
# An arm's-length approach to trademark royalty rates

The transfer of intangible property may have a material effect on domestic taxes. While estimating trademark royalty rates for intercompany transfer pricing is fraught with difficulty, it can be helpful to adopt a systematic approach

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**Valuation analysts are** often called on to estimate arm's-length trademark royalty rates as part of tax-related intercompany transfer price analyses. This article summarises the regulations for transfer pricing for federal income tax purposes and describes the intangible property intercompany transfer price methods which can be used to evaluate whether transactions between members of controlled groups satisfy the arm's-length standard. It then offers insight into factors to consider when estimating trademark royalty rates for intercompany transfer price analyses, with a particular focus on comparability factors for selecting market-based transactional data.

### *Amazon.com*

In recent years, the Internal Revenue Service (IRS) has increased its scrutiny of intangible property transfer price arrangements amid growing concern that domestic taxpayers can avoid domestic taxes by transferring intangible property – and allocating the associated income – to a related foreign entity located in a country with a lower tax rate. A significant portion of a taxpayer's income may be associated with its intangible property. Accordingly, transferring it may have a material effect on the domestic taxes incurred.

In the recent *Amazon.com* decision, the IRS contended that the reported buy-in payment of $254.4 million for the controlled transfer of intangible property (including trademarks, trade names and domain names, as well as software and other technology, and customer lists) had not been determined at arm's length (*Amazon.com Inc v Commissioner*, 148 TC 8 (2017)). The IRS then determined a buy-in payment of $3.6 billion, which the US Tax Court found to be unreasonable.

*Amazon.com* suggests that the IRS is paying far more attention to intangible property transfer price arrangements as a matter of course. However, it also provides crucial insight into how intercompany transfer price trademark royalty rates are estimated.

This article focuses on intercompany transfers of intangible property – specifically trademarks, trade names and brand names (referred to collectively here as 'trademarks') – between international subsidiaries of a multinational parent corporation. Trademarks are frequently transferred or licensed from one related entity to another related entity; from a valuation perspective, trademark royalty rates are one of the most hotly contested aspects of transfer pricing disputes.

For US income tax purposes, related-party transactions are regulated by the IRS according to

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Section 482 of the Internal Revenue Code and the associated Treasury Regulations. This article focuses on the best practices described in Section 482. The trademark royalty rate estimation methodology presented here may also be applicable to trademark valuations for other purposes.

To develop credible and defensible transfer pricing trademark royalty rates, analysts should:

- have a clear understanding of Section 482 and the general factors and circumstances that affect the pricing of trademark royalty rates; and
- prepare a defensible analysis that considers the best method rule, relevant comparability criteria and reliable market-based transactional data.

## Overview of Section 482 and arm's-length standard

Analysts should develop a thorough understanding of Section 482 when estimating trademark royalty rates as part of an intercompany transfer pricing engagement for federal income tax purposes.

Section 482 is designed to ensure that taxpayers clearly reflect the income attributable to controlled transactions and treats controlled taxpayers in the same way that it does uncontrolled taxpayers. For the purposes of Section 482, 'taxpayers' includes any one of two or more persons, organisations, trades or businesses that is not owned or controlled directly or indirectly by the same interests.

The standard to be applied under Section 482 is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer. A controlled transaction meets the arm's-length standard if the results of the controlled transaction are consistent with the results that would have been realised if uncontrolled taxpayers had engaged in the same or comparable transaction under the same or comparable circumstances.

The definition of '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" (Treasury Regulations §1.482-1(i)(4)).

The US Tax Court and transfer pricing practitioners often equate the arm's-length price of a property to its fair market value at the time of the transaction.

The arm's-length price of intangible property should be commensurate with the income attributable to it. If the intangible property transferee pays nominal or no consideration for the intangible property at the transaction date and the transferor retains a substantial interest in the property, the arm's-length consideration may be in the form of royalty payments.

If intangible property is transferred through an arrangement that covers multiple years, the consideration charged in each taxable year may be adjusted to ensure that it is commensurate with the income attributable to the intangible property.

