$700bn up for grabs through more effective management of the world's 500 most valuable brands

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As the relative role of brands, IP and other intangible assets in business continues to grow, multi-nationals are increasingly looking to shelter the value created by these assets from tax authorities.

In the current political climate, there is a risk that legitimate re-structuring of the brand or IP management function, together with the creation of cross-border internal licensing agreements, will be viewed with increasing suspicion by the affected tax authorities. There is no doubt that such moves are already coming under intense scrutiny.

Despite huge negative political sentiment, significant commercial and financial benefits are available to organisations that transfer the management of international brands to dedicated brand management companies in locations such as Switzerland, Ireland and Singapore and many companies are pursuing this route.

Careful planning through a detailed feasibility study is recommended to avoid potential complications and pitfalls but the benefits will often outweigh the risks.

*Brand Finance has calculated that the value uplift created by moving the most valuable 500 brands in the world (according to the 2009 BrandFinance™ Global 500) to offshore locations would be **$700bn**, a **30% uplift** in value and equal to the $700bn spent by Hank Paulson in his US bank bailout.*

I. If you can't stand the heat…

The role of tax havens has been coming under increasing scrutiny as political hostility grows on both sides of the Atlantic. The Obama administration is set to bring in laws to clamp down on avoidance, prompting many US firms to look towards more sympathetic tax regimes in Europe.

On this side of the pond, the EU is planning a tightening of tax rules, requiring increased transparency and disclosure. Gordon Brown has personally called for the whole world to take action against "tax havens in the parts of the world which have escaped the regulatory attention they need".

As the political temperature rises, multi-nationals continue to re-structure their operations in order to minimise their effective global rates of tax. Notable examples in recent years include Accenture (Bermuda to Ireland), Kraft Foods (London/Vienna to Zurich) and, this July, McDonald's Corp announced its relocation from London to Geneva.

From a tax perspective, any financial planning or re-structuring that involves moving profits offshore is justifiable provided that the functions, assets and risks associated with these profits are also transferred.

This gap is considered to have arisen partly as a consequence of a shift in ownership of brands and other IP to tax havens and yet, in many cases, the decision to focus international brand management in a single location will have been driven by the significant commercial benefits that can arise from such arrangements, in addition to the financial benefits.

As we will discuss, the commercial and financial benefits from managing an international brand from a central 'BrandCo', or a broader range of

IP from an 'IPCo', can be substantial. Brand Finance estimates that the impact of assuming that all of the brands in its 2009 BrandFinance Global 500™, a league table of global brand values, are managed centrally from a specialist centre such as Switzerland or Singapore, would be an increase in brand value of $700bn, a 30% uplift in total value.

Why are an increasing number of companies moving the global management of their brands and other IP to IPCo's in central, specialist locations and how are they benefitting from doing so?

II. An explanation of IPCo's

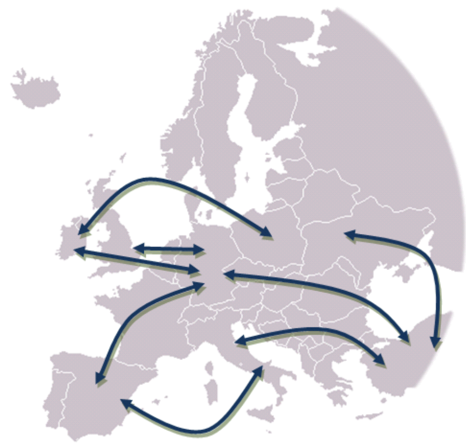
Multinational companies grow by acquisition and expansion. Any one of their subsidiaries can be responsible for creating a new brand, or other IP (patents, recipes etc). To understand how an IPCo works we must assess the treatment of IP in two distinct scenarios:

Irrational IP arrangement

In this scenario IP remains in the country in which it is generated, and is then licensed for use by subsidiaries in other territories. In most situations agreements are put in place for each license, and arm's-length royalties are developed and documented. However, in some instances (often depending on the type of IP in question) no formal agreement is put in place. As a result, a complex web of licenses, royalties and tacit agreements will develop.

