Is Excess Rent Intangible?

by Stephen D. Roach, MAI, SRA, AI-GRS

Abstract

Excess rent is a term commonly understood by real estate appraisers to refer to contract rent that exceeds market rent at the date of an appraisal. This portion of the income stream generated by leased property is often mischaracterized, however, by those who fail to identify it as an intangible asset. Through logical application of long-accepted definitions of relevant terms, this article shows that the present value of excess rent is intangible, and it should be identified when included in the property rights being valued by appraisers.

Introduction

Real property appraisers are often asked to value properties encumbered by leases. The very nature of income-producing real estate is that cash flow is created through agreements with a tenant or tenants to make periodic payments in exchange for the right to occupy space. The value of a property subject to these agreements is largely a function of the level of revenue required by the contracts, and it is intuitive that, all else being equal, the higher the periodic payments, the higher the resulting value. Such an agreement is called a *lease*[1] and the periodic payment is called *rent*.[2] Because the fundamentals of leases and patterns of rental payments are well covered in the Appraisal Institute's body of knowledge and course materials,[3] this article will not cover those topics in any depth. Rather, this article analyzes the nature of the rent produced pursuant to a lease, specifically to answer the question, "Is excess rent intangible?"

What Is Excess Rent?

While it is likely that no amount of revenue is viewed as "excess" from the perspective of property investors, most appraisers understand that *excess rent* is a term used to describe rent that is higher than the market rent for a property. The term is commonly used by professional real estate appraisers but is rarely used outside of the profession. *The Dictionary of Real Estate Appraisal*, sixth edition, defines *excess rent* as "the amount by which contract rent exceeds market rent at the time of the appraisal."[4] This concept can be shown in equation form as

Excess Rent = Contract Rent – Market Rent

Excess rent is also addressed in *The Appraisal of Real Estate*, fourteenth edition, which explains,

> A lease never increases the market value of real property rights to the fee simple estate. Any potential value increment in excess of a fee simple estate is attributable to the particular lease contract.[5]

This statement reinforces that the fee simple interest (the real estate) can obtain market rent but no more. This statement also indicates that anything above the market-rent level must be

1. A *lease* is "a contract in which the rights to use and occupy land or structures are transferred by the owner to another for a specified period of time in return for a specified rent." Appraisal Institute, *The Dictionary of Real Estate Appraisal*, 6th ed. (Chicago: Appraisal Institute, 2015), s.v. "lease."
2. *Rent* is "an amount paid for the use of land, improvements, or a capital good." Ibid., s.v. "rent."
3. For excellent general discussions of leases, rent, and other income capitalization approach topics, consult Appraisal Institute courses *General Appraiser Income Approach/Part 1*, *General Appraiser Income Approach/Part 2*, and *Advanced Income Capitalization*.
4. The full definition states, "The amount by which contract rent exceeds market rent at the time of the appraisal; created by a lease favorable to the landlord (lessor) and may reflect unusual management, unknowledgeable parties, a lease execution in an earlier, stronger rental market, or an agreement of the parties." *The Dictionary of Real Estate Appraisal*, 6th ed., s.v. "excess rent."
5. Appraisal Institute, *The Appraisal of Real Estate*, 14th ed. (Chicago: Appraisal Institute, 2013), 441.

produced by something other than the physical property itself. While the lease may "run with the land" (that is, the beneficial interest in the lease relates to a specific property and this beneficial interest transfers with a transfer of the property), it is distinct from the bundle of rights in the property itself.

Defining Key Concepts

Because excess rent is contract rent minus market rent (when contract rent is higher than market rent), it is helpful to review those two terms for a full understanding of excess rent. According to *The Dictionary of Real Estate Appraisal*, sixth edition,

- *Contract rent* is the actual rental income specified in a lease.[6]
- *Market rent* is the most probable rent that a property should bring in a competitive and open market reflecting all conditions and restrictions of a specified lease agreement, including the rental adjustment and revaluation, permitted uses, use restrictions, expense obligations, term, concessions, renewal and purchase options, and tenant improvements (TIs).[7]

The "competitive and open market" from which the most probable rent is ascertained for a property should include rents from available comparable properties that have the same highest and best use; that highest and best use should be defined as narrowly as possible to ensure that the amount of excess rent is truly only intangible personal property and does not accidently include any real property interests.

