

Estimating Intercompany Transfer Price Trademark Royalty Rates

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Valuation analysts are often called on to estimate an arm's-length price trademark royalty rate as part of a tax-related intercompany transfer price analysis. This discussion summarizes the regulations that govern transfer pricing for federal income tax purposes, and it describes the factors that analysts and (other transfer pricing practitioners) often consider when estimating intercompany transfer price royalty rates. This discussion focuses on the methods and procedures used to estimate a trademark royalty rate and on the facts and circumstances that affect the pricing of trademark royalty rates for tax-related intercompany transfer price purposes.

INTRODUCTION

Trademarks, trade names, and brand names are valuable intangible property that are frequently transferred (or licensed) from one related entity to another related entity.

Intangible property transfer price analyses are performed for various purposes, including the following:

1. Cost accounting within multi-business unit consolidated corporations (particularly when company employees are compensated based on business unit profitability)
2. Cost accounting between wholly owned subsidiaries and less than wholly owned subsidiaries (particularly when the wholly owned subsidiary parent controls the accounting)
3. Intangible property transfers between a for-profit entity and a related not-for-profit entity (for example, the license of a not-for-profit hospital's trademark to a for-profit medical practice subsidiary)
4. The license of intellectual property (IP) between operating companies and a related IP holding company (which has state and local income tax implications)

5. Intangible property and services transfers between close corporations owned by the parent corporation and the children generation (which has federal gift and estate tax implications)
6. The intercompany transfer of intangible property between international subsidiaries of a multinational parent corporation (which is the topic of this discussion)

For U.S. income tax purposes, these related-party transactions are regulated by the Internal Revenue Service (the "Service") according to the Internal Revenue Code Section 482 and the associated Treasury Regulations (the "Section 482 regulations").

In recent years, the Service increased its scrutiny of this common intangible property transfer price arrangement. This is because the Service is concerned that a domestic taxpayer could avoid domestic taxes by transferring property, and allocating the associated income, to a related foreign entity located in a lower-tax-rate country.

From a valuation prospective, trademark royalty rates are typically one of the most hotly contested aspects involved in a transfer pricing dispute. The key to developing credible and defensible transfer

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pricing trademark royalty rates is to provide a thorough comparability analysis of the relevant functions and risks associated with the transferred trademarks and to develop an accurate understanding of the relevant financial information.

In addition, it’s important that analysts have a clear understanding of the regulations and the general factors and circumstances that affect the pricing of trademark royalty rates.

First, this discussion presents an overview of the Section 482 regulations that govern the transfer pricing of trademarks. Second, this discussion focuses on the methods and procedures used to estimate trademark royalty rates and the factors and circumstances that analysts often consider when selecting a trademark royalty rate for transfer pricing purposes.

OVERVIEW OF SECTION 482 REGULATIONS AND THE ARM’S-LENGTH PRICE STANDARD

When estimating a trademark royalty rate as part of an intercompany transfer pricing engagement for federal income tax purposes, analysts should work closely with counsel to develop a thorough understanding of the Section 482 regulations.

The purpose of Section 482 is to ensure that taxpayers clearly reflect the income attributable to controlled transactions.¹

The standard to be applied in every case is that of a taxpayer dealing at arm’s length with an uncontrolled taxpayer.² A controlled transaction meets the arm’s-length price standard if the results of the controlled transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same or comparable transaction under the same or comparable circumstances.³ Typically, U.S. courts and other transfer pricing practitioners equate the arm’s-length price of a property to be the fair market value of the property at the time of the transaction.

For purposes of Section 482, “controlled includes any kind of control, direct or indirect, whether legally enforceable or not, and however exercisable or exercised, including control resulting from the actions of two or more taxpayers acting in concert or with a common goal or purpose.”⁴

Because Section 482 is applied by comparing the subject controlled transaction to a similar uncontrolled transaction, the arm’s-length price standard and the comparability test give Section 482 a market orientation that requires the examination of:

1. the facts and circumstances relevant to the controlled transaction and
2. the facts and circumstances relevant to the uncontrolled transactions used to test the arm’s-length result of the controlled transaction.