Section 482 discusses guidelines for comparing the subject controlled transaction to similar uncontrolled transactions. This comparative analysis requires the examination of facts and circumstances relevant to the controlled transaction, as well as the uncontrolled transactions used to test the arm's-length result of it.

## Intangible property transfer price methods

There are four intangible property intercompany transfer price methods discussed in Section 482:

- the comparable uncontrolled transaction (CUT) method;
- the comparable profits method;
- the profit-split method; and
- unspecified methods

These may be used to evaluate whether the transfer of intangible property between members of a controlled group satisfy the arm's-length standard. If the transfers are found not to meet this standard, these methods may be used to estimate an intercompany transfer price arrangement that does comply with the arm's-length standard.

### CUT method

Analysts can use the CUT method to evaluate whether the amount charged for a controlled transfer of intangible property meets the arm's-length standard by reference to the amount charged in a comparable uncontrolled transaction.

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" (Treasury Regulations §1.482-4(d)(1)).

Section 482 allows 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.

Circumstances are considered comparable if:

- there are minor differences only between the controlled and uncontrolled transactions;
- the differences have a definite and reasonably ascertainable effect on the amount being charged; and
- appropriate adjustments are made to account for any differences.

> "The arm's-length price of intangible property should be commensurate with the income attributable to it

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 similar products or processes within the same general industry or market and have similar profit potential.

Controlled transactions and comparable uncontrolled transactions do not have to be identical. With regard to the standard of comparability, Section 482 mandates that controlled transactions and comparable uncontrolled transactions need only be "sufficiently similar" to indicate a reliable result. Comparability of controlled and uncontrolled transactions is analysed further below.

In *Amazon.com* the expert witnesses for both the respondent and the petitioner employed the CUT method to value the subject marketing intangibles. The Tax Court affirmed that this method was appropriate for this particular analysis.

#### Comparable profits method

The comparable profits method evaluates whether the amount charged in a controlled transaction is at arm's length based on objective measures of profitability derived from uncontrolled entities (ie, persons, organisations or businesses) that engage in similar business activities under similar circumstances.

#### Profit-split method

The profit-split method evaluates whether the allocation of the combined operating profit or loss attributable to a controlled transaction meets the arm's-length standard by reference to the relative value of each party's contribution to the combined profit or loss of both parties.

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

#### Unspecified method

An unspecified method may be used to determine whether a controlled transaction meets the arm's-length standard by indicating the prices or profits that the controlled party could have realised by choosing a realistic alternative to the controlled transaction.

An unspecified method should take into account the general principle that the parties of an uncontrolled transaction typically evaluate the terms of a transaction based on the consideration of the realistic alternatives to that transaction. The parties of an uncontrolled transaction typically will enter into a particular transaction only if there are no better alternatives.

To the extent that an unspecified method relies on internal data rather than on uncontrolled comparable data, its reliability is reduced.

### Best method rule

Section 482 requires that arm's-length considerations for intercompany transactions be determined using the best method rule. This states: "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... There is no strict priority of methods, and no method will invariably be considered to be more reliable than others" (Treasury Regulations, §1.482-1(c)(1)).

Analysts should thus select the method that relies on the most comparable data available based on the results of transactions between unrelated parties. If comparable market transactional data is available, the CUT method may be the most relevant method for trademark transfer price analyses. In many cases, comparable trademark licence transactions (ie, market-based transactional data) provide the most defensible and reliable evidence of an arm's-length result.

For example, the Tax Court indicated in *Amazon.com*: "If an uncontrolled transaction involves transfer of the same intangible under the same or substantially similar circumstances, the CUT method will generally yield the most reliable measure of the arm's-length result. If uncontrolled transactions involving the same intangible under the same or substantially similar circumstances cannot be identified, uncontrolled transactions involving 'comparable intangibles under comparable circumstances' may be used, but the results may be less reliable" (*Amazon.com, Inc*, 148 TC 8 at *32).

The two main factors to consider when determining which of two or more available methods provides the most reliable indication of an arm's-length result are the quality of the data and assumptions used in the analysis and the degree of comparability between the controlled transaction (or taxpayer) and any uncontrolled comparable transactions.

