

Royalties From The Marketplace

Dave G. Weiler, AUS Consultants

More and more, royalties are becoming the focal point in litigation. And, as a result, issues of comparability and documentation arise.

In a New York State case, Burnham Corporation ("Burnham"), as petitioner, filed a tax appeal for the years 1989 through 1991, and litigation ensued¹. Burnham's tax appeal was in response to a determination by the Division of Taxation that it should be required to file its corporation franchise tax reports on a basis that combined it with two of its Delaware subsidiaries. One of these Delaware subsidiaries, Burnham Properties Corporation ("Burnham Properties"), was formed in 1989 and sold shares of its stock to Burnham in return for the assignment to it of the "Burnham" trademark, which had been valued at \$13 million. Burnham Properties also sold shares of its stock to New York Steel Boiler, Co. (another Burnham subsidiary) in return for the assignment to it of its "New Yorker" trademark which had been valued at \$1 million.

Burnham Properties then granted to Burnham and New York Steel Boiler, Co. an exclusive, non-transferable right to use the respective trademarks. Based on a valuation and royalty rate study performed by an accounting firm, Burnham agreed to pay a royalty of 3 percent of the net sales price and New York Steel agreed to pay a royalty of 2 percent of net sales price of trademarked products, according to the terms of this license. The fair market value of the trademarks was estimated using a relief from royalty approach, and in its report, the accounting firm gave the following explanation on the derivation of the royalty rates:

"The most important factor in determining an appropriate royalty rate is the market recognition of the name, and the market share of the products sold under it. The Burnham name, and the Company's market share in the residential boiler market suggests a higher than average rate. Burnham's long-standing presence in this industry and the fact that it is one of the two dominant producers enhance the recognition, and value, of the name. Industry factors that would tend to lower the appropriate rate are the relatively low technology, and the maturity of the industry. Based on our analysis of these factors, a royalty rate of 3% was deemed to be appropriate for the Burnham tradename. A royalty rate of 2% was selected for New Yorker Steel Boiler."

In the trial, Burnham presented the testimony of an expert witness from a valuation firm. This witness opined that the accounting firm's valuation had been prepared in accordance with proper valuation and appraisal techniques and that he agreed with the conclusions of the study with respect to the royalty rates.

The valuation witness introduced the results of a study of royalty rates from licensing transactions asserted to be comparable. The study was obtained from another firm and presented royalty rates from six licensing transactions, which ranged from 1.5 percent to 3.5 percent. In this analysis, licensor and licensee were described generically, and the valuation witness was not able to disclose the identity of the parties.

Much of the evidence in this case appears to have concerned the business purpose for the Delaware subsidiaries, and their operation and the nature of the intercompany transactions between them and the parent. However, it was of interest to us that the court, in its decision, included a discussion of the royalty rate evidence. The court noted the paucity of support for the royalty rate conclusions and the comparability of the market transactions presented in their support:

"[Accounting firm's report] states that petitioner is one of two dominant producers in the boiler market. The market share claimed by petitioner's strongest competitor matters a great deal in evaluating the study's conclusions. But the study does not identify the other dominant producer or reveal its market share. It does not reveal the number of producers sharing the market. There are no facts or statements in the study that identify the basis for the study's conclusion regarding the royalty rates. There are no comparables and no discussion which indicates that [the firm] undertook a study of royalty rates in comparable industries." "There is no evidence in this record that would enable me to draw such a conclusion [that the subject transactions were at arm's length]. Rather, I am asked to accept the expert opinion of [valuation witness] and the opinions expressed in the [accounting firm's] valuation study without knowledge of any of the facts which support their conclusions."

Interestingly, the court then quotes from IRS Section 482 regulations relative to the use of information deemed comparable. Closing this discussion, the court concluded:

"In any case, there must be some basis in the record to conclude that the businesses and transactions being compared are, in fact, comparable. The facts in this record do not provide support for such a conclusion." "[The valuation witness] was silent as to whether the transactions alleged to be comparable were between controlled or uncontrolled companies."

While the valuation witness correctly noted that it is almost impossible to achieve exact comparability, we think that this decision sends a clear message to us, as consultants, about the need to carefully analyze and document royalty rates which are utilized either by themselves or as an input to the valuation process. Our analysis must include an examination of the transactions that result in those rates, as well as the parties to the transactions.

¹ 1997 WL 413931 (N.Y. Div. Tax. App.).