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8 Common Challenges To Trademark Royalty Deductions

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(July 30, 2019, 12:46 PM EDT)

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The 100 most valuable global brands have a combined value of $2 trillion. Two-thirds of that value is associated with U.S. consumer, industrial and financial services companies.[1] Twenty percent of the remaining value is associated with Japanese and U.K. companies.

U.S. and Organization for Economic Cooperation and Development guidance require that companies pay for the use of valuable intangibles, including brand intangibles. Yet tax authorities routinely challenge deductions taken by local affiliates for trademark royalties. Several cases involving trademark royalties are currently in the U.S. competent authority inventory and another is pending in U.S. Tax Court.[2] The transfer pricing of trademarks is a matter of increasing interest.

This article identifies eight lines of attack commonly taken by tax authorities seeking to challenge deductions for trademark royalties and identifies the counterarguments or lines of inquiry to develop in response to these lines of attack. The tax authority arguments are discussed in the sequence the authors generally encounter them, from the most general to the most specific.

The theme developed here is that taxpayers should anticipate and should be prepared to meet local tax authority challenges to trademark royalty deductions. Trademark royalty programs, done right, can and should withstand challenge.

Tax Authority Arguments That No Charge Is Permitted

1. OECD Guidance Indicates No Intercompany Charge Is Appropriate For Trademark Use

The first line of attack is a broad assertion, leveled without citation to specific authority, that no deduction is appropriate for a trademark royalty because OECD guidance indicates that no royalty should be paid between related parties for the license of a trademark (or for the license of a trade name, which is a type of trademark). This argument was first put to one of the authors by a tax authority representative who was his country's delegate on transfer pricing matters to the OECD.

This argument is easily rebutted. OECD guidance recognizes that “[t]rade names are intangibles”[3] for which a charge is appropriate in a related party context. OECD paragraph 6.82 states that “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 … it is reasonable to conclude that a payment for use would have been made in arm’s length transactions.”

The guidance further recognizes that the arm’s length charge is the amount that would be paid by parties at arm’s length based on the anticipated benefit. OECD paragraph 6.83 states that “[i]n 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[.] Factors that would be important in a license of the name to an independent enterprise under comparable circumstances … should be taken into account.” OECD paragraph 6.84 continues: “If there is a reasonable expectation of financial benefit … from using the [parent’s] branding, then the amount of any payment should be informed by the level of that anticipated benefit.”

2. Affiliate Is Allowed by Local Law to Use Parent’s Trademark Without Permission (and Therefore Without Charge)

A second line of attack is an assertion that no deduction is allowed for use of a trademark because an affiliate is allowed by local law to use the mark for free and therefore would not pay for it at arm’s length. This argument asserts that local intellectual property law allows an IP owner to enjoin use of its trademark only if such use would cause customer confusion.[4]

The tax authority argues that no customer confusion is caused by use of a mark by an affiliate because, by virtue of being an affiliate, the entity using the mark is in fact associated with the holder of the mark and therefore the implied association or endorsement is truthful, not confusing. In the jurisdictions where the authors have encountered the issue, IP counsel have advised that this is a misstatement of IP law and that the owner of a mark may indeed prohibit its use by affiliates and nonaffiliates alike. When confronted with IP counsel’s advice, tax authorities have abandoned the argument (and moved to others).

3. Use of Name Adds No Value Beyond a Statement of Affiliation

Another line of attack is that no deduction is appropriate because the real value to an affiliate of using the parent’s trademark is to communicate affiliation and no charge is permitted for a factual statement of affiliation, e.g., a statement that “Company A is a wholly owned subsidiary of Company P.” For this proposition, they cite OECD paragraph 6.81 which states: “As a general rule, no payment should be recognized for transfer pricing purposes for simple recognition of group membership or the use of the group name merely to reflect the fact of group membership.”

The tax authority argues that anything more than a statement of affiliation, such as use of a logo or use of a shared name, is surplusage that doesn’t add value and therefore does not support a charge. A tax authority may argue, particularly in a business-to-business setting, that customers are sophisticated, not influenced by logos or legal names, and care only that the company they’re doing business with is owned by and under the control of the well-known and highly regarded parent.

