JAMES A. GRAASKAMP COLLECTION OF TEACHING MATERIALS

IX. MISCELLANEOUS PROJECTS AND CORRESPONDENCE WITH INDUSTRY

C. Appraisal Consulting

3. "Quaker Bridge Mall - Real Estate Tax Assessment Constraints", James A. Graaskamp: Proposition paper to explain rationale of assessment methodology, circa early 1980s

Index

QUAKER BRIDGE MALL
REAL ESTATE TAX ASSESSMENT CONSTRAINTS
Rationale of Assessment Methodology

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Real Estate & Urban Land Economics
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Introductory Summary

The development and sale of an interest in a super regional shopping center represents the sale of a going business concern so that the purchase price can only be allocated in part to real estate and the other tangible assets of the enterprise. When the purchase price based on the income power of the business exceeds the values of the tangible assets, it is customary in accounting practice to allocate value to intangible assets such as copyrights, patents, plans and patterns, special formulas, or a competitive edge and momentum ascribed to past efforts of management and termed "goodwill". A special category of goodwill is franchise value growing out of mutual agreements for the distribution, promotion, and merchandising of goods and services.

It is the object of this paper to demonstrate that a shopping center development interest is a going business, a franchisor, whose abilities to support and benefit from joint retailing efforts and promotion arise out of certain operating agreements and other written arrangements relative to major department stores in a shopping center project. Ownership of interest in these operating agreements is a significant part of sale of the development interest and similar to intangible assets like copyrights and formulas which provide special income power to an enterprise.

The contribution of these intangible assets must be subtracted from shopping center sales prices with realism to allocate remaining values to tangible real estate, the proper base value for administration of real estate tax.

QUAKER BRIDGE MALL
REAL ESTATE TAX ASSESSMENT CONSTRAINTS
Rationale of Assessment Methodology

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Proposition #1: Development of a regional shopping center is a specialized business which involves single purpose real estate, just as the hotel business or the chemical business is a synergy of marketing, management, and technical expertise which involves a specialized piece of real estate equipment. In valuing the real estate component of such a business, it is necessary to carefully allocate income among management, marketing and promotion skills, and real estate attributes. Only income attributable to tangible real estate is subject to real estate tax.

Proposition #2: The drawing power of a super regional shopping center first depends on the concentration of major department stores with which the trade area population can identify. The developer of a regional shopping center is then expected to exploit this initial marketing recognition of trade names by creating a synergy of promotion from selection of individual retail specialties and collective marketing efforts. These retail specialty stores are attracted by the opportunity of joint marketing efforts with the major department stores and by the special services and risk reduction attributes offered by a single ownership agglomeration as compared to the fragmented ownership and counterproductive retail development of traditional downtowns and commercial strips.

Proposition #3: Under New Jersey law a joint marketing contract which establishes a specific community of interest subject to certain rules, regulations and conditions, regardless of whether the agreement is a lease or a contract for services, is a franchise.

Proposition 4: The special relationship with selected major department stores enjoyed by a shopping center development firm is created and defined in the basic operating agreement to which the major department stores subscribe to define the rules, regulations and conditions under which all parties will cooperate in the community of interest. The marketing power created by this agglomeration is marketed by the developer to specialty stores. General implementation requires the use of easements, the sale of conditional fees subject to multiple covenants, and leases. Marketing promotional efforts are implemented through a tenant association and association assessments. However, the documentation among the parties binding performance of their mutual obligations should not obscure the fact that the completed mall is intended as a retailing vehicle for the sale of goods and services so that these arrangements are very analogous to a franchise agreement. Such agreements, like patents, copyrights and secret formulas are intangible assets.

Proposition 5: Agreement among a group of major department stores on a common site and a common time horizon for development is difficult to obtain. Whoever successfully binds the major department stores in such a mutual marketing arrangement will then be able to attract the smaller specialty stores, and can be

considered a franchisor subject to the rules, regulations and conditions of an operating agreement with the Majors; and whoever is permitted to participate in the shopping center venture as a retailer is a franchisee. In the case at hand, the partnership, Lawrence Associates (which includes Macy and Kravco among others), is the franchisor, which employs Kravco for a variety of technical services. It is useful to extend this direct analogy to New Jersey franchise definitions to better understand the intangible character of asset values inherent in purchase or sale of a shopping center venture, but the analogy is not necessary, since the principle of separating returns to business management skills from returns attributable to real estate used in a business is well established.

Proposition #6: If the franchisor (Lawrence Associates) were to sell all of its interest in Quaker Bridge, it would represent sale of a contractual privilege to exploit the synergy created by its operating agreements with the four major tenants and its selection of tenants for the specialty retail areas. The operating responsibilities inherent in these existing arrangements are those of a going concern and price paid would represent going concern value. The buyer expects to generate profit from management of the total enterprise, from leasing of space, from custodial operations, and from sharing in the retail profits and expansion opportunity created by joint marketing efforts and management involvement.

