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Optimising brand value through strategic tax planning

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Optimising brand value through strategic tax planning

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As brands expand globally, their owners increasingly are, and should be, considering how to maximise brand value by seeking legitimately to minimise tax exposure. At the same time, most major countries are stepping up their efforts to make sure they get their fair share of taxable corporate profits.

Where brands are owned and how they are licensed can have enormous tax consequences and can pose significant trademark validity issues if not structured carefully. While each company needs to find its place on the spectrum of risk tolerance, no company operating internationally can afford to mismanage these important issues in the current enforcement environment.

Top-tier concern

The US Internal Revenue Service announced on 9th March 2007 a three-tiered approach to enforcement of tax issues. The top tier identifies issues that the IRS perceives as the greatest compliance risks and is where the IRS said that it will focus its resources. This top tier includes issues such as tax abuse, abusive foreign tax credit generators and tax shelters. Although these names suggest ill-motivated conduct, the IRS also included among these issues "Transfer of Intangibles Offshore." The IRS's use of the term "offshore" probably has a negative connotation for most, but it merely refers to the transfer of an intangible to a related company in a non-US jurisdiction, which sometimes is, but need not be, a low tax jurisdiction. We know from experience that the IRS and other country taxing authorities are examining legitimate related-party transfers of intangibles, including trademarks.

Trademarks can work their way into the "Transfer of Intangibles Offshore" category in several ways. A US company might transfer a trademark to a non-US jurisdiction holding company. A US company might license a trademark to a non-US subsidiary for use in that other jurisdiction. A non-US company might license a trademark to a US subsidiary that will spend its own marketing dollars to enhance the value of the trademark in the US. The variations are many, and the IRS and other taxing authorities worldwide, are interested in obtaining their fair share of income to tax in all of these situations. The consequences of implementing inter-company transactions under terms that the taxing authority does not initially agree with can result in staggering tax adjustments, as illustrated by the IRS's recently reported US$3.4 billion settlement with GlaxoSmithKline.

In addition to these serious tax consequences, increased enforcement in this area also implicates trademark validity issues. Where the IRS is seeking to challenge a tax structure involving trademark transfers or licensing, the IRS may be inclined to argue or take positions calling into question the validity of a trademark. An adverse decision or evidence on these issues in a tax proceeding potentially could lead to trademark rights being forfeited.

We are hopeful that the IRS's 1st January 2007 clarification of its trademark ownership rules (finally agreeing that the trademark owner is the owner and the licensee merely holds rights as a licensee) signals that the IRS is becoming more sensitive to trademark considerations and that IRS agents will now be precluded from making arguments that the licensee of a trademark is the owner in an otherwise typical inter-company trademark transaction.

There remains reason to be concerned, however, in view of other IRS rules from 1st January 2007, under which the IRS plans to use broad latitude in re-characterising inter-company agreements and imputing new terms that may run counter to trademark law. Further, there already has been at least one US case outside the IRS context in which a holding company was found to have forfeited its trademark rights by failing to exercise quality control over its wholly owned subsidiary that used its trademarks.

The bottom line is that we have seen and expect to continue to see stepped-up examination and scrutiny of related-party transactions involving intangibles, including trademarks. This does not mean companies should stop transferring and licensing intellectual property, including trademarks, to related entities in other countries. Rather, companies should continue to increase their focus on understanding how transfer pricing tax law impacts inter-company trademark transfers and use.

Structuring optimal global brand ownership and licensing

The best practice for structuring global brand ownership and licensing is to manage tax and trademark issues concurrently and consistently. Decisions about brand ownership and licensing – whether arising in connection with acquisitions or proactive tax-planning strategy – involve a multi-factor, cost-benefit analysis. On the one hand, the driver of the analysis is the long-term tax strategy, with a view towards structuring brand ownership and licensing in a way that will result in reduced overall income tax over time. On the other hand, there are a myriad of potential issues and pitfalls to manage from both the tax and trademark perspective, particularly in the areas of transfer pricing and trademark quality control.

