Best Practices

The Valuation of Trademark-Related Intangible Property

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Valuation analysts are often called on to perform valuation, damages, and transfer price analyses of trademark-related intangible property for various purposes. This discussion describes the valuation of trademarks within the context of both financial accounting and income tax accounting (in particular, tax-related intercompany transfer pricing). This discussion summarizes the generally accepted trademark analysis approaches and methods, particularly within the context of financial accounting and tax-related transfer price analysis. And, this discussion presents three examples, using different analytical methods, to illustrate the analysis of trademarks.

Introduction

Trademarks present a difficult but interesting challenge from a valuation, damages, and transfer price perspective. They represent an important tool of commerce and can become very valuable. *Forbes* magazine recently listed the "Google" trademark as the world's most valuable at $44 billion, exceeding the gross domestic product of many small countries.

This discussion describes the factors that are relevant to the valuation, damages, and transfer price of trademark-related intangible property in a variety of contexts, including financial accounting and tax-related transfer pricing.

This discussion explains the generally accepted trademark valuation approaches and methods as it applies to these contexts. And this discussion presents three examples to illustrate the trademark analysis approaches and methods described.

Description of Trademark-Related Intangible Property

What is a trademark and what economic advantages does it provide? Under the Trademark Act of 1947 (the Lanham Act), the statutory federal laws governing trademark rights, a trademark is defined as "any word, name, symbol, or design, or any combination thereof, used in commerce to identify and distinguish the goods of one manufacturer or seller from those of another and to indicate the source of the goods."[1]

At its essence, a trademark is an economic tool to help consumers to assess the quality of goods and services in making a purchase decision based on the reputation of the manufacturer or seller.

Businesses that provide higher quality products enjoy more goodwill in the mind of typical consumers than those that do not. Advertising plays an important role in shaping and reinforcing this goodwill.

Marketing and other corporate executives tend to conflate a trademark with the marketing concept of a brand. Indeed, the two concepts may be hard for laypersons to distinguish, particularly where a trademark represents an entire business enterprise like it does for Google. For this reason, many laypersons use the terms interchangeably.

However, this conflation of the terms trademark and brand is not technically correct. A trademark, at its essence, serves as but one identifier of a brand—it does not reflect the entirety of the brand itself. Think of it this way: a business with a good reputation can enjoy an advantage over a competitor even if it employs no trademark.

Customers, for example, may distinguish the business by its location or owner, or the business may simply employ names or symbols for which it possesses no trademark rights. It follows that the value of a trademark ordinarily is something less than the value of a brand.

Further confusing the distinction between a brand and a trademark for nonpractitioners is the use of trade names. A trade name is a name used to identify a business. But unless it is also registered as a trademark, or recognized under common law as a trademark, it generally carries no legal rights of protection and has no material value as an asset for valuation purposes.

This is also true of domain names. A domain name is part of a web address that links to the internet protocol (IP) address of a particular website. Registration of a domain name with a domain name registrar provides no trademark protection; instead, a separate trademark registration is necessary.

As is true for other intellectual property, a trademark conveys a bundle of legal rights and protections to its owner. These rights include the right to exclude others from employing the trademark if such use would cause confusion in the marketplace.

When the entire bundle of rights is transferred to another party, an assignment is given. Anything less than a transfer of the entire bundle of rights is a license. The licensee pays for those rights by means of a royalty.

Trademark Registration

Trademarks are created through use and do not require registration. Registration is generally recommended, however, because it offers additional benefits over common law trademark protection.

A trademark can be recognized under common law in the geographic area in which it is used, the channel of trade in which the goods or services are sold, and for the goods or services with which the trademark is used.

A trademark is registered with the United States Patent and Trademark Office (USPTO) via an application process. Registration provides constructive notice to the public of the registrant's claim of exclusive rights to the trademark and serves as *prima facia* evidence of the ownership and validity of the trademark.[2]

If a registration has been on the register for more than five years, has been in continuous use during that time, and has not been the subject of an adverse or pending proceeding, the registrant can file to have the trademark declared incontestable.

Once a trademark is declared incontestable, the registration is deemed to be conclusive evidence of the exclusive right to use the registered mark in commerce.

Each registration of a trademark with the USPTO remains in force for a 10-year term. An owner can renew the registration for successive 10-year terms upon filing an application.

Trademarks, strictly speaking, are marks used to identify goods. Marks used to identify services are registered as service marks. For the purpose of this discussion, however, the term "trademark" will be used in the collective sense to refer to both trademarks and service marks.

Valuation Purposes

There are a myriad of reasons why analysts would be asked to value a trademark. Those reasons often fall into one of three buckets:

1. Valuation for transactional purposes other than tax compliance
2. Valuation for financial accounting purposes
3. Valuation for income tax and other tax compliance purposes

The first bucket of reasons pertains broadly to transactions between parties that involve a trademark where the value of the trademark is necessary to define the terms of the transaction or otherwise complete the transaction. For example, a buyer may require independent assessment of a trademark's value.

A lender may require the valuation of a trademark before the trademark can be pledged as part of the collateral for a loan.

The second bucket of reasons pertains to financial accounting requirements under the securities laws of governing jurisdictions. In the United States,

federal securities law is enforced by the Securities and Exchange Commission (SEC). The SEC may, under certain circumstances, require the recognition of trademarks and other intangible property on a reporting company's balance sheet. For example, this may occur when a trademark is acquired in a business combination.

