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An Arm's Length approach to Trademark Royalty Rates

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Contents

Introduction	1
Arm's Length Price	2
Legal Necessity	3
Economics of Trademarks	4
Ownership of Trademarks	5
Royalty Rate Methods	9
Most Appropriate Method	14

INTRODUCTION

Over the years, the advent of globalization and burgeoning advancement in the technological sector, has given immense exposure to the corporate's to expand their operations and presence around the world. In this digital era, wherein, the tools of data transmission, media and communication are of utmost importance, enterprises have been successful in developing, enhancing and maintaining invaluable intangibles in the form of trademarks, trade names, brand names and brand identity.

These valuable intangibles developed over the years, though registered in the name of the promoters or intangible holding entities of the group, are frequently licensed or transferred from one group entity to another group entity having presence around the world. Intangible property conceptualized and developed by the efforts of the group are exploited by the other entities of the group to derive maximum returns and profits.

Considering the value such intangibles hold and their contribution in profit making ability of the entities, the regulatory authorities around the world and in India have started advocating and following the concept of arm's length pricing of transactions of intangibles between the group and related entities. Considering the potential of intangibles and the possibility of aggressive tax planning around the same, various regulations have been introduced and put in place over the years to keep a check and assure that the transactions of Intellectual properties amongst related entities is at arm's length and the same are not used as a tool to deviate profits and reduce the tax burdens.

Irrespective of the government regulations, multi national enterprises have also adopted the arm's length approach to trademark royalty rates, as it assists the group in strategic planning. The management have over the years realised that knowledge of the value contribution of each of the intangibles, and the linkages between them is essential for corporate strategy, intangible management and intangible valuations.

ARM'S LENGTH PRICE

An arm's length transaction is one in which the parties to the transaction act independently and do not have any relationship to each other. The concept of an arm's length transaction assures that the parties in the deal are acting in their own self-interest and are not subject to any pressure or duress from the other party. It also assures third parties that there is no collusion between the buyer and seller.

An arm's length transaction describes a situation; business deals in which the buyer and seller act independently and with no interest in the other's benefit. When two parties engage in an arm's length transaction, acting solely on their own interest and with equal access to information, there is a reasonably good chance that the consideration for the transaction will be close to its fair market value.

A transaction in which the two parties somehow do have an interest in helping each other, such as a transaction between family, friends or entities within the same group, is called an arm-in-arm transaction. This is much less likely to produce a sale price that is fair market value, because one party may give favourable terms to the other. For example, if a buyer and seller do not know each other, then the buyer will want the lowest price, and the seller will want the highest price. Each will use available information and their self-interest to determine the agreed-on price. This is how fair market values are generally determined.

Any non-arm's length transaction is considered a higher risk for regulators, tax authorities, lenders and other stake holders because knowing fair market value is critical to determine the correct profitability and return on investment. If the buyer and seller are doing an arm-in-arm deal, there is also a chance that it may be perceived as hiding issues from the regulators, tax authorities, lenders and other stake holders, which may lead to unintended consequences and litigation. The "arm's-length principle" states that the amount charged by one related party to another for a given product must be the same as if the parties were not related. Thus, it is the need of the hour, that the related parties entering into transactions should adopt arm's length price as the transaction value and conduct business considering them to be independent unrelated parties.

LEGAL NECESSITY

Adoption of arm's length price in transaction between group entities and related entities is also a growing necessity because of the increasing legislative and regulatory dictum.

Regulations and projects such as:

- **Transfer Pricing;**
- **Income Tax Act, 1961;**
- **Base Erosion and Profit Shifting;**
- **Income Computation and Disclosure Standards;**
- **IND AS (Accounting Standards);**
- **Companies Act, 2013;**
- **Goods and Services Tax, 2017;**
- **Cost Accounting Standards;**
- **Customs Act; and**
- **Foreign Exchange and Management Act, 1999**

have recognized the concept of fair value and arm's length pricing. The aforesaid statutes have also laid down the regulations that the transactions between the group and related entities should be at arm's length price, absence of which would lead to levy hefty penalties and unintended litigation at various forums.

