Brand Finance®

Whitepaper

Improve Your Brand Management, Minimise Your Tax Compliance Risk.

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- **Seventeen years of Brand Finance studying the value of intangible assets has revealed glaring inaccuracies in financial accounting, mostly due to a dearth of knowledge**
- **Internally, this lack of knowledge of what intangible assets are owned and what they are worth is causing a misallocation of investment and ineffective brand management**
- **Misunderstanding of intangible asset value has also led to billions of dollars in company fines and the introduction of a new global initiative to tackle base erosion and profit shifting (BEPS), which is putting brands at the top of the business agenda**

By highlighting over US$50 trillion worth of tax base assets at stake, Brand Finance's Global Intangible Finance Tracker (GIFT™) 2018 exposes the need for tax payers and tax authorities to pay attention to where valuable intangible assets are owned and what can be charged for their use.

At Brand Finance, we started to study the value of companies' intangible assets in 2001 principally to show the glaring inaccuracies of financial statements globally due to the underreporting of intangible asset values. Although already a key issue when we began, the impact of our findings on tax and transfer pricing policy was not as clear nor deliberate then as it is now.

The study's impact on tax planning has become particularly prescient in light of newly coordinated international action on the prevention of erosion of countries' corporate tax incomes – the OECD's Base Erosion and Profit Shifting (BEPS) initiative.

By highlighting the enormous value of intangible assets and the lack of due diligence performed in accounting for them, we have come to use the GIFT™ 2018 study to expose the need to identify where value is created and exploited internally, by large corporates, and taxed, by authorities.

The total value of assets on global stock markets at the end of the financial year surpassed US$100 trillion for the first time in history to reach US$109.3 trillion. At the start of our study 17 years ago, that figure was only US$30.9 trillion. the value has grown 254% over the 17 years, an equivalent growth rate of 8.22% per year.

Of the US$30.9 trillion in 2001, US$14.5 trillion was disclosed on companies' balance sheets and US$16.4 trillion was not. Today, US$65.6 trillion is internally understood and disclosed on balance sheets while US$43.7 trillion is not.

Between 2001 and 2007, the proportion of value explained by balance sheets was on average 50% of total value, with 50% of value unexplained and undisclosed. Following the financial crisis, there was greater clarity on the value of businesses since the "new normal" proportion of undisclosed value became 37% - excluding 2008 which most would consider an extraordinary year.

One would think that this reduction in undisclosed value was a sign that reporting of business assets was improving and to some extent they would be right: the proportion of disclosed intangible assets and goodwill increased to around 20% of total value in 2011 and unexplained value was only 29% at that point.

However, since 2011 we have seen a downward trend and now explained value is at a nadir – disclosed intangible assets (including goodwill) make up only 12% of global enterprise value, a number almost equivalent to the 11% we saw all the way back in 2001.

While the quality of financial reporting does not necessarily mean poor quality of internal reporting and management accounting, a lack of external oversight often correlates with a lack of internal understanding. Where there is a lack of understanding of what is owned and operated by the company, management's ability to direct investment, price functions, and enhance those assets' values is obviously made more difficult.

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Managing and pricing the use of intangibles internally

'Transfer pricing' refers to the practice of pricing transactions between companies within a commonly controlled group. The concept is originally a management accounting one, used by companies to ensure that individual divisions profit maximise in the absence of a true market for what they buy and sell – this true market not existing since the common control gives incentives to buy internally.

Most everyday transactions, such as selling raw materials in a production process, are obvious and simple as there is an easily recordable transaction and, generally, a market price comparable. However, there are many transactions which are more complicated to

recognise, understand and account for. Charging for the use of brands and intellectual property (IP) is one of those types of transactions.

Brands and other IP are assets that one party owns and another uses. In any third party transaction, the user would usually be expected to pay the owner for the privilege of use. Internally, the use by one group company of IP owned by another group company would therefore be a transaction just like any other and is usually covered by a licence agreement.