The SEC designated the Financial Accounting Standards Board (FASB) as the authoritative organization in the private sector for standardizing generally accepted accounting principles (GAAP) that govern the preparation of financial statements.

These standards are known as the Accounting Standards Codification (ASC). ASC topic 805 governs business combinations and requires the recognition of trademarks acquired as a result of a business merger or acquisition.

Paragraph 2-5-5 of ASC topic 805 states:

> All identifiable intangible assets that are acquired in a business combination should be recognized at fair value on the acquisition date. Identifiable intangible assets are recognized separately if they arise from contractual or other legal rights or if they are separable (i.e., capable of being sold, transferred, licensed, rented, or exchanged separately from the entity).

A trademark is recognized on a reporting company's balance sheet as an intangible asset separate from goodwill because it satisfies either of the following two tests under paragraph 2-5-5:

1. It arises from legal rights (remember, a trademark is essentially a bundle of rights)
2. It is capable of being sold, transferred, and licensed separately from other assets of the acquiring company

The recognition of an acquired trademark is performed as part of a purchase price allocation (PPA), whereby a portion of the price paid by the acquirer for all of the acquired assets is assigned to the trademark using an acceptable valuation methodology. Later, this discussion explores in more detail the valuation of a trademark within a financial accounting context.

The third bucket of reasons pertains to the analysis of a trademark for tax compliance purposes. Many transactions involving the sale or transfer of trademarks qualify as taxable events. Income tax rules generally stipulate how the tax basis of transferred assets is determined and what expenses associated with the assets are permissible for computing taxable income.

An important and challenging area of federal income tax compliance is known as intercompany transfer pricing. At a general level, intercompany transfer pricing involves the setting of prices for exchanges of goods, services, or use of intellectual property, such as trademarks, between two or more controlled entities located in different tax jurisdictions.

Often, agreements are structured between subsidiaries of multinational corporations located in different countries with the aim of minimizing the total amount of corporate income tax paid. Tax jurisdictions have developed rules to ensure that these agreements have economic substance and reflect market realities so as to not become a tool of tax avoidance.

Chief among these rules is the requirement known as the "arm's-length standard," which is codified in the Section 482 regulations.[3]

The Section 482 regulations state in part:

> In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case 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 transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances.[4]

Valuation standards applied in the financial accounting context and in the tax-related transfer pricing context share a general consistency; namely, a market perspective is imposed upon the transactions. In the financial accounting context, accounting for the acquisition of a trademark is performed under the fair value standard.

The fair value standard is defined in ASC topic 820. ASC topic 820 requires that the valuation of the trademark reflect the consideration of what a market participant would pay for the trademark in a bargaining situation in view of the highest and best use of the trademark regardless of how the acquirer intends to use it.

Similarly, in the tax-related transfer pricing context, the benchmark for the transfer price of a trademark is determined in consideration of what "uncontrolled taxpayers"—essentially, market participants—would agree to pay in a bargaining situation.

Generally Accepted Trademark Valuation Approaches and Methods

Three generally accepted valuation approaches are employed by valuation analysts to estimate the value intangible property, including trademarks.

These generally accepted intangible property valuation approaches are as follows:

1. The cost approach
2. The market approach
3. The income approach

The cost approach is less commonly used to estimate the value of trademarks than the other approaches. This is because the concept of cost is ordinarily not the same as the concept of value. Analysts may use more than one valuation approach, or more than one valuation method of a particular valuation approach, and then synthesize the results of the various analyses.

The transfer pricing rules under the Section 482 regulations impose a further framework incorporating elements of these valuation approaches in a manner designed to satisfy the arm's-length price standard for income tax compliance purposes.

Cost Approach

Because a trademark grants exclusive rights to the owner, it provides economic advantages that ordinarily are not fully reflected in the cost to create and develop the trademark. The cost approach, therefore, is not always applicable to a trademark valuation analysis.

Nonetheless, the cost approach does have application to trademarks in certain circumstances, such as where the trademark is not being used by the owner. The cost approach typically reflects a minimum value of the trademark, as the owner ordinarily will not sell the trademark for less than the owner's investment in it.

The replacement cost new 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 new 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 analyst should also consider as cost components both:

1. developer's profit and
2. entrepreneurial incentive.

These two components are often overlooked by inexperienced analysts. 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.

Finally, the analyst should adjust the cost estimate for all forms of obsolescence. The replacement cost new less depreciation method is based on present costs and circumstances, so its resulting value may be greater than that of the trademark actually being assessed.

Market Approach

Because trademarks are associated with particular products and businesses, sales of trademarks are less common than licenses for their use. As such, there exists a fair amount of publicly available information on trademark licensing, often collected from financial reports filed with the SEC. This information allows the analyst to develop units of comparison for trademarks, most notably a royalty rate.

The relief from royalty method makes use of the royalty rates involved in comparable uncontrolled transactions (CUT)—essentially, comparable arm's-length trademark license transactions between willing buyers and willing sellers—to derive the value of the subject trademark.

The theory behind the relief from royalty method is one of cost avoidance—that is, the value of the trademark is reflected in the trademark license royalty payments the trademark owner avoided having to pay by owning the trademark.