Proposition #7: Generally accepted accounting principles would require that the purchase price of such a business be allocated among tangible and intangible assets. Not all tangible assets are real estate as these assets could include cash in banks, accounts receivable, inventory and similar items, and intangible assets might include certain past expenditures which were capitalized, such as organization expense and unfinished research. Once these tangible and intangible items have been valued at cost to replace or salvage value, then most all of the remaining value paid for the business could be allocated to the broad category of goodwill, or in the case of shopping centers, franchise value.

Proposition #8: The Internal Revenue Service requires allocation of the purchase of a going concern between tangible assets and intangible assets, including good will and franchise value in order to establish an equitable base for taxation. It would follow that real estate tax procedure must also be sensitive to such allocation for consistency and equity among governmental entities.

Proposition #9: The real estate tax is intended to fall only on those tangible assets which can be defined as a fee simple title in reality to the benefit of private interests. The value to be taxed is the value at which the fee simple title of the real estate would sell or would cost to replace and does not include the privileges and entitlements which are part of intangible assets or personal property of the going concern.

THEREFORE: An estimate or prediction as to the sales price of Lawrence Associates' interest in the Quaker Bridge Mall must be allocated between tangible and intangible assets. Tangible assets must be further allocated between personalty and realty.

THEREFORE: Consistent with generally accepted accounting principles, the proper method for appraising the real estate portion of a franchisor interest in a super regional shopping center would be as follows:

A. Determine cost of land zoned for shopping center use and with off-site improvements in place, including auto access routes (using historical cost approach or comparable sales of prepared sites).

B. Determine reproduction cost of buildings and related improvements as of date of appraisal and adjust for functional obsolescence and wear and tear.

C. Determine indirect costs of site acquisition and development of construction costs prior to full operation of center, which must be capitalized, rather than expenses (costs of negotiating an operating agreement, promotion of development and other similar items represent investment in the franchise component).

D. Sum the total from A, B, and C to determine total values allocated to real estate.

E. To calculate franchise value, it would then be necessary to allocate income earned by the center between income attributable to the total real estate investment and surplus income attributable to the franchise opportunity.

F. Review of mortgage rates in the shopping center market, together with preferred minimum rates of return for equity position in the regional shopping center field will provide the basis for determining capitalization rate to be multiplied times real estate value (Item D) to calculate income attributable to real estate interest of development partnership.

G. Total income to the development partnership from his participation in the center operation less income calculated in Item F is the income attributable to the franchise value of the developer's position in the center.

DISCUSSION OF PROPOSITION #1

Proposition #1: Development of a regional shopping center is a specialized business which involves single purpose real estate, just as the hotel business or the chemical business is a synergy of marketing, management and technical expertise which involves a specialized piece of real estate equipment. In valuing the real estate component of such a business, it is necessary to carefully allocate income among management, marketing and promotion skills and real estate attributes. Only income attributable to tangible real estate is subject to real estate tax.

The Quaker Bridge Mall is a super-regional center, as defined by the Urban Land Institute.[1] Aside from the requirements of a gross leasable area in excess of 750,000 square feet and more than three department stores, the critical elements of true shopping centers are:

1. Unified architectural coordination of grounds and buildings.
2. Unified site plan for appropriate entrances, parking, delivery and pedestrian movement.
3. Tenant grouping and selection to provide a merchandising interplay among stores and the diversity of merchandise.
4. Unified management and ownership to provide agreeable surroundings and to secure environment which will enhance the result of joint promotional marketing efforts by tenants and owners.

The management skills, working capital and political finesse required to develop and operate a regional center has been increasing as a rapid rate and is concentrated in a relatively limited number of development firms with capacity for participation in several projects the scale of a super regional center. The major department stores have become aware of the value they create for a center by congregating to support one-stop comparative shopping. Thus, there is a symbolic relationship between the developer and the department store consortium. Engineering and retailing skills may not be enough. In the future, governmental bureaucracy, with its various levels of permits, will license the owners of a particular project for a shopping center.

The shopping center project of the present and the future requires the ability to deal not only with complex mechanical and financial considerations, but also with the emerging problems attendant to various facets of governmental regulation. In the past, developers could get their permit for a shopping center after satisfying zoning authorities and presenting the appropriate traffic studies and sewer and water plans. Today and tomorrow the bureaucratic web may well require several additional equivalent procedures. Transportation regulations, land use legislation, pollution control and a range of indirect source regulations will face the developer.

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[1] The Shopping Center Development Handbook, ULI Shopping Center Council, Page 7, 1977.

[2] From "Shopping Center: Recent Problems and Development Trends", a seminar prospectus prepared in 1974 by the Practicing Law Institute. As quoted in The Shopping Center Development Handbook, ULI Shopping Center Council, Page 19, 1977.