The comparison between controlled transactions and uncontrolled transactions is performed on actual results (i.e., real transactions between unrelated parties) over a similar time period. Similarity of the controlled transactions to comparable uncontrolled transactions in one period does not indicate that this similarity holds in other periods.

Periodic comparability tests are therefore typically performed to confirm that the controlled transactions correctly reflect the economic and business realities of a given set of transactions.

The following section describes the various tax-related intangible property transfer price methods permissible under the Section 482 regulations and the criteria that analysts should consider when selecting the best method.

Intangible Property Transfer Price Methods

For purposes of Section 482, the arm’s-length price of intangible property should be commensurate with the income attributable to the intangible property.⁵

There are four intangible property intercompany transfer price methods specified under the Section 482 regulations:

1. The comparable uncontrolled transaction (CUT) method
2. The comparable profits method (CPM)
3. The profit split method (PSM)
4. Unspecified methods⁶

Comparable Uncontrolled Transaction (CUT) Method

The CUT method evaluates whether the amount charged for a controlled transfer of intangible property was at arm’s length by reference to the amount charged in a comparable uncontrolled transaction.

That is, the CUT method compares a controlled transaction to similar uncontrolled transactions to provide a direct estimate of the price the parties would have agreed to had they resorted directly to a market alternative to the controlled transaction.⁷

The Section 482 regulations allow for application of the CUT method both where the comparable transaction involves the same intangible property under substantially the same circumstances as the controlled transfer and, absent such evidence, when the comparable transactions involve comparable intangibles under comparable circumstances.

One factor in a CUT method analysis is to determine if the results of the controlled transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same or comparable transaction under the same or comparable circumstances.

The intangible property transferred in an uncontrolled transaction is generally considered to be comparable to that transferred in the controlled transaction if both intangible properties are used in connection with:

1. similar products or processes
2. within the same general industry or market, and
3. have similar profit potential.⁸

Inexact comparable transactions (i.e., similar transactions) are permitted under the Section 482 regulations because truly identical transactions are rare. Similar intangible property license transactions, however, occur more frequently and such royalty data are widely available.

If material differences exist between the controlled and uncontrolled transactions, adjustments should be made to the results of the uncontrolled transactions if the effect of such differences on price or profits can be ascertained with sufficient accuracy to improve the reliability of the results.

Comparable Profits Method (CPM)

The CPM evaluates whether the amount charged in a controlled transaction is at arm's length based on objective measures of profitability (profit level indicators) derived from uncontrolled taxpayers that engage in similar business activities under similar circumstances.

Profit Split Method (PSM)

The PSM evaluates whether the allocation of the combined operating profit or loss attributable to a

controlled transaction is arm's-length by reference to the relative value of each controlled taxpayer's contribution to that combined profit or loss.

The combined operating profit or loss should be derived from the most narrowly identifiable business activity of the controlled taxpayers.

Unspecified Method

An unspecified method should take into account the general principle that uncontrolled taxpayers evaluate the terms of a transaction by considering the realistic alternatives to that transaction. Such taxpayers will only enter into a particular transaction if there are no better alternatives.

To the extent that this method relies on internal data rather than on uncontrolled comparables, its reliability will be reduced.

According to the Section 482 regulations, there is no strict priority to which method is used, and no method will invariably be considered to be more reliable than others. In addition, each of the methods must be applied in accordance with all of the provisions of the Section 482 regulations, including the best method rule and the arm's-length price standard.

Best Method Rule

The Section 482 regulations require that arm's-length considerations for intercompany transactions be determined using the best method rule. The best method rule states that "the arm's length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result."⁹

The best method is the pricing method that provides the most reliable measure of an arm's-length result, based on the following:

1. The degree of comparability between the controlled transaction (or taxpayer) and any uncontrolled comparable transactions
2. The quality of the data and assumptions used in the analysis

The degree of comparability between controlled and uncontrolled transactions should be evaluated considering all factors that could affect comparability under a particular transfer price method.