Furthermore provisions of Transfer Pricing as provided in Income Tax Act, 1961, and the Transfer Pricing Model by Organisation for Economic Cooperation and Development (OECD) provides guidance and methodology of arriving and analyzing the arm's length pricing for transaction amongst related enterprises in various transactions.

ECONOMICS OF TRADEMARKS

Technology, trademark and other Intangibles are typically combined with other assets in order to generate cash flows. The value of an enterprise is a function of the free cash flow that it is expected to generate and the associated risk. The resources of the business are the building blocks of enterprise value.

Knowledge of the value contribution of each of these building blocks, and the linkages between them, is essential for corporate strategy, trademark and other intangible management, and trademark and other intangible valuation, be it royalty for licence or lumpsum fees for outright transfer. Competitive advantage is increasing due to the development , integration and reconfiguration of trademarks and other intangibles.

The economic characteristics of trademark and other intangibles are significantly different to tangible assets:

- Trademark is not diminished by use and can be simultaneously used by many parties;
- There is seldom not a linear relationship between the cost of creating trademark and its value. The risk of wasted investment is high, but this is countered by a high upside potential if the trademark is successfully commercialized.
- The value of trademark often results from linkages with other assets.
- Most companies have inadequate knowledge and analysis regarding the strength, performance and value of their trademarks and other intellectual properties.

Value creation maps can be used to identify the relative importance of trademark and other intellectual properties within a business, and the linkages with other resources. These map illustrate how the resources of an organisation are deployed to create a differentiated market position and generate cash flows. The direction and extent of the resource inter-relationships, and their role as value drivers, can be estimated through a combination of market research, statistical analysis and historical data.

OWNERSHIP OF TRADEMARKS

Legal rights and contractual arrangements form the starting point for any arm's length pricing analysis of transactions involving intangibles. The terms of contracts may be found in written contracts, public records such as copyright or trademark registrations, or in correspondence or other communication among the parties. Contracts may describe the roles, responsibilities, and rights of the group entities with respect to intangibles. They may describe which entity or entities provide funding, undertake research and development, maintain and protect intangibles, and perform functions necessary to exploit intangibles, such as manufacturing, marketing and distribution. Where no written terms exist, or where the facts of the case, including the conduct of the parties, differ from the written terms of any agreement between them or supplement these written terms, the actual transaction must be deduced from the facts as established, including the conduct of the entities of the group.

The right to use some types of intangibles may be protected under specific intellectual property laws and registration systems. Patents, trademarks and copyrights are examples of such intangibles. Generally, the registered legal owner of such intangibles has the exclusive legal and commercial right to use the intangible as well as the right to prevent others from using or otherwise infringing the intangible. These rights may be granted for a specific geographical area and/or for specific period of time.

The transaction value between the group entities for trademark licencing or trademark sale depends on the legal ownership of the trademark and the economic ownership over such trademark. OECD in its regulations provides that the legal owner will be considered to be the owner of the intangible for the value purposes. If no legal owner of the intangible is identified under applicable law or governing contracts, then the member of the group that, based on the facts and circumstances, controls decisions concerning the exploitation of the intangible and has the practical capacity to restrict others from using the intangible will be considered the legal owner of the intangible for transfer pricing purposes.

OWNERSHIP OF TRADEMARKS

While determining legal ownership and contractual arrangements is an important first step in the analysis, these determinations are separate and distinct from the question of remuneration under arm's length principle. OECD provides that legal ownership of intangibles, by itself, does not confer any right ultimately to retain returns derived by the group from exploiting the intangible, even though such returns may initially accrue to the legal owner as a result of its legal or contractual right to exploit the intangible. The return ultimately retained by or attributed to the legal owner depends upon the functions it performs, the assets it uses, and the risks it assumes, and upon the contributions made by other group entities through their functions performed, assets used, and risks assumed. For example, in the case of an internally developed trademark, if the legal owner only has registration of that trademark in its name but does not perform any relevant functions, uses no relevant assets, and assumes no relevant risks, but acts solely as a title holding entity, the legal owner will not ultimately be entitled to major portion of the return derived by the group entity from the exploitation of the intangible, other than arm's length compensation, for holding title.