DISCUSSION OF PROPOSITION #2

> Proposition #2: The drawing power of a super regional shopping center first depends on the concentration of major department stores with which the trade area population can identify. The developer of a regional shopping center is then expected to exploit this initial marketing recognition of trade names by creating a synergy of promotion from selection of individual retail specialties and collective marketing efforts. These retail specialty stores are attracted by the opportunity of joint marketing efforts with the major department stores and by the special services and risk reduction attributes offered by a single ownership conglomeration, as compared to the fragmented ownership and counterproductive retail development of traditional downtowns and commercial strips.

On December 9, 1974, the developer, Lawrence Associates, a partnership, concluded a four-party operating agreement for development and operation of a project to be known as Quaker Bridge Mall at the site on U. S. Route 1, Lawrence Township, New Jersey. With further amendments and modification of these operating agreements to admit Sears, Roebuck & Company into the Quaker Bridge project, these arrangements represent, among other things, a joint marketing agreement through which Kravco and the department stores will operate a retailing business under their well established trade names, in order that the developer can market space on lease terms to smaller shops and businesses who could benefit from proximity to the Majors and participation in joint promotions of the Mall.

The operating agreement provides a unified program for development and promotion of the tract as a specialized retailing machine which exploits the interdependency of retailing skills, trade areas and shared customer profiles of the various tenants. The operating agreement obliges the department stores and the development partnership to provide an environment for the small retailer which includes the following benefits:

1. Unified, coordinated store hours, parking accessibility and pedestrian flows that are designed into the physical structures and the operating rules of the project.

2. Guarantees that the major department stores must operate under their established trade names, irrespective of profitability, of personal style of their management or of physical destruction. (The operating agreement requires department stores and the Mall developer to reconstruct, even if changing times and conditions might not support the reinvestment of insurance proceeds.)

3. Assurance that the tenant mix will be controlled to balance supply and demand, location and display, and diversity of attractions to provide the strongest possible overall penetration into the available trade area. Moreover, each tenant can expect his neighbors to operate, to maintain common business hours and to contribute to business development, rather than just pay rent or waiver irratically in its will to merchandise.

4. An association that requires merchant participation and contribution to joint promotion of the center and its attraction, as well as ongoing consumer research to improve servicing of the relevant trade area.

5. Physical design that will enhance not only security of store owner premises and merchandise, but will reinforce the customer's perception of safety, comfort and relaxation. This greater sense of well being of the customer, despite climate, social disorder or irritability of claustrophobic stress, increases significantly the frequency with which shoppers visit the Mall and the average expenditure per visit.

6. Unlike a downtown area of multiple ownership, the shopping center will remain in a specific configuration of shopping, access and promotion over long periods of time, sustained by the mutual contracts for performance. Thus, a smaller store gains some insulation from the vagueries of independent land use decision, which characterize traditional shopping strips, so that this marketing efforts can be directed toward longer term goals.

These benefits to the retailer mean additional revenues, better control of expenses, and less uncertainty about the long-term stability of his operation. Logically, these benefits generate an economic value for participation in the center well beyond the contribution of raw space to housing of his operation. It is these benefits which the franchisor (developer) can offer the retailer (franchisee) within the community of interest represented by a collection of stores operating as Quaker Bridge Mall. It is the same kind of support which permits McDonald's to sell its services to those capable of running a local hamburger stand, Hilton Corporation services to local hotel investors, and Midas to serve as developer of muffler shops, when one could install a muffler in one's own garage. Each of these examples uses the same piece of real estate that could be used by a local entrepreneur without benefit of coordinated, sophisticated continuous promotion and marketing. However, without such marketing investment, results would be far less than satisfactory in most cases.

But, the incremental revenues from alliance with recognized brand names is apparently so great that many are willing to accept the rules and constraints of the larger association, with its attendant extra costs. The increment in income is not due to the real estate involved, but due to the joint marketing agreement. By the same argument, the benefits to the specialty retailer of leasing within the marketing shelter of the regional mall justifies costs in excess of charges for the use of real estate capital. That fact is obscured by the tendency to frame payment for that franchisee as rent on a lease, when, in fact, the rent includes both space and multiple services, as well as a percentage of future sales.

DISCUSSION OF PROPOSITION #3

Proposition #3: Under New Jersey law a joint marketing contract which establishes a specific community of interest subject to certain rules, regulations and conditons, regardless of whether the agreement is a lease or a contract for services, is a franchise.

In defining the nature of the contractual relationship between Lawrence and Associates and the Majors, it is useful to look at both the New Jersey Franchise Practices Act and recent cases. The name Quaker Bridge Mall and its related site environs can be construed as the trade name and community of interest in the marketing of goods or services provided by Lawrence Association as franchisor.

