More on Trademark Royalties

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Trademark royalties (and valuation issues as well) were again the subject of a long-running tax court litigation involving DHL Corporation. [1] DHL, an international air courier company, uses a family of trademarks and logos which features the "DHL" element. This case, focused on transfer pricing issues under Section 482, also addressed the fair market value of DHL Corporation's family of trademarks and an appropriate arm's-length royalty for their use.

Valuation

A number of value indications and expert opinions were in evidence:

> In 1989, an advisor to a group of foreign investors made a "rough estimate" of the value of the DHL trademarks outside of the United States in the amount of $25 million. This advisor opined that a 30% return on capital was required which, based on an assumed $250 million of invested capital for DHL would result in pre-tax operating profits of $75 million. DHL's pretax operating profit of $80 million indicated "excess earnings" of $5 million. The advisor extended this premium for five years to reach a $25 million estimate.
>
> Later that year, the foreign investors offered to purchase an interest in DHL for an amount which included $50 million allocated to the trademarks, though it was understood that this amount was not based on an appraisal or valuation.
>
> In 1992, in connection with an intracompany transfer, a DHL advisor valued the trademark rights to be conveyed at $20 million as of 1990. In commenting on this data, the Court noted that:
>
> > There is some confusion as to whether [this] valuation is a current value or a present value of a future interest. [Since the trademark rights would be encumbered by a 15 year royalty-free license.]

As part of the original IRS examination, an IRS economist performed a valuation of the U.S. and non-U.S. rights to the trademarks as of 1990 and 1992:

	1990 ($ Millions)	**1992 ($ Millions)**
U.S.	**$289.3**	**$350.9**
Non-U.S.	**$227.2**	**$250.5**
	$516.5	**$601.4**

In the presentation of its Tax Court case, the IRS utilized two experts, whose opinions were:

	1990 ($ Millions)	**1992 ($ Millions)**
U.S.	**$93.0**	**$102.0**
Non-U.S.	**$194.0**	**$307.0**
	$287.0	**$409.0**
U.S.	**$89.3**	**$122.2**
Non-U.S.	**$238.2**	**$367.4**
	$327.5	**$489.6**

An expert for DHL presented testimony in the case as follows:

	1990 ($ Millions)	**1992 ($ Millions)**
U.S.	**$24.2**	**$18.2**
Non-U.S.	**$31.0**	**$52.0**
	$55.2	**$70.2**

The valuation issues in this case were complex and the reader should consult the Tax Court Memorandum [2] for a fuller understanding. One of the issues concerned the ownership of the trademarks and the quality of DHL's trademark rights in the United States versus internationally. On this subject, the Court concluded:

> We hold that DHL owned and controlled the worldwide rights to the DHL trademark, but that, as discussed above, the rights outside the United States were subject to weaknesses and questions that would affect the quality and value of DHL's interest.

Another complexity was the extent to which DHL's trademarks or other intangible assets contributed to its success. The Court observed the nature of the DHL business, and the relative importance of some of its intangible assets:

> The air express business is highly competitive, and consistency and reliability of service, and to a lesser extent, delivery speed and price, engender customer satisfaction and loyalty. In order to provide consistently reliable service, an air express company must possess and maintain an extensive pickup and delivery network; an infrastructure of shipment facilities, planes, vans and computer systems; tracking technology; and a great deal of know-how and expertise. These components are of greater significance to customers than the name or trademark of the delivery entity. Generally, a delivery business' tradename or trademark will have less value when separated from the delivery infrastructure. On occasion, an established delivery company acquires another operating delivery company solely for its operating infrastructure, and the acquired company's name is phased-out and/or discarded.

Obviously, from the above, the Court was also faced with widely disparate value indications and opinions. The Court noted this wide range and commented (quoting from two other cases):

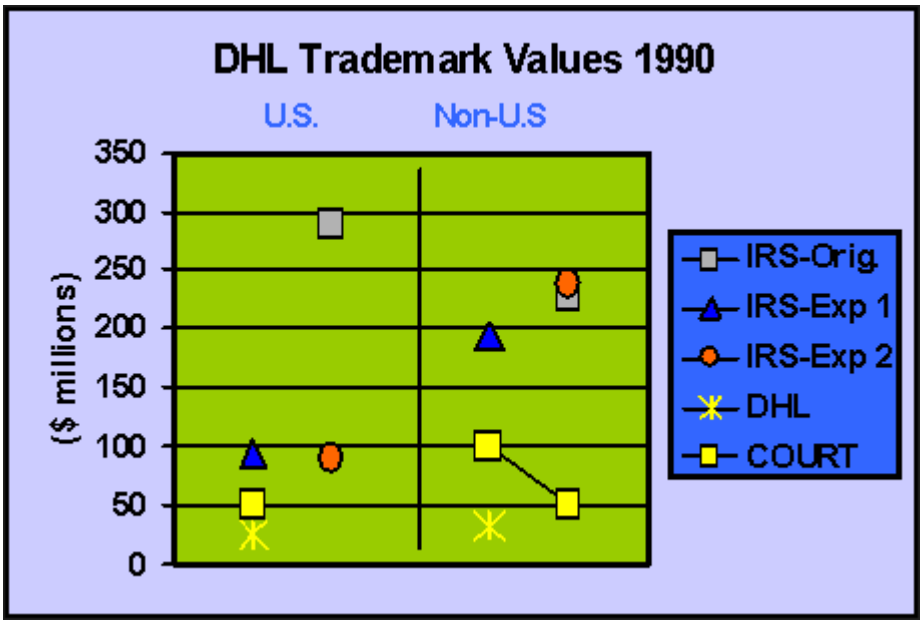
> In that regard, we note that such extreme differences demonstrate the caution that is necessary in weighing expert valuations that zealously attempt to infuse a talismanic precision into an issue which should frankly be recognized as inherently imprecise.