OECD provides that legal ownership and contractual relationships serve simply as reference points for identifying and analyzing controlled transactions relating to intangibles and for determining appropriate remuneration to members of a controlled group with respect to those transactions. Identification of legal ownership, combined with the identification and compensation of the relevant functions performed, assets used, and risk assumed by all contributing members, provides the analytical framework for indentifying arm's length prices and other conditions for transactions involving intangibles.

OECD reiterates that a determination that a particular group member is the legal owner of intangibles does not, in and of itself, necessarily imply that the legal owner is entitled to any income generated by the group after compensating other members of the group for their contributions in the form of functions performed, assets used, and risks assumed.

OWNERSHIP OF TRADEMARKS

In identifying arm's length prices for transactions among group entities, the contributions of members of the group engaged in the creation of intangible value should be considered and appropriately rewarded. OECD also emphasized on the fact that the arm's length principle require that all members of the group receive appropriate compensation for any functions they perform, assets they use, and risks they assume in connection with the development, enhancement, maintenance, protection, and exploitation of the trademark. It is therefore necessary to determine, by means of a functional analysis, which member(s) perform and exercise control over development, enhancement, maintenance, protection, and exploitation functions, which member(s) provide funding and other assets, and which member(s) assume the various risks associated with the intangible. Of course, in each of these areas, this may or may not be the legal owner of the intangible.

If the legal owner of an intangible in substance:

- performs and controls all of the functions related to the development, enhancement, maintenance, protection and exploitation of the intangible;
- provides all assets, including funding, necessary to the development, enhancement, maintenance, protection, and exploitation of the intangibles; and
- assumes all of the risks related to the development, enhancement, maintenance, protection, and exploitation of the intangible,

then it will be entitled to all of the anticipated returns derived from the group's exploitation of intangibles. To the extent that one or more member of the group other than the legal owner performs functions, uses assets, or assumes risks related to the development, enhancement, maintenance, protection and exploitation of the intangible, such enterprise should be compensated on arm's length basis for its contributions. This compensation may, depending on the facts and circumstances, constitute all or substantial part of the return anticipated to be derived from the exploitation of the intangible.

OWNERSHIP OF TRADEMARKS

Ownership over the Group Name

Where one member of the group is the owner of a trademark or other intangible for the group name, and where use of the name provides a financial benefit to members of the group other than the member legally owning such trademark, it is reasonable to conclude that a payment for use would have been made in arm's length transaction.

In determining the amount of payment with respect to a group name, it is important to consider the amount of the financial benefit to the user of the name attributable to use of that name, the costs and benefits associated with other alternatives, and the relative contributions to the value of the name made by the legal owner, and the entity using the name in form of functions performed, assets used and risk assumed. Careful consideration should be given to the functions performed, assets used and the risk assumed by the user of the name in creating or enhancing the value of the name in its jurisdiction.

ROYALTY RATE METHODS

There are numerous attributes to consider in the trademark royalty rate analysis. These attributes may be either quantitative or qualitative in nature.

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)

ROYALTY RATE METHODS

Considering the aforesaid attributes and the analysis, there are different methods, which are generally used in analyzing the arm's length pricing of the trademark transaction between related entities.

Comparable Uncontrolled Price Method (CUP)

The CUP method evaluates whether the amount charged for a controlled transfer of intangible property is at arm's length by reference to the amount charged in a comparable uncontrolled transaction. That is, the CUP method compares a controlled transaction to similar uncontrolled transactions to a direct estimate of the price the parties have agreed to had they resorted directly to market alternative to the controlled transaction.

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

- (i) similar products or processes;
- (ii) within the same general industry or market; and
- (iii) have similar profit potential

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.

