Chapter 1: Identification of Intangible Assets

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Introduction

This chapter discusses the following topics: the definition of an intangible asset, the distinction between tangible assets and intangible assets, the distinction between real estate and tangible personal property, the distinction between real property interests and intangible personal property, common categories of intangible assets, and the distinction between intangible assets and intellectual property.

The discussion suggests a framework for answering the question: What is an intangible asset? It identifies economic attributes or characteristics that are typically present in an intangible asset. This discussion addresses the related question: What is not an intangible asset? The absence of the identified economic attributes or characteristics may indicate that the subject economic phenomenon is not an intangible asset. If the subject phenomenon does not qualify as an intangible asset, it may be an intangible influence (on either a tangible asset or an actual intangible asset) or it may be an intangible attribute (of an actual intangible asset). It may still be a meaningful exercise to examine intangible influences and intangible attributes. This is because such influences and attributes may affect the value, transfer price, or damages estimate related to an intangible asset. For this reason, this chapter discusses intangible influences and intangible attributes.

Definition of an Intangible Asset

There are numerous legal, accounting, and taxation definitions for the term *intangible asset*. Most of these definitions typically relate to a specific purpose and are extracted from a particular statutory authority, administrative ruling, or judicial precedent. Such a definition may be entirely sufficient and appropriate for the specific legal, accounting, or taxation application for which it was intended. One example is the definition of the term *intangible asset* for purposes of a federal income tax amortization deduction under Internal Revenue Code (IRC) Section 197.

Such a narrow definition is typically appropriate only for the specific purpose for which it was intended. In contrast, this chapter focuses on the general economic

attributes of intangible assets. A general definition of *intangible asset* should be applicable across specific legal, accounting, and taxation applications. This discussion formulates such a general definition of an intangible asset. Such a definition needs to be robust enough to apply to the various intangible asset analyses considered in this text, including valuation, transfer price, and economic damages analyses.

Before applying a general *intangible asset* definition, the analyst may research whether a purpose-specific definition of intangible asset is more appropriate to the subject analysis. The analyst may consider the particular purpose and objective of the intangible asset analysis and the particular jurisdiction or venue in which the intangible asset exists.

The analyst may consult with other professional advisers (counsel, accountants, and the like) in the research of a purpose-specific definition. The analyst may need professional advice to both identify and interpret the appropriate legal, accounting, or taxation definition.

This discussion focuses on defining the questions that are relevant to these intangible asset analyses: (1) a valuation, (2) a lost profits or other damages measurement, and (3) a transfer price or royalty rate estimation. There are two defining questions that the analyst typically considers:

1. What economic phenomena or bundle of property rights qualify as an intangible asset?
2. What economic phenomena or bundle of property rights manifest as, or are applicable to, the measurement of intangible asset value, damages, or price?

Characteristics of an Intangible Asset

For an economic phenomenon to qualify as an intangible asset, it should possess certain characteristics or attributes. These characteristics are summarized below.

First, the phenomenon should be intangible. Second, the phenomenon should be an asset. These two attributes of an intangible asset appear to be self-evident, but they are not always as obvious as they seem.

The **intangible** quality of an intangible asset means that the asset's value does not come from its physical qualities. Rather, the value comes from the bundle of legal rights associated with that asset. For a tangible asset, the value comes from the ability of an owner/operator to use the physical attributes of the asset. For example, the owner/operator can occupy a building, can drive a truck, and can operate a machine. Whether through operating income or ownership (that is, rental) income, the owner/operator expects to generate income from the physical use or operations of the tangible asset. Intangible asset value comes from the ability of the owner/operator to exploit (or to keep others from exploiting) the legal rights associated with that asset. The intangible asset physical attributes (if any) do not contribute to the operating income or ownership (that is, license) income that the owner/operator expects to generate from the asset.

To be an **asset**, the economic phenomenon has to be subject to private ownership. Like any other asset, an intangible asset can be owned, bought, sold, or otherwise transferred. And, these rights of private ownership can be protected in a court of law. Like any other asset (including any tangible asset), an intangible asset has the following ownership characteristics:

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1. It is subject to a specific identification and a recognizable description.
2. It is subject to legal existence and legal protection.
3. It is subject to the rights of private ownership, and that private ownership should be transferable.
4. It is documented by some tangible evidence or manifestation of its existence (for example, a contract, a license, a registration document, a compact disc, a listing of customers, or a set of financial statements).
5. It is created or comes into existence at an identifiable time or as the result of an identifiable event.
6. It is subject to being destroyed or to a termination of existence at an identifiable time or as the result of an identifiable event.