Adhering to the arm's-length standard in tax transfer pricing

Transfer pricing refers to the general idea that companies must choose a price or a royalty rate in order to transfer something to a related company across an international border. For multinational companies, there is an inherent tension in managing transfer pricing risk. The outbound taxing authorities and the inbound taxing authorities both want to ensure that the price or royalty is set so that sufficient income is recognised in their respective countries. This natural tension exists but there can be only one price used on the corporate books.

Taxing authorities have addressed this natural tension in part by using a universal standard to test results – the arm's-length standard. By requiring the results of a transaction (eg, a royalty rate, a trademark valuation or a product price) to be consistent with the results that would have been realised between unrelated parties; taxing authorities are bound to limit their adjustments to replicate what happens in the real world. The IRS expressly requires the arm's-length standard "to be applied in every case."

In most circumstances, no identical transactions are available to test the related-party licence. Thus, the rules allow use of inexact comparable transactions so long as appropriate comparability adjustments are considered and made. If it is not possible to make appropriate comparability adjustments, then the unrelated party agreements are generally not useful in applying the arm's-length standard.

Given the reliance on unrelated-party transactions and behaviour, it is critical to consider how unrelated-party trademark licences and sales are structured in developing inter-company trademark transactions. While the concept of a trademark licence may seem simple on some level, it is critical that any inter-company trademark licence or usage take account of trademark law.

Understanding brand owners' rights and responsibilities

Under US trademark law, a trademark owner must at all times control the nature and quality of the products sold under its trademarks. A trademark owner can allow another company to use its trademark; and such use will inure to the benefit of the trademark owner, but only if the trademark owner exercises the requisite degree of control.

In other words, if the trademark owner directs and controls the licensee, then the trademark owner obtains the benefits of the licensee's use. Indeed, the use of the trademark by the licensee is deemed use of the mark by the trademark owner. If the trademark owner does not exercise the requisite control, then the trademark rights can be lost.

Although these legal issues have not been sufficiently litigated in the US to determine with precision what aspects of quality control the trademark owner must exercise, a US court analysing a challenge to trademark validity would probably examine certain benchmarks of control, including whether the trademark owner makes final decisions, and has ultimate authority concerning matters relating to the use of the trademark and the quality of the goods and/or services provided under the mark.

Practical steps for inter-company trademark transfers and licences

Any global brand ownership and licensing structure should adhere at a minimum to the following general principles:

- The company should have an inter-company trademark agreement structure. The agreement structure should reflect economic substance.
- The inter-company trademark licences and transfers should be made consistent with both trademark law and tax law.
- The inter-company agreements should be explicit about ownership of the trademark and marketing intangibles.
- The royalty or other payment amount should be based upon or supported by sound transfer pricing economic analysis.
- The structure should ensure the exercise of ongoing brand management and control by the brand-owning company.

Notwithstanding substantial non-tax legal and policy arguments in favour of treating all members of a corporate family as a single economic unit, there is no US statute or case law stating that the control requirement does not apply when the trademark owner and the entity that uses the trademark are affiliates. As noted above, the control requirement has even been found violated in the case of a wholly owned subsidiary, where control generally would be presumed.

This means that the licensor in any US trademark licence – by the terms of the licence and by its actions – should exercise at least minimal quality control.

Although to avoid invalidity the trademark owner should be required to exercise only minimal quality control, the IRS could be less likely to impute alternative arrangements allocating value enhancements to the licensee where there is a greater level of quality control by the trademark owner. Accordingly, it is now more important than ever to ensure that any structure for global brand ownership and licensing take into account the longer-term costs of maintaining staffing and procedures to exercise trademark quality control, and ensure that there will be commitment to such operations over time.

Challenges raised by 2007 changes to trademark tax transfer pricing rules

The new IRS rules effective 1st January 2007 make very clear in the context of related-company transfers that the IRS believes that a trademark licensee that enhances a brand should be compensated by the licensor under certain circumstances. That is, any premium return received by the licensor is compensated through a payment by the licensor to the licensee if the licensee's marketing intangibles resulted in the premium return. This novel concept could lead to very large IRS (or other country) tax liabilities if not managed upfront and appropriately. In addition, the IRS explains how a perfectly valid trademark licence could be disregarded based upon an economic substance analysis. In addition, the IRS introduces its new rules for trademark ownership for tax purposes.