While the definition of market rent appears clear on the surface, one word in the definition must be analyzed carefully for a complete understanding of the definition and to follow the logic in this article; that word is *property*. The definition states that market rent is rent that should be obtained by a property, but the term *property* is arguably ambiguous as used in the market rent definition. As *The Dictionary of Real Estate Appraisal* explains, *property* is "something tangible or intangible to which its owner has legal title."[8] This definition is helpful in that it clearly shows there is more than one type of property to which market rent could, at least in theory, be referring. A more comprehensive definition of *property* appears in the glossary of *International Valuation Standards* (IVS), eighth edition (2007); it states as follows:

> Property—A legal concept, encompassing all the interests, rights, and benefits related to ownership. Property consists of the private rights of ownership, which entitle the owner to a specific interest or interests in what is owned. To distinguish between real estate, a physical entity, and its ownership, a legal concept, the ownership of real estate is called *real property*. Ownership of an interest in an item other than real estate is referred to as *personal property*. The International Valuation Standards Committee recognises the following four property types: real property, personal property, businesses, and financial interests.[9]

This excellent definition furthers the understanding that the term *property* is properly used to describe the "interests, rights, and benefits related to ownership." In this context, property does not refer to the thing itself but to the rights associated with owning the thing. Further, the definition explicitly distinguishes between real estate (the physical thing) and real property (the rights associated with the ownership of the real estate) in a manner that is consistent with the Appraisal Institute's definitions and body of knowledge.[10] Applying this definition to the prior definition of market rent, "property" would logically refer to the rights of ownership of something, either real estate or personal property. Since the lease contract is personal property (more on this subject later), it is critical to determine whether

6. *The Dictionary of Real Estate Appraisal*, 6th ed., s.v. "contract rent."
7. Ibid., s.v. "market rent."
8. Ibid., s.v. "property."
9. The definition of *property* is not included in subsequent editions of the IVS. Definitions of the 2007 International Valuation Standards are reprinted in *The Dictionary of Real Estate Appraisal*, 5th ed., 241–260.
10. The Uniform Standards of Professional Appraisal Practice (USPAP) makes the identical distinction between the real estate and real property. See Appraisal Standards Board, "Definitions," in *Uniform Standards of Professional Appraisal Practice*, 2016–2017 ed. (Washington, DC: The Appraisal Foundation, 2016).

the "property" in the definition of market rent is referring to the physical real estate or to the other property involved in this discussion, the lease.

Despite the clarity of the IVS definition of property,[11] the prior definition of market rent ascribes a different meaning to the term. In the market rent definition, it does not make sense that "property" is being used to describe anything other than a physical real estate asset; in other words, the term is being used in a nontechnical sense. An example of a nontechnical definition that focuses largely on the physical aspect of property can been seen in the following Merriam-Webster.com definition:

- something that is owned by a person, business, etc.
- a piece of land often with buildings on it that is owned by a person, business, etc.
- a special quality or characteristic of something.[12]

In summary, the only logical reading of the definition of market rent is that it is the most probable rent that a *parcel of real estate* should bring in a competitive and open market, subject to the other elements of the definition.

With the definitions understood, the next question is, what causes excess rent? This is addressed in the second part of the definition of excess rent, which notes that excess rent is "created by a lease favorable to the landlord (lessor) and may reflect unusual management, unknowledgeable parties, a lease execution in an earlier, stronger rental market, or an agreement of the parties." As indicated by this part of the definition, excess rent can be created by market conditions (a lease executed in an earlier, stronger market) and transaction conditions (unusual management, unknowledgeable parties, or an agreement of the parties).[13]

The final question to be asked for context is, what do we do with excess rent? *The Appraisal of Real Estate*, fourteenth edition, states "due to the higher risk inherent in the receipt of excess rent, it may be calculated separately and capitalized at a higher rate."[14] Excess rent is a consideration in the income capitalization approach,[15] and it gets capitalized (or discounted) and included in the value when appraising a leased fee interest.

Excess Rent in Appraisal

Appraisal Institute reference materials and courses do a very good job of explaining that appraisers must be aware of excess rent in properties being appraised and in sales used as comparables. One of the primary reasons for this requirement is that excess rent is inherently riskier than market rent and it is relatively shortlived; it goes away at the expiration of a lease. The question of how to characterize excess rent is also significant for several other reasons, including whether the value created by excess rent is assessable for property tax purposes, how it should be treated in purchase price allocations for income tax purposes, and how it should be treated in the secured lending process (more on these issues later). The question is also significant to appraisers who must comply with the Uniform Standards of Professional Appraisal Practice (USPAP), which includes requirements relating to intangible assets. For example, the specific requirements in Standards Rule 1-2 state as follows:

> In developing a real property appraisal, an appraiser must:
>
> …
>
> (e) identify the characteristics of the property that are

11. The noted IVS definition is consistent with the definition of *real property* in *The Dictionary of Real Estate Appraisal*, 6th ed., which refers to "the interests, benefits, and rights inherent in the ownership of real estate."
12. "Simple definition of property," http://bit.ly/defineproperty.
13. A common cause of excess rent is concessions contained in a lease. For example, assume that the market rent for a property is \$20.00 per square foot per year. Further assume that a tenant leases the property for five years at \$25.00 per square foot, with the first year of rent abated. While the effective rent for the lease term on a straight-line basis is the market rent of \$20.00 (\$25.00 × 4 ÷ 5 = \$20.00), as soon as the free rent is burned off, the lease contract requires the tenant to pay excess rent.
14. *The Appraisal of Real Estate*, 14th ed., 449.
15. Although the impact of excess rent must also be considered in the sales comparison and cost approaches to value, the proper treatment in these approaches is beyond the scope of this article.