New Jersey Franchise Practices Act
56: 10-3. Definitions
"Franchise" means a written arrangement for a definite or indefinite period, in which a person grants to another person a license to use a trade name, trade mark, service mark, or related characteristics, and in which there is a community of interest in the marketing of goods or services at wholesale, retail, by lease, agreement, or otherwise.
L.1971, c.356, 3, eff. Dec. 21, 1971

Various annotations to the statute taken from case decisions state:

In its simplest terms, a "franchise" is a license from the owner of a trademark or trade name permitting another to sell a product or service under that name or mark; more broadly stated, the "franchise has evolved into an elaborate agreement under which the franchisee undertakes to conduct a business or sell a product or service in accordance with methods and procedures prescribed by the franchisor, and the franchisor undertakes to assist the franchisee through advertising, promotion and other advisory services. H & R Block,Inc. v. Lovelace, 493 P.2d 205, 211, 208 Kansas 538 (1972).

A "Franchise" is a contractual relationship under which franchisee is granted, in return for certain fees, the right to market franchisor's goods or services under franchisor's trade name, trademark, or service mark, in accordance with tested uniform procedures and methods prescribed by franchisor and is to receive continuing assistance from franchisor in form of operational guidance, coordinated advertising, research and development, quality purchasing, training and education and other specialized management resources. Mobil Oil Corp. v. Rubenfeld, 339 N.Y.S.2d 623, 631, 72 Misc. 2d 392.

In the typical "franchise agreement," a company, the "franchisor," owns a trademark or trade name which it licenses to others, the "franchisees," to use upon the condition that the users conform their business to standards established by the licensor insofar as that business is associated with the trademark or trade name; franchise agreements invariably require a cooperative effort between the licensor and the licensee.
Evans v. S. S. Kresge Co., D.C.Pa., 394 F.Supp. 817,843.

"Franchisee," though an independent contractor in a limited sense, must perform according to the judgment, rules, regulations, methods and guidelines of the franchisor, while customary "independent contractor" exercises his independent judgment and performs his contract according to his own method and is not subject to the control of the other party to the contract. Matarazzo v. Friendly Ice Cream Corp., D.C.M.H., 70 F.R.D. 556, 559.

DISCUSSION OF PROPOSITION #4

Proposition #4: The special relationship with selected major department stores enjoyed by a shopping center development firm is created and defined in the basic operating agreement to which the major department stores subscribe to define the rules, regulations and conditions under which all parties will cooperate in the community of interest. The marketing power created by this agglomeration is marketed by the developer to specialty stores. General implementation requires the use of easements, the sale of conditional fees subject to multiple covenants and leases. Marketing promotional efforts may be implemented through a tenant association or promotion assessments. However, the documentation among the parties binding performance of their mutual obligations should not obscure the fact that the completed mall is intended as a retailing vehicle for the sale of goods and services, so that these arrangements are very analogous to a franchise agreement. Such agreements, like patents, copyrights and secret formulas are intangible assets.

If Lawrence Associates were to sell its shopping center interests in amongst the department store pads, the buyer would take by assignment all of the privileges and responsibilities imposed by the existing operating agreements with the Majors and subject to the lease terms of the subordinate specialty tenants. The buyer would have purchased real estate rights and duties, plus the benefit of performance obligations by the Majors and the tenants. That is significantly more than fee simple title. Accounting practice would require that the buyer of such assets allocate purchase price to a variety of asset accounts, in addition to real estate.

Consistently, the real estate tax must fall on that portion of the purchase price which represented tangible real estate. The burden on the assessor is similar, but more complex than the necessity to separate the drapes and personal property from the sale price of a home, the fixtures and inventory from the sale of a small tavern, or equipment from the sale of a dairy. Operating agreements bestowing valuable services and warranties from the developer to the store owner are the stock and trade of the shopping center developer and grow out of a complexity of arrangements which, in some, can be termed a franchise in order to distinguish values inherent in these arrangements from the tangible real estate rights which are the concern of the assessor.

The confusion of business value with real estate is common to industries which have a high level of management expertise, but nevertheless use a piece of real estate that stands tall on the skyline. A chemical plant depends on low silhouette research and scientific technique, but the petroleum refinery is what people see and consider the principal asset. Hotels represent complex marketing with a variety of subcontractors inside the hotel and a sales force marketing conventions, business meetings and a recreational fantasy throughout the region. Nevertheless, the income is attributed to the building when, in fact, it is generated by promotion, rather than location. These types of going concerns are significantly different than a multiple tenant office building where the landlord has nothing to do with promoting the individual business concern of the tenants, and rents are not related to gross sales or net profits of any of the tenants. Nor do the office tenants have any significant interrelationships which provide a certain mutuality of interest. Providing space for an operation should not be confused with using real estate as a device for marketing goods and services, since the latter depends on entrepreneurship, rather than cubage.

Lawrence Associates is marketing the existence of mutual pledges among the Majors and the developer to the specialty tenants, which occupy space in the developer's share of the mall. The developer is sharing the economic benefits of this mutual marketing effort with his tenants, in exchange for servicing fees, capital charges for the use of the retail shell, and a percentage of sales as yet to be determined. The tenant pays all his own operating expenses.