The five factors typically used to determine the degree of comparability include the following:

- Functions performed
- Risks assumed

- Contractual terms
- Economic conditions
- Nature of the property or services

To determine the quality of the data and the assumptions used in the analysis, the following factors are typically considered:

- Completeness and accuracy of the data
- Reliability of assumptions
- Sensitivity of the results to deficiencies in data and assumptions

For purposes of the best method rule, analysts consider each of the methods specified in the regulations to determine which method is most reliable in consideration of the fact pattern and the availability and reliability of the existing data.

Although the regulations at times indicate a preference for transactional methods, an arm's-length result may be determined under any method without establishing the inapplicability of another method. Thus, it is important that analysts apply the best method rule to determine the best method for a particular trademark transfer price analysis.

If comparable market transactional data are available, the CUT method is often the best method for trademark transfer price analyses.

This is because, in most cases, the availability of comparable trademark license transactions (i.e., market based transactional data) provides the most defensible/reliable evidence of an arm's-length result.

Because the CUT method is typically selected as the best method to estimate a trademark transfer price, this discussion focuses on estimating trademark royalty rates for application in a CUT method trademark valuation analysis.

DEFINING THE SUBJECT INTANGIBLE PROPERTY

An initial procedure in estimating trademark royalty rates is the identification of the subject property. Trademarks are one type of intangible property.

For purposes of Section 482, intangible property is considered to be property that comprises any of the following items and has substantial value independent of the services of any individual:

1. Patents, inventions, formulae, processes, designs, patterns, or know-how
2. Copyrights and literary, musical, or artistic compositions

3. Trademarks, trade names, or brand names
4. Franchises, licenses, or contracts
5. Methods, programs, systems procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data
6. Other similar items

An item is considered similar to those listed here if it derives its value not from its physical attributes but from its intellectual content or other intangible property.¹⁰

The above listed intangible property can be transferred as a single asset or as a bundle of assets. It is, therefore, important for analysts to identify exactly what property was transferred and what property is being valued. This important point cannot be overstated.

Determining the analysis subject is an important procedure in any tax-related transfer price analysis, and it is especially important when using the CUT method. This is because the credibility of the CUT method is based on identifying comparable transactions involving comparable property.

If, for example, the controlled transaction in a CUT method analysis included the transfer of a bundle of marketing-related intangible property, including trademarks, brand names, contracts, methods, customer lists, and technical data, then any selected CUT should include a similar property bundle.

For purposes of the Section 482 regulations, "In order to be considered comparable to a controlled transaction, an uncontrolled transaction need not be identical to the controlled transaction, but must be sufficiently similar that it provides a reliable measure of an arm's length result."¹¹

In other words, the Section 482 regulations allow for inexact comparable transactions to be used to estimate an arm's-length result, if adjustments are made to increase the degree of comparability with the controlled transaction.

OTHER CONSIDERATIONS IN THE ANALYSIS OF TRADEMARK ROYALTY RATES

There are numerous attributes to consider in the trademark royalty rate analysis. These attributes may be either quantitative or qualitative in nature. Table 1 presents a list of some of the economic attributes that analysts typically consider in a trademark royalty rate analysis.¹²