How does this relate to brand and intellectual property management?

A profit-seeking brand owner and its profit-seeking brand user counterpart would both aim to maximise the return they receive from the deal partly through forceful negotiation but also through the professional management of processes for developing, protecting and exploiting the value inherent in its brand.

Virgin, which owns its brand in a subsidiary called Virgin Enterprises, is a particularly clear case in point. Virgin does not own majority stakes in most of its companies. Instead, it operates a minority stake and brand licence model where management identify opportunities that will maximise royalties to the brand-owning company while also developing and enhancing the brand to promote its other enterprises. It expects its licensees to invest in substantial amounts of advertising, PR and other types of promotion but keeps strategic control of the brand's positioning and direction firmly under the remit of Virgin Enterprises.

The company audits any brand-related investments or partnerships, prevents improper use by licensees or counterfeiting by unscrupulous third parties, and manages its valuable intellectual property much like one would manage a real estate portfolio. By doing that, Virgin has become one of the world's most recognised brands and one of the most valuable licencing operations in the world.

Surprisingly, this sort of commercial management is often not present within group companies despite the fact that brands are on average between 10% and 20% of a company's enterprise value and intangible assets generally are between 40% and 50% collectively.

As a result, companies are often unable to say where their brands are owned or by whom; which is both complicated by new BEPS rules on "economic" versus "legal"

ownership requirements and essential for managing a complicated portfolio of trademark registrations across a global business.

This lack of understanding means that subsidiaries are often unclear on how they can use their brands. This can be as basic a point as what colours should be used for a business card or as important a question as which brand should be used on the launch of a new business.

This frequently means that a company's portfolio of brands becomes confused, slowing down business and reducing the efficacy of attempts to focus around a business strategy or create corporate change.

Most people now accept that brands hold significant value, principally as a result of the demand that they generate through customers' perceptions of their quality and reputation. Where brands or brand portfolios are managed in a confusing way, the ability of those perceptions to drive business performance is hindered.

As a simple example of this, consider what would happen to milk sales in a supermarket if the "Dairy" sign was on the wrong side of the shop floor.

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 should be expected to contribute as effectively as possible to the overall results of the group. 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.

What relevance does this have for tax?

As far back as 2001, the UN noticed the relevance and importance of allocating appropriate value to activities within as well as between multinationals. In that year, the Ad Hoc Group of Experts on International Cooperation in Tax Matters identified that over 60% of international trade was carried out within multinationals, so an actual majority of trade was seen to be between connected parties.

The transfer pricing of goods, services and assets is therefore a hugely important concept for understanding what value is generated where and therefore how it should be taxed.

On one side, transfer pricing is important because it can be used by corporations to minimise or avoid their taxable income in high tax countries thereby reducing the tax base of countries already struggling with tax income reduced by the so-called Great Recession.

There are many examples of companies using corporate vehicles or opaque accounting practices seemingly for the sole purpose of reducing tax. One need only look at the recent example of the IRS' objection to Amazon's sale of its EU trademark rights to a Luxembourg subsidiary to see tax authorities' fear of this happening.

On the other side, it is important because transfer pricing can expose multinationals to significant amounts of double tax. For example, in 2006, GSK was forced to pay US$3.1 billion in double taxation of its income when arbitration between US and UK tax authorities could not agree on the amount of value created in building the Zantac and other brands in each of their representative countries.

The key challenge when it comes to intangibles stems from the underlying "separate and independent" principle adopted by Article 7 and Article 9 of the OECD's Model Tax Convention – the model for OECD country bilateral tax treaties. These articles essentially state that profits accruing to a branch or company within a group should be equivalent to what you would expect to accrue to an independent party.

This principle has also been incorporated into the UN's Model Tax Convention and the default tax conventions of many countries, such as the US. Collectively, these model conventions act as the basis for the clear majority of bilateral tax treaties meaning almost all countries tax inter-company income under this principle.

