

# VALOREM PRINCIPIA

The Principles of Value

Volume 11 Issue 2 June 2003

## Intellectual Property and Intangible Assets

by Forrest Vickery, Northern California Manager for SP&H

Intangible assets are non-physical assets (such as franchises, trademarks, patents, copyrights, and goodwill) that grant the potential for certain rights and privileges as well as the possibility for economic benefits to the owner. The economic benefits may be fruitful or fleeting, depending on the nature of the intangible asset and the company exploiting it. Unlike physical or tangible assets, which you can see and touch, intangible assets cannot be physically distinguished. On the other hand, similar to tangible assets, in the appropriate circumstances an intangible asset can be exchanged, purchased, or licensed. For some companies intangible assets may have such a bearing on the business' value that shareholders are willing to go great lengths and expend funds to define their intangible assets, monitor and manage them, and protect them from infringement and damage. Nonetheless, an intangible asset's influence on business value may be simply ephemeral, subject to the gyrations of the stock market, consumer sentiment, and unrelenting competition.

The importance of intellectual property rights to shareholders is illustrated in the case of *W. Earl Bennett, et al. vs. The Walt Disney Company, et al.*, involving the Winnie the Pooh litigation.<sup>1</sup> A class action lawsuit has been filed on behalf of purchasers of securities of the Walt Disney Company between 1997 and 2002. The complaint in this case alleges that Disney and certain of its officers and directors violated the Securities Exchange Act of 1934 by failing to disclose to the investing public the existence, details, and potential effects of a pending lawsuit over merchandising rights concerning "Winnie the Pooh". The pending lawsuit alleges that Disney miscalculated royalties due from the sale of Winnie the Pooh dolls, books and other merchandise, and that millions of dollars of additional royalties are due for Winnie the Pooh videos, DVDs, computer software and other electronic products. If successful, the pending lawsuit could force Disney to pay hundreds of millions of dollars in damages, or even possibly affect Disney's merchandising agreement for Winnie the Pooh products. This could result in a substantial potential loss of revenues and profits each year. This case and the related lawsuits demonstrate how intellectual property litigation can involve significant monetary exposure. By contrast, in some cases, the value of an intellectual property asset may dwindle to zero based on competition, market forces, and consumer preference.

Intellectual property is simply a subset of intangible assets. Certain "new economy" companies, which may be defined by the nature of their intellectual property, are now competing in a



knowledge-based economy. While some old economy companies compete under the armor of their bricks and mortar, those new economy companies that depend on their intangible assets contend for market share with adaptation and innovation. This article will describe the various types of intangible assets and intellectual property, the various approaches and methods to valuing them, and what situations may require the need for a valuation. Given the limited scope of this article, only a brief overview of intangible assets and intellectual property follows.

### IDENTIFYING INTANGIBLE ASSETS AND INTELLECTUAL PROPERTY

To qualify as an intangible asset, the owner should be able to specifically identify and describe the asset, and it should be subject to legal protection. Moreover, one should be able to privately own the asset and legally transfer or sell it to another party. The asset should also have come into existence at an identifiable time or as the result of an identifiable event.

For an intangible asset to have quantifiable value from an appraisal perspective, it should possess certain economic attributes or characteristics in addition to those that indicate the legal existence of the intangible. In particular, the asset should generate some measurable amount of economic benefit to its owner. Also, it should potentially enhance the value of the other assets with which it is associated. The defining characteristics

*Continues on Page 2*

## INSIDE THIS ISSUE

- 1-2,4..... "Intellectual Property and Intangible Assets"
- 1..... SP&H Updated Website Announcement
- 3..... "When Your Inheritance is a Tax Liability"
- 3..... SP&H Offers MCLE Courses
- 4..... SP&H Calendar: Recent & Upcoming Events
- 4..... Quote

SANLI PASTORE  
& HILL



*The Measure of Value<sup>SM</sup>*

Los Angeles  
San Diego  
San Francisco  
Sacramento



and economic benefits of an intangible asset will manifest in a business' day-to-day operations. The following list demonstrates examples of intangible assets some businesses may possess:

