the meaning of section 267(b) or 707(b)(1)) to the 10-percent owner.

(f) Cross reference.--

For provisions relating to penalties for failure to file a return required by this section, see section 6721.

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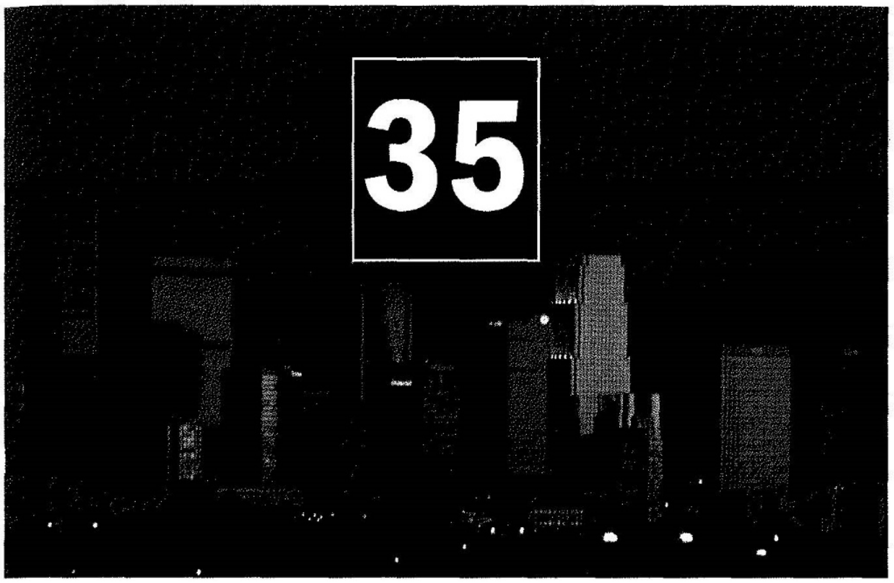


Valuation of Real Property with Related Personal Property or Intangible Property

The primary benefit of private real estate ownership is its ability to house human activities. For example, unimproved land is used for raw materials, agriculture, recreation, and open space. Improved properties provide shelter for households or businesses. Income to real property is generally in the form of rent or royalties. Whenever the income to a property includes payments for goods or services other than real property rents, the property potentially includes non-real property assets that needed to be addressed appropriately. The presence of services that generate income over and above rent on the real property may create intangible property value. Often, however, the net income attributable to those services is viewed as being only incidental, and any incremental value created is considered to be inconsequential. As the proportion of income attributable to non-real estate sources increases, the potential for the property to include intangible assets also rises.

Standards Rule 1-4(g) of the Uniform Standards of Professional Appraisal Practice states, "When personal property, trade fixtures, or intangible items are included in the appraisal, the appraiser must analyze the effect on value of such non-real property items." Those standards do not require a specific allocation of the value opinion between realty and non-realty components or a separate valuation of those components. However, the scope of work for appraisals prepared for ad valorem taxation, eminent domain, financial reporting, mortgage lending, and other purposes may encompass an allocation or a separate valuation of the real property component. For some property types like hotels, car washes, and assisted-living facilities, the real property rarely sells independently of personal property and intangible property. In those cases, establishing a reasonable allocation of the value opinion among the realty and non-realty components can be challenging.

If a separate value in exchange opinion is provided for a non-realty component, the appraiser needs to consider the conditions of the value definition being used. For example, *market value* presumes a hypothetical sale of the asset being valued under certain stated conditions. The analyses and conclusion of value for the component must be consistent with the value definition. On the other hand, allocation is usually a matter of considering how much the component contributes to the larger asset–for example, how much it contributes to the going concern. The allocated amount does not necessarily represent a value in exchange. More likely, it represents a value in use. Furthermore, when a separate value in exchange opinion is developed for each component, the sum of those values may be more (or less) than the value of the whole as if sold together. However, in the case of allocation, the sum of the amounts allocated to each component will equal the value of the whole.

Asset Classes and Transaction Types

Appraisal practice identifies three general classes of property:

