Branding Valuation and Tax Implications

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Some Fundamental Questions

- What is the basic relationship between GAAP and U.S. taxation?
- What is the current treatment of expenditures on intangible assets such as marketing assets?
- What is the current treatment of internally developed marketing assets?
- What is the current treatment of externally acquired marketing assets?

Relationship Between GAAP and Taxation

- Tax law requires that a taxpayer must use the same general method of accounting for tax purposes as for books
- Conformity is only required for the overall method of accounting
- Except for LIFO, there is no required conformity of individual accounts
- Tax principles are somewhat driven by GAAP rules (accountants are skilled at measuring income) but the law deals with numerous economic and social issues that have produced nonconformity

Tax Policy Objectives

- Social and economic objectives of tax policy require a number of adjustments to book income to arrive at taxable income
- These adjustments include exclusions of certain income, deductibility or non deductibility of certain expenses and income and expense timing differences
- Examples of such differences are exclusion of municipal bond interest, non deductibility of penalties and fines, different revenue recognition methods, different depreciation methods and timing of expense recognition

Some General Tax Principles

- Asset revaluations and related income are not generally recognized for taxation except for a minor mark-to-market exception for securities dealers
- Otherwise, unless there is a transaction, there are no adjustments up or down to market value
- Expenses are not generally recognized for taxation that are based on estimates, e.g. inventory write-downs, bad debts, warranty costs, until there is a transaction
- One prevailing principle in taxation is that economic events must be objectively measurable, usually by a transaction

Current Treatment—Marketing Expenditures

- For tax, GAAP (Generally Accepted Accounting Principles) and IAS (International Accounting Standards), advertising and marketing expenses should be deductible on a current basis

- It is held that these costs should be expensed because the benefit period is presumed to be short or the periods of benefit and amount of economic benefit are not easily or objectively determinable

Tax Law View

- **The tax view is that advertising and promotional expenses cannot be charged to future years as deferred charges nor amortized over future years where the taxpayer fails to show that "the future benefits can be determined precisely and are not of indefinite duration"**

GAAP Rationale for Expensing Advertising

- Financial statement preparers generally presumed that the benefit period is short
- Advertising is undertaken to provide or increase future economic benefits but the periods during which the future economic benefits probably would be received and the amounts of such benefits could not be measured and determined easily and objectively
- The advertising costs for some entities are not material
- Rationale does not address activities other than advertising

IAS Reasons for Expensing Certain Intangibles Such As Advertising

Costs of internally developing, maintaining, or restoring intangible assets (including goodwill) that are not specifically identifiable, that have indeterminate lives, or that are inherent in a continuing business and related to an entity as a whole, shall be recognized as an expense when incurred

IAS Position on Marketing Intangibles

- An entity recognizes an intangible asset (purchased or self-created) if benefits will flow to the entity and cost can be measured reliably
- IAS holds that certain marketing expenditures do not pass these tests
- Internally generated brands, mastheads, publishing titles, customer lists and items similar in substance are not recognized as assets
- Some intangibles that are originally valued at cost may subsequently be treated under a cost model or a revaluation model

GAAP v. IAS

- GAAP is more rules-based than IAS which results in more judgment with IAS
- For example, under GAAP R&D is treated as a current expense
- IAS treats “research” as a current expense and requires capitalization of “development”
- In general companies focusing on earnings would prefer capitalization which delays deductions and thus produces higher current income

GAAP v Tax Conformity--Purchased Goodwill

- Purchased goodwill may be entered on both tax books and GAAP books from the same transaction
- For tax, goodwill is amortized over 15 years
- For GAAP, goodwill is not amortized but is subject to write-down if its value is impaired
- No conformity

GAAP v. Tax--Example of Marketable Securities

- For tax purposes, securities dealers must follow the mark-to-market rules for certain securities held and include in income changes in market prices
- Under GAAP trading securities and available for sale securities are marked-to-market