> relevant to the type and definition of value and intended use of the appraisal, including
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> …
>
> (iii) any personal property, trade fixtures, or intangible items that are not real property but are included in the appraisal.[16]

In addition, Standards Rule 1-4 states as follows:

> In developing a real property appraisal, an appraiser must collect, verify, and analyze all information necessary for credible assignment results.
>
> …
>
> (g) 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."[17]

While USPAP does not define "intangible items," it does define *intangible property (intangible assets)* as "nonphysical assets, including but not limited to franchises, trademarks, patents, copyrights, goodwill, equities, securities, and *contracts* as distinguished from physical assets such as facilities and equipment." [emphasis added]

Based on the previously mentioned Standards Rules and the definition quoted, USPAP requires the appraiser to analyze the effect on value of intangible items (including contracts such as leases) in the appraisal. Additional applicable USPAP standards relate to the appraiser's obligations in reporting the results of an appraisal that includes intangible items, including Standards Rules 2-1 and 2-2. Standards Rule 2-1 states,

> Each written or oral real property appraisal report must:
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> (a) clearly and accurately set forth the appraisal in a manner that will not be misleading;
>
> (b) contain sufficient information to enable the intended users of the appraisal to understand the report properly; and
>
> (c) clearly and accurately disclose all assumptions, extraordinary assumptions, hypothetical conditions, and limiting conditions used in the assignment.[18]

Standards Rule 2-2 states,

> (a) The content of an Appraisal Report must be consistent with the intended use of the appraisal and, at a minimum:
>
> …
>
> (iii) summarize information sufficient to identify the real estate involved in the appraisal, including the physical, *legal* and *economic property characteristics* relevant to the assignment; [emphasis added]
>
> …
>
> (viii) summarize the information analyzed, the appraisal methods and techniques employed, and the reasoning that supports the analyses, opinions, and conclusions; exclusion of the sales comparison approach, cost approach, or income approach must be explained;
>
> Comment: *An Appraisal Report must include sufficient information to indicate that the appraiser complied with the requirements of STANDARD 1*. The amount of detail required will vary with the significance of the information to the appraisal.[19] [emphasis added]

The reporting requirements that are significant to this discussion include the requirements to report the results of the assignment in a manner that is not misleading, to report enough information that the intended users can understand it, to summarize the relevant legal and economic characteristics of the property being appraised, and to report enough information to demonstrate compliance with Standard 1, the appraisal development standard. These standards collectively require the appraiser to determine whether the appraised property includes solely real property or whether other types of property (tangible personal property or intangible property) are included. If such items are included, the appraiser must analyze the effect of these items on value. The standards further require that the appraiser's report clearly present the analyses performed, which would include explaining the inclusion and effect on value of any such items.[20]

16. *Uniform Standards of Professional Appraisal Practice*, 2016–2017 ed.
17. Ibid.
18. Ibid.
19. Ibid.
20. USPAP FAQ 192, "Allocation of Value Opinions," further discusses the appraiser's obligations when performing real property appraisal assignments that include not only real property but also personal property and/or intangible items. Appraisal Standards Board, *USPAP Frequently Asked Questions*, 2016–2017 ed. (Washington, DC: The Appraisal Foundation, 2016), 297–299.

Is Excess Rent Intangible?

At this point in the discussion, logical application of the definitions cited can only lead to the conclusion that excess rent is not an interest in real estate—it is intangible. The logical steps to reach this conclusion are as follows:

- By definition, the real estate (a property) can produce market rent, but no more.
- By definition, excess rent exceeds market rent.
- By definition, excess rent is created by the contract, not the real estate.
- By definition, a contract is an intangible asset; it's not real estate.
- Therefore, excess rent is intangible.

Each step in the argument is based on long-accepted definitions and concepts of the terminology.

Does Everyone Agree Excess Rent Is Intangible?

USPAP FAQ 193, "Leased Fee Interest When Intangible Assets Exit," addresses situations where there is a lease at above-market rent.[21] The scenario presented in FAQ 193 involves a single-tenant retail property that is being sold and financed by a bank, which has engaged an appraiser. The appraiser notes that the property was recently completed for a total development cost of $1,500,000. A large retail chain will occupy the building at an above-market lease rate, and the property is being sold to an investor on a sale-leaseback basis for over $2,000,000. Both parties recognize the lease rate is above-market and the price is well above replacement cost. The question asked in FAQ 193 is "Should I allocate the portion of above-market rent to the real estate or treat it as an intangible?"

Unfortunately, the Appraisal Standard Board's answer does not resolve the issue. The answer states, "The subject of this appraisal is real property, not intangibles, specifically the leased fee estate; therefore, Standards Rule 1-2(e) applies. The characteristics of the lease must be identified in accordance with Standards Rule 1-2(e)(iv)." The answer then recites requirements in Standards Rules 1-2(e) and 1-4(d), which require the appraiser to identify whether any intangible items are included in the appraisal and to analyze the effect on value of the terms and conditions of the lease.