There should be a specific bundle of legal rights associated with any intangible asset. These attributes are summarized in the following section.

Intangible Assets as Property

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An intangible asset should be property. Whether an asset is tangible or intangible, it is subject to the rights of property. For any asset to be subject to property rights, it should be identifiable. There should be a clear and concise description that identifies the particular intangible asset as a unique property. Of course, an intangible asset cannot be easily described by reference to the metes and bounds system that is commonly used in the legal description of real estate. However, an intangible asset should be subject to a straightforward "25 words or fewer" description.

If an economic phenomenon cannot be identified and described, then it may not qualify as an intangible asset. The phenomenon may be an idea or a concept, but it may not qualify as an intangible asset. Likewise, it may be an intangible attribute, an intangible characteristic, or an intangible influence. But, it may not itself qualify as an intangible asset. Attributes of intangible assets and intangible influences (on tangible assets) are discussed in subsequent chapters.

To qualify as property, an intangible asset should possess the legal rights of property and should enjoy all of the legal rights, benefits, and privileges of property. Among these are the rights of the property owner to claim ownership rights and to protect those rights in a court of law. The intangible asset owner, like the owner of any other type of property, should be able to petition the courts for relief from damages as a result of the wrongful actions of a defendant party. The owner should also be able to seek protection of the intangible asset from the criminal or civil actions of another party (like theft by another party).

The intangible asset owner is subject to the same responsibilities as any other property owner. For example, the intangible asset owner may be subject to taxation and other governmental powers. In addition, the owner may be legally responsible for any damages to another party caused by the intangible asset.

Among the basic rights of property are that it is subject to private ownership, and the private ownership is transferable. These property rights also apply to an intangible asset. In order for it to exist economically, the intangible asset should be subject to private ownership, and that private ownership should be transferable. This characteristic does not necessarily mean that the intangible asset ownership has to be regularly sold. An active secondary market in which the subject intangible asset will

ordinarily transact does not need to exist. Rather, the intangible asset ownership should be able to be transferred. The fact that an asset can be efficiently sold in an established marketplace is indicative of its value and not of its existence.

Some observers who are not familiar with intangible asset economics believe that transferability means that an intangible asset has to be transferred separately from any other asset. In other words, these individuals believe that an intangible asset should be sold "one off" or one at a time. This belief is simply incorrect. Legal, accounting, and taxation authority consistently indicates that an intangible asset is transferable if it is normally sold either (1) separately or (2) with other intangible assets or (3) with other tangible assets. In other words, if an intangible asset is transferable as part of a bundle of assets, then it is transferable.

An intangible asset does not need to be transferable separately and independently from any other assets. Some intangible assets are typically transferred separately and independently from other properties. Other intangible assets are typically transferred as part of an assemblage of assets (for example, two or more intangible assets transferred collectively or an intangible asset transferred with a tangible asset). Regardless of the structure of these transfers, the intangible asset legal ownership is transferable from one owner to another owner.

Tangible Evidence of Intangible Assets

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The next attribute of intangible asset existence is not immediately obvious: there should be some tangible evidence of the asset's existence. The value of an intangible asset is not derived from or attributable to its tangible elements. However, there should be some tangible element to the intangible asset. This tangible element documents the intangible asset's economic existence. This tangible element may also document some of the other attribute requisites (legal protection, transferability, and so on).

Tangible Documentation

All property rights are intangible. This statement does not imply that all property rights are intangible assets. To be enforceable, the property rights should have some tangible documentation. This same concept applies to intangible assets. There should be a file, a listing, a drawing, a schematic, a contract, a financial statement, a license, a permit, a document, a letter, a compact disc, a computer printout, or some other tangible evidence that the subject intangible asset exists. The intangible asset's value does not result from this tangible documentation (because the documentation is often just a sheet of paper). However, the intangible asset's economic (and legal) existence does result from this tangible documentation. It provides evidence of either the intellectual property content or the legal rights associated with the asset.

For example, the customer relationships intangible asset may be evidenced by a customer listing, a file of historical purchase orders or shipments, a credit file, a correspondence file, and so on. Franchise, license, and other contract rights are evidenced by a contract or other written agreement. Trademarks, patents, and copyrights are evidenced by written registration documents. An assembled workforce may be evidenced by employee listings, personnel files, employment-related payroll tax returns, and so forth. Proprietary technology (sometimes referred to as *know-how*) or trade secret intellectual property may be evidenced by engineering drawings, blueprints, flowcharts, schematics, diagrams, procedure manuals, notebooks, or memorandums. Goodwill and going concern may be evidenced by historical financial statements, income tax returns,

corporate records and documentation, operational and financial budgets, or business plans.

