Royalties for Intracompany Sales of Fancy Trademarked Cheese

Abstract - The United States is currently considering issuing new guidance on the allocation of taxable income from marketing intangibles among related entities of multinationals. With this guidance, policymakers hope to settle an ongoing debate between advocates of the arm's length principle and proponents of the principle of legal ownership. The purpose of this paper is to propose the net present value method be used to allocate income among related taxpayers. With this method, affiliates that market an intangible that they do not own are compensated as advocated by proponents of the arm's length principle. Legal owners are also compensated for their opportunity costs.

INTRODUCTION

During the 1980s, multinational enterprises (MNEs) around the globe appeared to be using marketing intangibles (trade names and trademarks) to avoid taxes. Specifically, affiliates in low tax countries would license the right to exploit their company’s intangibles to related affiliates in high tax countries in exchange for royalty payments. Affiliates in high tax countries would then advertise the intangibles. Tax deductions would be reported in high tax countries for royalty payments made by the high tax affiliates to the low tax affiliate and for the advertising expenses of the high tax affiliates. Royalty payments would be reported as taxable income in the low tax countries. Thus, it appeared that deductions were being claimed for MNEs for investments made in high tax countries while taxes were being paid on income stemming from such investments in low tax countries.

When a taxpayer licenses an intangible to an independent taxpayer, the value of the royalty payment and the resulting income on which the licensee and the licensor are liable for tax are both determined by the market. Since related taxpayers have common interests and do not exchange intangibles with one another in the market, it is often unclear how taxable income from such intangibles should be allocated among them. Governments around the globe look to the arm’s length principle to address this problem. Specifically, they value royalty payments between related taxpayers with reference to royalty payments between independent taxpayers for simi-
lar intangibles under similar circumstances. Once royalty payments between the related taxpayers are determined, the allocation of taxable profit is known.

A problem arises if an intangible that is licensed between related parties is unique and there are no royalty payments between independent taxpayers to reference. For example, license agreements for marketing intangibles between independent firms generally do not require licensees to invest significant amounts in advertising. As a result, authorities generally can not look to such agreements to determine the royalty high tax affiliates should pay low tax affiliates to license the marketing intangibles. Instead, the U.S. government estimates the royalty payments that the related taxpayers would have agreed to if they had been independently rather than commonly owned.

Many question the wisdom of following the arm’s length principle when the transactions of related and independent taxpayers are dissimilar. For example, when it was first suggested that the principle be used to address the marketing intangibles problem, a critic poked fun of the proposal by asking:

“If I had a brother, would he like cheese?”

To some, asking what royalty the related parties would agree to if the parties were unrelated is a bit like asking whether one’s brother would like cheese if one had a brother.

Although the U.S. government and the Organization for Economic Cooperation and Development (OECD) published guidance on marketing intangibles during the 1990s, the United States is currently considering this issue again in the context of regulation projects involving the transfer pricing of services and intangibles. The purpose of this paper is to suggest that net present value estimates be used to determine the royalty an affiliate that advertises an intangible that it licenses from a related affiliate would be willing to pay if the two were independently owned. If the two were truly independently owned, both would be likely to use net present value estimates to determine a mutually acceptable royalty payment.

The paper is organized as follows. Issues raised by existing U.S. and OECD guidance are discussed in the second section. The third section illustrates how the net present value method can be used to estimate royalty payments between related parties for marketing intangibles, like trademarks of fancy cheeses. The fourth section concludes.

ISSUES RAISED BY EXISTING GUIDANCE

The United States and the OECD each issued guidance on marketing intangibles during the 1990s. The U.S. Treasury Department and the Internal Revenue Service (IRS) published comprehensive transfer pricing regulations in 1994 that included a provision in §1.482–4(f)3 that addresses issues raised by marketing intangibles. In 1995, the OECD published Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. Chapter 6 of these guidelines addresses the amount of compensation a taxpayer should receive to advertise in its local market a trade name or trademark that it does not own.

U.S. Guidance

Published views of commentators like Mentz and Carlisle (1997), Ossi (1999), and de Hosson (2000) suggest that the current guidance in §1.482-4(f)3 lacks clarity, possibly as a result of compromises struck during the regulatory process. When the guidance was drafted, there was no consensus within the legal community about the appropriate principle for attributing taxable profit from a marketing intangible among legal entities of a MNE. Some believed legal ownership principles in intel-
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Intellectual property law should be used. Others preferred to ignore legal ownership and look exclusively to the functions performed and risks borne in the development of the intangible.

Ossi (1999) argues that intellectual property law principles should be used to attribute taxable profit among related taxpayers. The determination of ownership of any asset under the tax law is complex. Generally, the legal owner of an asset is considered the tax owner unless another taxpayer has rights with respect to the asset that allow it to enjoy greater economic benefits, and bear a greater amount of risk, with respect to the asset. If, for example, a licensor is the legal owner of and maintains the right to dispose of the trademark it has licensed then it is considered the owner of the trademark for general tax purposes. In Ossi’s opinion, this principle should be used in the transfer pricing context to determine tax ownership of intangibles and, incidentally, the taxpayer to which income from intangibles should be attributed.