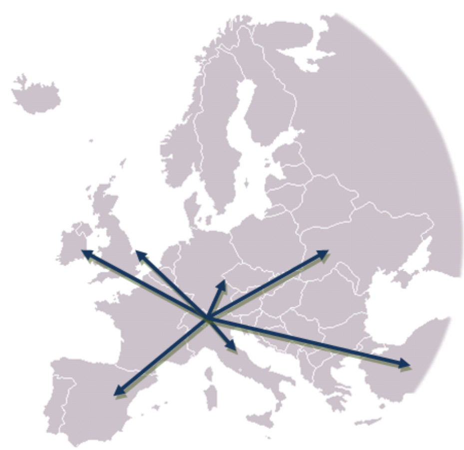
Central IP arrangement

A central IPCo can be created in a suitable territory and this entity then acquires any IP intended to be shared globally from each of the local entities. The movement of the IP from the local entities to the IPCo involves valuations of this IP, and possible capital gains, but once the migration is accomplished, the administration of the global licenses is greatly simplified and the commercial benefits resulting from central IP management can be realised.



Irrational IP arrangement:

When this happens it is not only tax inefficient, but also a significant administrative burden.



Central IP arrangement:

This structure can be established for both acquired and internally-generated IP that is intended to be shared globally.

In Fig.1, PLC is the legal owner of the IP in perpetuity. In the existing structure, it had entered into royalty-free license agreements for the use of the IP with its OpCo's. Under the new structure, PLC grants a 10 year master license to the newly incorporated IPCo, which in turn enters into sub-license agreements with the OpCo's and takes advantage of the opportunity to make these license agreements more rigorous and detailed in terms of the rights and obligations of each party.

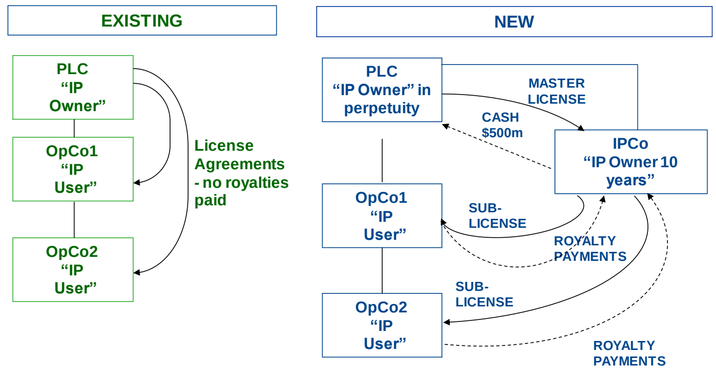


Fig 1. *Creation of a central IP management company (illustrative example)*

III. Central brand management – the benefits of BrandCo's

There are a number of specific considerations, benefits and risks that arise from the decision to manage brands centrally via a system of internal license agreements operated by a BrandCo.

Key benefits from establishing centralised brand management in a BrandCo include:

Better brand management and therefore higher return on brand investment

- *Operating companies are likely to make better brand decisions, ensuring effective application of brand strategy and guidelines, and operational compliance and consistency, when they are contractually bound in their use of the brand, and required to pay a fee for it. This enhances brand impact in markets driving revenues, price premium and customer loyalty.*
- *Internal licenses clarify the rights and responsibilities of the BrandCo and operating units and therefore facilitate the close alignment of brand strategy to business strategy.*
- *The structural disciplines of creating a separate organisation and internal licensing system are also the most effective ways to ensure tangible and sustainable culture change, should this be an objective, i.e. change in work practices and attitudes both strategically and operationally towards the brand or brand portfolio.*
- *The creation of a separate legal entity will also have the important benefit of enabling the BrandCo to exercise stricter, unified and more consistent control over the advertising and marketing of the brands in the form of licensing and franchise - type controls.*
- *Brand extension and cross branding is accomplished more effectively and efficiently. This reinforces understanding that the brand is a shared resource. For example, if one territory operates an established brand, centralised management makes it more likely that the brand can be successfully transferred elsewhere.*

Better resource allocation and higher return on brand investment

- *Brands can demonstrate their specific financial contribution to the business, because they have a separate and transparent P&L, and can thereby better justify increased marketing* *investments, and demonstrate the return on them.*

- *The creation of a revenue stream of royalties will also create an independent revenue stream which can be ploughed back into brand development.*
- *Benefits also arise 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 exploiting. The charge made for the use of a brand is seen to relate directly to the value of the asset being licensed.*