The main counterargument is that there is value in the use of a name beyond a statement of affiliation — there is the endorsement feature of a shared name. This is seen often in the marketplace where different brands are owned by a common parent. The suggestion that all brands have equal value if customers are told the brands are under common control defies experience. Attaching a luxury brand name to a product carries an endorsement value that a statement of common corporate ownership does not.

A shared name has endorsement value in a business-to-business context as well. This was highlighted in the GE Capital Canada case where the Canadian Revenue Agency argued emphatically through its experts and in its briefs that the decision of the GE parent to allow its Canadian affiliate to use the GE name was a clear signal to the market that the parent would stand behind its affiliate, making the issuance of a written guarantee to support $3 billion in loans superfluous and therefore noncompensable.[5] The Tax Court of Canada referenced the testimony regarding the importance of the GE shared name in eight separate paragraphs of its opinion,[6] raising the affiliate's credit rating by three notches based in part on the value of the shared name.[7]

4. No Evidence That the Trademark Has a "Premium Value"

Next, tax authorities argue that no royalty is appropriate unless the licensed trademark allows the licensee to earn a premium return, based on the notion that intangible property doesn't warrant compensation unless it contributes to so-called excess profit. In practical terms, this commonly means the local tax authority will seek to disallow a trademark royalty if the licensee's pre-royalty financial results do not exceed the top of an agreed arm's length interquartile range.

This argument may have force if there is genuine doubt that a trademark has value to a licensee and the absence of profit is proffered as evidence of its lack of value. But the argument is dubious and has been rejected in similar contexts by the IRS where it is used to justify the absence of, or denial of a deduction for, royalties for valuable intangible property simply because the licensee is not profitable. The IRS insists that the appropriateness of a payment for intangible property must be judged by the same standard as payment for any other property — such as electricity or packaging material.

The proper standard is whether the property is valuable to the licensee. If it is valuable to the licensee, the licensor should be compensated (currently or in the future[8]) even if the licensee is incurring losses from its operations. (In this context and others, a person trying to discern whether a trademark has value to a licensee might usefully ask whether the licensee would be worse off or incur any expense if the trademark were taken from it. If the answer is yes, there is prima facie evidence of trademark value.)

Tax authorities also argue that if the licensee had previously operated under a valuable brand, no trademark royalty is permitted unless the licensee can show that its new brand is more valuable than its prior brand.

The latter argument is claimed to be supported by OECD paragraph 6.84, which states: "Where an existing successful business is acquired by another successful business and the acquired business begins to use a name, trademark or other branding indicative of the acquiring business, there should be no automatic assumption that a payment should be made in respect of such use. If there is a reasonable expectation of financial benefit to the acquired company from using the acquiring company's branding,

then the amount of any payment should be informed by the level of that anticipated benefit."

The "no better than the previous brand" argument is based on a misreading of the OECD guidance. The OECD guidance does not frame the question in comparative terms, asking whether the acquiring company's brand is more valuable than the acquired company's prior brand. It asks only if the acquiring company's brand has value — in other words, is more valuable than starting from scratch. If it is valuable to the licensee, a royalty may be appropriate.

5. Trademark Value in Locality Created By the Licensee

Even where a tax authority concedes that a trademark has value to the licensee, it may challenge trademark royalties on the ground that the trademark acquired value in the licensee's territory only through the work of the licensee and therefore is not something for which the licensee is required to pay. A second version of this argument is that a group trademark is a "collective asset" to which each member of the group contributes, therefore no member of the group should receive a charge for its use. These arguments effectively equate value generation with ownership of the resulting asset.

It is certainly possible for parties at arm's length to agree to this result — e.g., agree that a licensee, in return for its promotional activity, will be permitted royalty-free use of a mark. A grant of such a right would be an element of compensation to the licensee for its efforts. Absent agreement, however, it should not follow that a person that contributes value to a trademark acquires an ownership interest in the trademark. This is certainly not the case where the parties are unrelated; there is no reason for the rules to apply differently where the parties are related. And indeed, the OECD guidelines do not provide for a different answer. The OECD text cited above, specifically at paragraphs 6.82-6.83, makes clear that a trademark may be owned by one member of a group and licensed to others within the group, and that the arm's length pricing exercise is governed by the traditional arm's length standard, i.e., the price that would be charged to an independent, unrelated party.