In this method, the analyst assumes the actual owner does not own the trademark and, therefore, must pay a hypothetical third party for a license to use it. The hypothetical trademark royalty payment is calculated as a market-derived running royalty rate multiplied by the actual owner's projected revenue over the remaining useful life of the trademark.

Because the relief from royalty method depends on applying the royalty rate to the projected revenue, it overlaps with the income approach, and some analysts will characterize this method as an income approach method.

"... comparable trademark license transactions are those involving a similar product or business to that of the subject trademark. ..."

The selected trademark royalty rate is determined from an analysis of the CUT trademark license royalty rates. No "true comparable" exists because trademarks are, by their nature, unique.

So, in practice, the analyst typically identifies CUT licenses based on a degree of similarity.

The degree of similarity may include an assessment of the following:

1. Product similarity (the trademark in controlled and uncontrolled transactions should be used in association with similar products or processes within the same general industry or market)
2. Profit potential (taking into consideration growth expectations)
3. Form of the royalty payment (e.g., lump-sum amount or running royalty)
4. Duration of the trademark license
5. Restrictions (e.g., exclusivity, geographical area or territorial limitations, and market limitations)
6. Stage of development
7. Collateral transactions or ongoing business relationships between the transferor and transferee (e.g., joint venture arrangements, cross-licensing arrangements, or the exchange of other intangible property or services as part of the transaction)

Generally, comparable trademark license transactions are those involving a similar product or business to that of the subject trademark with similar license terms, particularly with regard to the structure of the royalty (e.g., a lump-sum amount versus annual royalty payments) and restrictions of use (e.g., exclusivity).

Even after identifying reasonably comparable trademark licenses, some dissimilarity can remain. So the selected royalty rate may be adjusted to fit the particular facts and circumstances surrounding the subject trademark. Some factors that analysts often consider in the adjustment of the royalty rate are presented in Table 1.[5]

Income Approach

Income approach methods are often used in trademark valuation. There are various income approach valuation methods used in practice.

These methods commonly estimate the value of a trademark by calculating the present value of future income streams expected to be generated by use of the trademark over its remaining useful life (RUL). The methods generally differ in how those income streams are determined.

The various income approach methods typically employ one or more of the following types of income analysis:

1. Relief from Royalty Income—Commonly used methodology that assumes that if a corporation owns a trademark, then it is relieved from paying a royalty, so a hypothetical royalty payment can be estimated. This analysis is also characterized under the market approach and is described in more detail in that section of this discussion.
2. Profit Split (or Residual Profit Split) Income—The total income that a trademark owner or licensee is expected to generate from use of the trademark over its RUL is allocated (or split) between the trademark and all the other tangible and intangible property that contribute to generating the income.
3. Incremental Income—The income indicative of the value of a trademark is estimated as the difference between (a) the amount of income that the owner or licensee would be expected to generate with the use of the trademark and (b) the amount of income that the owner or licensee would be expected to generate without the use of the trademark.
4. Residual (or Excess) Income—The income estimated to be generated from the use of a trademark is estimated by subtracting from the total income of the owner or licensee a capital charge on contributory assets, which reflects the fair rate of return on all identifiable tangible and intangible property.

Intercompany Transfer Price Methods

Transfer pricing methods reflect a specialized area of valuation that follows the Internal Revenue Code and the related regulations. The Section 482 regulations require the transfer price analyst to apply the "best method" rule in allocating taxable income between related parties in certain transactions.

The best method rule stipulates that the arm's-length result of a controlled transaction should be determined under the method that, under the facts

Table 1
Factors Considered in the Adjustment of the Royalty Rate

Item	Factor	Consideration
1	Age, absolute	Long established or newly created trademark
2	Age, relative	Older or newer than competing trademarks
3	Use, consistency	Used consistently on related products or inconsistently on unrelated products
4	Use, specificity	Used on a broad range of products and services vs. narrow range
5	Use, geography	Has wide appeal (e.g., can be used internationally) vs. narrow or local appeal
6	Potential for expansion	Unrestricted vs. restricted ability for use on new and different products
7	Potential for exploitation	Unrestricted vs. restricted ability for licensing in new industries and uses
8	Associations	Trademark associated with positive vs. negative person, event, or location
9	Connotations	Name has positive vs. negative connotations and reputation among consumers
10	Timeliness	Trademark is perceived as modern vs. old-fashioned
11	Quality	Trademark is perceived as respectable vs. less respectable
12	Profitability, absolute	Profit margins on associated products is higher vs. lower than industry average
13	Profitability, relative	Profit margins on associated products is higher vs. lower than competitor(s)
14	Expense of promoting	Low vs. high cost of advertising and marketing of trademark
15	Means of promoting	Numerous vs. few means to promote the trademark
16	Market share, absolute	Associated product has high vs. low market share
17	Market share, relative	Associated product has higher vs. lower market share than competitor(s)
18	Market potential, absolute	Products are in an expanding vs. contracting market
19	Market potential, relative	Market for products expanding faster vs. slower than competitor(s)
20	Name recognition	Trademark has high vs. low recognition among consumers

and circumstances, provides the most reliable measure of that result.

Three transfer pricing methods are specified in the Section 482 regulations: the CUT method, the profit split method, and the comparable profits method.[6]

The analyst is permitted under the Section 482 regulations to use an unspecified method if any of the specified methods would not yield the most reliable measure under the circumstances.

The CUT method and profit split method generally follow the same principles as the relief from royalty method under the market approach and the profit split analysis under the income approach, respectively.