The USPAP FAQ 193 answer is unhelpful, as no one disputes that the subject of the appraisal is a leased fee interest in a specified parcel of real estate. The question asked, was whether the above-market portion of the income stream (which is, of course, reflected in the leased fee interest) is intangible. The answer given is internally inconsistent, as the title of the question is "Leased Fee Interest When Intangible Assets Exist." It is unfortunate that Appraisal Standards Board failed to address excess rent as an intangible asset, since the very premise of the question is that intangible assets do exist.

International Accounting Standard (IAS) 38, "Intangible Assets,"[22] contains guidelines to assist in the identification of intangible assets. First, IAS 38 defines an intangible asset as

> an identifiable non-monetary asset without physical substance. An asset is a resource that is controlled by the entity as a result of past events (for example, purchase or self-creation) and from which future economic benefits (inflows of cash or other assets) are expected. [IAS 38.8] Thus, the three critical attributes of an intangible asset are:
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> - identifiability
> - control (power to obtain benefits from the asset)
> - future economic benefits (such as revenues or reduced future costs).

IAS 38 further defines intangible assets by describing "identifiability"; IAS 38 provides that an intangible asset is identifiable when

> it is separable (capable of being separated and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract) or arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

21. Ibid., 299–300.

22. For additional discussion, see IFRS Foundation, *Technical Summary IAS 38* Intangible Assets, http://bit.ly/IAS38. Financial Accounting Standards Board Standard FAS 141, "Business Combinations," is consistent with these statements in terms of the definition and identification of intangible assets, http://bit.ly/FAS141.

The present value created by excess rent meets the three criteria of identifiability, control, and future economic benefits. It meets the identifiability criterion by arising from contractual (legal) rights.

That excess rent is intangible is not news to certain segments of the real estate industry. For example, a 2006 *National Real Estate Investor* article, "New Rules on Intangibles,"[23] by real estate analyst Kenneth J. Rogers, cites Financial Accounting Standard (FAS) 141 and notes that purchases of real estate must be allocated into a number of asset categories, including above-market leases. This principle has been further developed elsewhere in the literature. For example, *A Closer Look at Purchase Price Allocations* by The Brenner Group[24] notes four asset classes into which the acquired assets should be allocated. Based on this article and others, asset classes can be summarized as shown below.

Asset Class	Examples
Financial assets	Cash and marketable securities, accounts receivable
Tangible assets	Land, buildings, plant, and equipment
Identifiable intangible assets	Software, trademarks, patents, contracts
Goodwill (residual intangible assets)	Assembled workforce, other goodwill

Court Opinions on Excess Rent as Intangible

The courts have addressed the issue of whether excess rent is an intangible asset. As discussed later, the issue of intangibles arises in the courts most often in the context of property tax assessment appeals. A number of cases from across the United States have concluded that excess rent is intangible and should therefore be excluded from consideration for assessment purposes. A summary of some of these court cases follows.

Walgreen Co. v. City of Madison. In *Walgreen Co. v. City of Madison*,[25] Walgreens appealed the assessment of two of its stores in Madison, Wisconsin. Walgreens worked with developers who found sites for its stores, bought out existing businesses, bought the sites, and developed the sites to suit Walgreen's needs. Thus, Walgreen's lease payments included compensation for the developer's financing, land acquisition, construction, and development costs. The assessor valued the properties based on contract rents; Walgreens argued that a lower market rent must be used. The trial court agreed with the assessor.

The appellate court upheld the use of contract rents, reasoning that "because the monthly payments are appended to the properties by the lease agreement, they are 'rights and privileges appertaining thereto' within the Wis. Stat. § 70.03 definition of 'real property'."[26] The Wisconsin Supreme Court overturned the appellate court, however, ruling that market rent must be used if the contract rent is above market rent. The state supreme court stated,

> [W]e reaffirm … that Wis. Stat. § 70.32(1) "proscribes assessing real property in excess of market value." This holding follows the nationally recognized principle that "[a] lease never increases the market value of real property rights to the fee simple estate." *The Appraisal of Real Estate* 473 (12th ed. 2001).

Grant County Assessor v. Kerasotes Showplace Theatres. In *Grant County Assessor v. Kerasotes Showplace Theatres*,[27] the Indiana Tax Court states,

> Given the uncontroverted testimony that sale-leaseback transactions often reflect the sale of more than just real property, the Indiana Board [of Tax Review] explained that one should approach the rental data from such transactions with caution, taking care to ascertain whether the sales prices/contract rents reflect real property value alone or whether they include the value of certain other economic interests.