This means that the functions performed, assets owned and risks borne by group companies should command payments commensurate to what one would expect a third party to receive in an arm's length transaction.

Herein lies the challenge: how does a tax manager establish where value would be created or charged for in an arm's length transaction between independent parties when the parties have not been acting independently or at arm's length for many years?

So how do you set the correct rate of return for the use of a brand?

Action point 8 of the OECD's BEPS initiative relates to intangibles. Intangibles are identified as one of the highest risk issues in transfer pricing as a result of: the lack of comparable transactions due to the unique nature of such assets; the difficulty of separating earnings specifically related to the IP from the earnings derived from the rest of the business; and the difficulty of determining ownership over their value.

Lack of comparables

The OECD specifies that taxpayers should use the "most appropriate" method for determining a transfer price. This can be any method provided it is agreed that it is the most appropriate. However, as a guide, it specifies five methods that can be used. In practice, only two can be used for the transfer pricing of intangibles which are:

- The “Comparable Uncontrolled Price” (CUP) method which determines a price based on similar agreements – usually with an adjustment to make the fee seen in the market transaction more comparable – and;

- The “Profit Split” method which determines the price by identifying the profits made from the transaction and attempting to split these profits according to each party’s contribution.

Establishing comparability in transfer pricing is notoriously hard. Companies operate in slightly different geographies, sell slightly different products, at different times, and with brands that have different strengths in the minds of consumers. Databases for agreements are small, often out of date, skewed towards particular regions (in particular the US) and contain limited information on the underlying businesses to the transactions. This causes significant issues when using comparables to defend a transfer price. In the UK’s landmark 1997 case, DSG retail v HMRC, every single one of the comparables put forward was rejected for various reasons that made them non-comparable. This inevitably means that most documentation will require a combination of the CUP method and the Profit Split method.

Some practitioners consider the Profit Split method to comprise solely of what is known as the “25% Rule” or “Rule of Thumb” which assumes that most IP licensing negotiations start with an assumption that a licensee will pay between 25% and 40% of their earnings before interest and tax on licenced IP. This ‘rule’ is widely discarded by tax courts due to incomparability and is therefore at best a useful corroborative check after a more fundamental review of the impact of the functions performed, assets owned and risks borne of each party to a transaction.

Determining the value of IP earnings

The Amazon.com, Inc. v. Commissioner 148 T.C. 8 (2017) case confirmed what most intangible asset valuers and transfer pricing consultants already knew: that the best method for determining the value that a brand owner should receive

is a royalty on sales. Where a valuation is necessary, this precipitates a discounted cash flow method known as the "Royalty Relief" approach whereby the value of a brand is determined by the present value of hypothetical intercompany royalty payments.

The challenge with this method comes in determining that royalty. Since brands and other IP are unique both in strength and in application, it is generally necessary to at least make comparability adjustments to market rates. In the case of Amazon, it was necessary to review the business model since profits were kept deliberately low through reinvestment in order to drive higher revenues. The brand was therefore valuable for driving growth rather than for driving profitability and therefore it was determined that the final rate on sales must be lower than comparable market agreements since sales were higher and growing faster than in those transactions.

However, rather than making arbitrary changes to non-comparable "comparables", it is generally preferable – given the paucity of even vaguely comparable transactions – to assess the overall earnings from a brand from first principles. This is also beneficial from a commercial perspective since it can also be used as a tool to help management use their brands to maximise earnings and therefore their business value.

In various cases we at Brand Finance have established value via the statistical analysis of brand attractiveness data to understand brands' impact on demand (and some costs), comparing what earnings would be under a "generic" brand and identifying the difference to estimate the yearly uplift. This is a challenging approach but it tends towards a more satisfactory approach when faced with strong, unique and large global brands.

