Brand Finance Report

Brands and tax planning

Issue 3

The increasing importance of branding

Brands have gradually been moving up the corporate agenda and today play a major role in the life of most successful companies. The financial role of brands has increasingly been recognised and accounting standards and tax legislation have been introduced that begin to recognise their growing importance and reflect the value that brands and other intangibles add to the bottom line.

In terms of accounting standards, Financial Reporting Standard 10 ("FRS10") in the UK, effective since 28th December 1998, was one of the first standards to allow separate recognition of acquired intangible assets, provided that their fair values could be measured reliably. This was a sign of recognition from the accounting bodies of the real value those intangibles, especially brands, add.

New US accounting standards, effective since 1st July 2001, took the accounting treatment of intangibles a step further. FAS 141 "Business Combinations" requires acquired brands and other intangibles (provided they arise from contractual or other legal rights or are "separable" (para 39, FAS 141)) to be disclosed separately from goodwill on the balance sheet. FAS 142 "Goodwill and Other Intangible Assets" then sets out the appropriate accounting treatment of intangibles post acquisition, with the requirement for impairment reviews to be conducted in certain circumstances.

Finally, a new International Accounting Standard ("IAS"), IFRS 3 "Business Combinations", was issued on 31 March 2004, together with revised standards IAS 36 "Impairment of Assets" and IAS 38 "Intangible Assets". IFRS 3 is effective for all UK (and numerous other countries where it is being adopted) quoted companies for business combinations entered into on or after 31 March 2004 and requires acquired intangibles to be recognised separately from goodwill provided their fair values can be measured reliably.

With auditors coming under increasing scrutiny, the requirement for independent intangible asset valuations following the acquisition of a business, and their subsequent impairment reviews, has significantly increased as a result of the new US and international standards.

In addition to accounting standards, the UK tax regime for intellectual property ("IP"), goodwill and intangibles, including brands, which for so long failed to keep pace with developments elsewhere, was also modernised in Schedule 29 of the Finance Act 2002, "Gains and losses of a company from intangible fixed assets". The underlying principle of this legislation is the alignment of the tax and accountancy treatment of intangibles and goodwill. Companies are entitled to tax relief, based on the amortisation of assets in the accounts, for the cost of most intangible fixed assets and goodwill incurred from 1st April 2002. Similarly, all receipts from this date relating to intangibles and goodwill within the new regime will be treated as income (good news for companies with substantial brought forward trading losses, provided the intangibles are held for the purposes of the trade).

More recently, the UK tax regime as it relates to brands and other intangibles was affected by the European Court of Justice ("ECJ") ruling that transfer pricing rules between UK and continental European companies must also be applied to transactions within UK groups. New legislation to implement this took effect on 1 April 2004. As a result, Brand Finance is assisting IP-owning companies in the UK with their reviews of internal licensing arrangements.

We now discuss in more detail specific applications of tax planning connected with brands and IP management.

Tax planning and brands

Internal licensing and centralisation of IP management

The realisation that brands are contributors to profits, coinciding with a rise in joint ventures and brand use by third parties, has led to companies increasingly charging royalties for the use of, and considering the appropriate domicile for, their brands. Consequently, tax authorities now show a keen interest in brands and most international organisations carefully consider the tax implications of internal licensing arrangements and cross-border transfers of brands. The recent ECJ ruling on UK to UK transfer pricing means that this interest will now also extend to UK only transfer pricing arrangements.

Nestlé, Vodafone and BAT are examples of international companies that have created central brand management organisations which then charge royalties to operating subsidiaries around the world.

Internal licensing

Until the mid-1990's, organisations would generally allow their affiliates to use their brands for little or no charge. Some companies allowed their affiliates to use the brands completely free, or otherwise they merely passed on direct costs on a cost-sharing basis. Organisations may have charged for the use of their technology or for their management time but tended to allow the brand name to be used at no cost.

However, with the growing realisation that brands irrefutably add value to businesses, an increasing number of brand-owners are now charging for the use of their brands by other group companies. It is therefore imperative that internal license agreements contain credibly constructed royalty rates. Brand valuation techniques are usually used to substantiate internal royalty rates. Many tax authorities, including the Inland Revenue and IRS, are prepared to acknowledge independent brand valuations as a basis for this process.