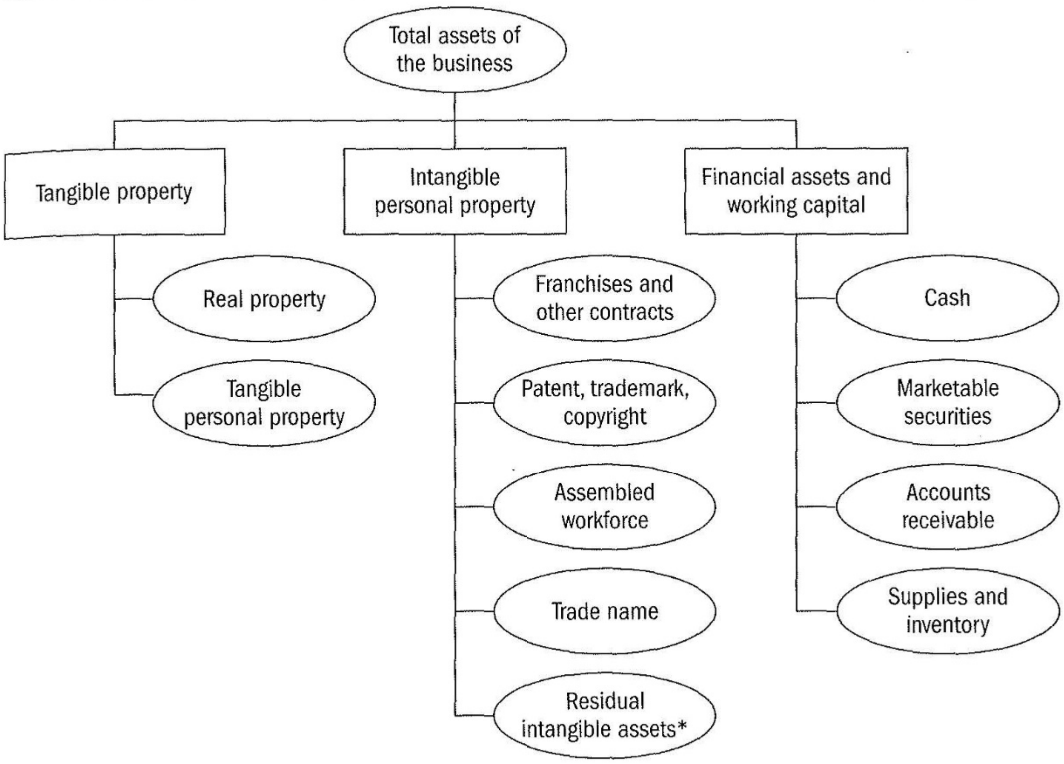
1. Real property
2. Personal property
3. Intangible property (intangible assets)

Real property and personal property make up the tangible asset class. Personal property includes all tangible property not classified as real property. Intangible property is defined as nonphysical assets, including, but not limited to, contracts, franchises, trademarks, copyrights, and goodwill items such as a valuable trade name and a trained workforce. Businesses also generally require working capital and other financial assets, which are best placed in a separate category called *financial assets*. Financial assets include cash and other assets the business intends to eventually convert to cash.

Sales of businesses can be classified in two general transaction types: (1) entity-based transactions and (2) asset-based transactions. In an entity-based transaction, the buyer acquires the actual business entity of the seller through a purchase of the stock, partnership interests, membership interests, or other specified interests, depending on the form of the business. In an asset-based transaction, the buyer acquires only the assets of the business but does not acquire the business entity itself. Say, for ex-

> The appraiser must make clear to the reader of the report what assets are included in the value opinion.

Figure 35.1 **Components of the Total Assets of a Business in an Asset-Based Transaction**



Note. Some appraisers consider supplies and inventory to be a subset of tangible personal property rather than a financial asset, which is also acceptable. In any case, the appraisal report must make it clear to the reader what assets are included in the valuation and how they are allocated.

* The earnings that an entrepreneur receives after all other agents of production have been paid (agents being capital, land, and labor, including management)

ample, a hotel is owned by Jones Hotel Inc. and is the primary asset of that business. In an entity-based transaction, the buyer would acquire the ownership interests through stock certificates in Jones Hotel Inc. and would assume control of that company. The buyer would not only acquire the hotel and any other assets of Jones Hotel Inc. but also any liabilities of the company. In an asset-based transaction, the buyer would acquire only assets of Jones Hotel Inc., such as the real property, the personal property, certain financial assets (when appropriate), and perhaps certain intangible assets. The business entity, Jones Hotel Inc., would remain in the hands of the seller. For small businesses, asset-based transactions are often preferred because of simplicity, reduced legal exposure, and potential tax advantages.

Regardless of the form of a sale, an appraiser must take care to identify which assets were included in the transaction. For some property types, it is common for an asset-based transaction to include real property, related personal property (such as furniture, fixtures, and equipment, commonly referred to by the acronym FF&E), and certain intangible assets, but to exclude the financial assets. However, that is not always the case. In some asset-based sales contracts, a mechanism is set up for the transfer of certain financial assets like accounts receivable or inventory, but the price of those items may or may not be included in the stated purchase price. When this is the case, it poses an additional requirement for the appraiser analyzing comparable sales to determine which assets where included in the transfer. The verification process of comparable sales should also focus on the presence of any financial assets that were included. This is critical to ensure that proper rates and ratios are developed.

The Going-Concern Premise

Business appraisers generally consider the value of a business under both a going-concern premise and a liquidation premise. Under the going-concern premise, the business is assumed to continue operating indefinitely. Under the liquidation premise, it is assumed that the business operation is closed and the assets are sold off. The premise that results in the highest value indication is used for the development of the final value opinion. The appraiser's determination of the appropriate premise is critical in determining the proper appraisal techniques, in selecting comparables, and in making an appropriate allocation of value to the various asset classes.