The comparable profits method evaluates the arm's-length result of a controlled transaction based on objective measures of profitability (known as profit-level indicators, or PLIs) derived from uncontrolled taxpayers that engage in similar business activities under similar circumstances.

With regard to cost-sharing arrangements, an income method is also specified.[7]

The income method was introduced as part of the revised cost-sharing regulations adopted in 2009. This method measures the value of the subject trademark (as a platform contribution under a cost sharing arrangement) as the difference of the profits that the party that did not develop the trademark expects to realize as a participant to the cost sharing arrangement and the profits it would expect to earn under a "realistic alternative."

As the name implies, the method follows the income approach and is a form of incremental income analysis.

Remaining Useful Life

RUL is a deceptively simple notion. It reflects the period during which a trademark is expected to contribute directly or indirectly to the owner's or

licensee's future cash flow. It may be shorter than the legal or statutory life of the trademark. The general concept of the RUL was introduced earlier in this discussion, but it warrants further discussion here.

Determining the RUL of a trademark is integral to determining its value under all three generally accepted valuation approaches.

Using the cost approach, the RUL of the trademark is a consideration when estimating obsolescence factors.

Using the market approach, the RUL of the guideline trademark assets is a factor of consideration for comparability when selecting and applying those guideline assets.

And using the income approach, the RUL directly influences the timing and duration of future cash flow expected to be generated by the trademark.

The RUL also affects how the value of the trademark is adjusted over time for financial accounting purposes. A trademark with a definite RUL is amortized over that period. A trademark with an indefinite RUL is not amortized; rather, it is periodically tested for impairment.

It is a simplifying assumption often made by valuation analysts and other practitioners that the RUL of a trademark is indefinite so long as the company using the trademark expects to use (and maintain) it in the foreseeable future. It is not advisable, however, to naively accept this assumption in lieu of further inquiry.

Reilly and Schweihs (2013) explain that estimating the RUL of a trademark involves an analysis of a number of pertinent factors,[8] including the following:

1. The expected use of the trademark by the owner or licensee. Where use is closely tied to a particular product or service line, the life cycle of the associated products or services should be considered.
2. The expected useful life of another asset or group of assets to which the useful life of the trademark may relate.
3. Any legal, regulatory, or contractual provision that may limit the useful life. A license to use a trademark, for example, generally restricts the useful life to the term of the license, though the option for renewal and the likelihood of exercising that option are also factors to consider.
4. The historical experience of the owner in extending the right to use the trademark and the licensee in renewing such right. Note that market participants would consider the highest and best use of the trademark when making assumptions regarding renewals or extensions.
5. The effects of obsolescence, demand, competition, and other economic factors.
6. Regular maintenance expenditures that would be required to support the expected future cash flow from the trademark. More than maintenance fees for the trademark registration, these expenditures typically include the advertising and marketing required to maintain the impression of the trademark in the mind of the consumers from whom the future cash flow depends.

In addition, Smith and Parr (2005) explain obsolescence as four distinct factors that influence the RUL of a trademark. These four types of obsolescence are presented with added commentary, as follows:[9]

1. Functional obsolescence: Trademarks suited for specific purposes typically have shorter remaining useful lives than those suited for more general purposes because the risk of obsolescence increases at greater levels of specificity. A trademark associated with an iPad product will tend to have a shorter RUL than a trademark for Apple.
2. Economic or event obsolescence: The remaining useful life of a trademark may be affected by economic circumstances or events outside the course of normal trademark activities. Examples of such events include legislative action affecting the regulatory environment and natural disasters causing long-term disruptions in manufacturing or distribution.
3. Technological obsolescence: A trademark can suffer technological obsolescence when it is tied closely to a product or service with a high risk of being substituted for more technologically advanced products or services. The value of trademarks associated with Smith Corona typewriters rapidly diminished as computer-based word processors became commonplace.
4. Cultural obsolescence: Cultural issues may affect the trademark's remaining useful life. For example, a trademark may become obsolete because it is politically incorrect or offensive. Lay's retired its "Frito Bandito" trademark in the 1970s after complaints

that the trademarked mascot invoked an unflattering "Mexican bandit" stereotype—replete with gold teeth and guns—to steal corn chips in Frito's advertisement.

There exist some examples of trademarks that appear to have indefinite remaining useful lives. The Coca-Cola trademark is more than 120 years old, and the Coca-Cola Company may well continue to maintain the market for its sugary drinks for another 120 years.

On the one hand, the uncertainties of forecasting cash flow far into the future are mitigated by discounting the cash flow to its present value. For example, using a discount rate of 10 percent, the present value of $1,000 earned 120 years from now is one penny—less than a rounding error.

Given the amount of discounting, it seems immaterial to our valuation if Coca-Cola instead earns $700 during that future year, as the difference is a fraction of a penny on a present value basis.

On the other hand, there exist many examples where the expectations of companies are undermined by significant shifts in the market that can occur abruptly.

On April 2, 1993, one of the most famous and valuable brands in the world, Marlboro, announced it would reduce its prices permanently by 20 percent to cope with the emerging competition from cheaper, generic brands. The date become known as "Marlboro Friday," and it was heralded as a watershed moment in marketing history.