An internal licence – where the licensee is a subsidiary company or associate company of the licensor – arises because the user of the trademark or licence will not necessarily be the owner. An US company which is a wholly owned subsidiary of an UK company is a separate legal entity, and therefore can only use the trademark after receiving explicit or implicit permission.

It could be argued that formally granting a licence between different parts of the same company – where ultimately the same set of shareholders will benefit from the licence exploitation – is bureaucratic and unnecessary. However, every part of an organisation is now expected to contribute as effectively as possible to the overall results of the group, and many directors and brand managers argue that formalising the relationship between those who own the brand and those who use it acts as an incentive to maximise the use of the licensed brand rights, and to ensure that the rights and obligations on both sides are more fully understood and adhered to.

MNE tax strategies aim to distribute income flows and assets between countries so as to avoid one territory paying tax while accumulating tax losses in another. Inevitably IP management seeks to locate expenses to obtain tax relief at the highest local rate possible and income in low tax jurisdictions.

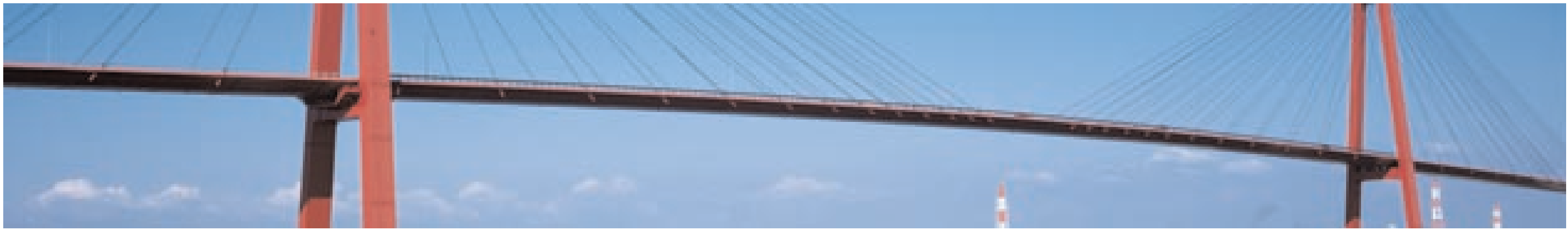
When this occurs internationally, tax authorities are particularly vigilant. Numerous large organisations have been struck with retrospective tax charges for imputed royalties not levied on foreign affiliates. Additionally, certain companies have also come under attack for charging excess brand royalties to their US affiliates as a means of expatriating profits earned in the US. Importantly, independent brand valuations help to support companies against claims made by the tax authorities regarding the selection of an appropriate royalty rate.

Our understanding is that, in the UK, the Inland Revenue will perhaps be more vigilant in their reviews of international arrangements than UK to UK arrangements, nevertheless, a de minimis level of analysis and support for UK to UK arrangements will certainly be required.

One of the key drivers for the growing trend of international licensing is the desire to understand and measure the profit contribution from different geographical and business divisions. Several leading edge companies are now taking the issue of internal licensing so seriously that they are creating central trademark holding companies. This means that the ad hoc trademark and licensing system that has grown up over the years is replaced by a system where one company - the trademark holding company - holds all the group's trademarks and licences. The most famous examples of this transfer of trademarks to one separate legal entity are Nestlé, Shell and Vodafone (with IP located in Switzerland for the first two and Ireland for the latter). The IP is then licensed to the subsidiaries and those subsidiaries are charged for the use of the trademarks, patents and licences. The primary driver for this depends on which company you talk to. Some claim improved efficiency and control of brand management (e.g. Shell) while others admit it is primarily about the tax benefits.

In terms of the efficiency and control of brand management, benefits accrue because operating companies do not take for granted the use of valuable assets. Just as they would pay for the use of central research facilities or for shared production facilities, operating companies also pay for brands they are using. The charge made for the use of a brand is seen to relate directly to the value of the asset being licensed.

All companies which own trademarks, copyrights and licences should continually audit the inter-group use of those assets. There is increasing evidence that managing, protecting and developing such intangible assets requires specialist marketing and finance skills, and therefore, all such assets should be held and managed centrally.