The Indiana court goes on to quote the opinion in *Walgreens v. City of Madison*, which had refer-

23. Available at http://bit.ly/newrulesintangible.
24. September, 2012, http://bit.ly/purchasepriceallocations.
25. *Walgreen Co. v. City of Madison*, 752 N.W.2d 687 (Wis. S. Ct. 2008).
26. Wisc. State § 70.03(1) states, "'Real property,' 'real estate,' and 'land' … include not only the land itself but all buildings and improvements thereon, and all fixtures and rights and privileges appertaining thereto."
27. *Grant County Assessor v. Kerasotes Showplace Theatres*, Cause No. 49T10-0908-TA-47 (Ind. TC, October 20, 2011).

enced *The Appraisal of Real Estate*, twelfth edition; the court in *Kerasotes* states,

> A lease never increases the market value of real property rights to the fee simple estate. Any potential value increment in excess of a fee simple estate is attributable to the particular lease contract, and *even though the rights may legally "run with the land" they constitute contract rather than real property rights*.[28] [emphasis added]

***SCP 2006-C23-182 LLC v. Cox (Platte)*.** In *SCP 2006-C23-182 LLC v. Cox (Platte)*,[29] the State Tax Commission of Missouri reviewed an appeal of the Platte County Board of Equalization's valuation of a CVS drug store. The subject property was a build-to-suit property subject to a sale-leaseback agreement. The commission noted that the lease "represents the cost to construct the project rather than the market." In this case, CVS's appraiser grouped rentals in three categories. The first category was referred to as "first generation leases," where "the circumstances regarding the leases and the terms of the leases "reflect a sale leaseback for build to suit properties," and "these leases may not reflect actual market and instead reflect the cost to construct and the financing of the purchase of the property." The second category of leases was referred to as second generation leases where the properties involve a new tenant coming into the structure after renovations were made by the owner. The third category included "rentals in which the tenant takes the space 'as-is.'" CVS's appraiser also reviewed former CVS spaces around the country. The tax commission was unpersuaded by the evidence however. It found, "The [assessor's] premise was correct because [its] appraiser recognized that the appraisal was for market value and not value in use."

***Meritax, LLC, as Agent for CVS #8024-02 v. City of Richmond*.** In *Meritax, LLC, as Agent for CVS #8024-02 v. City of Richmond*[30] the "[City's] sales comparison and income approaches indicate very similar values for the subject property, both of which are substantially higher than that indicated by its cost approach." The appraiser for CVS, however, "concluded that the higher values associated with these approaches reflect entrepreneurial profit or some other business-related value, and relied on the cost approach." In *Meritax* the tax tribunal acknowledged that "the income approach reflects lease rates for pharmacies, which are typically based on construction costs plus the cost to acquire the land," and that "built-to-suit leases are above-market rent." It found,

> [CVS's] appraiser successfully established that pharmacy retailers are not motivated by the resale value of the stores and that secondary uses of such properties, much like big-box stores, result in a lower market value than the original construction cost. This is because, like big-box stores, modern pharmacies and drugstores are specifically constructed to meet the design, location, and physical requirements of one major retailer's business needs. [CVS's] selected comparables were vacant and available at the time of sale and the Tribunal finds that these sales best represent the fee simple interest in the property.

In *Shelby County Assessor v. CVS Pharmacy*,[31] and *Prieb Properties v. Shawnee County*,[32] Indiana and Kansas courts, respectively, also concluded that excess rent should not be included when

28. The italicized language also is present in the thirteenth edition of *The Appraisal of Real Estate* but does not appear in the fourteenth edition of the text.
29. *SCP 2006-C23-182 LLC v. Cox (Platte)* (Mo. TC, December 17, 2013).
30. *Meritax, LLC, as Agent for CVS #8024-02 v. City of Richmond* (Mich. TT, October 18, 2012).
31. *Shelby County Assessor v. CVS Pharmacy, Inc. #6637-02*, Cause No. 49T10-1112-TA-96 (Ind. TC, September 23, 2013). The Shelby County decision notes, "Given this evidence, the Indiana Board found that the Assessor's use of the subject property's contractual rent in her income approach likely was capturing more than the value of the real property (i.e., the 'sticks and bricks') in her computation." The court upheld the Indiana Board of Tax Review's findings that rejected the income approach used by the assessor, which included capitalizing the existing contract rent.
32. *In the Matter of the Equalization Appeal of Prieb Properties, LLC*, No. 105,298 (Kan. Ct. App., March 16, 2012). The appeal was for the tax years 2006 and 2007 in Shawnee County, Kansas. The court opinion states, "Kansas tax statutes do not use the term 'fee simple'; however, it is clear that the legislative intent underlying the statutory scheme of ad valorem taxation in our State has always been to appraise the property as if in fee simple, requiring property appraisal to use market rents instead of contract rents if the rates are not equal."

valuing a fee simple interest for property tax purposes; this conclusion is consistent with the argument that excess rent is not an interest in real estate (rather, it's an interest in a contract), and therefore should not be included in a valuation of the fee simple interest for property tax assessment purposes.

While the above-mentioned courts and others that have addressed the issue of excess rent and intangibles have concluded that excess rent must be excluded in determining assessed value for ad valorem property tax purposes, some courts have reached a different conclusion.

