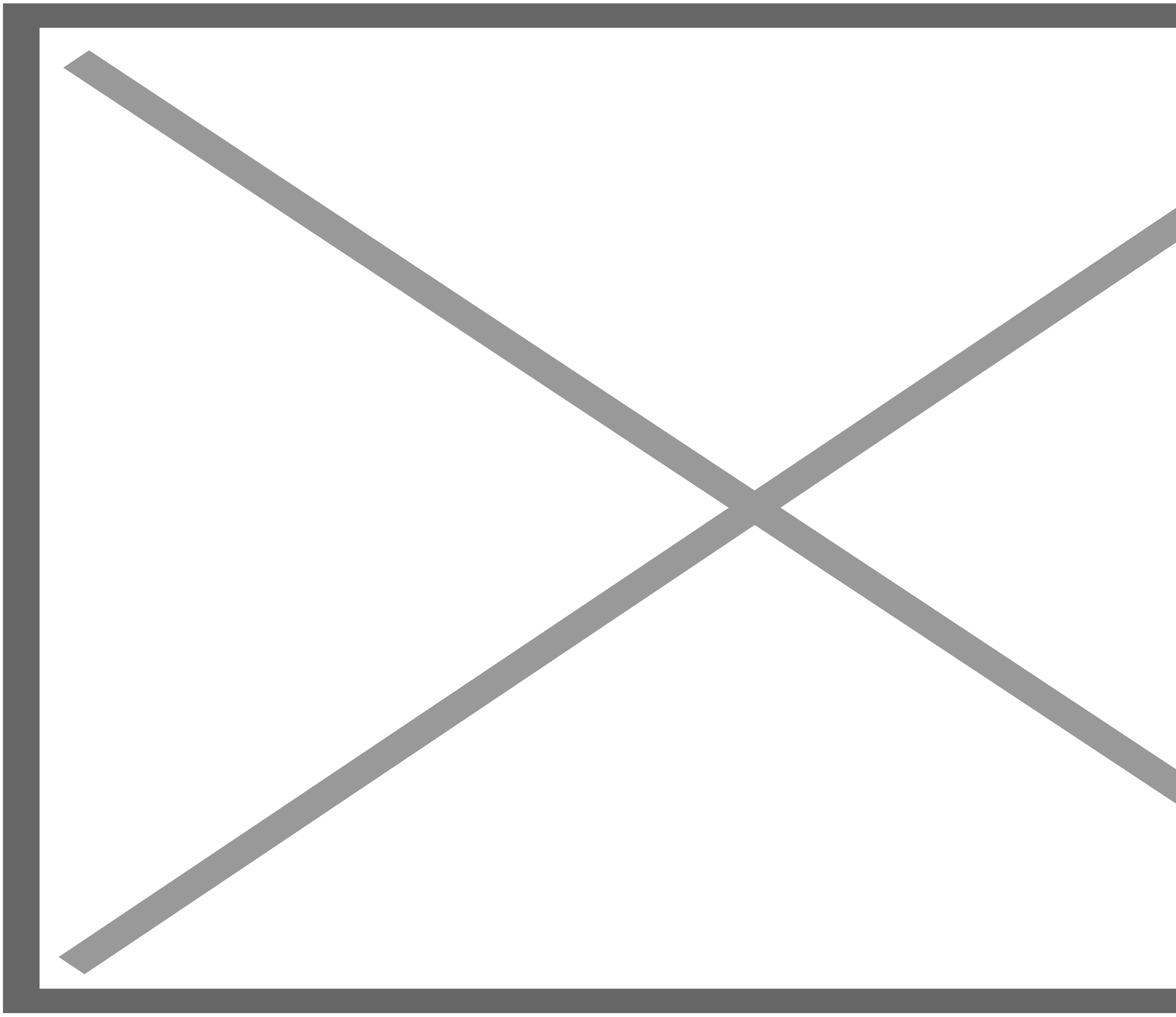
Maximise the value, minimise the tax compliance risk

International Tax Tax voice



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In the first of a two-part article, Alex Haigh, highlights the importance of accounting, managing and pricing intangibles.

By highlighting over US$50 trillion worth of tax base assets at stake, Brand Finance's Global Intangible Finance Tracker (GIFTTM) 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.

Accounting for intangible value

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 GIFTTM 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.

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.

Conclusion

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. We will look at some of the significant tax issues in part 2 of this article.