Text and an example contained in the 1994 guidance recognize the importance of intellectual property law principles to the determination of tax ownership. Specifically, the guidance identifies “The legal owner of the right to exploit an intangible” as a tax owner of an intangible generally. In addition, the guidance contains a series of examples that begin as follows:

FP, a foreign producer of cheese, markets the cheese in countries other than the United States under the tradename, Fromage Frere. FP owns all the worldwide rights to this name ... In 1995, FP decides to enter the U.S. Market and incorporates U.S. subsidiary, USSub, ... to develop the name Fromage Frere in the United States. Example 4 of this series concludes that USSub is the tax owner of U.S. income from the tradename, Fromage Frere, because it owns the right to exploit Fromage Frere in the United States.

Mentz and Carlisle (1997) and Ossi (1999), however, find the guidance problematic. In their opinion, the language confuses the right to use property with ownership rights. USSub, in example 4, is a licensee. As a result, it owns the right to use Fromage Frere in the U.S. market. FP owns the worldwide rights to Fromage Frere. Since the legal owner of a trade name is generally considered its tax owner, Mentz, Carlisle, and Ossi would identify FP, not USSub, as the tax owner of income stemming from Fromage Frere.

Advocates of the arm’s length principle are quick to point out, however, that inappropriate results could occur if all taxable income stemming from the intangibles of multi-jurisdictional companies is assigned to the legal owner. To mitigate taxes, such companies might simply assign legal ownership of their intangibles to an entity in a no-tax jurisdiction. For example, in the article, “More States Eye Trademarks as Tax Trove,” Feffer (1994) describes how Toys R Us assigned legal ownership of its trademark, Geoffrey the Giraffe, to a holding company in Delaware in the early 1990s. No production or sales took place in Delaware. The holding company was established to license use of Geoffrey to stores in other U.S. states in exchange for royalty payments. Through this organizational makeup, Toys R Us mitigated its aggregate state tax liability by locating income from the trademark in Delaware, a jurisdiction with no state tax on corporate income, and claiming deductions for royalty payments in states that tax corporate income.

In recognition of a similar possibility for inappropriate results at the federal level, additional text and an example were included in §1.482-4(f)3 to recognize the importance of looking to functions performed and risks borne in the development of the intangible. Specifically, the current provision also indicates that “Allocations may be made to reflect arm’s length consideration for assistance pro-
vided to the owner of an intangible in connection with the development or enhancement of the intangible.” In addition, the third example in the series on trademarked cheese states:

\[
\ldots \text{the expenses incurred by USSub are significantly larger than the expenses incurred by independent distributors under similar circumstances. FP does not reimburse USSub for its expenses.}
\]

The example concludes that some taxable income derived from U.S. sales of Fromage Frere should be taxable in the United States. Specifically, it argues that the reason USSub’s expenses are higher than those of independent distributors is that USSub performed a marketing service for FP for which it must receive arm’s length compensation.

In sum, the current guidance in §1.482-4(f)3 lacks clarity. It suggests that two principles, legal ownership and the arm’s length standard, should be considered when allocating taxable income from marketing intangibles among related entities of a MNE. However, it is not obvious from the guidance how the two principles should be used in concert. At first blush, it appears that taxpayers could achieve different results under the two principles. All income, for example, could be allocated to an entity that holds legal title to an intangible under the legal ownership principle. Under the arm’s length principle, one could allocate income among the entities based on functions performed and risks assumed.

### OECD Guidelines

In 1995, the OECD also issued guidelines responding to perceived tax avoidance by MNEs involving marketing intangibles. Delegates to the OECD working group that deals with these issues side stepped the question of identifying the legal owner of an intangible. Instead, they focused on the amount an enterprise that markets a trademark or trade name that it does not own should be compensated for its marketing activities.

In the guidelines, they suggest that the amount of compensation that the non-owner should receive should depend on the functions it performs, the risks it bears, and the assignment of legal rights and obligations under the license agreement. If, for example, the non-owner markets the intangible but does not bear risk, the OECD suggests that it should be paid a normal return for its marketing services. If, however, the non-owner markets the intangible and bears risk, it might be entitled to some of the additional return attributable to the intangible.

Mentz and Carlisle (1997), Ossi (1999), and de Hosson (2000) also comment on the OECD guidelines. They seem to agree that marketing affiliates should be compensated for promoting trademarks or trade names that they do not own. They also seem to concede that an affiliate may be entitled to a portion of the non-routine return attributable to an intangible if the affiliate bears risk. Mentz and Carlisle (1997), however, point out that it is unclear from the OECD guidelines how the fraction of non-routine return that should be attributed to the affiliate should be determined.