If the income generated by the business is less than the amount required to support the value of the assets, liquidation (closing the business and selling the assets) is the best course of action because it results in the highest value. Unless a forced liquidation is specifically assumed, the liquidation premise assumes an orderly disposition without atypical seller motivation or a limited marketing period.[1]

Suppose, for example, that an appraiser is asked to value a car wash operating under a franchise agreement with a large national chain. The building has a distinctive design and an upgraded facade required by the franchisor, and the equipment includes some specialized detailing equipment to provide services that are required by the franchise agreement. If the operation is highly profitable, the appraiser may conclude that continued operation of the business will produce the highest value. In that case, the proper allocation of value to the real property and personal property could be as high as the physically depreciated replacement cost (because the facade upgrades and specialized equipment contribute to the value of the tangible assets as a part of the going concern), and the franchise contract could be viewed as a valuable intangible asset. Alternatively, the appraiser may conclude that a higher value may be realized by closing the franchised business operation and reduce costs by eliminating franchise fees and cutting staff and other expenses related to the special services. In that case, the proper allocation to real property may be lower because the spe-

1. A value indication under the liquidation premise is not commensurate with *liquidation value* as that term is used in real estate appraisal.

William H. Beazley, *Valuation of Real Estate Within Senior Living Facilities*, 19 Seniors Housing & Care J. 23-33 (2011)

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Valuation of Real Estate Within Senior Living Facilities

William "Trey" Beazley III, MAI; Steven Sparks, MAI; Michael Bates, MAI, ASA

Abstract

To properly establish the value of a specialized health care facility such as seniors housing, an analyst must understand the underlying elements that create value in the business entity. It may be difficult to separate the market value of the land and the building from the total value of the business, but such division of realty and non-realty components of value is often required. Estimating the value of any complex property, where the income and expenses are driven by both the real estate and business, one must rely on a recognized methodology supported with market data to properly account for the components of land and buildings, along with tangible and intangible personal property. This article builds on growing market knowledge and provides a quantitative analysis to support reasonable allocations of the real estate component of various seniors housing facilities.

Introduction

Is senior living considered an operating business, real estate, or both? The answer has important implications, since real estate assets are different from business assets. Investors, lenders, and specifically appraisers should be knowledgeable in component allocation to properly understand seniors housing transactions. Appraisers are required by Standard Rule 1-2 of the Uniform Standards of Professional Appraisal Practice (USPAP) to separately identify any assets being valued that are not real estate.

Independent living facilities (ILFs) and assisted living facilities (ALFs) provide primarily room and board and limited care services, and the funding for these facilities is mostly private pay. Skilled nursing facilities (SNFs) are more special-purpose institutional structures due to governmental controls and health care regulations. In recent years, most of the funding for SNFs is via public programs, including Medicaid and Medicare. Medicaid and Medicare payments for skilled nursing services do not consider the quality of real estate improvements, but there is a cost factor for real estate as part of the overall cost reimbursement process underlying the payment formulas. Under real estate theory, the age of an SNF should be a more important factor in determining value than the revenue generated by Medicaid or Medicare program rate reimbursements.

Real estate appraisal literature includes a bounty of articles (Lennhoff, 1999; Mullen, 1999; Wallery, 1991) citing the existence of intangible value in seniors housing properties, which include ILFs, ALFs, and SNFs. A going concern is an established and operating business with an indefinite future life. For certain types of properties, the physical real estate assets are integral parts of an ongoing business. Accounting regulations require this allocation between the real estate and the business personal property (BPP), which is both tangible and intangible. Seniors housing and care is correctly defined as a "real estate-based business," and real estate is a depreciable asset while intangible business value in not depreciable. A proper allocation of the real estate value is also important for real estate lending, accounting integrity, or property tax valuations.

According to the *Dictionary of Real Estate Appraisal* (2010), the term market analysis is "a process for examining the demand for and supply of a property type and the geographic market area for that property type." This term is used more broadly in economics but has a more specific meaning within the real estate discipline. Market analysis investigates the relationship between the demand for and competitive supply of real estate in a defined market. Seniors housing market analysis requires extensive examination to properly support the value of the going concern and to estimate the portion of the going concern that is real estate.

Proposition

Is there a mechanism that gives supportable allocations? Market evidence indicates that there is quantitative support for reasonable real estate allocation ranges for seniors housing properties. The analytical framework begins with the Principle of Substitution. This article provides a methodology to support a reasonable allocation range for the real estate component and BPP component out of the total going concern value.

Overview

The task facing most analysts is that seniors housing properties are bought and sold as going concerns with residents in-place. The going concern includes all tangible and intangible personal property in the sales transaction. Tangible personal property encompasses office equipment, kitchen equipment, and resident furniture. Intangible personal property includes accounting systems, workforce, personnel manuals, medical records, insurance contracts, reputation and goodwill, working capital, and in most cases, corporate marketing and management expertise necessary to attract and maintain market occupancy.