Marlboro was an iconic brand and boasted the longest running advertising campaign in history, the Marlboro Man having been launched in 1954. Philip Morris, the owner of the Marlboro trademarks, saw its stock price plummet 23 percent in one day, knocking $13 billion off the value of the company.

From one perspective, the $13 billion loss could be attributed in large portion to a reduction in the value of the Marlboro trademarks.

The repercussions of Marlboro Friday reverberated into other industries. Companies with well-known trademarks such as Proctor & Gamble collectively lost tens of billions of dollars that same day.

The rationale behind the loss was that if a premier product like Marlboro, with a trademarked name and image that had been carefully bred and bolstered by more than a billion dollars in advertising investments over many years, was reduced to competing on price with generic brands, then the strategy of relying on trademarks to support premium pricing was placed in doubt.

It shows that trademarks can suffer severe obsolescence despite diligent efforts to maintain them.

Other studies suggest that, on the whole, the useful life of trademarks tends to be getting shorter, further signaling that caution should be taken in assuming an indefinite useful life for valuation or other analytical purposes.

This is likely a result of shortened product life cycles, shortened trademark license periods, shortened duration of advertising effects, and an increasing rate of obsolescence, among other things, that are increasingly characteristic of today's global, technology-infused, highly competitive markets.

Stangler and Arbesman (2012) report that the average duration of companies in the Fortune 500 has been decelerating over the past few decades.[10] Of the companies listed in the Fortune 500 at the beginning of 1955, only about 170 remained in 1990, resulting in a turnover of 330 companies over 35 years, or about 9 companies per year.

By 1995, the turnover rate had accelerated and 220 companies remained in 2010, resulting in a turnover of 280 companies over 15 years, or about 19 companies per year. Hence, between 1955 and 2010, the turnover rate of companies in the Fortune 500 effectively doubled.

The increasing turnover points to decreasing useful lives for trademarks as the lives of the underlying businesses are shortening.

This is similar to the turnover observed by Bruner (2005), who reports that of the 501 firms listed on the New York Stock Exchange in 1925, only 65 (or 13 percent) remained in 2004.[11]

Let's consider Eastman Kodak, for example. Founded in 1880, it reigned as one of America's great technology companies for over a century—one of the bluest of the blue chips.

Despite inventing the digital camera to succeed its successful but aging film business, the relatively sudden emergence of smartphones with integrated digital cameras in the late 2000s triggered a collapse in Kodak's sales. In 2010, it was removed from the S&P 500 to make way for newer companies like Netflix.

In another study, MARKABLES, an aggregator of trademark license agreements, analyzed the useful lives asserted in the valuations of 4,500 trademarks and brands between 2003 and 2013.[12]

The MARKABLES study concluded that there has been a strong shift towards the assertion of definite useful lives in trademark valuations, and the definite useful lives are getting shorter. In 2003, trademarks with definite useful lives accounted for little less than 20 percent of all valuations.

By 2013, the portion increased to around 60 percent. Further, the average remaining useful life fell to 10.7 years in 2013 from 12.5 years in 2003. This finding is consistent with earlier studies, such as a study published in *Tax Executive* in which 57 trademark license agreements were examined, and the average duration was found to be less than 10 years.[13]

In the tax-related transfer pricing context, there are further considerations for assessing the RUL of a trademark. The interpretation of tax regulations can affect this assessment, and two issues are particularly noteworthy:

1. Internal Revenue Code Section 367(d)
2. Whether a cost-sharing arrangement (CSA) for a subject trademark is treated under the Section 482 regulations as the transfer of a preexisting asset for the purpose of calculating a buy-in payment

With regard to Section 367(d), Congress enacted the regulation to ensure that U.S. corporations are unable to avoid income taxes by transferring certain intangible assets to low-tax foreign jurisdictions after claiming significant expenses on U.S. tax filings for the development of those intangible assets.[14]

It requires the transferor to include as income an appropriate arm's-length charge for the transferee's use of a transferred intangible property over its RUL. Importantly, Section 367(d) limits the RUL to 20 years.

Given the commonalities of the Section 367(d) purpose to Section 482, and because Section 367(d) is used by the Internal Revenue Service (the "Service") as a backstop to Section 482,[15] some analysts advocate applying the 20-year RUL limitation to analyses performed under Section 482.

While the RUL limitation under Section 367(d) lends theoretical support to the reasonableness of asserting a definite useful life under Section 482, the Service has provided no validation of this position and, to the contrary, has applied an indefinite RUL under Section 482 transfer price analysis in recent tax cases.

With regard to the issue of a CSA buy-in payment, revised cost-sharing regulations were adopted in 2009 to provide for an "investor model" approach that frames the subject intangible property as an ongoing development activity rather than a one-time transfer of a preexisting intangible property.

The modified provisions under Section 482, therefore, appear to offer the Service more substantive grounds for assuming an indefinite RUL with regard to transactions determined under the new regulations.

For transactions conducted under the previous regulations, the application of an indefinite RUL for a buy-in payment was found to be inconsistent with the provisions of Section 482, as written at the time.

In *Veritas Software Corp. v. Commissioner*,[16] the Tax Court rejected the Service's assertion of an indefinite RUL in that matter, holding that Section 482 required only that participants make a buy-in payment with respect to the preexisting intangible property actually transferred, not subsequently developed intangible property.

The rationale was that subsequent development and maintenance costs would be borne by participants under the CSA and the buy-in payment was intended to address only the market value of the asset developed up to the time of the transaction.