Table 1
Attributes That Affect the Pricing of Trademark Royalty Rates

Item	Economic Attribute	Positive Influence on Pricing Analysis	Negative Influence on Pricing Analysis
1	Age-absolute	Long established trademark	Newly created trademark
2	Age-relative	Older than competing trademarks	Newer than competing trademarks
3	Use-consistency	Subject trademark used consistently on related products and services	Subject trademark used inconsistently on unrelated products and services
4	Use-specificity	Subject trademark is general and can be used on a broad range of products and services	Subject trademark is specific and can only be used on a narrow range of products and services
5	Use-geography	Subject trademark has wide appeal (e.g., can be used internationally)	Subject trademark has narrow appeal (e.g., can only be used locally)
6	Potential for expansion	Unrestricted ability to use subject trademark on new or different products and services	Restricted ability to use subject trademark on new or different products and services
7	Potential for exploitation	Unrestricted ability to license subject trademark into new industries and uses	Restricted ability to license subject trademark into new industries and uses
8	Associations	Subject trademark associated with positive person, event, location	Subject trademark associated with negative person, event, location
9	Connotations	Subject trademark has positive connotations and reputation among consumers	Subject trademark has negative connotations and reputation among consumers
10	Timeliness	Subject trademark is perceived as modern	Subject trademark is perceived as old-fashioned
11	Quality	Subject trademark is perceived as superior	Subject trademark is perceived as less superior
12	Profitability, absolute	Profit margins or investment returns on products and services higher than industry average	Profit margins or investment returns on products and services lower than industry average
13	Profitability, relative	Profit margins or investment returns on products and services higher than competing subject trademarks	Profit margins or investment returns on products and services lower than competing subject trademarks
14	Expense of promoting	Low cost of advertising, promotion, deals, or other marketing of subject trademark	High cost of advertising, promotion, deals, or other marketing of subject trademark
15	Means of promoting	Numerous means available to promote subject trademark	Few means available to promote subject trademark
16	Market share, absolute	Trademarked products and services have high market share	Trademarked products and services have low market share
17	Market share, relative	Trademarked products and services have higher market share than competing names	Trademarked products and services have lower market share than competing names
18	Market potential, absolute	Trademarked products and services are in an expanding market	Trademarked products and services are in a contracting market
19	Market potential, relative	Market for trademarked products and services expanding faster than competing trademarks	Market for trademarked products and services expanding slower than competing trademarks
20	Trademark recognition	Subject trademark has high recognition (e.g., high aided or unaided recall among consumers)	Subject trademark has low recognition (e.g., low aided or unaided recall among consumers)

Some of the economic attributes may be more relevant to one trademark than another. However, these attributes can help the analyst perform an overall assessment of the quality and nature of the subject trademarks before conducting a pricing analysis. This assessment assists the analyst in:

1. understanding the use and function of the subject trademarks and
2. identifying the factors (and, ultimately, the methods and procedures) that are important in the pricing of the subject trademarks.

SOURCES OF TRADEMARK LICENSE AGREEMENTS

Analysts rely on a number of data sources in order to identify comparable trademark license agreements. These data sources include government databases, news and industry trade publications, and third-party subscription-based royalty rate databases.

Examples of third-party intangible property license agreement royalty rate databases include the following:

1. Business Valuation Resources ktMINE Database
2. Royalty Connection Database
3. RoyaltySource Intellectual Property Database
4. Royalty Range European Royalty Database

These third-party royalty rate data providers collect transactional data involving intangible property (including trademark) license agreements from publicly available sources, such as SEC filings, news articles, industry trade publications, and company press releases.

Analysts can search these royalty rate databases to identify license agreements that have factors comparable to the factors of the subject intangible property.

The transactional data contained in these third-party royalty rate databases can provide analysts with the fact-based evidence required to estimate an arm's-length trademark royalty rate.

SELECTING COMPARABLE TRANSACTIONS

When selecting comparable trademark license transactions for a transfer pricing analysis, all of the

relevant factors that affect the price that would be paid or the profit that would be earned in the transactions should be considered.

The Section 482 regulations indicate that in order for the intangible property involved in an uncontrolled transaction to be considered comparable to the intangible property involved in the controlled transaction, both intangible properties should be used (1) in connection with similar products or processes and (2) in the same general industry or market. In addition, both intangible properties should have similar profit potential.¹³

Analysts should focus on these three comparability factors when reviewing and selecting comparable trademark license transactions.