The following factors are particularly relevant in evaluating the quality of the data and the assumptions used in the analysis:

- completeness and accuracy of the data;
- reliability of assumptions; and
- sensitivity of the results to deficiencies in data and assumptions.

### Controlled transactions versus uncontrolled transactions

Section 482 specifies general factors to determine the degree of comparability between the controlled transaction (or taxpayer) and any uncontrolled comparable transactions, including the following.

#### Functions performed

Analysts should perform an in-depth comparative analysis of the economically significant activities undertaken by the entities in the controlled and uncontrolled transactions. Functions analysed may include R&D, product design and engineering, manufacturing, production and process engineering, marketing and distribution, and other relevant functions.

#### Contractual terms

An analysis of contractual terms may include the form of consideration paid, sales or purchase volume, duration of the licence, collateral transactions or ongoing business relationships between the parties and extension of credit and payment terms.

#### Risks assumed

Comparability with regard to risks assumed requires consideration of risks that may affect prices charged or profits earned. This analysis may consider risks associated with market fluctuations in cost, demand and pricing, the success or failure of research and development activities, financial risks such as interest rates, foreign currency exchange rates and credit and collection risks, product liability risks and other general business risks.

**Economic conditions**
A comparative analysis of the economic conditions affecting the controlled transaction and any uncontrolled transactions may include factors such as the geographic markets served, the size and economic development of markets, the level of market (ie, wholesale or retail), market share and competition.

**Nature of the property or services**
Analysts should perform a comparative analysis with regard to the property or services of the controlled and uncontrolled transactions.

Analysts may make adjustments to transactional data in any method in order to increase the comparability between the controlled transaction or taxpayer and the uncontrolled comparable transactions. Adjustments may be made based on commercial practices, economic principles or statistical analyses. However, the number, magnitude and reliability of adjustments to transactional data may affect the reliability of the analysis results.

For the purposes of Section 482, "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" (Treasury Regulation, §1.482-1(d)(2)). In other words, inexact comparable transactions may be used to estimate an arm's-length result.

These comparability factors are useful for identifying relevant market-based transactional data and selecting the most appropriate intangible property transfer price method. Based on the availability of market-based transactional data, the CUT method is often selected as the best method for trademark transfer price analyses. Therefore, the rest of this article focuses on the factors and circumstances to consider when selecting a trademark royalty rate for transfer pricing purposes.

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## Defining subject intangible property
The first thing to do when estimating trademark royalty rates using the CUT method is to identify the property subject to analysis. Determining the analysis subject is also crucial for 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.

For the purposes of Section 482, 'intangible property' is considered to be property that comprises any of the following items:
- patents, inventions, formulae, processes, designs, patterns or know-how;
- copyrights and literary, musical, or artistic compositions;
- trademarks, trade names or brand names;
- franchises, licences or contracts;
- methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists or technical data; and
- other similar items that derive value not from physical attributes, but rather from intellectual content or other intangible properties.

Intangible property can be transferred as a single asset or as a bundle. It is important for analysts to identify exactly what property was transferred and what is being valued.

With regard to the identification of intangible property, transferred intangible property is not equivalent to the business enterprise into which the intangible property is transferred. In *Amazon.com*, an expert witness for the IRS estimated the value of the transferred intangible property by capitalising cash flows from the entire business enterprise into which the intangible property had been transferred.

The Tax Court rejected this analysis, stating that it "in effect treated the transfer of pre-existing intangibles as economically equivalent to the sale of an entire business... By employing an enterprise valuation, [the expert witness] necessarily sweeps into his calculation assets that were not transferred under the [cost sharing arrangement] and assets that were not compensable 'intangibles' to begin with... These include workforce in place, going concern value, goodwill, and what trial witnesses described as 'growth options' and corporate 'resources' or 'opportunities'" (*Amazon.com, Inc*, 148 TC 8 at *27-29).

## Other considerations
There are numerous additional attributes that may affect estimates of trademark royalty rates. These include the following:
- age of the trademark (both absolute and relative to marks owned by competitors);
- consistent use of the trademark;
- specificity of use (ie, whether the trademark applies to a wide range of products);
- geographic limitations of trademark recognition;
- potential for trademark expansion and exploitation;
- association with positive events, persons or locations; and

- timeliness of the trademark (ie, whether the trademark is perceived as modern).