Case study:
The advantages of Centralised Internal Licensing ("CIL")

Brand extension and cross branding is accomplished more effectively and efficiently if brand control is held centrally. This reinforces understanding that the brand is a shared resource. For example, if one territory operates an established brand, CIL makes it more likely that the brand can be successfully transferred elsewhere. The maintenance of brand rights involves considerable effort. It is vital that trademarks are registered, renewed and that all necessary actions for brand protection (prosecuting infringement and pursuing passing-off actions) are pursued with appropriate vigour. In an increasingly multi-national trading environment legal action is often cross border, reinforcing the need for central control. By performing the function centrally, organisations ensure that they make best use of expensive specialist skills and also that they take a consistent approach to the issues across all territories. Without central co-ordination local management may be too fastidious or too lax in registering trademarks, or in pursuing legal action for real or imagined infringement of the trademarks. Many argue that CIL ensures that the value of brands is more acutely appreciated across a group in areas such as finance and legal. Over the years, many marketers have argued that they alone have understood and appreciated the value of this particular class of assets. CIL backs up the centralised marketing concept, where marketing resource is shared and co-ordinated, maximising the homogeneous nature of brand image, product development and advertising. CIL generates a holistic, group-wide approach to brand licensing ensuring that the management and development of the brand is controlled for the whole of the group and not just one part of it, which may have a narrow or particular focus.

Despite the centralisation of brand management, it is still possible to ensure that brand managers in individual territories are incentivised to ensure brand value is maintained and enhanced in those countries. This has a direct impact on maximising shareholder value. With CIL it is possible to standardise performance targets and the remuneration structures across groups (although flexibility may need to be maintained in response to local conditions). CIL is the first step to incorporating brand values within management accounts. Using CIL means that there will be a payment from the subsidiary to the licence holding company. By ensuring that payment is made, the directors of the subsidiary clearly focus on the value in use for their part of the organisation. Some also argue that directors of subsidiaries react better to being charged a licence fee for the use of brands and trademarks, rather than an amount charged to cover head office costs, which are often perceived as being unfair and arbitrary. The use of a royalty payment can reinforce and align with the tax implications of valuing brands and IP. Finally, CIL provides a solid base for new licensing deals within the company and with joint venture partners or other third parties.

Choice of location for IP management companies

After the decision to manage IP centrally has been made, the location for the management company must be decided. Both Nestlé and Shell hold their IP in Switzerland, whilst Vodafone selected Ireland. They then charge arm's length royalty payments for the use of brands by their subsidiaries. Lower tax rates in the country of brand ownership means such a policy can have major fiscal benefits in addition to management and organisational advantages.

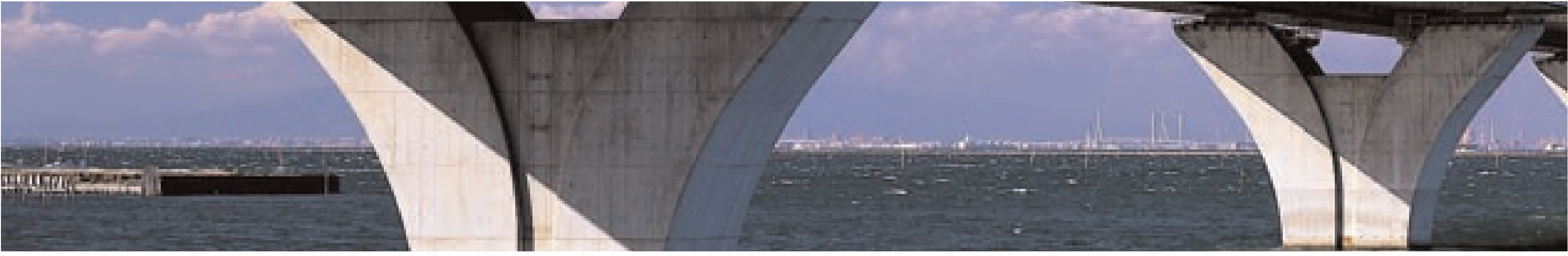
This practise is entirely legitimate. It is tax avoidance, rather than tax evasion. Switzerland/ Ireland, as the countries where the IP management companies are based, manage and control the brands. Tax authorities are unlikely to allow payment of royalties for the use of a brand (or any other asset) if the country that owns the brand, and is charging for the use, is not the place from which management of the brand is directed. It will, for example, be difficult for management to justify why an offshore shell company with no involvement in the management, control and direction of a brand should charge for the use of that brand.