In short, determining the RUL of a trademark involves consideration of a number of pertinent factors beyond its intended use by the current owner or licensee. These factors include legal, regulatory, or contractual provisions that may limit the useful life, as well as the effects of obsolescence and other economic factors.

Illustrative Examples of a Trademark Valuation

This section presents three simple trademark valuation examples.

Example 1 presents a trademark valuation for financial accounting purposes using the relief from royalty method of the market approach.

Example 2 presents a trademark valuation for financial accounting purposes using the residual profit split method of the income approach.

Exhibit 1
Alpha Company
Selected Comparable Uncontrolled Transactions
Trademark License Summary

#	Licensor	Licensee	License Start Year	License Term (Years)	General Industry	Specific Industry	Degree of Exclusivity	Royalty Low	Royalty High	Other Fee
1	Merchandising Corp. of America, Inc.	Sports Archives, Inc.	2010	10	Specialty Stores	SIC Code 59	Exclusive	1.0%	1.0%	N/A
2	Kmart Corporation	Kmart Australia Limited	2011	10	Department Stores	SIC Code 53	Exclusive	0.5%	1.5%	N/A
3	Trader International Corporation	Kheeler Specialty Stores, Inc.	2013	10	Specialty Stores	SIC Code 59	Exclusive	3.0%	3.0%	$2 M minimum
4	Rampage Licensing LLC	Charlotte Russe Merchandising, Inc.	2010	10	Specialty Stores	SIC Code 59	Exclusive	1.0%	3.0%	N/A
5	Toys "R" Us, Inc.	The Right Start, Inc.	2013	10	Specialty Stores	SIC Code 59	Exclusive	0.3%	0.5%	N/A
6	The Sports Authority, Inc.	Mega Sports Co., Ltd.	2011	10	Sporting Goods	SIC Code 59	Exclusive	2.0%	2.0%	N/A
7	Fila Sport S.P.A.	Renaissance Golf Products, Inc.	2012	10	Sporting Goods	SIC Code 59	Exclusive	0.8%	1.5%	N/A

Low	0.3%	0.5%
High	3.0%	3.0%
Median	1.0%	1.5%
Mean	1.2%	1.8%

Selected Trademark License Royalty Rate	**1.5%**

Exhibit 2
Alpha Company
Trademark Valuation
Market Approach Relief from Royalty Method
Valuation Summary
As of January 1, 2015

	Projected Fiscal Years Ending December 31,				
	2015 $000	2016 $000	2017 $000	2018 $000	2019 $000
Projected Net Revenue Attributed to the Trademark [a]	10,800	11,340	11,907	12,502	13,127
Market-Derived Trademark License Royalty Rate [b]	1.5%	1.5%	1.5%	1.5%	1.5%
Pretax Avoided Trademark License Royalty Expense	162	170	179	188	197
Less: Income Tax (at 40%)	65	68	71	75	79
After-Tax Avoided Trademark License Royalty Expense	97	102	107	113	118
Discounting Period [c]	0.5	1.5	2.5	3.5	3.5
Present Value (PV) Factor (at 12%) [d]	0.9449	0.8437	0.7533	0.6726	0.6726
PV of After-Tax Avoided Trademark License Royalty Expense	92	86	81	76	79
Indicated Fair Value of Trademark	**414**				

Notes:
[a] Based on projections provided by Alpha management
[b] Based on an analysis of CUT trademark license agreements. See Exhibit 1
[c] Based on the midyear convention, payment of the royalty is assumed to occur in the middle of the fiscal year
[d] Based on the weighted average cost of capital (WACC) for Alpha Company

And, example 3 presents a trademark buy-in price analysis for a tax-related intercompany transfer pricing purpose using the comparable uncontrolled transactions method.

Example 1—Relief from Royalty Method

Let's assume that Alpha Company ("Alpha") is an Internet-based retailer of consumer household and sporting goods. Alpha acquired a license to use the "WhooHoo!" trademark as part of its acquisition of Beta Company ("Beta") on January 1, 2015. Beta originally licensed the trademark from another company.

As part of a purchase price allocation governed by ASC topic 805, Alpha is required to identify and report the trademark at fair value. The date of the valuation is January 1, 2015.

Let's assume the trademark license expires five years from the date of acquisition and Alpha does not expect the licensor to renew it. Thus, the RUL of the trademark is five years.

Alpha management provided five-year revenue projections for products sold in association with the trademark, as well as estimated selling, general, and administrative expenses. Let's further assume that the appropriate effective income tax rate for Alpha is 40 percent and the analyst determined

Exhibit 3
Alpha Company
Trademark Valuation
Income Approach
Illustrative Profit Split Analysis
Valuation Summary
As of January 1, 2015