Improved earnings streams from external licenses

- *Brands can be more efficiently licensed into non-core areas of business, creating new revenue streams.*
- *Establishing the BrandCo as a profit centre enables incentive structures to be established for management to maximise third party licensing revenues.*

Governance and controls - more effective, efficient IP protection

- *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. This reduces costs, and enhances asset value.*

Greater visibility of the marketing function and the brand as a strategic business asset

- *BrandCo's ensure 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.*
- *Brands are managed as a strategic asset rather than a tactical resource. This enables more single-minded investments in longer-term brand development, which can be separated from general or short-term marketing spend.*

The relative importance of these benefits will differ from company to company. For example, they are likely to differ for companies that operate multiple brands, such as L'Oreal or Nestlé, compared to solus-branded multinationals, like Shell and Vodafone.

Vodafone sells products and services under the Vodafone brand in all 19 of its operating company markets and in some of its partner markets (under license to the local partner). Setting up a BrandCo in Ireland with a global brand management team allows Vodafone to ensure that its brand is presented uniformly in each of these markets (aligning the visual identity, brand promise, campaign message, etc) but allows sufficient flexibility for local tailoring of communication and positioning.

Similar benefits arise at Shell Brands International in Switzerland. Detailed license agreements clearly specify the expectations and obligations on each party with SBI having a clearly defined responsibility for strategy and policy and operating companies handling implementation. This helps build the brand and related marketing assets going forward. SBI has also been successful in generating licensing revenues from third parties, for example where Shell has decided to strategically exit a particular market but has then licensed the Shell brand back in to the new operator that would like to continue to exploit Shell's brand and reputation.

The operations of multi-branded companies such as P&G, Nestlé or Unilever are normally managed geographically and on a category basis. These companies will develop portfolios of brands in a particular category that cover the appropriate range of quality levels and price points demanded by consumers.
Cross-category the synergies from centralised brand management are less clear cut (why manage Ben & Jerry's and Persil together?) but it will make sense, for all the reasons stated above, to manage Ben & Jerry's as a global brand from a BrandCo and to have the other brand teams in the same category operating from the same location.

IV. BrandCo's – risks and considerations

In many cases, the benefits of establishing a BrandCo structure will outweigh the costs and potential risks, although it can be a long and complex process. A detailed feasibility exercise will be required (see Fig 2. 'Process for setting up a Brand Co').

Important tax and transfer pricing considerations for such a feasibility study include:

Capital gains tax

- *What is the up-front tax charge on the gain versus long run benefit of re-structuring?*
- *Can this be offset against existing capital losses?*
- *Should the transfer of IP occur over a period of tax years to smooth the CGT impact?*
- *Can the existing IP value be allowed to "wither on the vine" as new IP is created by the BrandCo to minimise CGT?*

Economic versus legal ownership

- *In a traditional business model, the legal owner of intangibles is often also the economic owner and remains liable for maintaining or increasing the value of those assets. However, increasingly for multi-nationals the economic and legal ownership of IP may be held in different entities, or the economic ownership may be shared by both the legal owner and other group entities.*
- *This has significant implications for CGT, transfer pricing (determination of the ongoing arm's length royalty rate) and future cost sharing arrangements, since the key determinants of economic ownership are the risk/ reward profiles of the entities involved and also the source of the funds spent developing the IP.*
- *When analysing funds spent to create the IP considerations include the time period over which investment is analysed (how much more important is recent spend to spend incurred several years ago?), the nature of the spend (other than marketing and promotion what else constitutes spend that create value in the brand - staff training, corporate affairs, product development?) and finally, whether the spend is over and above that which would typically be expected of a licensee in most arm's length arrangements).*

- *Additional complications may occur where continued development expenditure occurs in local entities and not centrally. In these cases the developments and creation of new IP must be acquired by the BrandCo from the subsidiary.*

Substance of the BrandCo

- *The basic premise for transferring profits offshore is that the functions, risks and assets related to those profits are also transferred. 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.*