- ◆ Trademarks, trade names, brand names, logos
- ◆ Process patents, product patents, technical know-how
- ◆ Copyrights, blueprints, trade secrets
- ◆ Computer software and automated databases
- ◆ Customer lists, customer contracts, open purchase orders
- ◆ License and franchise agreements
- ◆ Trained and assembled workforce, employment agreements
- ◆ Leasehold interests, mineral rights, air and water rights
- ◆ Going concern goodwill, professional practice goodwill

Amongst the above examples of intangible assets, there are five general classifications of intellectual property, including:

- ◆ Trademarks
- ◆ Patents
- ◆ Copyrights
- ◆ Know-How
- ◆ Trade Secrets

Intellectual property differs from other intangible assets in that it is the result of conscious creative activity. Moreover, the deliberate inventive activities can be attributed to the efforts of specific people.

### VALUING INTELLECTUAL PROPERTY

Valuation of intellectual property falls into three general approaches to value: *Income Approach*, *Market Approach*, and *Cost Approach*.

#### INCOME APPROACH

The Income Approach focuses on the future benefits that can be realized from a particular asset. In essence, the appraiser determines the potential future benefits from the asset as well as the inherent risks of realizing the benefits.

Methods that value intellectual property under the income approach may focus on:

- ◆ The greater level of income realized by the owner of the intellectual property compared to not owning the property (leading to higher profitability).
- ◆ The lower levels of costs realized by the owner of the intellectual property compared to not owning the property (also leading to higher profitability).
- ◆ "Relief From Royalty" methods, which are based on a hypothetical royalty payment that the owner of the intellectual property would be willing to pay or otherwise would have to pay to a third party to exploit the rights and benefits of the intellectual property. The royalty represents the rental charge that would be paid to the licensor if this hypothetical arrangement were in place.

In any of the above circumstances the value of the business is incrementally greater as a result of the business' ability to successfully exploit the intellectual property and realize the economic benefits.

#### MARKET APPROACH

The market approach focuses on actual arm's length transactions of similar intellectual property assets between unrelated parties. The market approach process includes:

- ◆ Researching the appropriate market for information on transactions and/or license arrangements of comparable intellectual properties.
- ◆ Analysis of the market data, facts, and circumstances of the comparable transactions.

#### COST APPROACH

Two common measures of cost include "reproduction cost" and "replacement cost". Reproduction cost is the total cost, at current prices, to develop an exact duplicate or replica of the subject intellectual property. This measures the amount of money that would need to be spent to develop the intellectual property in exactly the same way and to achieve the same final state as it currently exists.

Replacement cost, on the other hand, contemplates the cost to recreate the utility of the subject intellectual property, but in a form or appearance that may be different. This concerns the ability of the replacement property to perform its designed task, while, from an economic standpoint, having the ability to provide an equivalent amount of satisfaction. The replacement cost of an intellectual property is the total cost to create, at current prices, an asset having equal utility to the intellectual property subject to appraisal. However, the replacement intellectual property would be created with modern methods and developed according to current standards.

#### SIMPLIFIED EXAMPLE USING THREE APPROACHES

**INCOME APPROACH:** The subject patented technology allows the business to generate \$1 million in greater profits every year compared to not owning the patent. The added profitability adds \$4.2 million in value to the Business.

**MARKET APPROACH:** Comparable patent sales were found, and the comparable transactions yielded value indications ranging from \$3.5 to \$6.2 million, after making adjustments for specific differences between the actual patents sold and the subject patent. All sales were arms-length between unrelated parties.

**COST APPROACH:** The cost of developing the patent (including employee labor hours, testing costs, design costs, etc.) would range between \$2.1 and \$2.8 million.

A reconciliation of value from the three approaches shows that the benefits of owning and exploiting the patented technology were feasible and realizable. Therefore, more weight may be placed on the Income and Market Approaches, resulting in a value of approximately \$4.5 million.