"Date of Birth"

The intangible asset owner does not celebrate the asset's birthday the way a parent celebrates a child's birthday, but an intangible asset should have a birthday. Like any other asset, an intangible asset comes into existence at a certain point in time. Like many types of assets, an intangible asset may be created or developed over a long period. And, like many other assets, an intangible asset may evolve or change over time. Despite those realities, an intangible asset will come into existence at a particular point in time.

The intangible asset's actual creation date (or birthday) may be important to the analysis. In that case, one method for estimating the intangible asset's creation date is to measure the date using tangible documentation.

If an intangible asset comes into existence at a particular point in time, then it should be able to go out of existence at a particular point in time. This is not to say that the owner/operator necessarily plans for the intangible asset destruction. The owner/operator may hope for indefinite operation. This is also the case for tangible assets: the office building owner/operator may hope for the real estate to operate indefinitely. The intangible asset owner/operator may not know in advance when the intangible asset will demise, just like the office building owner/operator may not know in advance when the real estate will demise. But both types of asset are likely to eventually cease to exist.

As with other property types, there may be any number of events that cause or influence the intangible asset demise. A partial list of illustrative events follows:

- The legal expiration of a contract, a franchise, or a trademark or patent registration period
- The planned or unplanned replacement of the intangible asset with a newer intangible asset
- The actions of a government body or of a court
- The cessation of the owner/operator business operations

All of these causes of the intangible asset demise may be associated with an identifiable event.

Economic Phenomena That Do Not Qualify as Intangible Assets

Economic phenomena that do not have the characteristics described in the preceding sections typically do not qualify as intangible assets. That statement does not mean that these phenomena do not exist. It simply means that they are not intangible assets.

Many economic phenomena are merely descriptive or expository in nature. Those phenomena may contribute to the existence and value of intangible, or tangible, assets. They may also contribute to the existence of, and to the value of, a going-concern business in which an intangible asset operates. But such phenomena do not possess the requisite attributes to be recognized as an intangible asset.

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That distinction is important, whether the analysis relates to an intangible asset valuation, damages, or transfer price measurement. Inexperienced analysts sometimes confuse the term *intangible asset* with intangible factors, elements, influences, or attributes. Some courts may not appropriately distinguish between intangible assets and intangible influences or attributes. Intangible attributes may influence the intangible asset value, and intangible attributes may influence the tangible asset value. However, intangible influences or attributes are not intangible assets.

Some of the descriptive economic phenomena that do not qualify as intangible assets—but that may be considered intangible factors or influences—include the following:

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

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The following two attributes are intangible influences (in the case of item 1) and ownership characteristics (in the case of item 2):

1. Liquidity (or illiquidity)
2. Ownership control (or lack of control)

These intangible influences do not qualify as intangible assets. This is because they lack one or more of the requisite property rights associated with being an asset. For example, these intangible influences may not be transferable, they may not be subject to private ownership, they may not be legally recognized or legally protected, or there may be no tangible evidence of their existence.

Although these influences do not qualify as intangible assets themselves, they may indicate that an intangible asset does exist and that it has substantial value. For example, these descriptive influences may indicate the existence of—and may contribute to the value of—goodwill.

Intangible influences can be important contributors to intangible asset value. Likewise, some intangible influences may enhance tangible asset value, or the intangible influences may themselves have a value. For example, there is a value to high profitability (compared with low profitability). There is a value to market potential (compared with no market potential). And, there is a value to liquidity (compared with illiquidity). However, because these intangible influences are not property, the value accrues to the property with which these influences are associated. That property could be an intangible asset, a tangible asset, a business, or the securities of a business.

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Economic Phenomena That May Indicate Intangible Asset Value

It is possible for an intangible asset to have economic existence without having the requisite attributes to have measurable value. For an intangible asset to have a measurable value, it should possess certain characteristics in addition to those that indicate legal existence. This statement is true for all types of analyses, including valuation, transfer price, and damages analyses. Some of the additional characteristics that are indicative of intangible asset value are summarized in the following discussion.

First, in order for an intangible asset to have value, it will typically generate some amount of economic benefit to its owner/operator. That economic benefit may be in the form of an income increment or an expenditure (expense or investment) decrement. The economic benefit is sometimes measured by comparing the amount of income generated by the ownership of the intangible asset to the amount of economic income otherwise available to the owner/operator if the intangible did not exist. The economic benefit may be quantified using any measure of income, including net income (before or after tax), net operating income, operating cash flow, net cash flow, and so on.