Other factors that may be relevant in assessing the comparability between the controlled and uncontrolled transactions include the following:

1. The terms of the transfer (including exclusivity characteristics, limitations on use, or geographical area in which the rights may be exploited)
2. The stage of development of the intangible property
3. The rights to receive updates, revisions, or modifications of the intangible property
4. The uniqueness of the intangible property
5. The duration of the license and any termination or renegotiations rights
6. The economic and product liability risks to be assumed by the transferee
7. The existence of any collateral transactions or ongoing business relationships between the transferee and the transferor
8. The functions to be performed by the transferor and the transferee¹⁴

To select defensible comparable trademark royalty rates, analysts should prepare a thorough and well documented comparability analysis of the controlled and uncontrolled transactions based on the above listed comparability factors.

This procedure will ensure that the functions and risks related to the comparable uncontrolled transactions are similar to the subject controlled transactions. And, this procedure will demonstrate that the analyst considered the nature of the transactions, as well as the factors and circumstances that affect the price that would be paid or the profit that would be earned in the transactions.

ESTABLISHING THE ROYALTY RANGE

The Section 482 regulations allow that an arm's-length result could fall within a range. That is, if the taxpayer operating results fall within the arm's-length price range, which is derived from applying the same pricing method to two or more uncontrolled transactions that have a similar level of comparability and reliability, then no adjustment will be made to the taxpayer income or deductions.

What this indicates, in the context of this discussion, is that if the royalty rate charged by the taxpayer in the controlled transaction falls within the range of royalty rates derived from comparable uncontrolled transactions, then it will be considered to be an arm's-length price result.

The arm's-length price range consists of the results of all of the comparable uncontrolled transactions that meet the following conditions:

1. The information on the controlled transaction and the comparable uncontrolled transactions is sufficiently complete that it is likely that all material differences have been identified.
2. Each such difference has a definite and reasonably ascertainable effect on price or profit.
3. An adjustment is made to eliminate the effect of each such difference.

If there are no comparable uncontrolled transactions that meet these conditions, then the arm's-length range is derived from the results of all the comparable uncontrolled transaction that achieve a similar level of comparability and reliability. In such cases, the reliability of the analysis should be increased, where it is possible to do so. This objective is accomplished by adjusting the indicated range through the application of a valid statistical method.

The interquartile range ordinarily provides an acceptable measure of this range. The interquartile range is the range from the 25th percentile to the 75th percentile of the results derived from the comparable uncontrolled transactions.

CONCLUSION

Trademarks, trade names, and brand names are valuable assets that are frequently transferred (or licensed) between related parties. Analysts are often

tasked with estimating an arm's-length royalty rate as part of a tax-related transfer pricing analysis.

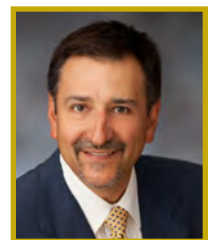
Trademark royalty rates are typically one of the contested aspects involved in a transfer pricing dispute. In order to establish credible and defensible trademark transfer price royalty rates, analysts should:

1. follow the guidance provide in the Section 482 regulations,
2. confirm that the functions and risks related to the comparable uncontrolled transactions are similar to the subject controlled transaction, and
3. develop a comparability analysis that clearly documents the relevant factors and circumstances that affect the pricing of the subject trademark royalty rate.

Notes:

1. Treas. Reg. §1.482-1(a)(1).
2. Treas. Reg. §1.482-1(b)(1).
3. Ibid.
4. Treas. Reg. §1.482-1(i)(4).
5. Treas. Reg. §1.482-4(a).
6. Ibid.
7. Treas. Reg. §1.482-4(d)(1).
8. Treas. Reg. §1.482-4(c)(2)(iii)(B)(i)-(ii).
9. Treas. Reg. §1.482-1(c)(1).
10. Treas. Reg. §1.482-4(b)(1) through (6).
11. Treas. Reg. § 1.482-1(d)(2).
12. Robert F. Reilly and Robert P. Schweih, *Guide to Property Tax Valuation* (Chicago: Willamette Management Associates Partners, 2008), 359.
13. Treas. Reg. §1.482-4(c)(2)(iii)(B)(i)-(ii).
14. Treas. Reg. §1.482-4(c)(2)(iii)(B)(1)-(2)(i)-(viii).

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