With respect to methodologies, the Court noted that:

> [all the experts] relied on a relief-from-royalty analysis to reach their conclusions. We were not surprised that, using the same methodology, they reached results on opposite ends of the spectrum and that the results each reached favored the party that paid his fees. ...thus, each of the trademark valuation experts has used assumptions, rates, and factors that were useful in reaching the grossly disparate amounts to "assist" the Court as a fact finder in these cases.

The Court then concluded that the worldwide rights to the DHL trademarks should be valued at $150 million as of 1990, before considering any impairment in the quality of those rights. The Court allocated $50 million of value to the U.S. trademark rights and $100 million of value to the trademark rights outside of the United States. The Court then discussed "the effect of DHL's ownership imperfections on the value of the trademark[s]. " After drawing some parallels with other types of asset values in which a "marketability discount" is utilized to reflect reduced rights or defects in ass ets being appraised, a 50% marketability discount was applied to the overseas trademark rights being valued, so that the Court's final conclusion was that the U.S. trademark rights had a value of $50 million and the foreign trademark rights had a value of $50 million.

All of these value conclusions are shown on this chart:



Royalties

The experts in this case all utilized, at least in part, the relief from royalty technique in their trademark valuation. [3] That exercise produced some opinions about trademark royalties:

> As part of negotiations to sell an interest in DHL to foreign investors, an intracompany transfer of trademark rights was contemplated, by which DHL would license back the trademark rights, royalty-free, for either a 10 or 15 year period, and pay a royalty of .75% of gross sales thereafter.
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> The IRS economist, in his first valuation, utilized a 3% royalty rate.
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> In their valuation testimony in the Tax Court litigation, the IRS experts utilized royalty rates of 1% and 1.15% in their calculations.
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> In the Tax Court litigation, DHL's expert utilized a royalty rate of .31%, in his value calculation which resulted from a discounting of the .75% rate, presumably to reflect the royalty-free period of the intracompany license. [4]
>
> If one attempted to "back into" the royalty rate implicit in the Court's decision on trademark value (assuming a relief from royalty approach), the result would be somewhere between .31% (DHL) and 1.15% (IRS), depending upon the other valuation assumptions used.

Another element of this case was the direct transfer pricing issue, addressing what an arm's-length royalty should have been for the use of the marks between controlled DHL entities:

> The experts employed by the IRS "surveyed a wide range of businesses and found a broad range of royalties for trademark use from a low of .7 to a high of 15%. Respondent's experts settled on .75 - and 1% - rates, although the average and median rates would have been much higher." This gravitation to a lower percentage reflects both experts' recognition that a fair royalty would be a relatively low percentage in the setting of these cases."
>
> DHL did not offer expert testimony relative to an arm's-length royalty rate for the use of its trademarks[5]

The Court decided on a royalty rate of .75%, commenting:

> The DHL name, as we have already found, has value, and its use likewise has value. It is our understanding, however, that the DHL name was not the only factor for the financial success enjoyed by the DHL network. In a like manner to our discount of the trademark value, we hold that a .75% royalty rate would be appropriate in the circumstances of these cases.

Comment

It has never been our philosophy that valuation practitioners should slavishly follow methodologies or decisions emanating from litigation. The discussions embodied in both the DHL and Nestle cases are, however, illuminating. The highlights we have presented are only that, and we suggest that a perusal of the entire documents will be worthwhile.

(1)DHL Corporation and Subsidiaries vs. Commissioner of Internal Revenue, Docket Nos. 19570-95, 26103-95, United States Tax Court.

(2)Tax Court Memorandum 1998 - 461, 12/30.98. The source for this article was the text reported in Transfer Pricing, a 113/99 publication of Tax Management, Inc., a subsidiary of The Bureau of National Affairs, Inc.

(3)"We were interested to observe that the Court noted the Tax Court case of Nestle Holdings, Inc. vs. Commissioner which we wrote of in a previous article, as to the deficiencies of the typical application of this technique.

(4)"Court comment: "Another of Petitioners' experts, in reaching a value for the trademark, used the parties' .75-% rate (to begin in 2007) discounted to an amount that he believed would apply in 1990. The discounting was a present value approach. Although a present value approach has been held appropriate to reflect the time value of money, no meaningful reason was advanced for discounting a royalty rate for the passage of time. The value of a trademark or the amount of a royalty does not automatically increase or decrease with the passage of time."

(5)"Court comment: "Petitioners did not offer an expert who proposed a royalty rate for use of the DHL trademark. Petitioners' experts concluded that the trademark had little or no value and that, accordingly, no royalties are warranted."