The intangible asset economic benefit may be available directly to the owner/operator through the use of the asset, or the benefit may be available indirectly through the license of the asset. An intangible asset operator (independent of the owner) may use the asset and pay the owner a license fee or royalty rate for that use.

When considering the expenditure decrement economic benefit, it is sometimes appropriate to consider the avoidance of a revenue decrease or an expense decrease. For example, the owner/operator may not use the intangible asset (a patent, trademark,

or copyright, for example) in its own business operations. However, this intangible asset ownership may prevent a competitor from using the intangible against the owner/operator. Forbearance of the use of an intangible asset can also result in an economic benefit to the owner/operator.

It is sometimes difficult to measure the economic benefit to the owner/operator. This is particularly the case when the intangible asset prevents a revenue decrease, expense increase, capital expenditure investment, or an increase in business risk. Nonetheless, all of these factors are examples of an intangible asset economic benefit.

Second, as an indication of value, the intangible asset will typically enhance the value of the other assets with which it is associated. The other assets associated with the intangible asset may include tangible personal property, real estate, or other intangible assets. For example, if an intangible asset is added to an assemblage of other assets (tangible, intangible, or both), the combination of the assets should result in an overall value increment.

The intangible asset should contribute positively to the value of the assemblage of assets. This does not imply that the contributory value measure is the best indication of the intangible asset value. It only indicates that the intangible asset makes a positive value contribution to the associated tangible and intangible assets.

If the addition of an intangible asset to an assemblage of assets (tangible, intangible, or both) results in a lower overall value for the bundle of assets, then the intangible asset probably does not have a positive value, at least for that purpose. This conclusion is true regardless of the standard of value or the premise of value that is applied to value the assemblage of assets. The principles of standard of value and premise of value are discussed in chapter 5.

There is a difference between the existence of an intangible asset and the value of that intangible asset. An example of this situation is the registration of a legally binding and enforceable trademark. Upon the issuance of the registration by the U.S. Patent and Trademark Office, let's assume that the owner immediately and permanently locked the trademark registration in the corporate vault. For whatever reason, the trademark creator decided that the trademark should never be used for commercial or any other purposes. If the trademark is never (and will never be) used in either the production or protection of income, then it may have little or no value. (This conclusion assumes the owner did not develop the trademark for defensive purposes.) That trademark does have legal existence. The trademark will continue to have existence throughout the life of its legal registration period.

One way that the trademark may be used by the owner is for defensive use purposes. If the trademark registration purposefully keeps the trademark (or trade name, or service name, or the like) out of the reach of the owner's competitors, then that trademark is being used for commercial purposes. The trademark is being used by the owner to protect the income generated by the owner's other trademarked products. In that case, the defensive use of the trademark may cause the intangible asset to have value as well as existence.

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The Distinction Between Tangible Assets and Intangible Assets

For an analyst to better understand what an intangible asset is, it may be helpful to understand what an intangible asset is not. Obviously, an intangible asset is not tangible. A tangible asset generally possesses all of the legal rights previously discussed with regard to an intangible asset. That is, a tangible asset has all of the rights and privileges of property. For example, it is capable of private ownership and legal protection. The ownership of a tangible asset is legally transferable. The rights of a tangible asset may be protected in a court of law. In addition to these legal rights associated with any asset, a tangible asset possesses one attribute that an intangible asset does not: a tangible asset is tangible. That means that a tangible asset should have the following attributes:

1. It should have physical existence and substantial form; it should be corporeal.
2. It should be capable of being touched and seen.
3. It should be perceptible to the touch; it should be tactile.

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A tangible asset may be either immobile (affixed to the land) or mobile (not affixed to the land). This attribute distinguishes whether the tangible asset is classified as real estate (it is affixed to land) or personal property (it is not affixed to land).

The distinction between a tangible asset and an intangible asset does not appear to be definitive. One of the attributes of an intangible asset was that there is some tangible evidence of its existence. What, then, is the definitive difference between a tangible asset and an intangible asset? It is not necessarily this physical difference. The analyst can touch and see manufacturing machinery and processing equipment, office furniture and computer equipment, trucks and automobiles, land and buildings, and jigs and fixtures. These are all tangible assets. The analyst can also touch and see a contract document, a license or permit, a franchise agreement, a blueprint, a listing of computer code, a diagram of a computer chip mask (sometimes called a *master*), a set of employee files and records, a listing of customers or clients, a trademark registration, a patent registration, a copyright registration, a procedures manual, and a laboratory notebook. Are these tangible assets as well?