It should be noted that UK-based companies may encounter problems in transferring their IP rights to an offshore holding company, as CFC ("Controlled Foreign Company") rules dictate that the Inland Revenue can charge tax on the profit of a foreign subsidiary in exactly the same way as an UK-based company. Both the UK and the US have transparent regimes of this type which minimise the scope for shielding subsidiary earnings from tax in the head office country.

When IP is transferred to a central management company there are likely to be capital gains implications. The tax authorities in both jurisdictions involved are likely to take a keen interest in the capital value of the asset leaving or entering their jurisdictions. As with internal licensing rates, brand valuation techniques are used to establish a value when the domicile of a brand is changed.

Tax authorities are becoming generally more suspicious over the amount of value attached to any intangible asset. Estimates are, in the opinion of the authorities, susceptible to over or under inflation, to accord with the tax strategy of the company. Another benefit of a brand valuation being conducted by an independent body is that it adds credence to any brand value and is less likely to attract suspicion from the authorities.

The new regime for intellectual property, goodwill and intangibles



Tax planning in relation to brands has historically focussed on areas such as internal licensing and the relocation of IP to offshore tax havens. The new tax regime in the UK has sparked renewed interest in tax planning for brands as a result of planning ideas generated by the new legislation, and simultaneously raised the awareness of the importance of independent brand valuation to support such planning.

Generally speaking, the planning ideas developed in relation to the new regime fall into one of two areas. The first is to attempt to bring an existing (pre 1st April 2002) intangible asset, often a brand, within the scope of the new regime. The second is to create a completely new intangible asset, to which the new regime rules would apply, from an existing one.

The Inland Revenue moved quickly to close certain loopholes in the legislation relating to a particularly popular tax avoidance scheme falling into the first category above (known as a "de-relating" scheme). The principle of the scheme was for companies to transfer assets within a group for capital gains tax purposes but between parties that were not related for the purposes of the intangibles regime. Essentially, a transfer of an intangible asset between unrelated parties would bring that asset within the scope of the new regime, enabling the new owner to receive tax relief at 4% p.a. straight line for a period of 25 years.

Several companies have submitted corporation tax computations having implemented such "de-relating" transactions, resulting in swift preventative action by the Inland Revenue. It remains too early to tell whether the transactions implemented prior to the amendments will be successful but the fact that the Inland Revenue moved so quickly to close the loophole may be seen as an indication that it was a robust scheme.

The majority of schemes being implemented today fall into the second category. One such scheme involves the licensing of IP, such as a trademark, by one company to another in return for a lump sum. The key issue is whether the lump sum receipt falls under s171 TCGA 1992. Assuming that the receipt does fall under s171, then the transfer is at no gain/ no loss, and the new asset, the license, receives tax relief in line with its amortisation in the accounts.

This is also contested by the Inland Revenue. For s171 to apply there must be a disposal of an asset to another company. The Revenue argue that although one company has acquired an asset, it is not the case that the other has disposed of it, the license having been created from an existing asset by the transaction and not disposed of. This is analogous to the granting of a lease for land out of a freehold, which does fall under s171, but the Revenue argue that this is by concession only. Despite considerable resistance from the Inland Revenue, it seems likely that some companies will continue to implement tax avoidance planning relating to the new legislation.

Brand Finance is aware of several companies currently in the process of implementing such schemes. As part of the feasibility planning process, it is undertaking brand valuations to enable tax departments to assess the cost versus potential tax benefit of implementing such schemes. Clearly the maximum tax benefit will be derived from the highest valuation for the brand or other IP that can be reasonably justified to the tax authorities. Provided the auditors can be satisfied, it is likely that a directors' valuation would be sufficient. However, there can be a tendency for an internally prepared valuation to be rather conservative. Usually, those involved in the planning are more concerned with whether the scheme will work at all than the value attributed to the brand, and rightly so.