For example, in *Walgreens v. O'Neill*,[33] the Kentucky court found that in order to determine the "full cash value under Kentucky law, the lease must be considered," despite Kentucky's statutory definition of *real property* as "all lands within this state and improvements thereon."[34] This definition of real property is what the appraisal profession defines as real estate, however, the court in *O'Neill* effectively redefined it as a leased fee interest, subject to whatever lease was in place on the assessment date.

The cases cited in this article are assessment appeals matters, and state laws vary regarding the property rights to be appraised in such matters. Many such cases spend considerable effort dissecting the question of what constitutes fee simple.[35] In essence, the courts are determining whether the market value contributed by excess rent must be included in assessed values under state law, not necessarily whether the value is properly categorized as intangible or an interest in real estate.

Ramifications of Excess Rent as an Intangible Asset

There are a number of possible ramifications for commercial real estate markets that flow from excess rent being classified as an intangible asset. The three most obvious ones are the impacts on assessments for property tax purposes, purchase price allocations for income tax purposes, and secured lending.

Impact on property tax assessments. While state laws vary, a fee simple concept is often used for assessment purposes. For example, California law states, "When applied to real property, the words 'full value,' 'full cash value,' 'cash value,' 'actual value,' and 'fair market value' mean the prices at which the unencumbered or unrestricted fee simple interest in the real property (subject to any legally enforceable governmental restrictions) would transfer for cash or its equivalent under the conditions set forth in the preceding sentence."[36] The California Property Tax Rules expressly state that the appraiser must remove from a sale price of the subject property any value associated with beneficial financing and any value associated with an above-market lease that may be in place.[37] The effect of this rule is to recognize that value contributed by excess rent is an intangible asset, just like the value contributed by beneficial financing. While many states have already recognized excess rent as intangible—and therefore not assessable as an interest in real estate—expanded recognition of excess rent as intangible could affect the assessment practices of other states.

33. *Walgreens v. O'Neill* [Fayette County Assessor], No. 14-CI-1566 (Ky. Cir. Ct., February 18, 2015).

34. KRS § 18-112.

35. For an excellent discussion of related issues involving the concept of fee simple, see David C. Lennhoff, "Fee Simple? Hardly," *The Appraisal Journal* (October 1997): 400–402.

36. California Board of Equalization Property Tax Rules, Division 1, Chapter 1, Rule 2. The "conditions set forth in the previous sentence" refer to "the price at which a property, if exposed for sale in the open market with a reasonable time for the seller to find a purchaser, would transfer for cash or its equivalent under prevailing market conditions between parties who have knowledge of the uses to which the property may be put, both seeking to maximize their gains and neither being in a position to take advantage of the exigencies of the other."

37. California Board of Equalization Property Tax Rules, Division 1, Chapter 1, Rule 4(b). This rule states, "(b) When appraising an unencumbered-fee interest, (1) convert the sale price of a property encumbered with a debt to which the property remained subject to its unencumbered-fee price equivalent by adding to the sale price of the seller's equity the price for which it is estimated that such debt could have been sold under value-indicative conditions at the time the sale price was negotiated and (2) convert the sale price of a property encumbered with a lease to which the property remained subject to its unencumbered-fee price equivalent by deducting from the sale price of the seller's equity the amount by which it is estimated that the lease enhanced that price or adding to the price of the seller's equity the amount by which it is estimated that the lease depressed that price."

Exhibit 1 Tax Treatment Scenarios by Asset Category

	Asset		
	Bond ($)	**Real Estate ($)**	**Real Estate with Excess Rent ($)**
Total value	1,000,000	1,000,000	1,000,000
Classification			
Bond	1,000,000		
Land		300,000	300,000
Improvements		700,000	500,000
PV excess rent			200,000
Income	60,000	60,000	60,000
Less depreciation	0	(17,949)	(12,821)
Less amortization	0	0	(20,000)
Taxable income	60,000	42,051	27,179
Income tax liability at 40%	**24,000**	**16,821**	**10,872**

Impact on income tax. The classification of excess rent as an intangible asset also could have significant impacts in the income tax arena. One reason that investors are attracted to commercial real estate as an investment vehicle is its tax-favored status through the deduction for depreciation. For example, a fully taxable bond purchased at par for $1,000,000 with annual income of $60,000 would present the owner with an ordinary income tax burden on the full $60,000 of income. However, if the $1,000,000 asset with $60,000 of income were commercial real estate, the income tax burden might be calculated on an income of $42,051, lowering the income tax liability from $24,000 to $16,821.[38] However, if the $1,000,000 property includes land valued at $300,000, improvements worth $500,000, and present value of excess rent of $200,000, the situation changes dramatically. Here, the depreciation deduction is lower due to the lower value of the depreciable improvements, but the present value of excess rent is an intangible asset that can be amortized.[39] Through this characterization of the investment, the taxable income is reduced to $27,179, with an associated tax liability of $10,872, about 35% lower than the tax liability when no excess rent is involved. This is obviously a more favorable treatment of the investment for income tax purposes, because the amortization period for the present value of excess rent is likely to be shorter than the period over which the improvements are depreciated.[40] These scenarios are summarized in Exhibit 1.