6. Insufficient Proof of Value

Finally, the tax authority challenge gets down to brass tacks. The tax authority concedes (for purpose of discussion) the appropriateness in theory of a trademark royalty charge but argues that the taxpayer has failed to demonstrate the value of the mark in the particular local market. This argument is sometimes pushed to the extreme, with a demand that the licensee identify specific transactions that occurred because of the trademark or, conversely, that would not have occurred but for the trademark. In a case handled by one of the authors, the tax authority instructed that proof of such transactions had to be "verifiable and quantifiable." The response to a demand of this kind is to point out that parties at arm's length transact without imposing such conditions and that trademarks have value in the marketplace even absent an ability to meet such an exacting standard of proof.

In all cases, however, the taxpayer must be prepared to meet the more reasonable demand of demonstrating that the licensed mark has value in the licensee's territory — in other words, that someone at arm's length would pay to use the mark. Whether this can be done, or how it's done, depends on the facts.

While the specific facts will differ case-to-case, it is important to keep in mind that a company's trademark may have value to audiences other than customers. It may have value to suppliers and to

employees as well. The value of a company's trademark to suppliers is illustrated by the GE Capital Canada case, discussed above, where the CRA argued that third-party lenders (i.e., suppliers of money) would have priced loans favorably to the Canadian affiliate because it was allowed to use the GE name.[9] Suppliers may give better terms to companies with a valuable mark.

A trademark may be important in recruiting talent as well. Employees care about their job titles. They care about their employer as well. A business card that says "Famous Company Local" is more attractive to employees than a business card that says "Obscure Company" notwithstanding that the employee can explain to others that "Obscure Company" is owned by "Famous Company." A tax examiner at a national tax agency who is proud of his or her professional stature may understand this point, recognizing the professional satisfaction that accompanies a title associated with that agency.

Challenges to Royalty Amounts — Pricing

Even in cases where the tax authority accepts that a trademark royalty is appropriate, the tax authority may still, of course, challenge the amount of the royalty. Such a challenge could take many forms. Two are discussed below.

1. Evidence of "Brand Value" is Not Probative Because "Brand" Can Mean Many Things, Not the Same as "Trademark"

In cases involving companies that own some of the world's most valuable brands, a tax authority may seek to deflect the relevance of independent brand valuation studies by arguing that "brand" can mean many things and therefore does not provide helpful guidance for the valuation of the company's trademark associated with its brand. The tax authority may point out, accurately, that while "[t]he term 'brand' is sometimes used interchangeably with the terms 'trademark' and 'trade name,'" it may in fact "represent a combination of intangibles" that extend beyond trademarks and trade names to include "customer relationships, reputational characteristics, and goodwill."[10]

There are two responses to this. The first response is that brand valuation studies often define what they mean by the term "brand" in a way that demonstrates the equivalence of "brand" as they use the term and the term "trademark."[11]

The second response is that finely tuned definitions are beside the point because the value of a trademark is based on the value conveyed by the trademark, which may include goodwill and other attributes that accompany the use of a mark. The value does not depend on legal definitions. OECD guidance at paragraphs 6.95 and 6.96 states correctly that one cannot separate a trademark from goodwill for transfer pricing purposes. If the license of a trademark or trade name conveys the value of goodwill and reputational value, the value of those intangibles should be reflected in the arm's length price of the trademark license.[12] The question therefore is not whether the terms "brand" and "trademark" mean exactly the same thing but whether the latter conveys the value of the former. Typically, it does.

2. Licensor's Marketing Expenditures Don't Indicate an Investment Sufficient to Justify Royalty Return

The final tax authority argument addressed here is the argument, commonly encountered, that in the absence of direct evidence of specific trademark value in the licensee's particular market, the trademark

royalty cannot exceed a level that would provide a "reasonable" return to the licensor on its expenditures in that market to promote the mark. A compelling response to this challenge depends on the taxpayer's facts; it cannot be framed in the abstract. But obvious points to consider in framing a response include: (1) that a trademark's value often reflects the value of the product(s) or service(s) associated with the trademark rather than just the investment in trademark promotion per se, meaning that all of the costs associated with developing the product(s) and service(s) over some period of time are relevant costs in the analysis; and (2) that the size of an investment does not dictate the value of the asset generated by the investment.