	Projected Fiscal Years Ending December 31,				
	2015 $000	2016 $000	2017 $000	2018 $000	2019 $000
Projected Net Revenue Attributed to the Trademark [a]	10,800	11,340	11,907	12,502	13,127
Gross Profit Margin [b]	21.5%	21.5%	21.5%	21.5%	21.5%
Gross Profit (Revenue less Cost of Goods Sold)	2,322	2,438	2,560	2,688	2,822
Less: Selling, General, and Administrative Expenses [b]	1,858	2,024	2,125	2,150	2,258
Income Before Taxes	464	414	435	538	564
Less: Income Tax (at 40%)	186	166	174	215	226
After-Tax Income	278	248	261	323	338
Less: Contributory Asset Charges	70	62	65	81	85
Residual Income	209	186	196	242	254
Market-Derived Royalty Proft Split [c]	50%	50%	50%	50%	50%
Royalty Payment to Trademark Owner	104	93	98	121	127
Discounting Period [d]	0.5	1.5	2.5	3.5	3.5
Present Value Factor (at 12%) [e]	0.9449	0.8437	0.7533	0.6726	0.6726
Present Value of Royalty Payment	99	78	74	81	85
Indicated Fair Value of Trademark [f]	**417**				

Notes:
[a] Based on projections provided by Alpha management.
[b] Based on historical financial results and Alpha management estimations.
[c] Based on comparable public guideline license agreements indicating that a 50 percent residual profit split is appropriate.
[d] Based on the midyear convention, payment of the royalty is assumed to occur in the middle of the fiscal year.
[e] Based on the weighted average cost of capital (WACC) for Alpha Company.
[f] Ignores the value increment associated with the tax amortization benefit (TAB) only for purposes of simplifying this example.

the appropriate present value discount to be 12 percent.

The analyst performed extensive market research to identify CUT trademark license agreements, as summarized in Exhibit 1.

The analysis of these selected comparable license agreements indicated that the market-derived royalty rate appropriate for the "WhooHoo!" trademark is 1.5 percent. Accordingly, the analyst concluded that it would be appropriate to employ the market approach relief from royalty method.

A simplified example of the relief from royalty method is presented in Exhibit 2.

The selected royalty rate was applied annually to the net revenue to arrive at a pretax avoided royalty expense, which was then adjusted for income taxes. The resulting after-tax avoided royalty expense is tantamount to an income stream. This is because it reflects license royalty payments saved by owning the trademark.

The present value of the sum of this annual avoided royalty expense represents the fair value of the trademark, which the analyst concluded was $414,000 as of January 1, 2015.

Example 2—Profit Split Income Analysis

The same facts provided in Example 1 apply in this example, except that the analyst also concluded that it would be appropriate to employ the income approach residual profit split method.

For the present example, let's define the "profit split" residual income as:

	Net revenue
Less:	Cost of goods sold
Equals:	Gross profit
Less:	Selling, general, and administrative expenses
Equals:	Net income
Less:	Contributory asset charges
Equals:	Residual income

Let's assume that for each year the analyst appropriately determined the capital charge on contributed assets, reflecting the required rate of return on other identifiable intangible assets that contributed to the generation of income.

The analyst performed extensive market research to identify comparable trademark license agreements, including the agreements presented in Exhibit 1.

The analysis of these license agreements (not presented) indicated that the appropriate royalty rate for the "WhooHoo!" trademark would be a profit split of residual income of approximately 50 percent.

That is, in a typical agreement, the licensor receives 50 percent of the licensee's income attributable to the trademark, and the licensee receives the remaining 50 percent. The indicated profit split for a license agreement is either explicitly provided or implicitly derived from the terms of the agreement in view of the respective licensee's historical financial performance.

The residual (or excess) income—the income attributable to the trademark—is determined by deducting from gross profit the operating expenses, the income taxes, and the charge.

A simplified example of the profit split method is presented in Exhibit 3.

For financial accounting (particularly ASC 805) purposes, all income approach intangible asset valuations incorporate a tax amortization benefit (TAB) adjustment. Only for the purpose of simplifying this example, the calculation of the TAB value increment was left out of this illustrative example.

As presented in Exhibit 3, the 50 percent profit split royalty rate applied to the residual income reflects the portion of income that Alpha is able to generate annually as a benefit of using the subject trademark.

The present value of this income stream represents the fair value of the trademark, which the analyst concluded was $417,000 as of January 1, 2015.

Synthesis of Examples 1 and 2

A synthesis of the relief from royalty method and the profit split method is method is presented in Exhibit 4.

As presented in Exhibit 4, the valuation synthesis and conclusion reflects a weighted average of the market approach presented in Exhibit 2, and the income approach shown in Exhibit 3. After considering the relative strengths and weaknesses of the two valuation approaches under the facts and circumstances, the analyst concluded that the synthesis would be calculated as 50 percent of the value determined by each approach.

Accordingly, the indicated fair value of the "WhooHoo!" trademark was determined to be $415,000 as of January 1, 2015.

Exhibit 4
Alpha Company
Trademark Valuation
Value Synthesis and Conclusion
As of January 1, 2015

Valuation Approach	Valuation Method	Emphasis	Value Indication $000	Reference
Market approach	Relief from royalty method	50%	414	Exhibit 2
Income approach	Profit split method	50%	417	Exhibit 3
	Trademark Fair Value Conclusion		**415**	

Example 3—Buy-In Price Analysis

Changing gears to tax-related transfer pricing, let's assume that Alpha, a U.S. company, has entered into a CSA with its wholly owned foreign subsidiary Delta Company ("Delta"), to develop a trademark.

In a CSA, the parties share the costs of developing and maintaining intangible assets, including trademarks, in proportion to each party's share of anticipated benefits from the cost-shared intangible assets.

This agreement allows Delta to use the subject trademark by paying a share of the development costs rather than paying a royalty to Alpha, which lowers the overall income taxes paid because Alpha is in a higher tax jurisdiction than Delta. Delta is located in Ireland.