One factor complicating the analysis of sales is that most transactions involve multifacility (or portfolio) transactions, which may include a significant premium in price compared to individual facility sales. According to *The Senior Care Acquisition Report* (2008), the average price per unit for portfolio sales was 20.3% higher in 2007 and 26.4% higher in 2008 than single-unit sales. The second factor is many of these multifacility transactions involve real estate investment trusts (REITs). Under historical tax codes, REITs are not allowed to have more than 10% of their portfolio in non-realty items (recent legislation appears to be easing this requirement). As a result, there may be legal pressure to allocate a lower ratio to intangible or business value, so that real property is at least 90% of the acquisition price.

In a comprehensive article on sale-leasebacks, Sirmans and Slade (2010) provided documentation that sale-leasebacks occur at average price premiums that were 13.86% higher than non-sale-leasebacks: "The findings reveal that transactions structured as sale-leasebacks occur at significantly higher prices than market transactions." Based on this research, sale-leaseback transactions should not be used to estimate the market value of the fee simple real estate without further analysis to recognize the component allocation of real and personal property.

Sale-leasebacks are an investment vehicle commonly used by various investors to invest in health care properties. In some cases, the investor acquires the real estate and the same independent operator continues to operate the facility. The investor is partnering with the operator. Sale-leasebacks are considered financing transactions because of corporate tenant guarantees, buy-back options, joint ventures, income from the operating business determining the rental payments, and investor lease structures, which often include working capital as well as tangible and intangible personal property. Working capital (or short-term assets minus short-term liabilities) is the money that is needed to fund day-to-day business operations. Tangible personal property is furniture and equipment, while intangible personal property may be the value of the workforce or goodwill or other non-physical assets. The intangible personal property assets are also commonly referred to as business enterprise value. An investor lease structure will often include ownership or control of some of these non-real estate assets. This makes the process of separately identifying real estate value more difficult.

In most states, property taxes are assessed based on a fee simple real estate value, and courts have ruled that values derived from above-market leases reflect intangible or contract value rather than real estate value. According to Karvel and Patchin (2001), "Lease premiums that result in rental payments above market rental are a source of business value." This was further confirmed by a July 8, 2008, The Wisconsin Supreme Court case called *Walgreen & Co. vs. City of Madison*. In Section 96 of that case, the court stated (*The Appraisal of Real Estate*, 12th ed.), "a lease favorable to the lessor does not increase the fair market value of the real property; any potential increased value in excess of the value of a fee simple interest in the property is attributable to the particular lease and constitutes the value of contract rights rather than real property rights."

Another court ruled that there is significant intangible value in nursing homes. In a New Britain, Connecticut, superior court case in 2006, *Avon Realty, LLC vs. Town of Avon*, on page 14 of the ruling, "the court finds that a nursing home's intangibles, not its real estate, are its major components of value." The nursing home had an average physical age of approximately 30 years. In that case, an appraiser had observed, "the real estate is worth little without the intangibles." ILFs and ALFs also clearly have significant BPP components.

In *The Journal of Property Tax Management*, Wallery (1991) states, "There are businesses housed within congregate care facilities, including food service, housekeeping, and activity. Services are provided for a fee that usually includes business profit. These services are labor intensive, and the profit earned is attributable to the business, not to the tangible real property." Over the past 20 years, these services have expanded multifold and now also include vans for transportation to events in the community, as well as shopping, activities, salons, exercise classes, and other programs. This has expanded the overall going concern.

According to Lennhoff (1999), "senior housing is another good example of the type of property in which business enterprise value plays a major role." This was reinforced by Lennhoff, quoting the CEO of a senior living company: "Assisted living is not a real estate business. It's an operating business that happens to take place in real estate." According to Lennhoff, "When asked to value just the real estate, using the Cost Approach is relatively straightforward." (The Cost Approach is discussed in detail in a later section.)

Mullen (1999) estimated real estate ratios at 73.5% for congregate care facilities, 53.1% for assisted living facilities, and 36.7% for nursing homes. Mullen's calculations support the real estate allocation ranges derived in this article.

Income Approach

The Income Approach is a common appraisal methodology that capitalizes real estate income into an estimate of property value. This approach becomes complicated because a seniors housing property's actual revenue and expense statement represents a going concern operation rather than an income statement based on real property only (land and building). Supporting a going concern value for the entire business operation is fairly straightforward using the Income Approach. The biggest difficulty valuing a senior living facility by the Income Approach is allocating the total going concern between 1) real estate; 2) personal property; and 3) business enterprise.