An independent brand valuation does have advantages, however. Firstly, it is likely that a valuation report prepared by an independent party has a greater chance of being accepted by the tax authorities, possibly also with less scrutiny. This is even more likely where the valuers, like Brand Finance, have had brand valuations put before the tax authorities in the past and accepted. Secondly, it is likely that an experienced valuer would be able to support a less conservative valuation which would result in higher tax relief, provided the scheme itself is accepted.

The future of tax planning for brands

Brands and the values that they represent have significantly increased over the last decade. Following this, companies increasingly need to look at brand values when planning for tax purposes. They need to gauge how to most effectively gain value from their intangible assets while minimising tax payments. The domicile of the brand needs to be carefully considered, as does the royalty rate charged for its use. Both the domicile and royalty rate are likely to be reviewed by the tax authorities, who are increasingly paying attention to brands and other intangible assets, using their extensive databases - a fact that needs to be remembered at the initial point of planning. Due attention must be paid by organisations or they may be forced to pay a heavy penalty by the tax inspectors.

The new regime for IP, goodwill and intangibles adds a new dimension to tax planning opportunities for certain companies. Although the Inland Revenue has moved swiftly to block certain schemes, opportunities remain. Recent changes to UK to UK transfer pricing regulations also add another layer of compliance for IP owners.

In all the cases of tax planning for brands that we have discussed, the case for independent brand valuation is a strong one and specialist companies like Brand Finance, with a strong track record of tax related intangible asset valuation work, will be monitoring further developments in this area with interest.

Appendix 1

Royalty rate determination for internal licensing

Step 1: Establish royalty rate range

The royalty rate range is set by reference to a review of comparable licensing agreements and industry norms.

The ultimate test is always, what would an unrelated third party pay to use the trademark under review?

A review of existing licensing agreements for other trademarks in comparable sectors will reveal the royalty rates set between third parties in arm's-length transactions. Brand Finance has extensive practical experience of appropriate royalty rates used in comparable circumstances. Where possible, it would be helpful to speak to licensing professionals in the sector under review to obtain a qualitative assessment of the typical royalty rates for that sector.

Step 2: Establish the appropriate royalty rate within that range for the trademark in question

Having established the royalty rate range, it is necessary to pin-point where in the range is appropriate for the trademark under review. This is calculated by reference to a "Brand Strength Index".

The Brand Strength Index score (out of 100) demonstrates how strong or weak the trademark is. Brand Finances scores the trademark relative to its key competitors with reference to a number of different business and brand attributes. Each competitor is scored out of 10 on each attribute. The attributes are then weighted and an overall score out of 100 is calculated for each competitor. The resultant score for the trademark is then applied to the royalty range to pinpoint the royalty rate figure. A score of 100 would result in a top of range royalty rate and the reverse for a score of zero.

Step 3: Compare royalty rate with operating margins within the business

The profitability of the licensee's business will also affect the level of royalty rate that it is able to pay. This must be taken into account when concluding on the royalty rate to be used.

A "Rule of Thumb" exists within the licensing industry which states that, on average, a licensee would expect to pay approximately 25% of its expected profits for access to the Intellectual Property (which could include brands) attached to the license itself .

The "25% rule" has been widely used for many years, is supported by empirical studies and has been adopted in legal infringement cases. The theory behind the "25% rule" is that the licensor and licensee should share in the profits resulting from the licensed property with the preponderance of profits going to the licensee, for its role in "commercialising" the property. Excluding special cases, the profit receivable by the licensor is generally accepted as reasonable if it is in the range from one-quarter to one-third of profits from the exploitation of the licence.

It is important to note that the "25% rule" is only a starting point for royalty negotiations and the royalties are often adjusted to be higher or lower, depending upon, among other factors, the negotiating strength of each party and the commercial realities of that specific situation. Such adjustments to the split to reflect special factors have been recognised by the courts.

The rule is based on historical use and proven relationships between royalty rates and operating margins and is accepted by many experts as a valid approach to value royalties. However as Goldwater, Jarosz and Mulhern conclude in their article, "Ultimately, royalty rates are often higher or lower than 25% of fully-loaded product profits, depending upon a host of quantitative and qualitative factors that can and should affect a negotiation (or litigation)".

When setting internal royalty rates, the "25% rule" is therefore a useful indicator of what an appropriate royalty rate might be and, therefore, whether the rate established from the comparable licensing agreements search and Brand Strength Index score appears reasonable.

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