The current operating agreement which provides expectations to the specialty tenants was drawn by four major parties as of January 29, 1976, and entitled "Second Amendment to and Restatement of Four-Party Operating Agreement, Quaker Bridge Mall". Using this document as a page reference, provisions illustrative of various attributes of a franchise are presented below:

A. p. 91-92 of the above agreement:
The term of the operating agreement begins 12/9/74 (the date of the original four-party operating agreement) until the Shopping Center opening date and thereafter for fifty years.

Eminent Domain (p. 69), Demolition, Damage, and Destruction (p. 78), and other contingencies must be met by rebuilding and continuing obligations.

B. "Second Amendment To And Restatement of Four-Party Operating Agreement, Quaker Bridge Mall", dated 1/29/76:
The four parties are: Macy, Penney, Hahne and the Developer. There is a separate agreement between Sears and the Developer, so that practically speaking, there are five in the current mutual pact.

C. p. 34A of the above agreement:
"Developer agrees with the Majors that subject to Sec. 23 and 24, so long as at least two (2) Majors are operating as Department Stores, in accordance with obligations of Sec. 14.1 hereof, Developer shall continually operate the Shopping Center . . . under the name "Quaker Bridge Mall . . . ."

D. p. 24 of the above agreement:
Each Major, Sears and the Developer, is responsible for the construction of its own building, parking area, and common area on its facilities. Each Major and Sears has some control over the architecture of the mall court adjoining its building (p. 6) and over the types of businesses located within 150 feet of the mall entrance to its store (p. 37).

p. 32 of the above agreement:
The Majors, Sears and the Developer agree to open their stores and the mall by a specified date and within a specified time period of the opening of each others' stores and of the mall.

pp. 91-93 of the above agreement:
Each Major and Sears agrees to operate a Department Store on the mall for a specified number of years, but this time period is somewhat dependent upon the other stores also remaining open for

business (pp. 38-42, 72). The Developer agrees to keep the shopping center open as long as two of the Majors, including Sears, are open for business (p. 34A).

E. pp. 6, 36 of the above agreement:
The Developer is required to submit to the Majors for approval the architectural drawings of the Preliminary Plans for on-site and off-site improvements and for the areas of the enclosed mall which abut each Major's building.

The rights and requirements of the Developer are clearly stated in this agreement:

requirement to build the enclosed mall -	p. 17
requirement to build the mall store buildings -	p. 17
requirement to lease the mall store buildings -	p. 31
requirement to operate the mall -	p. 34
requirement to maintain the mall, except for the buildings and landscaping of the Majors -	pp. 61, 66
right to acquire up to 30 acres of adjacent land -	p. 21
right to build additional buildings on that land -	p. 21
but the use of those buildings is restricted -	p. 21

The dates of the start and completion of all construction (pp. 15, 17, 19, 24), the floor area and height of all buildings (pp. 17, 24-31, 37), the quality and placement of the utilities (p. 10), and the size and lighting of the parking areas (pp. 12, 13) and mall (p. 63) are all dictated by this agreement.

F. p. 67 of the above agreement:
When a Merchants Association is formed, the Majors and Sears are required to join if a specified percentage of mall occupants belong. This merchants association would provide for collective mall-wide advertising.

G. Not mentioned in this agreement specifically, Macy, Penney and the Developer have agreed to share expenses in the Site Work Agreement and in the Expense Rider.

In the Mobil Oil Corporation versus Rubenfeld Case (339 N.Y.S. 2d 623, p. 261) the decision clearly recognized that leases or other contracts that concern real estate must be considered "in a manner consistent with the true intent and purpose of the reasonable expectations of the parties as suggested, not only by the contents of the instrument, but by the whole of the relationship that existed between them . . . Furthermore, it should be apparent that we are not dealing here with a traditional landlord-tenant relationship, but with what is essentially a form of commercial venture -- a franchise -- for the marketing of Shell's products, in which both parties have a common interest and profit from the activities of the other."

However, a franchise does not require the franchisor to sell goods or services to a franchisee "since that concept may apply to a method of doing business as well as to a method of distributing a particular product or line of product."[1] This decision goes further to say that while the formal agreement can deny the existence of any partnership or joint venture de jure, nevertheless, many situations produce the equivalent of an economic or de facto partnership within which each has defined his particular contribution of expertise and responsibility toward their common marketing objectives.

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[1] Mobil Oil, op. cit.

DISCUSSION OF PROPOSITION #5

> Proposition 5: Agreement among a group of major department stores on a common site and a common time horizon for development is difficult to obtain. Whoever successfully binds the major department stores in such a mutual marketing arrangement will then be able to attract the smaller specialty stores, and can be considered a franchisor subject to the rules, regulations and conditions of an operating agreement with the Majors; and whoever, is permitted to participate in the shopping center venture as a retailer is a franchisee. In the case at hand, the partnership, Lawrence Associates (which includes Macy and Kravco, among others), is the franchisor, which employs Kravco for a variety of technical services. It is useful to extend this direct analogy to New Jersey franchise definitions to better understand the intangible character of asset values inherent in purchase or sale of a shopping center venture, but the analogy is not necessary, since the principle of separating returns to business management skills from returns attributable to real estate used in a business is well established.