The items in this latter group of assets are generally recognized as intangible assets. The analyst can confirm the tangible manifestation of each of these (and other) intangible assets: the documentation, the forms, the files, the drawings, the compact discs, the lists, the agreements, and so on. These tangible manifestations are tactile, corporeal, and visible. These manifestations are important elements in the intangible asset valuation process. Without a tangible manifestation, an intangible asset cannot be recognized as an asset. If an intangible asset is not an asset, then it has no value.

The important economic difference between a tangible asset and an intangible asset is this:

- The value of a tangible asset is derived from its tangible nature.
- The value of an intangible asset is derived from its intangible nature.

The tactile, corporeal, and visual elements of a tangible asset are the source of the tangible asset's value. The tangible asset value flows from its physical features and depends entirely on those physical features. The tangible asset owner/operator derives economic benefit (directly or indirectly) from the physical use, operation, or occupancy

of the tangible asset. This statement is equally true for real estate (for example, land and buildings) and for tangible personal property (for example, machinery and equipment).

The value of an intangible asset does not flow from its physical features. The owner/operator derives economic benefit (directly or indirectly) from the legal rights associated with the intangible asset and the intellectual property content of the intangible asset. The physical components of the tangible asset *are* the asset. The physical components of the intangible asset are merely a representation of the asset. This statement is equally true for intangible real property (for example, leases, building permits, water rights, and air rights) and intangible personal property (for example, trademarks, patents, customer relationship, supplier contracts, and assembled workforce).

First, intangible asset value flows from the legal rights associated with the ownership of the asset. These legal rights include the right to exploit, commercialize, sell, lease, license, use, not use, hypothecate, and transfer the intangible asset. As with all legal rights, these ownership rights are intangible.

Second, intangible asset value flows from the intangible attributes or influences discussed previously. Such influences include the owner/operator's ability to maintain creativity, broad consumer appeal, uniqueness, and a competitive edge. Some of the influences represent the effect of the ownership or operation of the subject intangible asset, such as high profitability, high market share, heritage, or longevity.

Intangible asset value does not come from, and does not accrue to, the piece of paper that the contract, license, registration, or other document is printed on. The piece of paper (or drawing or computer compact disc) can be easily copied and inexpensively reproduced. The intangible asset value comes from the legal rights and intellectual property content associated with its intangible value. Also, the intangible attributes and influences related to an intangible asset either contribute to its value or indicate the effects of its value.

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The Relationship Between Tangible Assets and Intangible Assets

The presence of tangible assets is sometimes required in order to fully realize the intangible asset value (or its income-producing capacity). For example, the owner/operator may need to have computer hardware (a tangible asset) in order to effectively exploit the positive attributes of computer software (an intangible asset). Working capital (and other monetary assets) and machinery and equipment are often (but not always) necessary for the commercialization of an intangible asset (such as customer relationships, an assembled workforce, trade secrets, and goodwill).

That statement does not imply that an intangible asset has no value separate and distinct from the value of tangible assets. Although it is not a requirement for an intangible asset, many intangible assets can be sold or licensed separately from any other assets (tangible or intangible). How can an intangible asset possess a value of and by itself and still require an association with tangible assets or financial assets in order to fully realize its value? The answer is that the same party that owns the intangible asset need not own the tangible assets that are used to exploit the intangible asset value. In fact, the intangible asset owner need not own any assets at all (except for the intangible asset). The intangible asset owner does not need to be the same party as the intangible asset operator.

For example, the owner of a manufacturing plant and equipment can license the use of the intangible asset (such as a trademark, patent, computer software, and the like). The intangible asset owner receives the royalty income from the intangible asset operator related to this license agreement. This situation creates value (that is, economic benefit in the form of royalty income) for the intangible asset owner/licensor. In this scenario, the intangible asset owner does not need to own any tangible assets.

Likewise, the owner of tangible assets may exploit the value of (investment in) those tangible assets through the use, via license, of the intangible asset. This situation also creates value (that is, economic benefit in the form of operating income) for the intangible asset operator/licensee. In fact, through the combination of tangible assets (for example, a manufacturing plant and equipment) and intangible assets (for example, a licensed patent or product formulation), the tangible asset owner could develop a new intangible asset (for example, customer contracts or relationships, going-concern value, or goodwill).

The intangible asset owner could also realize the intangible asset value directly (as opposed to indirectly through a license agreement) without making a substantial investment in tangible assets. For instance, the intangible asset owner could lease the requisite plant and equipment (just as the tangible asset owner could license the requisite intangible asset). The point of this example is that the intangible asset owner can realize intangible asset value through the use of tangible assets without having to own the tangible assets.