Some of these economic attributes may be more relevant to one trademark than another. However, they can help the analyst perform an overall assessment of the quality and nature of the subject trademarks when conducting a pricing analysis. Such an assessment can help an analyst to understand the use and function of the subject trademarks, as well as to identify factors (and, ultimately, methods and procedures) that are important in the pricing of the subject marks.

## Sources of trademark licence agreements

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

Examples of these include the following:

- RoyaltySource (www.royaltysource.com) – this AUS Consultants database provides intangible property licence royalty rates and sales data. RoyaltySource provides access to source documents.
- RoyaltyStat, LLC (www.royaltystat.com) – RoyaltyStat is a subscription-based database of intangible property licence royalty rates, license agreements and sale data compiled from Securities and Exchange Commission (SEC) documents.
- RoyaltyRange (www.royaltyrange.com) – RoyaltyRange provides online access to licence royalty rates and other licence information related to technology, patents, trade secrets and other intangible property.
- ktMINE (www.bvmarketdata.com) – ktMINE is an interactive database that provides direct access to intangible property licence royalty rates, licence agreements and sale agreements. Source documents may be printed.

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

## Selecting comparable transactions

This article previously presented comparability criteria to assist analysts to identify which intangible property transfer price method is most supported by available market-based transactional data under the best method rule.

This criteria may be used to identify comparable uncontrolled transactions in the CUT method. In addition, Section 482 discusses further comparability considerations, specifically with regard to selecting comparable uncontrolled transactions.

When selecting comparable trademark licence 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.

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 in connection with similar products or processes in the same general industry or market, and have similar profit potential.

Section 482 states that factors that might be relevant for assessing the comparability between the controlled and uncontrolled transactions include:

- the terms of the transfer (including exclusivity characteristics, limitations on use and the geographical area in which the rights may be exploited);
- the intangible property's stage of development;
- the rights to receive updates, revisions or modifications of the intangible property;
- the uniqueness of the intangible property;
- the duration of the licence, contract or agreement, and any termination or renegotiation rights;
- the economic and product liability risks to be assumed by the transferee;
- the existence of any collateral transactions or ongoing business relationships between the transferee and the transferor; and
- the functions to be performed by the transferor and the transferee.

Additionally, the comparison between controlled transactions and uncontrolled transactions should typically be performed over a similar period. Similarity of the controlled transactions to comparable uncontrolled transactions in one period does not indicate that this similarity holds in other periods.

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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 factors listed above.

This procedure will ensure that the functions and risks related to the comparable uncontrolled transactions are similar to the subject controlled transaction. It will also 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 royalty ranges

Section 482 allows an arm's-length result to fall within a range. An analyst may develop a range of results by applying the same pricing method to as few as two uncontrolled transactions with a similar level of comparability and reliability.

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

- 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;
- each such difference has a definite and reasonably ascertainable effect on price or profit; and
- 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 may be derived from the results of all the comparable uncontrolled transaction that achieve a similar level of comparability and reliability.

If the taxpayer operating results fall within the arm's-length price range, then no adjustment will be made to the taxpayer income or deductions. That is, 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 royalty rate result.

## Conclusion

Trademarks, trade names and brand names are valuable intangible property 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 transfer pricing disputes. Analysts often use the comparable uncontrolled transaction method when estimating trademark royalty rates for intercompany transfer price analyses.

Analysts should estimate intercompany transfer price trademark royalty rates using guidance from Section 482. In order to establish credible and defensible trademark transfer price royalty rates, analysts should:

- consider the comparability of market-based transactional evidence to the controlled transaction when selecting the transfer price method under the best method rule; and
- confirm that the functions and risks related to the comparable uncontrolled transactions are similar to the subject controlled transaction when using the comparable uncontrolled transaction method.

When trademark royalty rate CUT data is available, the CUT method may provide the most defensible and reliable indication of an arm's-length royalty rate. **WTR**

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