### USES OF INTELLECTUAL PROPERTY VALUATIONS

For new economy companies and bricks and mortar businesses that are increasingly dependent on their intellectual property assets for a competitive edge, valuations of intellectual property have been and will be needed for a variety of purposes, including:

- ◆ Identifying assets that enhance value or need protection
- ◆ Evaluating assets of a potential merger or acquisition candidate
- ◆ Purchase price allocation after an acquisition
- ◆ Making informed financial decisions for asset protection, maintenance, and commercialization
- ◆ Evaluating potential for research & development projects
- ◆ Supporting loan collateral analysis
- ◆ Litigation disputes and damage claims

## When Your Inheritance is a Tax Liability

by Michael B. Luftman and Joseph Broyles of Reish Luftman McDaniel & Reicher

When a taxpayer dies owing taxes, his or her heirs may inherit those tax liabilities along with any assets they may inherit. Internal Revenue Code § 6901 authorizes the Internal Revenue Service to assess taxes against the heir of a decedent who dies owing taxes and where the decedent's property is transferred to the heir. This assessment against the heir is referred to as "transferee liability" because the heir is made liable for the taxes of the transferor on account of the receipt of the transferor's property.

Transferee liability is not limited to cases involving decedents; it can be imposed anytime one taxpayer owes taxes and transfers property to another taxpayer without paying the taxes. If the IRS becomes aware of the transferred property, they may assert transferee liability against the transferee in an effort to recover the property. For obvious reasons, this is common when the transferor dies and the transfer of property occurs pursuant to trust or probate administration.

Internal Revenue Code § 6901 provides a formal procedure for assessing the tax against the transferee and making the tax liability a personal obligation of the transferee. Frequently, however, the IRS does not actually go through the formal procedure to assess the tax against the transferee. Rather, it persuades the transferee to pay the transferor's taxes by threatening to assess the liability against the transferee. Once the transferee realizes the transferor owed taxes and the IRS has the right, pursuant to Internal Revenue Code § 6901, to recover the transferred property to pay those taxes, the transferee often pays the tax voluntarily.

Recently, an elderly widow was referred to us with this exact fact pattern. Her husband had died two years earlier without paying a substantial amount of payroll taxes. The widow inherited a sizeable estate through a normal trust administration. The IRS never filed nor asserted any claim during the administration of the trust; although, it was given notice of the death of the decedent.

Two years after the husband's death, the IRS began sending collection notices to the widow demanding full payment of the payroll taxes. The IRS threatened to make a transferee assessment against the widow and levy assets which were providing her monthly income. Panicked and out of options, she sought our legal advice.

Internal Revenue Code § 6901 generally only applies to income, gift and estate taxes. There is no provision in § 6901 making it applicable to any other type of tax, except under special circumstances. When we researched the authorities interpreting § 6901, we located a case decided by the U.S. District Court for the Northern District of Texas, which expressly held Internal Revenue Code § 6901 inapplicable to payroll taxes. The court said the IRS should have availed itself of the normal state law remedies of a creditor. In that case, as in ours, the time for making a creditor's claim against a decedent under state law had passed.

Armed with this authority, we contacted the IRS Revenue Officer assigned to the case and made him aware of the Texas case. The Revenue Officer indicated that he would seek the advice of District Counsel and get back to us. A few days later, the Revenue Officer called back to tell us he was closing the case since they could not collect the tax from the widow using transferee liability and the time provided under the California law for filing a claim against the decedent's estate had passed. This was very welcome news to our elderly client.

As mentioned above, it is common for IRS Revenue Officers to persuade heirs to pay their deceased relative's taxes, from whom they inherited property, with threats of transferee liability. Normally, the IRS is well within its power to make good on such threats. In such cases, it may be advisable to negotiate a settlement with the Revenue Officer rather than go through the formal transferee liability assessment procedure. However, before you advise your client to pay his or her dead relative's taxes, make sure the IRS actually has the authority to make the transferee liability assessment. Just because they threaten to do something, does not mean they actually can.

*Michael B. Luftman is a founding partner with the Los Angeles law firm of Reish Luftman McDaniel & Reicher where he focuses on taxation and estate planning; Joseph Broyles is an associate attorney with Reish Luftman McDaniel & Reicher who handles tax controversy matters. He is Second Vice Chair of the Tax Section of the Beverly Hills Bar Association and Editor of the quarterly publication of the Tax Procedure and Litigation Committee, of the Tax Section of the State Bar of California. They may be reached through the firm's web site at [www.reish.com](http://www.reish.com).*



**SP&H is an APPROVED PROVIDER  
of the California State Bar  
for Mandatory Continuing  
Legal Education (MCLE) Credits**