We 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.

ROYALTY RATE METHODS

Cost Method

The Cost method is used to evaluate the royalty rates where the trademark is new; is not much exploited and is not well established in the market. The cost approach typically reflects a minimum value of the trademark, as the owner ordinarily will not sell the trademark or will not licence the trademark for less than the owner's investment in it. The replacement cost less depreciation method is often used for valuing trademarks under the cost approach. Sometimes the term "re-creation cost" is used instead to reflect the notion that a trademark is a creative or artistic form of intellectual property.

The replacement cost less depreciation method requires identification of all costs that may be incurred in re-creating the trademark. These costs would include legal fees, registration fees, and advertising costs for promoting the trademark.

The following two components:

- (i) developer's profit and
- (ii) entrepreneurial incentive.

are often overlooked, however, these should be considered as part of the analysis in determining the fair value of the lumpsum payment or royalty for usage of the trademark. The developer's profit reflects the reasonable profit expected on the development costs incurred in the creation of the trademark and the entrepreneurial profit reflects the economic benefit required to motivate the trademark creator into the development process, which is often viewed as an opportunity cost.

ROYALTY RATE METHODS

Profit Split Method

Profit Split Method is an appropriate method to determine the ALP of international transactions in cases 'where both parties to a transaction make unique and valuable contributions (e.g. contribute unique and valuable intangibles) to the transaction. In such a case independent parties might effectively price the transaction in proportion to their respective contributions, making a two-sided method more appropriate. Furthermore, since those contributions are unique and valuable there will be no reliable comparables information which could be used to price the entirety of the transaction in a more reliable way, through the application of another method. In such cases, the allocation of profits under the Profit Split Method may be based on the contributions made by the group entities, by reference to the relative values of their respective functions, assets and risks.

It has been found that Profit Split Method is an appropriate method for determining the ALP of royalty paid by an licensee to a licensor. In the era each group typically concentrates its intangibles (IP, trade secrets, trademark, software copyrights: basically the most valuable assets of the group) in an asset holding company. Group companies are set up in various countries for the purpose of manufacture, sale & distribution, or both and such companies enters into a licensing agreement with the IP holding company, vide which the IP holding company agrees to give the other group companies the right to use its patents/know-how in return for a royalty.

Profit Split Method (PSM) is an appropriate method to benchmark the royalty payable by the licensee to the licensor. The licensor has developed the IP. It owns and updates the IP. It incurs all R&D risks. On the other hand, the licensee is the entrepreneur who implements the IP to develop and sale products. Both make unique and valuable contributions. So the profits from commercialization of the IP should be shared by both in ratio of their value-drivers.

ROYALTY RATE METHODS

Return on Market Value

Where the market value of trademark has been determined, this provides a relevant basis for calculating an appropriate return earned through a royalty. Market value accounts for factors such as the unique characteristics of the asset, ease of replication, and income potential. The return earned by the owner through a royalty will therefore be largely influenced by the useful economic life of the asset, any unique contribution made by the licensee, and the terms of the license agreement.

Residuary Method

The residuary method 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. Thus, the royalty expenses and profitability in a controlled transactions are analysed vis a vis different profit level indicators and the ratios which are computed are compared with the ratios of an unrelated entity having similar transactions and engaged in similar business activities.

MOST APPROPRIATE METHOD

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

- (i) The degree of comparability between the controlled transaction (or taxpayer) and any uncontrolled comparable transactions; and
- (ii) 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 Functions performed; the Risks assumed; the Contractual terms; the Economic conditions; and the Nature of the property or services.

To determine the quality of the data and the assumptions used in the analysis, the Completeness and accuracy of the data; Reliability of assumptions; Sensitivity of the results to deficiencies in data and assumptions are the factors that are typically considered.

For purposes of the most appropriate method rule, we 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. Whatever the primary method of valuation, it is strongly recommended that the output is checked by other methods. A process of triangulation can provide strong support for a royalty range in situations where no single method is compelling.

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