A related challenge occurs here when considering the case of rebrands. Head office might decide to rebrand in order to reduce central costs or to create a strong global brand but in the short run this may actually destroy brand value in the rebranded company. The net effect may be neutral or negative and so many tax authorities will argue that a charge to a brand outside their country is unacceptable (since there is a perfectly good brand that could be used and would keep value in their own country).

The case of Suzuki Maruti in India highlights this issue. When Suzuki acquired Maruti it decided to cobrand under 'Suzuki Maruti' and charge for the use of the Suzuki brand. Indian authorities argued that the effect of this cobranding was that Suzuki was actually building its own value in India by associating itself with Maruti which was a strong brand. They argued that Suzuki should actually pay Maruti for the privilege – a reverse royalty.

The result ended with no royalty chargeable but the case highlights the fact that taxpayers need to be careful when charging royalties to

rebranded subsidiaries either by waiting to charge or by charging a ratcheted royalty dependent on performance.

Determining ownership and the right to make a charge

The new BEPS rules – as well as the domestic rules now being adopted by many states – outline that while legal ownership is the starting point, the ability to charge a share of profit rate of return is more dependent on economic ownership of the asset. Legal ownership refers to contractual rights whereas economic ownership refers to rights created through Development, Enhancement, Maintenance, Protection, and Exploitation (DEMPE) functions that create value in the IP. The idea is that, since a group relationship is not exactly equivalent to a licensor-licensee one, group subsidiaries sometimes spend time and energy adding value to IP that a normal licensee would not be expected to do.

The OECD therefore believes that assets should be owned by (and therefore charged from) the parties that generate the value since, in the absence of tax considerations, that is where they would legally be registered and owned in many cases.

Often, tax authorities take this principle and assume it is equivalent to where money is being spent on marketing and advertising. However, when thinking again of Virgin, one can see why this argument does not hold up to scrutiny. As we have seen, Virgin is involved in strategic decision-making and legal protection but does not spend much itself. Despite this, it is still able to charge high royalties to a large number of parties.

Granted, there are examples of companies where central spend is high – if you consider the amounts spent by Nike on global celebrity endorsements you will see how this can be the case – but typically licensors do not spend much and instead expect licensees to spend large amounts on promotion in their markets, albeit under strict rules.

Therefore, to determine where economic ownership lies, one must establish what constitutes 'strategic' spend and activities and what constitutes 'tactical' spend and activities, and split these. Preferably this will have been completed before an audit, because it is easier to state ownership is central when strategic spend or activities (that will often occur in subsidiaries) have already been compensated for.

Taking a different type of IP as an example: if a new type of Mars bar were created in Mars's UK subsidiary and the group decided it wanted to sell it around the world, it is easier for the centre to claim ownership and charge a share of profit from the centre when it has already paid the routine payments for the R&D facilities that created that product. Otherwise, the UK would be the party that owns it and can charge for it.

In the case of a rebranded enterprise, it should be made clear that as well as making the change in brand there should also be a scaling back of strategic activities to the centre. In practice, this is generally easy since a primary reason of rebranding is often to reduce headcount and cost in marketing and brand functions.

What next?

The management of brand and other IP is often ad hoc at best in large, complicated multinational enterprises. This is very understandable at least partly because of four core issues: investors do not demand scrutiny since they do not see the assets' value on balance sheets; management knowledge of how brands and other IP impact businesses mean information is often limited; brand managers have historically lacked the knowledge to explain the importance of the assets they manage; and tax authorities did not care much until very recently.

If the Brand Finance GIFT™ study highlights the issue of companies not understanding their IP well, the new BEPS rules highlight its importance. Tax authorities are getting more and more aggressive coming after big companies they deem to be exploiting the principles of transfer pricing

to avoid tax. The transfer pricing of companies' brands is one of their biggest areas of contention.

This highlights the need for companies to confront the complicated issue of charging for brands. The steps to confront it are as follows:

1. Identify where all intellectual property is legally owned and registered and identify where new IP is likely to be developed.