The R. H. Macy & Co., Inc. (Macy) assembled the Quaker Bridge Mall (Mall) site in 1969-70. The property was zoned industrial. Macy was successful in changing the zoning to allow a Regional Shopping Center.

In 1971, Macy and Kravco, Inc. entered into negotiations for the development of a regional shopping center on the Macy site. Although Penney was not firmly committed, they indicated a sincere interest in opening a store at this location. Macy's intention to open a Bamberger's store and Penney's desire to join in the Mall added impetus to the negotiations between Macy and Kravco, Inc. This ultimately resulted in Macy approving the formation of a limited partnership, Lawrence Associates, on January 21, 1973, for the purpose of owning and developing Quaker Bridge Mall.

Macy was introduced to Kravco at Oxford Valley Mall, a regional shopping center development in Levittown, Pa., which is approximately 15 miles southwest of Quaker Bridge Mall, in Northeast Philadelphia. Oxford Valley is a four-department store-mall, including a Bamberger's (Macy's) as an anchor store. Contemporaneously with the Quaker Bridge development, Kravco was developing (not with Macy) two other malls in Pennsylvania, which included a Bamberger's store. All of the above developments included three or four department stores, with a Mall containing approximately one hundred to one hundred thirty stores.

Upon approval of the joint venture with Macy, Kravco moved to finalize the deals with the other department stores, i.e. Hahnes, Penney and Sears with whom negotiations have been taking place. Penney, in April, 1973, and Hahnes, in July of 1973, accepted Kravco's invitation to become anchor stores at the Mall. Sears was invited to participate, however, they were somewhat committed to another developer's project in Hopewell, New Jersey (Northeast of Quaker Bridge - approximately 10 miles). It was not until early 1975 that Sears decided to enter Kravco's project as a result of the Hopewell project not achieving a zoning change.

John Wanamaker, a local department store, was invited to come into the project, but they declined.

It is interesting to note that it is common subdivision practice to create homeowners associations where restricted covenants are generally regarded to enhance the enjoyment of all the residents. These associations serve as private governmental units on matters of close personal governments of the residents, including maintenance, extérior design, fencing, lighting and signing. The operating agreement between the department stores and the shopping center developer is, in some ways, similar and makes the private development entity a government or private municipal entity within the confines of the shopping center site and relative to matters of governance. Such a government can then bestow a franchise on various specialty retailers, not unlike the public municipality which grants an opportunity for an exclusive territorial service within the confines of the mall. This analogy is useful in perceiving the developer's role as a franchisor.

DISCUSSION OF PROPOSITIONS #6 AND #7

Proposition #6: If the franchisor (Lawrence Associates) were to sell all of its interest in Quaker Bridge, it would represent sale of a contractual privilege to exploit the synergy created by its operating agreements with the four major tenants and its selection of tenants for the specialty retail areas. The operating responsibilities inherent in these existing arrangements are those of a going concern, and price paid would represent going concern value. The buyer expects to generate profit from management of the total enterprise, from leasing of space, from custodial operations and fees from the tenant association and from sharing in the retail profits and expansion opportunity created by joint marketing efforts and management involvement.

Proposition #7: Generally accepted accounting principles would require that the purchase price of such a business be allocated among tangible and intangible assets. Not all tangible assets are real estate as these assets could include cash in banks, accounts receivable, inventory and similar items, and intangible assets might include certain past expenditures which were capitalized, such as organization expense and unfinished research. Once these tangible and intangible items have been valued at cost to replace or salvage value, then most all of the remaining value paid for the business could be allocated to the broad category of goodwill, or in the case of shopping centers, franchise value.

The existing operating agreement would permit Lawrence Associates to sell its position in the operating agreement and the real estate fees sandwiched and encumbered among the major department stores. There is a long-term management contract between Kravco and Lawrence Associates, but there is provision for cancellation of that contract for payment of certain fees and liquidation penalty. Thus, the buyer would purchase a business opportunity for which it would receive service fees, overage rent, and a share in unknown residual values at the end of the fifty-year term. It would be buying an opportunity to franchise, and accountants would find it necessary to represent this investment on a financial statement. A portfolio of leases,or franchises, like copyrights or trade names lacks a physical existence and is often characterized as having a high degree of uncertainty concerning future benefits that may be received from its existence. Franchise intangibles may have value only to a given enterprise, an indeterminate economic life, and acyclical and volitile value since benefits are based on competitive advantages, which may be lost. In short, the duration and timing of future benefits are difficult to predict.[1]

These characteristics certainly describe the uncertainties of a large regional center operator at a time when energy costs will make the premise of air conditioning at an acceptable cost improbable and the premise of frequent long-distance trips by automobile subject to doubt. As food and energy costs rise and the demographic attributes of regions change, it may well be that the discretionary income which is the target of the shopping center, may also evaporate. and consumer values will change.