Impact on secured loans. The identification of excess rent, and the present value of the excess rent, as an intangible asset could affect the use of an investment property as collateral for a secured real estate loan. Using the prior example, consider the difference if an investor seeks financing to acquire the investment under two scenarios,

38. The example uses a 40% combined federal and state income tax rate and is based on the assumption that the land value is $300,000, with the balance allocated to improvements that are depreciated over 39 years (used for non-residential real estate, per Department of the Treasury, Internal Revenue Service, Publication 946). The tax liability associated with the amount sheltered through the depreciation deduction is deferred, not eliminated completely.

39. For purposes of this example, the present value of the excess rent has been amortized over an assumed remaining lease term of 10 years. Although this treatment appears to be consistent with IRS regulations, specific tax advice regarding the treatment of excess rent relative to the remaining term of the lease would be required.

40. If the remaining term of the lease is longer than 39 years, the reverse could be true if the present value of the excess rent is amortized over the entire remaining term.

one in which the entire $1,000,000 is considered real estate, and the second in which $800,000 is identified as real estate and $200,000 is identified as the present value of excess rent and is considered to be an intangible asset. If a financial institution offers a loan program with a maximum loan-to-value (LTV) ratio of 70%, in the first scenario, the borrower could theoretically get a loan of $700,000, requiring an equity commitment of $300,000. In the second scenario, if the financial institution underwrites the loan based solely on the value of the assets identified as real estate, the maximum loan amount would be only $560,000, requiring an equity contribution of $440,000.[41]

In secured lending on commercial real estate, financial institutions sometimes quote artificially high maximum LTVs for competitive and promotional reasons but then limit the effective maximum LTV using a debt coverage ratio (DCR). If the excess rent is considered to calculate the DCR, the existence of the excess rent might result in a higher LTV than would have otherwise occurred.

Some guidance on the issue of intangible assets in the context of secured lending is provided by the *Interagency Appraisal and Evaluation Guidelines*.[42] There are at least five points in the guidelines that directly or indirectly address intangible assets; these are shown in the below bullets.

Section VIII, "Minimum Appraisal Standards" in the interagency guidelines states as follows:

> The appraisal must:
>
> - *Conform to generally accepted appraisal standards as evidenced by the USPAP* promulgated by the Appraisal Standards Board of the Appraisal Foundation unless principles of safe and sound banking require compliance with stricter standards.

As noted earlier, USPAP requires appraisers to identify the nature of the property being appraised, including the existence of any non-realty components of value, and to analyze the effect on value of these components. Section VIII, "Minimum Appraisal Standards" also states,

> The appraisal must:
>
> …
>
> - *Be based upon the definition of market value set forth in the appraisal regulation*. Each appraisal must contain an estimate of market value, as defined by the Agencies' appraisal regulations. The definition of market value assumes that the price is not affected by undue stimulus, which would allow the value of the real property to be increased by favorable financing or seller concessions. *Value opinions such as "going concern value," "value in use," or a special value to a specific property user may not be used as market value for federally related transactions* [emphasis added]. An appraisal may contain separate opinions of such values so long as they are clearly identified and disclosed.

This requirement has the effect of removing elements of value that do not represent real property rights.

Appendix C, "Deductions and Discounts" states,

> The Agencies' appraisal regulations require an appraiser to analyze and report appropriate deductions and discounts for proposed construction or renovation, partially leased buildings, *non-market lease terms* [emphasis added], and tract developments with unsold units. For such transactions, an appraisal must include the market value of the property, which should reflect the property's actual physical condition, use, and zoning designation (referred to as the "as is" value of the property), as of the effective date of the appraisal.
>
> …
>
> Non-market Lease Terms—For properties subject to leases with terms that do not reflect current market conditions, the appraisal must clearly state the ownership interest being appraised and provide a discussion of the leases that are in place. If the leased fee interest is being appraised and contract rent is less than market rent on

41. Several senior and chief appraisers of large regional banks have indicated to the author that the institutions may consider the excess rent and its present value in the underwriting process, but it would be treated differently than the portion of the value identified as real estate value. The LTV ratio would likely be different, and the contribution of the excess rent may require the lender to use a higher debt coverage ratio requirement, or the excess rent might be ignored entirely in such a calculation.

42. *Interagency Appraisal and Evaluation Guidelines* (SR 10-16, December 2, 2010), issued by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision, and the National Credit Union Administration; available at http://bit.ly/appraisalguidelines.

> one or more long term lease(s) to a highly rated tenant, the market value of the leased fee interest would be less than the market value of the unencumbered fee simple interest in the property. In these situations, the market value of the leased fee interest should be used.

It is interesting to note that this portion of the guidelines addresses the impact and treatment of non-market lease terms when the contract rent is less than the market rent, but the reverse situation is not addressed.

