Tax-effective IP management: Brand valuation

As the first in a series of ten articles on tax-effective intellectual property (IP) management, Hendrik Fügemann, Philip de Homont and Alexander Voegele of NERA Frankfurt present a case study on brand valuation.

A number of Latin American (LA) telecommunications companies had been previously acquired by a European company, but the corresponding states continued to own minority shares in the respective companies. To market their services in the landline, mobile, and broadband segments, the LA companies used the European brand, which was unattractive and unpopular to parts of the customer base. This caused the minority shareholders to reject payments of brand royalties and the tax authorities to deny the tax deductibility of such payments, claiming the brand to be worthless.

At the same time, the European parent was facing high operating losses and low liquidity, while profitable LA subsidiaries generated high liquidity. The LA companies were subject to high taxes and high proportions of minority shareholders, whereas the European parent was facing a lower tax rate.

Brands allow firms to inform consumers about their products and to raise the perceived quality of their products; hence the provision of the brand must be appropriately remunerated, which had not been the case.

The following targets were identified:

- Establishment of a fair remuneration for the brand benefits LA companies receive;
- Appropriate redistribution of liquidity between the group members;
- Tax optimisation, also considering profits lost to minority shareholders.

To address these targets the brand value needed to be determined, which can be done most reliably through a consumer survey. This survey was conducted in the country with the population that was the most hostile towards the European brand and had the most reluctant minority shareholders.

Brand valuation

Brands are ultimately aimed at creating higher demand, giving a branded company the possibility to increase profits using two approaches: raising prices or choosing a quantity strategy, aimed at increasing revenue.

One problem in the valuation of a brand arises from the presence of a quantity approach. This is not observable in price or quantity premiums over competitors, which also have an established brand. Any comparison to the brand of a competitor does not capture the full benefits of the original brand, but can only identify the difference between the two brands, which is not the relevant determinant for a fair remuneration.

> **Brands allow firms to inform consumers about their products and to raise the perceived quality of their products**

A questionnaire was prepared, asking customers to reveal their willingness to pay for two products in each category: one with the European trademark and one with a fictional brand, with which consumers had no association. To obtain comparable results, consumers were shown stylised products that only differed in the logo they displayed.

Demographic data of the country was determined and target quotas were identified to ensure an appropriate spread between genders, places of residence, age, and occupation. The survey was then conducted through face-to-face interviews in conjunction with a local marketing firm to ensure unbiased results.

Following a thorough microeconomic analysis, this data enabled the identification of the markup a firm could obtain for branded products and, via revealed preferences,

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establish a lower boundary for the brand value itself, reflecting the contribution the brand makes towards the profits.

Royalty calculation

After determining the brand value, the economic owner of the brand needs to be identified to correctly attribute the profit that is generated by the brand. Since the local companies in LA had operated under this brand name for some time in their markets, they had contributed to the brand through their local marketing efforts. On the other hand, the European company independently contributed to the brand through marketing support to LA, provision of a global brand, and the historical contribution to the brand before it was introduced in LA.

It can take a long time to fully develop the identity of a brand. As an expert survey revealed, this time period may last up to 25 years in the telecom industry, with different weights assigned to each five-year interval within this time period.

In a second step, we then divided the contribution stemming from each interval according to the costs of the brand development that Europe and LA had paid during each of these periods. Through this approach we could identify the contributions that each party had made to the overall benefit that the LA companies enjoyed and therefore calculate royalties to remunerate the European headquarter. It was revealed that, despite the perceived ambiguity of the brand, a considerable brand value existed and necessitated remuneration.

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Alexander Voegele has over 25 years of experience in transfer pricing. He has led hundreds of transfer pricing projects and provided economic advice on numerous defense cases for a variety of clients in a wide range of industries.

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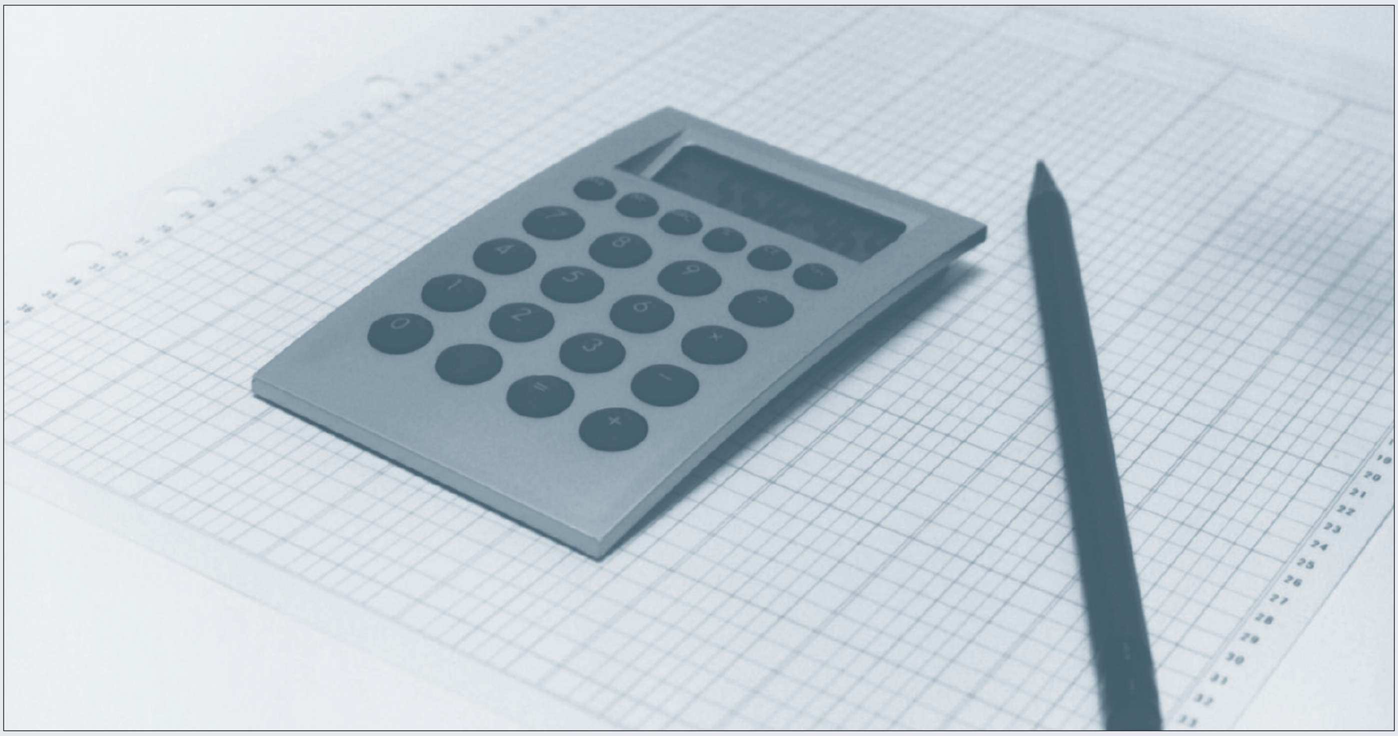
Withholding tax issues could be solved due to the specific circumstances of the case, but would have been no serious obstacle, as the withholding taxes were lower than the corporate tax savings.

Fair and significant

The royalties are fair, significant, and at arm's-length. Owing to the conservative approach, which was backed by real world data and a microeconomic model, the local management, the minority shareholders and the local tax authorities accepted the results. The liquidity is where it should be and the taxes are reduced significantly.



Accurate calculations are vital for effective brand valuation