There are published seniors housing industry operating and acquisition data that can be used to test the reasonableness of facility financials and operating data to estimate the going concern value, which is the value of all facility component assets. National occupancy data, loan data, new construction and capitalization rates are available by seniors housing property type from the National Investment Center (NIC). Another source providing average occupancy rates, purchase price data, gross income multiples and capitalization rates is the annual *Senior Care Acquisition Report* (Irvin Levin Associates, Inc.). *The State of Senior Housing* (American Senior Housing Association, ASHA) is an annual report that provides average income and expenses and ratios by seniors housing property type. This published and subject financial data can be used to estimate the net operating income (NOI), which is capitalized at a market overall rate that is readily available in the marketplace to estimate the going concern value. Additional sources are available from brokerage and consulting firms.

The sources in **Table 1** provide market overall capitalization rates that reflect the return investors are paying to acquire going concern interests for operating seniors housing properties:

All reported surveys reflect distinct differences in capitalization rates for ILFs, ALFs, and SNFs. The market is recognizing the difference in risk and required returns associated with each property type. There are fewer alternative uses for the more institutional SNF structures, which creates higher risks for potential buyers. As government controls, regulations, and potential insurance liabilities increase from ILFs to ALFs to SNFs, there are fewer prospective buyers. This creates higher risks and thus higher required returns; e.g., most pension funds and many other large investors will not buy SNFs because of government regulations and the associated higher liability risks. As a result of the increase in perceived risk, the market-indicated required returns also increase from ILFs to ALFs to SNFs.

When developing a methodology to separate the going concern value between the real estate and BPP, the starting point is to estimate the going concern value using revenues and expenses (market averages and actual), and market capitalization rates for the going concern. The Income Approach is the most applicable approach to support the going concern value.

Table 2 is a detailed analysis of the revenues and operating expenses of ILFs, ALFs, and SNFs.

Data on Lines 1, 2, and 4 come from data sources cited previously, including *The State of Senior Housing* (2010), *The Senior Care Acquisition Report* (2010), and the *NIC Investment Guide* (2010). The most common formula for Value is Income (NOI) divided by Rate (or V=I/R). Line 3 shows the net operating income (NOI) of the going concern, or expenses subtracted from total revenue. Total Going Concern is a calculation dividing NOI by the Overall Rate, resulting in average going concern values by property type. Next, this analysis looks at the principle of substitution via the Cost Approach to estimate the real estate component value and to separate the real estate value from the going concern value. This was implied previously by Lennhoff (1999) and stated explicitly by Bates (1997), which supports the Cost Approach as the preferred method to estimate component values for the total going concern value.

Cost Approach

A frequent misconception when valuing a senior living facility is that cost always equals value. The

Table 1

	Independent Living	Assisted Living	Nursing Home
NIC	8.8	9.9	13.3
Slysinc Study	8.5	9.1	12.8
Marcus & Millichap	8.5	8.9	12.5
Senior Acq Report	8.1	9.9	12.8
Concluded	8.8	9.5	12.5

Table 2

Line	Income Approach	Ind. Living	Assisted Living	Nursing
1	Total Revenue	$35.03	$57.79	$283.31
2	Expenses	$21.86 62.4%	$41.13 71.2%	$239.66 84.6%
3	NOI / SF	$13.17 37.6%	$16.65 28.8%	$43.65 15.4%
4	Overall Rate	8.8%	9.5%	12.5%
5	Total Value Going Concern via Income	$149.70	$175.31	$349.20

All dollar amounts are on a per square foot (SF) basis.

fact is that the cost may, under certain circumstances, be a reliable indicator of value. Reported improvement values may also reflect their "value in use" when they comprise an integral part of a business enterprise. Some factors determining the relevance of the Cost Approach: the Cost Approach is more reliable with sufficient data to support land value and replacement cost of the improvements; the Cost Approach is more relevant for properties where actual rents reflect going concern operating cash flows; the Cost Approach is typically more relevant when comparable sales include more than just real estate assets; and the Cost Approach has a great advantage in that it is not tainted with tangible and intangible personal property issues.

Table 3 is a quantification of the Cost Approach allocation process. It is assumed that anyone performing these calculations has a knowledge and understanding of current market conditions affecting the various health care industries (ILFs, ALFs, SNFs).

Going Concern Value in Table 3 comes from Table 2. "Replacement Cost New" estimates on a national basis from multiple sources, including but not limited to Marshall & Swift, RS Means, Design Cost Data,[1] and project managers who build these types of facilities. Land value is supported and estimated from the analysis of seniors housing properties using

Table 3

Line		Ind. Living	Assisted Living	Nursing
1	Going Concern via Income	$149.70	$175.51	$349.20
2	Replacement Cost New/SF	$86.92	$92.22	$138.75
3	Plus Land	$25.00 28.8%	$35.00 38.0%	$60.00 43.2%
4	Total Cost	$111.92	$127.22	$198.75
5	Average Effective Age	15[1]	16[2]	32[3]
6	Depreciation	30.00% 50	35.56% 45	80.00% 40
7	Market Value of Land & Improvements	$85.84	$94.43	$87.75
8	Implied BPP Market Value	$63.82	$80.83	$261.45
9	Percentage to BPP	42.6%	46.1%	74.9%
10	Percentage Real Estate	57.4%	53.9%	25.1%

[1] *IL Average Age Per National Investment Center for the Senior Housing & Care Industry is 15.4 years*

[2] *AL Average Age Per National Investment Center fir the Senior Housing & Care Industry is 15.8 years*

[3] *Nursing Home Average Age Per The Senior Care Acquisition Report, 15th Edition, 2010 is 32.1 years*

[1] Marshall & Swift, RS Means, and Design Cost Data are subscription-based cost services used frequently in the appraisal and construction industries.

ratios of land-to-replacement cost.