Incremental marketing intangibles

The IRS makes extensive use in the new regulations of the concept of incremental marketing intangibles. What the IRS has in mind with this is the idea that a trademark licensee will often make expenditures on advertising, sales personnel and other marketing-related items. These expenditures might lead to an enhancement to the trademark that, in turn, might lead to a benefit in the form of a premium profit or, in the words of economics, premium return. The premium return would benefit the licensee, the licensor or both. The IRS expects the party that benefits from the premium return attributable to incremental marketing intangibles to pay for those benefits either directly or through reimbursement of the other party.

Enhancement of the trademark is a well-established concept in unrelated-party trademarks and the so-called inure-to clause is not typically a significant item of dispute or discussion in a trademark licence between third parties. The IRS, however, might perceive tremendous value in the enhancement to the trademark and reject the common notion that the enhancement of the mark inures to the trademark owner. The IRS might attack the overall structure used by the taxpayer or seek to adjust the amounts exchanged between the parties. Either way, the IRS approach to the issue of incremental marketing intangibles is likely to be inconsistent with the approach under trademark law and may prevent the trademark owner from realising the full benefit of its licensee's activities.

Economic substance

If related parties use each other's trademarks without inter-company licences or other contracts, the IRS will impute agreements that it believes reflect the economic substance of the arrangement. Importantly, the new rules expressly say that the IRS will respect the taxpayer's actual transactions so long as the transactions reflect economic substance. This means that an inter-company trademark licence that reflects the actual economic transaction occurring between the related parties generally will be respected. To test the taxpayer's conduct the IRS will look to economic substance and re-characterise the transaction to reflect economic substance.

The new IRS rules say that the IRS will consider alternatives available to the taxpayer in determining whether the transaction reflects economic substance. Alternatives available to the taxpayer might also be used to adjust the transfer price rather than re-characterise the transaction. Consideration of alternatives can manifest itself in an IRS argument that the taxpayer, for example, would not license the trademark to a competitor on the same terms as the related party. As misguided and inappropriate as this argument has been in the past, we expect to continue to see it in its many variations now that the concept has been embraced in the regulations.

Examples in the new IRS regulations illustrate the IRS's view that if an inter-company arrangement does not address marketing intangibles potentially created by a trademark licensee, then the IRS can deem an arrangement that compensates the licensee for any premium return the licensor receives. Additional IRS examples illustrate that rights to trademark usage might be embedded in the purchase of a manufactured product for resale. This is not a safe harbour. Rather, it is further indication of the need to make explicit the inter-company arrangement. If the inter-company contracts memorialise the economic substance of the relationship, then the tax risks are reduced to a potential adjustment of the trademark royalty or other form of payment, without raising the spectre of trademark invalidity. A critical consideration is whether the inter-company contracts address the incremental marketing intangibles. If so, the focus of inquiry would be on the amount paid. If not, the focus could be on both the amount paid and on what kind of agreements the taxing authority should impute, implicating not only tax but also trademark invalidity issues. As discussed, both are manageable risks with careful planning.

Conclusion

Multinational brand-centric companies have unique risks and opportunities for minimising the worldwide tax burden. Every time a brand crosses an international border from one affiliated entity to another, whether attached to a product, a licence, or a transfer of ownership to another country, international transfer pricing rules apply.

As companies have expanded globally, most major countries have stepped up their efforts to make sure they are getting their fair share of taxable profits allocated to their tax system. Multinational corporations often have significant flexibility to structure their affairs from both a tax and trademark law perspective. Although tax planning regarding brand ownership can arise in a number of different scenarios, taxing authorities will be most interested in situations where ownership or licences of intangibles are granted to an affiliate in a foreign jurisdiction. Concurrent and consistent management of tax and trademark issues reduce risk and provide economic benefit to the multinational enterprise.

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