

## **Holding Company Trademark Royalties**

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In a 1995 New York State case, Express, Inc., Lane Bryant, Inc., The Limited Stores, Inc., and Victoria's Secret, Inc. filed a tax appeal for several years ending in 1989. This case (1995 N.Y. Tax LEXIS 493) is similar to the subsequent Burnham case (see "Royalties From the Marketplace") in that the State of New York Division of Taxation had proposed that petitioning entities should file combined tax returns with four Delaware holding companies which they had incorporated for the purpose of owning trademarks. Each of the petitioning entities had established a license with its respective holding company, under which it paid royalties (expressed as a percentage of gross sales) for the use of trademarks. There were a number of issues in the case, though this discussion focuses on royalty rates.

Close to the time each license agreement was established, the petitioning entities had retained the services of a valuation firm to provide an opinion of the "fair market royalty rate" for the use of the trademarks concerned. These royalty rate opinions ranged from 5.5 to 6.5 percent. On the basis of this information, the petitioners established royalty rates of 5.5 to 6.0 percent in their license agreements.

At trial, the petitioners submitted the testimony of an expert witness from an accounting firm. This witness testified that, under the principles of IRS Section 482, the royalties being paid under the respective licenses were within the range of arm's-length rates. This conclusion was based on a CUT (comparable uncontrolled transaction) analysis and the use of the CPM (comparable profits method) technique. In the CUT analysis, seven apparel company license agreements were identified, with royalty rates ranging from 4.0 percent to 8.5 percent. These were deemed to be comparable to some of the petitioners' transactions. Three additional transactions with royalty rates ranging from 5.0 to 8.0 percent were presented as being comparable to the licensing agreements of Victoria's Secret.

In its CPM analysis, the accounting firm analyzed the profit levels of seven corporations which were considered comparable to the petitioners. The conclusion of this study was that the operating profits of the petitioners after payment of the royalties fell within the arm's-length range as exemplified by the profit measures of the comparable companies.

Petitioners also presented the expert testimony of a consultant economist who compared the rates of return earned by the petitioner entities with rates of return earned by other U.S. retailers in general. This witness concluded from this analysis that the petitioners' royalty rates were at arm's-length.

In its decision, the court quoted from the then Temporary Regulations of Section 482, dwelling on the factors to be considered in determining comparability. The court opined that the CUT analysis was flawed, in general because of the lack of information presented to support the comparability of the transactions taken from the marketplace. More specifically, the court noted that the CUT analysis omitted an examination of the profit potential of the intangibles involved, did not verify that the comparable transactions were between unrelated parties, and that the analysis failed to evaluate significant contractual terms such as exclusivity, geographic limitations, and licensor/licensee obligations relative to infringements. On the other hand, the court felt that the CPM analysis presented met the standards of comparability and that its result was supportive that the royalty rates at issue were within an arm's-length range.

The petitions of the taxpayer were granted.



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**Comment**

First, we find it interesting that in this case the standards of Section 482 dominated the testimony relative to appropriate royalty rates. This was not so much in evidence in the later Burnham case, but we expect that Section 482 analysis methods will be an undercurrent whenever the issue concerns arm's-length royalties.

Second, while we recognize that information about licensing transactions is much better today than it was 8-10 years ago, professionals still have to contend with incomplete data. It becomes obvious, however, that the courts will continue to have high expectations when it comes to information about, and analysis of, licensing transactions from the marketplace.