This analysis only considers physical depreciation, assuming there is no economic or functional depreciation present. Physical depreciation is a reflection of the age of the improvements. There could be economic depreciation present if the property being valued was located in an area of low demand or oversupply. There could be functional depreciation, for instance, if there was a structural problem that negatively impacted occupancy or rental rate levels. For the purpose of this analysis, the authors have not considered any economic or functional depreciation.

Line 5 shows the average effective ages of each facility type. According to NIC, the average ages for ILFs and ALFs were 15.4 years and 15.8 years, respectively. The average age of SNFs was 32.1 years, according to *The Senior Care Acquisition Report* (2010). The average economic life for each facility type in Line 6 was derived from several sources, including Marshall & Swift and the American Hospital Association.

Line 7 represents the market value of the land and improvements of each facility type by the Cost Approach. This is the depreciated value of Line 2 plus Line 3. When compared to the going concern value (Line 1), Line 8 shows the implied premium paid for the business personal property (BPP), the non-realty component. Finally, in Line 9 and Line 10, the ratio between the BPP and real estate is calculated.

Case Study

This case study expands upon a previous methodology and demonstrates that it produces a reasonable allocation for the various interests in seniors housing transactions. The methodology follows USPAP in properly addressing non-reality component values that are part of the going concern. The reader is cautioned that in applying the Cost Approach, a qualified practitioner should use market-supported costs to support or complement any replacement cost estimates derived from costing services.

Table 4 uses the market data from Table 3 to show what ratios would be for various facilities of different ages. These ranges are quantitative results from data commonly available in the market, and the results of this analysis are reflective of the market. The reader is cautioned that these ratios are calculations based on market averages. The experienced analyst needs to make adjustments for particular property and market characteristics. Some of the main factors that would require potentially major comparative adjustments are:

- Superior location and high demand and occupancy rates
- Inferior location and low demand and occupancy rates
- A significant difference in the number of units and economies of scale compared to transaction averages
- Areas with limited demand and low land values
- Very new or very old facilities with or without functional issues

Table 4 includes a sensitivity analysis using the Cost Approach to calculate the real estate component ratio for the following building ages: 10 years, 15 years, 20 years, 25 years, 30 years, and 35 years. It is clear that as seniors housing facilities age, the ratio of real estate value declines and the ratio of BPP values rise. In reality, as the real estate ages the tangible personal property value usually also declines, while the intangible value increases. This makes sense because established businesses typically become more profitable as they mature (Advertising Beacon, 2011).

The bottom of Table 4 and the following graphs reflect changing real estate allocations as the facilities age.

The sensitivity analysis is a graphic representation of real estate ratios using simple age-life depreciation without consideration for functional or economic issues. The table and graphs indicate that the real estate ratio declines and the BPP ratio rises as a facility gets older, given the same level of total going concern value. In actuality, the ratio trend lines would not be linear, particularly in the earlier and

Table 4						
Inputs	Independent Living		Assisted Living		Nursing Home	
Going Concern Cap Rate	8.8%		9.5%		12.5%	
Subject NOI/SF	$13.17		$16.65		$43.65	
Going Concern Value	$149.66		$175.26		$349.20	
RCN	$86.92		$92.22		$138.75	
Land Value/SF Improve	$25.00		$35.00		$60.00	
Ratio of Land to RCN	28.8%		38.0%		43.2%	
	IL - Econ Life 50		AL - Econ Life 45		NH - Econ Life 40	
Age	RE %	BPP%	RE %	BPP%	RE %	BPP%
10	63.2%	36.8%	60.9%	39.1%	47.0%	53.0%
15	57.4%	42.6%	55.0%	45.0%	42.0%	58.0%
20	51.6%	48.4%	49.2%	50.8%	37.0%	63.0%
25	45.7%	54.3%	43.4%	56.6%	32.1%	67.9%
30	39.9%	60.1%	37.5%	62.5%	27.1%	72.9%
35	34.1%	65.9%	31.7%	68.3%	22.1%	77.9%

late years of a building's life. In the early few years of a building's life, there is typically very little physical depreciation, while in the later years the remaining building is usually depreciating very rapidly.