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[1] "Intangible Assets", Opinions of the Accounting Principles Board No. 17 (New York: AICPA, 1970), par. 10.

When several intangibles or a combination of intangibles and tangibles are bought in a basket purchase, the costs should be allocated on the basis of relative sales value.[1] The franchise attributes in a shopping center are classified as specifically identifiable because certain costs are incurred in creating the original arrangement, but it is far more difficult to isolate the value where the entire interests of Kravco were purchased as a going concern. In that case, the financial statement shows an account called Good Will, undoubtedly one of the most complex and controversial assets. Since current accounting measurement techniques are not very reliable when measuring the value of good reputation, a superior management team, or a mix of tenants, accountants often assume:

> that the existence of goodwill is indicated by the presence of profits above those that could be normally earned by the tangible and identifiable intangible assets. This method normally attempts to discount the extra earning potential of an enterprise and determine the present value of this extra inflow, which is called goodwill. Many times, however, a more indirect approach is used where the value of the individual assets is simply compared to the bargained price for the business. The difference is considered goodwill, which is why goodwill is sometimes referred to as a "gap filler" or "master valuation" account.[2]

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[1] "Intangible Assets", Opinions of the Accounting Principles Board No. 17 (New York: AICPA, 1970), par. 10.

[2] Donald E. Kieso and Jerry J. Weygandt, Intermediate Accounting (New York: John Wiley and Sons, Inc., 1974) p. 526.

DISCUSSION OF PROPOSITION #8

Proposition #8: The Internal Revenue Service requires allocation of the purchase of a going concern between tangible assets and intangible assets, including goodwill and franchise value in order to establish an equitable base for taxation. It would follow that real estate tax procedure must also be sensitive to such allocation for consistency and equity among governmental entities.

It is common knowledge that sale price of a business must be allocated among a variety of asset accounts because the sale is considered to be a sale of the assets involved and the allocation must be used to determine:[1]

1. The amount of gain or loss with respect to each asset
2. The character of the gain or loss as capital or ordinary
3. Whether proceeds are subject to depreciation or investment recapture provisions
4. The cost basis of particular items relative to the buyer of the business for purposes of future depreciation, inventory, and sale tax matters.

In arriving at such an allocation buyer and seller are often in conflict. The typical seller will try to maximize his capital gain and his ordinary losses (which are fully deductible) but such a result would minimize deductible expenses for the buyer and the buyer will seek to have the price allocated to depreciable assets and inventory.

One thing buyer and seller can agree on is the desire to minimize goodwill or franchise value in many circumstances because goodwill is often not depreciable and at the same time it or franchise value may be taxable as ordinary income to the seller.[2] Therefore, the IRS is often in the role of forcing a reallocation since it may disregard the allocation by sales agreement where it is determined these allocations are in conflict with economic reality. In the absence of any clear method for measuring going concern value, i.e., franchise or goodwill value, the taxpayer is expected to apply the residual method of valuation. The residual method determines the market value of tangible assets and subtracts this amount from the total purchase price, and this difference is termed goodwill.[3] However, where it is not possible to make a clear distinction among the contributions of tangible and intangible assets, a variation of the residual approach called the formula approach may be used to determine the fair market value of the intangible assets of a business.[4]

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[1] IRS Code Secs. 751 and 752; Watson v. Com., 345 US 544, Fed Tax Coord 2d Sect. I-5100; Tax Guide Sect 4550; 34 AM Jur 2d Sect 4550. See Tax Action Coordinator, Tax Analysis of Forms and Agreements, 171-F. Sale of a Business, P. 170,037, September 1977.

[2] See "Developments" I-5250 Federal Tax Coord 2d, November 29, 1979, relative to IRS Code Sec. 1253

[3] Code Secs. 167 and 1001, Standard Federal Tax Reports, as reported in Commerce Clearing House, October 1979. For example, see Black Industries, Inc. v. Commissioner, Commerce Clearing House, December 35,894(M); Dkt. 5286-76, February 22, 1979, T.C. Memo. 1979-61, opinion by Judge Simpson.

[4] See A. R. M. 68, C. B. 3,43 (1920), and O. D. 937, C. B. 4,43 (1921).