Conclusion

U.S., Japanese and U.K. companies own a majority of the world's top 100 most valuable brands with an estimated combined value of $1.45 trillion. There are many other U.S., Japanese and U.K. companies with valuable brands that undoubtedly push the total value much higher.

Many companies with valuable brands have licensing programs that require affiliates to pay arm's length royalties for use of licensed marks. Local tax authorities nevertheless routinely challenge the royalty deductions, often on multiple and shifting grounds. The foregoing discussion identifies some of

their most common arguments. It is important that taxpayers anticipate and prepare for these arguments. With preparation — aided by experience — the battle can be won.

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[1] See Interbrand at https://www.interbrand.com/best-brands/best-global-brands/2018/ranking/. Fourteen of the top 20 and nearly half of the top 100 brands are associated with U.S. companies, accounting for $1.3 trillion or 65% of the top 100 company $2 trillion in brand value. Japanese and UK companies account for about 20% of the remaining top 100 companies and 20% (or $146 billion) of the remaining brand value. Compare Brand Finance, https://brandfinance.com/images/upload/global_500_2019_locked_1.pdf (valuation of top 500 global brands applying different methodology, identifying U.S., Japanese, and UK brand value of $3.77 trillion accounting for 55% of $6.88 trillion global total). The brand value attached to financial services companies disproves the assertion by some tax authorities that trademarks are not valuable in that industry. In 2018 seven of the top 50 most valuable global brands and 12 of the top 100 most valuable global brands were associated with financial services companies. See https://www.interbrand.com/best-brands/best-global-brands/2018/ranking/.

[2] See Coca-Cola Company v. Commissioner, T.C. Docket 031183-15 (filed Dec. 14, 2015).

[3] See OECD ¶ 6.22 (“A trade name (often but not always the name of an enterprise) may have the same force of market penetration as a trademark and may indeed be registered in some specific form as a trademark…. Trade names are intangibles within the meaning of section A.1.”).

[4] This argument may be inspired in some cases by the language in OECD ¶ 6.82 which says that royalties “may be appropriate” in cases involving unregistered trademarks where “use of that trademark by another party would constitute misrepresentation.” See OECD ¶ 6.82. This statement has no bearing on registered trademarks, which is the context in which the author has encountered the argument recounted in the text.

[5] See Respondent’s Written Submissions, GE Capital Canada Inc. v. The Queen, 2006-1386(IT)G & 2006-1385(IT)G, Tax Court of Canada (filed June 26, 2009).

[6] See GE Capital Canada Inc. v. The Queen, 209 TCC 563 ¶¶ 23, 45, 47, 57, 111, 142, 145, 170 (2009).

[7] GE Capital Canada Inc. v. The Queen, 209 TCC 563 ¶ 301 (2009).

[8] The need to pay for a valuable trademark license does not foreclose the possibility of conditioning the payment, or the amount of the payment, on the profitability of the licensee’s operations, e.g., a sliding scale royalty structure, so long as the overall royalty agreement is consistent with the arm’s length standard. In the experience of the authors, however, the objecting local tax authority has not argued that the royalty arrangement be restructured in this manner but, rather, has sought simply to deny a current deduction without reference to a compensating increase in royalties in other years.

[9] See text accompanying notes 5-7, supra.

[10] OECD ¶ 6.23.

[11] The publication Brand Finance defines the term “brand” for purposes of its valuation exercise as the “Trademark and associated IP including the word mark and trademark iconography,” and measures brand value using the royalty relief method which looks to the price at which a third party could license the brand based on royalty rates paid for trademarks in third party licensing agreements. See Brand Finance website “Explanation of Methodology,” at http://branddirector.com/methodology.

[12] See OECD ¶ 6.96 (“It is important to identify situations where taxpayers or tax authorities may seek to artificially separate intangibles that, as a matter of substance, independent parties would not separate in comparable circumstances. For example, attempts to artificially separate trademarks or trade names from the goodwill or reputational value that is factually associated with the trademark or trade name should be identified and critically analysed. Example 21 in the Annex to Chapter VI illustrates the principles of this paragraph.”). See also Sallie Spilsbury, Media Law in Theory and Practice, page 450 (2000) Cavendish Publishing. Goodwill “is essentially the commercial benefit that a good name and reputation brings with it.”