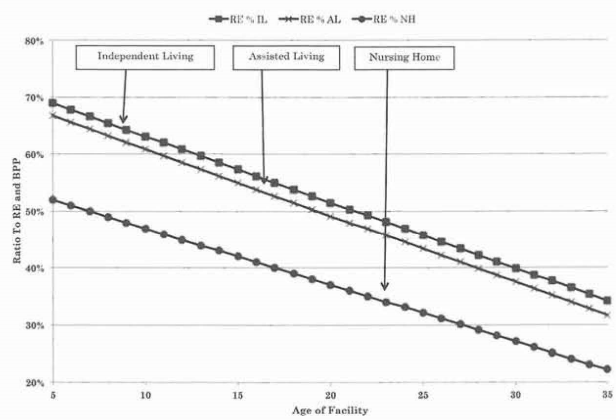
Table 5 is a summary of component allocations derived in this Cost Approach compared to previous allocations discussed by Mullen (1999). The authors have reconciled the results of these studies into ranges of real estate to going concern values for average-aged ILFs, ALFs, and nursing homes. A 15-year-old ILF should have a real estate component ratio of 35% to 70% of the going concern. A 32-year-old nursing home should have a real estate component ratio that ranges from 20% to 55%.

As long as there is a profitable operating business in the real estate, there is intangible business value that needs to be recognized. Just like there could never be 100% real estate value, there also could never be zero real estate value as long as an operating business continues to function profitably in the real estate. Hence, an appraiser would have to understand the seniors housing facility business to accurately opine about real estate component allocations.

The Income Approach is not considered reliable in estimating the real estate values or real estate ratios of seniors housing properties because revenues and expenses represent going concern operations rather than income and expense solely applicable to real property (land and building).

A Sales Comparison Approach to separately estimate the real estate of seniors housing facilities is hindered by the fact that most market transactions are going concerns and are often part of multifacility acquisitions. The lack of availability of clearly

Graph 1. Percent of Real Estate to Going Concern



Graph 2. Percent of BPP to Going Concern

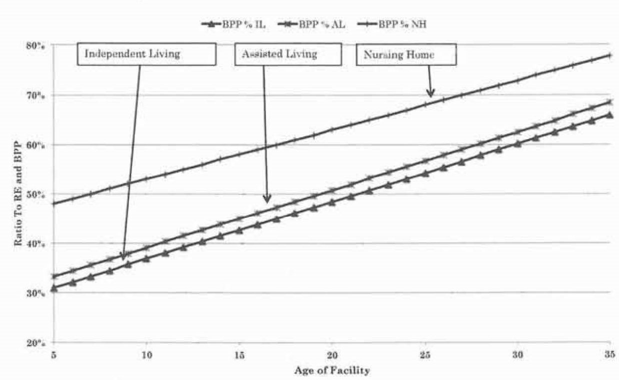


Table 5			
Allocation of Going Concern to Real Estate			
	ILFs	**ALFs**	**Nursing Home**
1999 Mullen's Article	73.50%	53.10%	36.70%
2011 Cost Approach Method	57.36%	53.88%	25.13%
Age	15	16	32
Range based on Age of facility	35% - 70%	30% - 65%	20% - 55%
Age Range for all facilites	5 to 35 years		

supported real estate-only sales makes the use of the Sales Comparison Approach difficult for this process. According to Unland (1993), "the sales comparison approach can provide a 'frame of reference,' but that is the extent of its usefulness..."

CONCLUSION

As with any analysis of a complex property, the availability of relevant market data is a critical factor in producing a reliable and supported conclusion. This analysis includes a market-supported methodology to allocate the real estate and BPP components within the going concern. The process is more difficult and time-consuming because both standard real estate due diligence and the business/management due diligence must be completed. The BPP and real estate allocations percentages change over time as facilities age. A combination of the Cost Approach and the Income Approach provides the market support for the allocation between the real estate and BPP.

Understanding the market forces that impact the seniors housing industry is the key to valuing a senior living facility. Again, according to Unland (1993): "To properly establish the value of a specialized health care organization or facility, one must understand the underlying elements that create value in the business entity."

Failure to perform a detailed market analysis of the industry and to understand the market forces that face the industry would preclude the possibility of a credible and market-supported analysis. According to *The Appraisal of Real Estate*, "It may be difficult to separate the market value of the land and the building from the total value of the business, but such division of realty and non-realty components of value is often required by federal regulations. Only qualified practitioners should undertake these kinds of assignments, which must be performed in compliance with appropriate USPAP standards" (Appraisal Institute, 1996). Employing nationally recognized market data sources and quantitative methods as described here with a detailed knowledge of the seniors housing industry, the allocation between BPP and real estate can be reasonably supported. This analysis confirms there are definable and supportable value ranges for the real estate component within going concern senior living facilities.

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Rev. Rul. 65-193 (IRS RRU), 1965-2 C.B. 370, 1965 WL 13021

Internal Revenue Service (I.R.S.)

Revenue Ruling

Published: 1965

26 CFR 20.2031-2: Valuation of stocks and bonds.

(Also Sections 1001, 2512; 1.1001-1, 25.2512-2.)