Let's assume that Alpha owns an intangible asset (such as a patent, trademark, franchise, or chemical process or product formulation). Let's assume that Beta owns tangible assets (such as a manufacturing plant and process machinery and equipment). Gamma (a third party) could (1) license the intangible asset from Alpha and (2) lease the plant and equipment from Beta. In this case, the intangible asset has value to the owner Alpha as represented by the stream of license royalty income from Gamma. The tangible assets have value to the owner Beta as represented by the stream of rental income from Gamma. Alpha has realized value without owning any tangible assets. Gamma has created a business enterprise (and perhaps created additional intangible assets) without owning either the intangible asset or the tangible assets used in the intangible asset commercialization and exploitation process. To use the terminology of 18th-century classic economist Adam Smith, Gamma has added coordination (that is, management or entrepreneurial expertise) but not capital (that is, tangible assets or financial assets) to this hypothetical venture.

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An intangible asset may have value that is separate and distinct from tangible assets even though the intangible asset may at some point in the commercialization process require the use of tangible assets in order to realize its full value. Tangible assets may have value separate and distinct from intangible assets and from other tangible assets. This statement is true even though the tangible assets may require the use of intangible assets or of other tangible assets in order to realize their full value. Computer hardware (a tangible asset) may need computer software (an intangible asset) in order to fully realize its value. A piece of manufacturing equipment such as a hydraulic press (a tangible asset) may need the use of tools, dies, jigs, and fixtures (also tangible assets) in order to fully realize its value.

An intangible asset, which may possess value by itself, may also enhance the value of the tangible assets with which it is associated. This is not to say that the entire value of the intangible asset should accrue to the tangible asset, or that the entire value of the tangible value should accrue to the intangible asset.

For example, a parcel of land is worth more with a building on it. This does not mean that the entire value of the building should accrue to the land, nor should the entire value of the land accrue to the building. Both assets contribute value, in part, to the other. In other words, both component assets enhance the value of the other asset. The same relationship exists with intangible assets and tangible assets.

The incremental value contributed by intangible assets to associated tangible assets is sometimes called the *in-use value* or the *going-concern value* element of tangible asset value. This incremental value is sometimes measured as the difference between the value-in-use of the tangible assets and the value-in-exchange of the tangible assets.

The contributory value of intangible assets that accrues to associated tangible assets is sometimes called *enhancement*. This is because intangible assets often enhance the value of the tangible assets with which they are associated. Similarly, tangible assets often enhance the value of the intangible assets with which they are associated. Enhancement is why tangible assets that are operated with intangible assets are often valued using a value-in-continued-use premise of value. This lack of enhancement is also why the value of tangible assets that are not operated with intangible assets is often based on a value-in-exchange premise of value. These alternative premises of value are discussed in chapter 5. The enhancement concept will be further explained in the discussion related to valuation approaches and methods and in the discussions related to specific types of intangible assets.

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Four Categories of Business Assets

For many analysis purposes (including valuation, damages, and transfer price measurements), it may be necessary to distinguish between tangible assets and intangible assets, as well as between real estate and personal property. These distinctions are important for a variety of accounting, taxation, legal, and financial reasons.

It is often important to distinguish whether a certain value is tangible or intangible and whether it accrues to real estate or personal property for purposes in the following situations:

1. *Financial accounting*. The correct classification of assets affects the financial statement presentation of the asset owner/operator.
2. *Income tax accounting*. Different depreciation lives and different depreciation rates apply to tangible assets versus intangible assets and to real estate versus personal property.
3. *Ad valorem property taxation*. Different property tax rates may apply to tangible assets versus intangible assets and to real estate versus personal property. In fact, in some taxing jurisdictions, certain property categories (like intangible personal property) are exempt from property taxation.
4. *Collateral value within a secured creditor environment*. Different creditors have different claims on the collateral value of a debtor company's assets (tangible versus intangible, real versus personal). This distinction in creditor claims is particularly important in matters related to bankruptcy and reorganization, when the value of a secured creditor's collateral interest is relevant to all parties of interest in the bankruptcy estate.

For valuation, damages, or transfer price measurement purposes, all assets or properties may be categorized into one of four categories:

1. Real estate
2. Tangible personal property
3. Intangible real property
4. Intangible personal property

For these analyses, one way to identify any type of business asset (tangible or intangible) is to locate that asset in one of the four boxes presented in Figure 1-1.

Figure 1-1
The Four Categories of Business Assets

	Realty Assets	Personalty Assets
Tangible Assets	Tangible Real Estate	Tangible Personal Property
Intangible Assets	Intangible Real Property	Intangible Personal Property

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Real Estate Assets

Analysts (and investors, executives, accountants, lawyers, and taxing authorities) are familiar with the real estate category of assets. Real estate is tangible. The fact that real estate is tangible means that its value comes from its physical elements. The fact that real estate is realty means that it is not moveable.