  --the change in value of trading securities are reported in the income statement

  --available for sale securities value changes are reported in other comprehensive income
- Again, conformity not required

Tax Treatment of Internally Developed (Self-Created) Intangibles

- Reporting internally developed (self-created) marketing assets on the balance sheet is not required for tax purposes since it is held that an economic benefit is not measureable
- Even assuming these costs created an economic benefit beyond the current year these costs were capitalized, such costs would be aggregation of historical costs and not a market measure of the economic benefit
- Regardless, companies usually prefer to expense costs as soon as possible to minimize tax

Summary—Tax Treatment of Current Marketing Expenditures

- Marketing expenditures are current deductions for tax purposes
- There is no conformity requirement between GAAP and tax so expenditures could be capitalized for GAAP and expensed for tax
- Firms generally prefer to accelerate tax deductions
- In the rare situation a firm that elects to capitalize marketing expenditures for tax purposes will be precluded from amortizing these expenditures in the future under the theory that they are self-generating and thus have an indefinite life

Tax Rules--Acquired Intangibles in a Business Acquisition

Under tax rules, an acquirer allocates the purchase price to seven classes of assets in the following order—

I. Cash general deposit accounts

II. Actively traded personal property

III. Mark-to-market assets

IV. Inventory

V. All other assets not in classes I-IV, VI and VII assets

VI. Section 197 intangibles except goodwill and going concern value

VII. Goodwill and going concern value

Section 197 Intangibles

- Section 197 intangibles include assets other than goodwill and going concern value. This class includes customer-based intangibles

- A customer-based intangible is any composition of market, market share, or other value resulting from the future provision of goods and services pursuant to contractual or other relationships with customers

Tax Allocation Issues

- There is a requirement that the seller and buyer agree in writing as to the allocation of these assets for tax basis purposes and gain or loss computations
- Since Section 197 intangibles (including goodwill, going concern value and other marketing intangibles) are generally subject to similar tax treatment for the seller and amortized over 15 years for the buyer there is little tax incentive to study these separate values

Valuation Approaches in Tax Practice

Valuation approaches in taxation are similar to those used for other purposes and include:

- **Cost-based**
- **Market-based**
- **Economic use or income-based approaches**
- **Formulary**
- **Special situation**

Intangibles Acquired in a Business Combination under GAAP

- Purchase price must be allocated to the assets acquired and liabilities assumed
- Intangible assets subject to two tests to see if it is recognized as an asset apart from goodwill
  - First test is whether it arises from a contractual or other right
  - Second test is whether it is separable, i.e. capable of being sold, transferred, licensed, rented, or exchanged
- Examples of marketing related intangibles include trade names, service marks, certification marks, trade dress, customer lists, and advertising contracts

Intangibles Acquired in a Business Combination under IAS

- Intangible assets are always measured at their fair value at the acquisition date
- Assets must meet the separability criterion or the contractual-legal criterion
- Brands are considered to meet the recognition criteria for inclusion in the balance sheet as assets

IAS Cost Model or Revaluation Model

- Under the cost model the intangible asset is carried on the balance sheet at cost less amortization or impairment losses
- Under the revaluation model approach intangible assets may be carried at fair value less any subsequent amortization and impairment losses only if fair value can be determined by reference to an active market
- The IAS expects that active markets may be uncommon for intangible assets
- IAS gives examples of possible active markets for production quotas, fishing licenses and taxi licenses

Conclusions

- It is unlikely that there will be any tax consequences from writing up branding asset on a GAAP or IAS balance sheet
- Such and event would not meet the criteria for income recognition for tax purposes
- It is doubtful that such a write up would be considered an income statement event for GAAP or IAS but more likely treated as an equity adjustment such as an addition to other comprehensive income
- IAS and GAAP will reach a conformity agreement
- IAS is more receptive to revaluation models than is GAAP

Fundamental Problems That Need To Be Addressed

- Observations and Discussion