***1** Revenue Ruling 59-60, C.B. 1959-1, 237, is hereby modified to delete the statements, contained therein at section 4.02(f), that 'In some instances it may not be possible to make a separate appraisal of the tangible and intangible assets of the business. The enterprise has a value as an entity. Whatever intangible value there is, which is supportable by the facts, may be measured by the amount by which the appraised value of the tangible assets exceeds the net book value of such assets.'

The instances where it is not possible to make a separate appraisal of the tangible and intangible assets of a business are rare and each case varies from the other. No rule can be devised which will be generally applicable to such cases.

Other than this modification, Revenue Ruling 59-60 continues in full force and effect. See Rev. Rul. 65-192, page 259, this Bulletin.

Rev. Rul. 68-609 (IRS RRU), 1968-2 C.B. 327, 1968 WL 15211

Internal Revenue Service (I.R.S.)
Revenue Ruling

Published: 1968

SECTION 1001.—DETERMINATION OF AMOUNT OF AND RECOGNITION OF GAIN OR LOSS, 26 CFR 1.1001-1: Computation of gain or loss.

(Also Section 167; 1.167(a)-3.)

The 'formula' approach may be used in determining the fair market value of intangible assets of a business only if there is no better basis available for making the determination; A.R.M. 34, A.R.M. 68, O.D. 937, and Revenue Ruling 65-192 superseded. Ruling is to update and restate, under the current statute and regulations, the currently outstanding portions the currently outstanding portions of A.R.M. 34, C.B. 2, 31 (1920), A.R.M. 68, C.B. 3, 43 (1920), and O.D. 937, C.B. 4, 43 (1921).

The question presented is whether the 'formula' approach, the capitalization of earnings in excess of a fair rate of return on net tangible assets, may be used to determine the fair market value of the intangible assets of a business

The 'formula' approach may be stated as follows:

> A percentage return on the average annual value of the tangible assets used in a business is determined, using a period of years (preferably not less than five) immediately prior to the valuation date. The amount of the percentage return on tangible assets, thus determined, is deducted from the average earnings of the business for such period and the remainder, if any, is considered to be the amount of the average annual earnings from the intangible assets of the business for the period. This amount (considered as the average annual earnings from intangibles), capitalized at a percentage of, say, 15 to 20 percent, is the value of the intangible assets of the business determined under the 'formula' approach.

The percentage of return on the average annual value of the tangible assets used should be the percentage prevailing in the industry involved at the date of valuation, or (when the industry percentage is not available) a percentage of 8 to 10 percent may be used.

The 8 percent rate of return and the 15 percent rate of capitalization are applied to tangibles and intangibles, respectively, of businesses with a small risk factor and stable and regular earnings; the 10 percent rate of return and 20 percent rate of capitalization are applied to businesses in which the hazards of business are relatively high.

The above rates are used as examples and are not appropriate in all cases. In applying the 'formula' approach, the average earnings period and the capitalization rates are dependent upon the facts pertinent thereto in each case.

The past earnings to which the formula is applied should fairly reflect the probable future earnings. Ordinarily, the period should not be less than five years, and abnormal years, whether above or below the average, should be eliminated. If the business is a sole proprietorship or partnership, there should be deducted from the earnings of the business a reasonable amount for services performed by the owner or partners engaged in the business. See *Lloyd B. Sanderson Estate* v. *Commissioner*, 42 F.2d 160 (1930). Further, only the tangible assets entering into net worth, including accounts and bills receivable in excess of accounts and bills payable, are used for determining earnings on the tangible assets. Factors that influence the capitalization rate include (1) the nature of the business, (2) the risk involved, and (3) the stability or irregularity of earnings.

***2** The 'formula' approach should not be used if there is better evidence available from which the value of intangibles can be determined. If the assets of a going business are sold upon the basis of a rate of capitalization that can be substantiated as being realistic, though it is not within the range of figures indicated here as the ones ordinarily to be adopted, the same rate of capitalization should be used in determining the value of intangibles.

Accordingly, the 'formula' approach may be used for determining the fair market value of intangible assets of a business only if there is no better basis therefor available.

See also Revenue Ruling 59-60, C.B. 1959-1, 237, as modified by Revenue Ruling 65-193, C.B. 1965-2, 370, which sets forth the proper approach to use in the valuation of closely-held corporate stocks for estate and gift tax purposes. The general approach, methods, and factors, outlined in Revenue Ruling 59-60, as modified, are equally applicable to valuations of corporate stocks for income and other tax purposes as well as for estate and gift tax purposes. They apply also to problems involving the determination of the fair market value of business interests of any type, including partnerships and proprietorships, and of intangible assets for all tax purposes.

A.R.M. 34, A.R.M. 68, and O.D. 937 are superseded, since the positions set forth therein are restated to the extent applicable under current law in this Revenue Ruling. Revenue Ruling 65-192, C.B. 1965-2, 259, which contained restatements of A.R.M. 34 and A.R.M. 68, is also superseded.