Lastly, Appendix D, "Glossary of Terms" of the interagency guidelines includes a definition of *Value of Collateral (for Use in Determining Loan-to-Value Ratio*), which states,

> According to the Agencies' real estate lending standards guidelines, the term "value" means an opinion or estimate set forth in an appraisal or evaluation, whichever may be appropriate, of the *market value of real property* [emphasis added], prepared in accordance with the Agencies' appraisal regulations and these Guidelines. For loans to purchase an existing property, "value" means the lesser of the actual acquisition cost or the estimate of value.

While it is tempting to note that this portion of the guidelines appears to limit the value of collateral to that produced by interests in real estate (defined as real property, and therefore by definition excluding any intangible value created by excess rent), the guidelines do not define either real estate or real property, and the document appears to use the terms interchangeably. This issue is clarified in other FDIC rules and regulations, which make it clear that other assets may be taken as collateral for loans, subject to certain requirements.[43]

About the Author

Stephen D. Roach, MAI, SRA, AI-GRS, has been an appraiser for thirty-six years. His appraisal assignments have included significant and complex assignments throughout the United States. Roach holds a bachelor of science degree in real estate from San Diego State University, and he has extensive deposition and trial testimony experience. Roach is a contributing editor to ten Appraisal Institute books and over twenty courses and seminars. His Appraisal Institute teaching experience includes basic and advanced courses on income capitalization, litigation courses, and over 200 additional courses and seminars. In addition to teaching courses throughout the United States, Roach has taught appraisal courses, seminars, or lectures in Switzerland, Germany, South Korea, Japan, and China. He also has served as a visiting professor of appraisal theory and practice at the International Center for Land Policy Studies and Training in Taipei, Taiwan, since 2004. Roach is a principal member of the Real Estate Counseling Group of America. **Contact: steve@jrcvaluation.com**

Conclusions

Based on longstanding and generally accepted definitions used in the real estate industry and the appraisal profession, the value created by excess rent is intangible. When properly identified, there are ramifications in assessment for property taxation, income tax calculations, and secured real estate lending. While some individuals involved in a real estate transaction may have compelling reasons to want there to be separate identification of excess rent as an intangible (the possibility of lower property taxes and lower income tax obligations), there are compelling reasons they would not want the present value of excess rent to be identified (for example, it may lower the amount of financing available, requiring more equity in a given investment). These motivations are irrelevant to professional appraisers, however, whose job it is to provide objective, credible analyses of the facts. This arti-

43. Appendix A to 12 CFR 365, Subpart A, Real Estate Lending Standards, states, "*Loan-to-value or loan-to value ratio* means the percentage or ratio that is derived at the time of loan origination by dividing an extension of credit by the total value of the property(ies) securing or being improved by the extension of credit plus the amount of any readily marketable collateral and other acceptable collateral that secures the extension of credit." It further states, "*Other acceptable collateral* means any collateral in which the lender has a perfected security interest, that has a quantifiable value, and is accepted by the lender in accordance with safe and sound lending practices. Other acceptable collateral should be appropriately discounted by the lender consistent with the lender's usual practices for making loans secured by such collateral. Other acceptable collateral includes, among other items, unconditional irrevocable standby letters of credit for the benefit of the lender." Therefore, it appears that present value of the excess rent qualifies as other acceptable collateral under these guidelines, so long as the lender has a perfected security interest in it, it is appropriately valued, it is accepted by the lender in accordance with safe and sound lending practices (meaning that the institution has existing policies in place regarding the use of this type of asset as additional collateral), and it is appropriately discounted by the lender (meaning that an appropriate LTV ratio is applied to this element of the entire collateral package used as security for the loan).

cle argues that under applicable professional standards, the identification of the present value of excess rent as an intangible asset is not optional; appraisers must watch for the existence of this component of property being appraised, and properly identify it when it exists. While not the case for all assignments, the value contribution of this intangible component of value may have to be quantified, depending on the intended use of the appraisal.

Additional Resources

Suggested by the Y. T. and Louise Lee Lum Library

Appraisal Institute

- **Education**
  http://www.myappraisalinstitute.org/education/default.aspx
  - *Advanced Income Capitalization*
  - *A Debate on the Allocation of Hotel Total Assets*
  - *Fundamentals of Separating Real, Personal Property, and Intangible Business Assets*
  - *General Appraiser Income Approach*
  - *International Financial Reporting Standards for the Real Property Appraiser*
  - *International Valuation Standards Overview*
  - *Purchase Price Allocations for Financial Reporting and Tax*
- ***Guide Note 5 Appraisals of Real Estate with Related Personal Property, Business Property or Intangible Assets***
  http://www.appraisalinstitute.org/assets/1/7/guide-note-5.pdf

Financial Accounting Standards Board

- **Statement of Financial Accounting Standards No. 141, "Business Combinations"**
  http://www.fasb.org/pdf/fas141r.pdf

International Accounting Standards Board

http://www.ifrs.org/About-us/IASB/Pages/Home.aspx