Real estate is either physically part of the earth (like land) or it is physically attached to the earth (like buildings). Therefore, real estate is (practically) immobile, and the real estate value comes from the owner's ability to occupy, traverse, build on, drill into, or otherwise physically interact with this tangible asset.

Examples of real estate are easy to identify: land, land improvements, buildings and permanently affixed structures, building improvements, and so on.

Tangible Personal Property Assets

Analysts (and other parties) are also familiar with the tangible personal property category of assets. Like real estate, tangible personal property is tangible. That means that the tangible personal property value comes from its physical elements.

The fact that tangible personal property is personal means that it is moveable. Personal property can be moved from one location to another location (that is, from one piece of real estate to another piece of real estate). The value of tangible personal property comes from the owner's ability to physically interact with this tangible asset.

Examples of tangible personal property are also easy to identify: industrial machinery and equipment, trucks and transportation equipment, office furniture, computer and laboratory equipment, and so forth.

Intangible Real Property Assets

Analysts (and other parties) are at least generally familiar with the intangible real property category of assets. This is because legal interests in real estate are often subdivided and transferred. Real property assets are the transferable legal interests in real estate. The real property asset value does not come from the ownership of the real estate asset itself. This is because a separate party (such as a landlord, a lessor, or a licensor) actually owns the real estate.

The real property asset owner actually owns the right to use, occupy, cross over, and extract from the subject real estate. The actual real property asset is an intangible asset. The value of intangible real property comes from the legal rights associated with that intangible asset, not from the ownership of the physical asset itself.

Examples of real property assets include leases, occupancy permits, building permits, surface rights, air rights, mining rights, water extraction rights, drilling rights, and the like.

These intangible assets are often documented in a license, lease, easement, or other contract. The tangible evidence of the real property right is the document (for example, the contract). The contract is an asset; it can be owned. The contract has a tangible element; it is a written document. However, the contract value does not depend on the physical aspects of the contract document (that is, the actual physical paper). Rather, the value of the real property contract depends on the legal rights (and economic expectations) associated with the contract document.

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Intangible Personal Property Assets

More sophisticated analysts (and other parties) are also familiar with intangible personal property. Some real property interests are, in fact, intangible assets. Less experienced analysts may think of the intangible personal property category of assets when they consider the term *intangible assets*. That intangible asset definition (as intangible personal property only) is too limited from a valuation perspective. This is because this definition excludes the intangible real property category of intangible assets. It will not necessarily invalidate this explanation of intangible assets to limit this discussion to intangible personal property.

The intangible personal property value comes from the legal rights, the intellectual property content, or the expected economic benefits that are associated with that intangible asset, or some combination. Like all assets (both tangible and intangible), intangible personal property (1) can be owned and (2) has value.

Business Enterprise Intangible Assets

Analysts often group intangible personal property assets into four categories. This categorization process may have accounting, taxation, regulatory, or legal significance. This categorization process just makes sense from a valuation perspective. This is because the four different categories of intangible personal property assets, although fundamentally similar, have slightly different economic attributes. These four intangible personal property asset categories are (1) financial assets, (2) general commercial intangible assets, (3) intellectual property, and (4) intangible value in the nature of goodwill. These categories are described in the following sections.

Financial Assets

The first intangible personal property asset category includes financial assets. All business observers are familiar with financial assets. Even though the inexperienced analyst may not think of this first intangible personal property category as an intangible asset, this category may provide the most illustrative example of an intangible asset.

Common examples of financial assets include cash, accounts and notes receivable, stocks and bonds, and other negotiable investment securities. When the financial assets owner is a business, these intangible assets are recorded as "current assets" for financial statement purposes.

As mentioned, a financial asset may be the most conceptually simple example of an intangible asset. Let's consider the example of cash in the form of a $100 bill. If the $100 bill is owned by a corporation, it is recorded as cash—that is, a current asset—on the corporation's balance sheet. If the $100 bill is owned by an individual, it is still recorded as cash—that is, a current asset—if the individual prepares a personal financial statement.

There would likely be no question at all that the $100 bill is an asset and has value. The value of the $100 bill does not result from the actual paper note. Rather, the value of the $100 bill results from the fact that the intangible asset owner has the legal right to exchange the paper instrument for goods and services. The value of this $100 bill intangible asset comes from the expected economic benefits it can provide to the owner.