Based on the Section 482 regulations and the relevant facts and circumstances, the analyst concluded that the CUT method would be the best method for determining the buy-in price that Delta would pay Alpha under the tax-related transfer pricing rules.

Exhibit 5
Alpha Company
Trademark Valuation
Buy-In Price Analysis
Valuation Summary
As of January 1, 2015

	Projected Fiscal Years Ending December 31,				
	2015 $000	2016 $000	2017 $000	2018 $000	2019 $000
Projected Net Revenue Attributed to the Trademarks [a]	10,800	11,340	11,907	12,502	13,127
Arm's-Length Trademark License Royalty Rate [c]	1.5%	1.5%	1.5%	1.5%	1.5%
Gross Pretax Trademark License Royalty Income	162	170	179	188	197
Less: Trademark License Expense [d]	108	113	119	125	131
Net Pretax Trademark License Royalty Income	54	57	60	63	66
Discounting Period [e]	0.5	1.5	2.5	3.5	3.5
Present Value (PV) Factor (at 12%) [f]	0.9449	0.8437	0.7533	0.6726	0.6726
PV of Pretax Trademark License Royalty Income	51	48	45	42	44
Sum of PV of Pretax Trademark License Royalty Income	230				
Valuation Summary					
PV of Discrete Period Trademark License Royalty Income	230				
Indicated Buy-In Price of the Trademark	**230**				

Notes:
[a] Based on projections provided by Alpha management.
[b] Based on an analysis of CUT trademark license agreements. See Exhibit 1.
[c] Projected license expense relating to maintaining, promoting, and protecting the subject trademarks into perpetuity.
[d] Based on the midyear convention, payment of the royalty is assumed to occur in the middle of the fiscal year.
[e] Based on the weighted average cost of capital (WACC) for Alpha Company.

The analyst performed extensive market research to identify CUT license agreements, as presented in Exhibit 1. After considering all relevant factors, particularly with respect to the similarity of the terms and circumstances of the CUT license agreements to the subject transaction, the analyst concluded that an appropriate arm's-length price royalty rate for the subject trademark would be 1.5 percent of net revenue.

A simplified example of the CUT method is presented in Exhibit 5.

While the determination of the buy-in price in Exhibit 5 is similar in many ways to the relief from royalty method illustrated in Example 1, there are two important differences.

First, under the tax-related intercompany transfer pricing rules, the buy-in price is calculated using pretax income, whereas the value indicated by the relief from royalty method is tax-affected.

Second, the buy-in price in the present example assumes a five-year RUL.

In determining the buy-in price, the analyst first adjusted the gross royalty income by deducting the cost of maintaining the trademark through advertising and other promotional activities in order to ward off obsolescence. The present value of the resulting pretax income yielded the value of the subject trademark for the discrete period of 2015 through 2019.

Based on the illustrative analysis, the analyst concluded that the indicated buy-in price of the subject trademark was $230,000 as of January 1, 2015.

Summary and Conclusion

This discussion introduced the valuation of trademarks. It first described the factors that are relevant to the identification and valuation of trademark-related intangible property.

Second, this discussion explained the generally accepted trademark valuation approaches and methods, particularly within the context of financial reporting and transfer pricing.

Third, this discussion described determining the remaining useful life of a trademark with respect to the various contexts.

Finally, this discussion presented three simple examples, using different analytical methods, to illustrate the valuation of trademark intellectual property.

As is the case with valuing other intangible property, it is important for the analyst to consider the generally accepted approaches and methods in view of the trademark intellectual property rights actually being valued, the economic environment in which the owner and/or licensee operate, and the facts and circumstances surrounding the use of the subject trademark.

Notes:

1. See 15 U.S.C. §1127.
2. Ibid., §1052.
3. See, generally, 26 CFR §1.482.
4. Ibid., 1.1482-1(b)(1).
5. See, for example, Robert F. Reilly and Robert P. Schweihs, *Guide to Property Tax Valuation*, (Chicago: Willamette Management Associates Partners, 2008), Exhibit 21-1.
6. See 26 CFR §1.482-4.
7. Ibid., 1.482-7.
8. See Robert F. Reilly and Robert P. Schweihs, *Guide to Intangible Asset Valuation* (New York: American Institute of Certified Public Accountants 2014), Chapter 21.
9. See Gordon V. Smith and Russel L. Parr, *Intellectual Property: Valuation, Exploitation, and Infringement Damages* (New York: John Wiley & Sons, 2005), Chapter 11.3.
10. Dane Stangler and Sam Arbesman, "What Does Fortune 500 Turnover Mean?" Ewning Marion Kauffman Foundation study, www.kauffman.org (2012).
11. Robert F. Bruner, *Deals from Hell: M&A Lessons That Rise Above the Ashes* (New York: John Wiley & Sons, 2005).
12. See "The Useful Life of Trademarks," MARKABLES Bulletin #1, www.markables.net (2014).
13. See McShan, Merwin, Stone, and Wright, "A Review of Third-Party License Agreements: Are Periodic Adjustments Arm's Length?," *Tax Executive* (July-August 1989).
14. See IRS Technical Advice Memorandum 200907024 dated February 13, 2009.
15. See IRC 1.376(d)-1T(g)(4).
16. See Veritas Software Corp. v. Commissioner, 133 T.C. 297 (2009).

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