The Commerce Clearing House has stated the formula approach as follows:[5]

> A percentage return on the average annual value of the tangible assets used in a business is determined, using a period of years (preferably not less than five) immediately prior to the valuation date. The amount of the percentage return on tangible assets, thus determined, is deducted from the average earnings of the business of such period and the remainder, if any, is considered to be the amount of the average annual earings from the intangible assets of the business for the period. This amount (considered as the average annual earnings from intangibles), capitalized at a percentage of say, 15 to 20 percent, is the value of the intangible assets of the business determined under the "formula" approach.
>
> The percentage of return on the average annual value of the tangible assets used should be the percentage prevailing in the industry involved at the date of valuation, or (when the industry percentage is not available) a percentage of 8 to 10 percent may be used.
>
> The 8 percent rate of return and the 15 percent rate of capitalization are applied to tangibles and intangibles, respectively, of businesses with a small risk factor and stable and regular earnings; the 10 percent rate of return and 20 percent rate of capitalization are applied to businesses in which the hazards of business are relatively high.
>
> The above rates are used as examples and are not appropriate in all cases. In applying the "formula" approach, the average earnings period and the capitalization rates are dependent upon the facts pertinent thereto in each case.
>
> The past earnings to which the formula is applied should fairly reflect the probable future earnings. Ordinarily, the period should not be less than five years, and abnormal years, whether above or below the average, should be eliminated. If the business is a sole proprietorship or partnership there should be deducted from the earnings of the business a reasonable amount for services performed by the owner or partners engaged in the business. See <u>Lloyd B. Sanderson Estate v. Commissioner</u> [1930 CCH Par. 9386], <u>42 F. 2d 160 (1930)</u>. Further, only the tangible assets entering into net worth, including accounts and bills receivable in excess of accounts and bills payable, are used for determining earnings on the tangible assets. Factors that influence the capitalization rate include (1) the nature of the business, (2) the risk involved, and (3) the stability or irregularity of earnings.

It follows that application to the IRS formula approach would also be relevant to valuation of the tangible assets of a shopping center venture for two purposes:

1. A test of the actual assessment value could be made to determine whether the various ratios of receipts, net income, and funds after

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[5] "Computation of Gain or Loss," Sec. 1001, page 52,005, Sect 4460,302, Reg. Sect 1.1002-1.

debt service as a ratio of total capital value are consistent with averages for super regional shopping center industry figures.

2. Should assessment indicate ratios which were unrealistic in terms of economic reality for the earnings of the industry as a total function of capital cost, then industry figures would provide a basis for allocation between tangible and intangible returns.

The formula approach for allocation of purchase prices relevant to federal taxation provides a precedent applicable to confusion between tangible and intangible values for real estate tax assessment relative to sale of a partnership interest in a super regional shopping center. Application of the formula approach at the federal level has the added elegance of providing consistency in the pursuit of equity among federal, state, and local tax systems.

DISCUSSION OF PROPOSITION #9

> Proposition #9: The real estate tax is intended to fall only on those tangible assets which can be defined as a fee simple title in realty to the benefit of private interests. The value to be taxed is the value at which the fee simple title of the real estate would sell or would cost to replace and does not include the privileges and entitlements which are part of intangible assets or personal property of the going concern.

This principle affects the appraisal of a shopping center site as though vacant; and the appraisal of the improvements, as well as the value attributable to management as represented by the operating agreement. There is a tendency for appraisers to confuse vacant land zoned to accommodate use as a regional shopping center with land on which the operating agreement and perhaps the buildings are already in place. The real estate tax must fall only on the land as though vacant, before the potential opportunity is made a specific reality by the franchise contract for personal services, which has been called above the operating contract. Indeed, this contract has been considered by some as a fiduciary arrangement.[1]

Relative to the building, it is necessary to distinguish the value of the basic space and mechanical systems and other site improvements, from the drawing power that accrues when national and regional department stores affix signs and emblems and advertising motifs, all of which are personalty and the result of heavy investment in institutional advertising and image building. The graphics and signage are not regarded as fixtures, but rather the personal property of the tenant and a part of that contribution of special retail entrepreneurship which has been marshalled by the developer to combine into a greater retailing experience and volume than might have been possible as free standing store sites. The problem of separating the real estate from the entrepreneurship is not unlike the problems of appraising a hotel; a high fixed cost, variable revenue, development which only makes money when it is marketed and managed to produce above average occupancy, above average room rates and above average utilization of its many restaurants and other centers of customer service. The separation of the contribution of entrepreneurship from the contribution of the capital investment has always been one of the most complex appraisal problems, for hotels, or shopping centers. One method is to take the income projections and strip out the allocation of income to management from customary management contracts, the income attributable to furnishings, and the income attributable to leasehold positions not justified by productivity or market rents.

Therefore, the alternative is to determine value of the land as though vacant and uncommitted to any specific operating agreement, plus the costs of real estate improvements at replacement value, less wear and tear, functional obsolescence, and locational obsolescence. In the case of a new center such

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[1] Black's Law Dictionary, 4th Ed., p. 753.

as Quaker Bridge Mall in 1976, the last two items can be assumed to be non-existent. However, as the costs of air conditioning and energy for all utility systems begins to rise, a significant element of functional obsolescence will appear. Should the adjustment of middle class America to smaller cars and expensive gasoline result in a significant compression of trade area or alteration of shopping habits, locational obsolescence will also appear, together with functional obsolescence of overbuilding. The ability of shopping center management to retard the erosion of sales after adjustment for inflation will be a return to entrepreneurship and investment in promotion.