- *BrandCo's must demonstrate that they make all key, strategic decisions but may outsource the analysis required to inform those decisions to other entities. The BrandCo will need to be able to demonstrate that it employs sufficient staff of appropriate experience and seniority to carry out the required functions and assume risks and assets. In reality, this evaluation is often far from clear cut.*

Location of the BrandCo

- *It will be important to carefully consider the most suitable location for the BrandCo. There must be a clear operational fit in terms of the existing and likely future structure of the business, together with a consideration of other factors already mentioned, such as education of the workforce, developed legal systems, attractive corporate and IP tax regimes and well established double tax treaty networks.*

1 Commercial Rationale

- Identify commercial rationale for change
- Clarify specific benefits realisable by your organisation, which may include:
  - Better brand management & resource allocation
  - Creation of new revenue streams
  - Better governance & control
  - Improved discipline over marketing investment

2 IP Audit/ Legal Review

- Confirm IP to be transferred and conduct IP audit to confirm legal ownership
- Marketing IP:
  - Trade marks; word marks; logos; colourways; trade dress; brand plans; designs; collateral; databases; image rights; copyrights; domain names
- Technological IP:
  - Patents; software; know-how; formulas; recipes
- Draft internal license agreements between BrandCo and operating companies

3 Operational Review

- Identify suitable location for the BrandCo (suitable from an operational, workforce, legislative system, tax treaty network perspective)
- Confirm BrandCo responsibilities and functions to be performed (some of which may be outsourced)
- Confirm staffing requirements based on structure determined as appropriate
- Review HR issues related to transfer of staff

4 Brand/ IP Valuation and Transfer Pricing

- Valuation: Establish a capital value for the IP transferred to the BrandCo:
  - Capital value will depend on many variables, including whether IP rights are transferred in perpetuity (outright sale) or for a fixed term (grant of a master licence to BrandCo)
- Transfer pricing study: Establish arm's length royalty rates for the use of the IP by operating entities and prepare documentation for each territory
- Consider APA's

5 Accounting & Tax Review

- Clarify accounting , cash flow and tax treatment of the proposed re-organisation at a consolidated and entity level (in some territories tax will follow accounting treatment)
- Tax treatment considerations for each territory affected by the re-organisation:
  - Corporation taxes
  - Capital Gains Taxes
  - Other tax consequences (WHT, VAT, Stamp Duty)
- Review funding considerations (gearing, thin cap, dividends)

Fig 2. *Process for setting up a Brand Co.*

V. Financial impact of creating BrandCo's in the 2009 BrandFinance™ Global 500

In order to assess the magnitude of the potential financial benefits from setting up BrandCo's, Brand Finance has re-analysed the brand value calculations in its annual study of global brands.

The methodology we use is known as 'royalty relief'. This is an approach which is widely accepted and commonly used for brand valuations. A royalty income stream is calculated for the brand and converted into a capital sum using a discount rate (the brand value is equal to the net present value of the post-tax royalty income stream).

The tax rate used for our original calculation was based on the geographic spread of operations (based on revenues) and the corporate tax rates in each market (i.e. a weighted average). We then re-ran our calculations on the assumption that all royalty income would be taxed at 10% (the Swiss rate on royalty income). For brand-owners domiciled in countries which already have a lower tax rate (for example those in the Middle East) then no adjustment was required.

The original total brand value of the 500 most valuable brands globally was $2.29tn. The adjusted value was $2.99tn, showing an estimated potential uplift of $700bn, or 30%. To put this figure in perspective the total value of Hank Paulson's US bank bailout bill of November 2008 was $700bn.

VI. Proceed with caution

Brands and the values that they represent have significantly increased over the last two decades. 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 come under intense scrutiny by the tax authorities, which are paying ever more 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 men. This increased level of attention has resulted in a much greater use of bilateral Advance Pricing Agreements as a way of managing this risk. The commercial and financial benefits will often outweigh these risks, provided that they are managed carefully from the outset.

Brand Finance plc is the world's leading independent brand valuation consultancy, advising organisations, large and small, on how to maximise shareholder value through effective management of their intangible assets. David Haigh is founder and CEO of Brand Finance and Mike Rocha is a Director in the Tax and Transfer Pricing practice.

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Appendix

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 is 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 "Brandßeta® Index". The Brandßeta® 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% to 33% 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. 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 Brandßeta® Index score appears reasonable.