2. Identify where each piece of intellectual property is being used.

3. Review marketing and IP related functions performed, assets owned and risks borne by each group company to establish where "DEMPE" activities are being performed.

4. Analyse customer and other research to determine the likely impact of the brand's reputation on demand drivers and cost pressures, and translate this into an earnings figure.

5. Review comparable licencing transactions and licencing best practice in your industry in order to identify what are common DEMPE obligations for licensor and licensee and to find comparable rates.

6. Decide on the appropriate royalty rate and determine whether any compensation should be paid for value-adding activities by brand users that would not usually be expected of a licensee.

7. Repeat the process for all other IP, markets and group companies and document in country by country reports.

Although a large task, with the prospect of large audits on the horizon for many companies, the diligence of this approach should avoid the threat of double tax that can rise up in to the billions. While financial accountants still avoid thinking about the huge value of IP that companies control, it is clear managers and tax planners cannot.

Consulting Services.

1. Valuation: What are my intangible assets worth?

Valuations may be conducted for technical purposes and to set a baseline against which potential strategic brand scenarios can be evaluated.

+ Branded Business Valuation
+ Trademark Valuation
+ Intangible Asset Valuation
+ Brand Contribution

2. Analytics: How can I improve marketing effectiveness?

Analytical services help to uncover drivers of demand and insights. Identifying the factors which drive consumer behaviour allows an understanding of how brands create bottom-line impact.

Market Research Analytics +
Return on Marketing Investment +
Brand Audits +
Brand Scorecard Tracking +

4. Transactions: Is it a good deal? Can I leverage my intangible assets?

Transaction services help buyers, sellers, and owners of branded businesses get a better deal by leveraging the value of their intangibles.

+ M&A Due Diligence
+ Franchising & Licensing
+ Tax & Transfer Pricing
+ Expert Witnessw

3. Strategy: How can I increase the value of my branded business?

Strategic marketing services enable brands to be leveraged to grow businesses. Scenario modelling will identify the best opportunities, ensuring resources are allocated to those activities which have the most impact on brand and business value.

Brand Governance +
Brand Architecture & Portfolio Management +
Brand Transition +
Brand Positioning & Extension +

MARKETING

We help marketers to connect their brands to business performance by evaluating the return on investment (ROI) of brand-based decisions and strategies.

FINANCE

We provide financiers and auditors with an independent assessment on all forms of brand and intangible asset valuations.

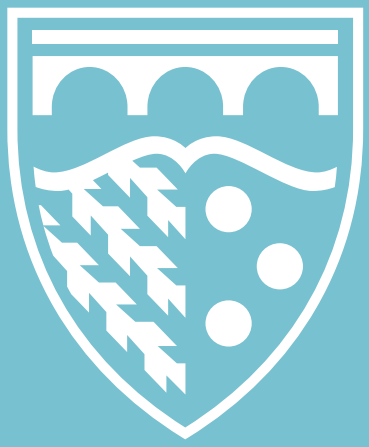
TAX

We help brand owners and fiscal authorities to understand the implications of different tax, transfer pricing, and brand ownership arrangements.

LEGAL

We help clients to enforce and exploit their intellectual property rights by providing independent expert advice in- and outside of the courtroom.

About Brand Finance.



Brand Finance is the world's leading independent brand valuation and strategy consultancy.

Brand Finance was set up in 1996 with the aim of 'bridging the gap between marketing and finance'. For more than 20 years, we have helped companies and organisations of all types to connect their brands to the bottom line.

We pride ourselves on four key strengths:
- Independence
- Technical Credibility
- Transparency
- Expertise.

Brand Finance puts thousands of the world's biggest brands to the test every year, evaluating which are the strongest and most valuable.

For more information, please visit our website:
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For further information on Brand Finance®'s services and valuation experience, please contact your local representative:

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