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General Commercial Intangible Assets

The second intangible personal property asset category includes most other commercial intangible assets. The economic attributes and common subcategorizations of these commercial intangible assets are presented in subsequent sections. Because this is a broad category, most intangible personal property assets may be classified as general commercial intangible assets.

Intellectual Property

The third intangible personal property asset category includes intellectual property. Intellectual property assets are distinguished by their special legal recognition and, therefore, their specific legal rights. There are four types of intellectual property:

1. Trademarks and trade names
2. Patents
3. Copyrights
4. Trade secrets

Intangible Value in the Nature of Goodwill

The fourth intangible personal property asset category includes intangible value in the nature of goodwill. The experienced analyst typically considers intangible value in the nature of goodwill to be a separate (or fourth) intangible asset category for various accounting, taxation, and other financial reporting purposes.

The intangible asset owner should be able to list and describe each of the other intangible asset types: (1) financial asset instruments, (2) general commercial intangible assets, and (3) intellectual property.

Intangible value in the nature of goodwill is often considered to be a residual intangible asset. For valuation purposes, goodwill is often considered to be the intangible value component of a business enterprise (of whatever legal form) that cannot be specifically assigned to (or identified with) any of the other three intangible asset types. This is true for both an individual's professional or celebrity goodwill and a corporation's institutional or business goodwill.

Like each of the other three categories of intangible personal property, goodwill can be owned and can have value. Although goodwill is an intangible asset, goodwill is not as easy to identify or to analyze as the other intangible personal property categories.

From a valuation, damages, or transfer price perspective, there are four categories of business assets. Each of these four categories of business assets may have several subcategories.

Two of the asset categories represent tangible assets, the value of which comes directly from their physical elements. Two of the asset categories represent intangible assets, the value of which does not come from their physical elements.

Two of the asset categories are immobile, so they relate to real estate. Two of the asset categories are moveable, so they relate to personal property. There are several subcategories of the intangible personal property asset category. These assets are commonly referred to as *intangible assets*.

Figure 1-2 expands the listing and relationships of the four categories of business assets that were introduced in Figure 1-1.

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Figure 1-2
The Four Categories of Business Assets, With Illustrative Examples

	Realty Assets	Personalty Assets
Tangible Assets	land building components building structures	machinery and equipment trucks and autos computers office equipment
Intangible Assets	leaseholds easements and rights of way mining and mineral rights	financial assets general commercial intangible assets intellectual property goodwill intangible value

Subsequent chapters describe how the analyst may identify, analyze, and value the intangible personal property category of assets. This text focuses on how accountants, corporate executives, financing sources, securities investors, and other capital market participants understand and analyze the economics of (and, particularly, the value of) commercial intangible assets.

Summary

This chapter introduced the attributes or characteristics that are relevant for determining what economic phenomena qualify as intangible assets and what economic phenomena do not qualify as intangible assets. Some of these intangible attributes or

intangible influences may indicate that an intangible asset does exist. Some of these intangible attributes or influences may affect the intangible asset value (or the tangible asset value), and some represent the effects of the ownership or operation of an intangible asset. This chapter also introduced the factors that contribute to a positive intangible asset value.

The categories of intangible asset analyses considered in this text include valuation, damages, and transfer price, analyses. In all of these analyses, the economic phenomena that do not qualify as intangible assets may, in fact, still have value. These phenomena simply do not qualify as intangible assets. For example, there may be a substantial value to a personal or institutional reputation, to high market share, to uniqueness or individuality. However, these intangible attributes or influences are not intangible assets.

This is not to say that these intangible attributes or influences cannot be protected or defended in a court of law. Some of them can be. Nor is it to say that these intangible attributes or influences cannot suffer damages. They can. The damages estimation is a subdiscipline within applied microeconomic analysis. Damages analyses, including lost profits, reasonable royalty rates, and other damages analyses, are described later in this text. However, our exploration of that discipline will be limited to intangible asset damages analysis.

This chapter introduced the concepts of property types and of property legal rights, as well as the four types of property:

1. Real estate
2. Tangible personal property
3. Intangible real property
4. Intangible personal property

Finally, this chapter explored some of the many attributes that distinguish intellectual property from general commercial intangible assets.

The economic analysis of intangible assets is not a new discipline. The identification, valuation, and remaining useful life (RUL) analysis of intangible assets was covered in the landmark text *The Valuation of Property*, by James C. Bonbright, first published in 1937.[1] *Guide to Intangible Asset Valuation* attempts to bring the analysis of intangible assets into the 21st century.

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[1] James C. Bonbright, *The Valuation of Property* (Charlottesville, VA: The Michie Company, 1965 [reprint of 1937 edition]).

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