### SAMPLE SEMINARS CURRENTLY OFFERED:

- ◆ **The Use of Business Valuation Experts in Litigation**
- ◆ **Valuing Stock Option Plans**
- ◆ **Valuing Growth Companies in a Dynamic World**
- ◆ **Business Valuations for Estate Planning**
- ◆ **Goodwill Loss for Eminent Domain**

*For more information about these or a custom seminar, please contact Christine Albino at (310) 571-3400 or [calbino@sphvalue.com](mailto:calbino@sphvalue.com).*



Friends and clients at SP&H's booth at the CRA Conference & Expo followed by a guest dinner party in Palm Springs hosted by Sanli Pastore & Hill, Inc.



*Continued from Page 2*

The resulting valuation of a business' existing or prospective intellectual property may be the determining factor in whether an acquisition goes forward or a potential research and development project continues to receive funding. Moreover, as certain businesses experience intellectual property gaining a greater proportion of their value, the quality and precision of valuations will be of increasing importance to shareholders and business owners.

Information regarding the Winnie the Pooh litigation per the website of Weiss & Yourman (<http://www.wyca.com/summary/dis-inf.htm>), and "Disney Loses Pooh Ruling, Plans to Fight Decision," The Wall Street Journal, May 10, 2003.

*Mr. Forrest A. Vickery, has been performing business valuations since joining SP&H in 1995. Mr. Vickery is a shareholder of SP&H and manages SP&H's operations in Northern California. Mr. Vickery can be reached at 916/614-0530 or [fvickery@sphvalue.com](mailto:fvickery@sphvalue.com).*

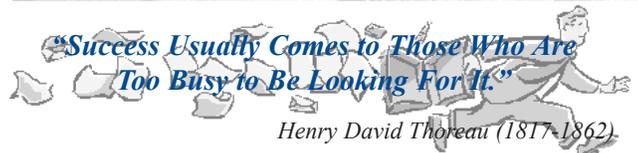
**May 10<sup>th</sup> - Universal City**  
**35<sup>th</sup> Annual Family Law Symposium -**  
**Los Angeles County Bar Association**  
 SP&H was an exhibitor

**May 12<sup>th</sup> - Irvine**  
**19<sup>th</sup> Annual Entrepreneurs Conference -**  
**Harvard Business School Association of Orange County**  
 SP&H was a sponsor and Nevin Sanli presented  
 "Buy, Build & Sell: Lessons from the Field"

**May 13<sup>th</sup> - San Francisco**  
**Lorman Educational Services - Estate Planning in California**  
 Thomas Pastore and Forrest Vickery presented "Business Valuations for Estate Planning"

**September 17<sup>th</sup> - Los Angeles**  
**Valuation for Equity Financings -**  
**The Los Angeles Venture Association (LAVA)**  
 SP&H will be a sponsor and Nevin Sanli will be a speaker

**October 23<sup>rd</sup> - San Francisco**  
**CLE Eminent Domain Conference**  
 Thomas Pastore and Forrest Vickery will be presenting "Goodwill Loss in California"



**Published by SANLI PASTORE & HILL, INC.**  
 1990 S. Bundy Drive, Suite 800, Los Angeles, CA 90025

**Telephone:** Los Angeles 310/571-3400 Fax: 310/571-3420  
 San Francisco 415/955-2699  
 San Diego 619/233-1801  
 Sacramento 916/614-0530

**E-mail:** [bizval@sphvalue.com](mailto:bizval@sphvalue.com)

SP&H does not accept responsibility for statements or opinions advanced in articles appearing herein, and their appearance does not necessarily constitute an endorsement by SP&H.

Articles, letters, comments and suggestions are welcome. Please contact Christine Albino at 310/571-3400 or [calbino@sphvalue.com](mailto:calbino@sphvalue.com) ♦

www.sphvalue.com

Los Angeles  
 San Diego  
 San Francisco  
 Sacramento

PRSR STD  
 U.S. POSTAGE PAID  
 LOS ANGELES, CA  
 PERMIT NO. 33

**SANLI PASTORE & HILL**

1990 S. Bundy Drive, Suite 800  
 Los Angeles, California 90025  
[www.sphvalue.com](http://www.sphvalue.com)