Ossi (1999) also points out that in actual, arm’s length, long-term, exclusive license agreements, licensees often capture little to no non-routine profit associated with a marketing intangible. Specifically, he points to a 28-year license agreement between two independent companies, Japan’s Descente and Germany’s Adidas. Under the terms of the agreement, which commenced in 1970, Descente received the rights to manufacture and sell Adidas-brand products in Japan (Nikkei Business Report, 1998). In return, it paid Adidas brand usage fees. During the 1980s, Descente invested its own money to develop high quality products for Japanese consumers and to adver-
tise the name, Adidas, in Japan. Between 1990 and 1996, the investments appeared to be paying off. Descente’s sales nearly trebled from 15 billion yen to 43 billion yen. In 1998, however, Adidas terminated the license agreement and established a wholly owned subsidiary to sell its products in the Japanese market. As a result, Adidas was able to capture any remaining return due to Descente’s investments.

**USING THE NET PRESENT VALUE METHOD TO ESTIMATE RELATED PARTY ROYALTIES**

When allocating income from marketing intangibles, it is important to compensate non–owners for their advertising service as the OECD suggests. It is also important to compensate the legal owner of an intangible for the opportunity cost of foregoing the right to exploit the intangible under a license agreement. Thus, there are two transactions that must be accounted for in the allocation and any royalty the non–owner pays for the right to exploit the intangible should net the value of the two transactions.

After the two transactions are netted, the value of the royalty should depend largely on three factors. The first is the allocation of functions under the license agreement. In general, the net royalty payment should be negatively correlated with the number of functions undertaken by the licensee. If, for example, the licensee only distributes the trademarked good, it should pay a higher royalty then if it distributes the good and advertises the trademark in its market. The second factor is the allocation of risk of under the license agreement. The relationship between the number of risks undertaken by the licensee and the value of the net royalty payment depends on the outcome of the risk. Finally, the opportunity costs of the legal owner should influence the value of the net royalty. Suppose the intangible is widely known prior to the license agreement as a result of a global advertising campaign financed by the legal owner. Since some of the benefits of that campaign are yet to be realized in the licensee’s market, some fraction of future sales in that market should be attributed to the legal owner. The value of these unrealized benefits is commonly referred to as the business opportunity. Generally, the value of the net royalty payment increases with the value of the business opportunity.

In the remainder of this section, I demonstrate how the net present value method can be used to account for these three factors when determining the arm’s length royalty that a licensee should pay a related licensor for a marketing intangible. The assumptions used to apply the method are explained first. Next, the net royalty that a licensee should pay when it is entitled to only a normal return for its functions is determined. Finally, I illustrate how the net royalty should be determined when the licensee is entitled to both a routine return for its functions and some of the non–routine return associated with the marketing intangible.

**Assumptions**

Suppose a parent company of a foreign MNE owns the worldwide rights to a marketing intangible, a trademark. It licenses the right to exploit the trademark in the United States to a wholly owned subsidiary. The exploitation involves two functions, production and distribution. Production includes both producing final goods and affixing the trademark to those goods. Distribution involves both marketing and selling the final goods in the United States. For simplicity, assume that the trademark is the only intangible used to sell final goods in the U.S. market. There are also two risks associated with the exploitation of the trademark: unexpected distribution costs and unexpected sales. Suppose further that the parent and the
U.S. subsidiary specify responsibility for the two functions and the two risks in a contract prior to undertaking the license agreement. They also project and document the following information about the U.S. market at the time of the agreement: the expected rate of return on investments, the discounted present value of the business opportunity, the value of production and distribution costs, and the discounted present value of future U.S. sales of trademarked goods. During the agreement, the responsibilities are completed as specified in the contract.

To keep things simple, assume there are only two time periods associated with the exploitation of the trademark in the U.S. market. During the first period, the parties invest money in the production and distribution functions. In the second period, sales occur. A two time period model implies that any investments made to advertise the trademark in the U.S. market by the U.S. sub have a one period useful life.

Let the projected cost of investing in the production and distribution functions to sell the trademark goods in the U.S. market be represented by $c_p^p$ and $c_p^d$, respectively. The projected future value of sales in the U.S. is $s_p$. The projected value of the trademark in the U.S. market at the time of the agreement is $b$. Note $b$ is intended to represent the business opportunity of the legal owner. Finally, let $r$ be the weighted average cost of capital of the MNE at the time of the agreement.

The discounted net present value of investing in the production and distribution of trademarked goods in the U.S. market is equal to the discounted value of the business opportunity at the time of the agreement,

$$\text{NPV} = -c_p^p - c_p^d + \frac{s_p}{(1 + r)} = \frac{b}{(1 + r)}.$$  

This implies that projected sales of the trademarked good are correlated positively with the value of the business opportunity. In other words, the greater the business opportunity (the greater the worldwide recognition of the trademark prior to the agreement), the higher sales are expected to be under the agreement.

**Routine Return is Attributed to U.S. Sub**

If actual distribution costs and actual U.S. sales are as projected, manipulation of equation [1] yields the total taxable profit of the MNE that stems from U.S. sales of the trademarked good:

$$s_p - c_p^p - c_p^d = b + r(c_p^p + c_p^d).$$  

Equation [2] suggests that the MNE is liable for tax on the projected value of the business opportunity, $b$, and the expected return on both the production and distribution functions, $r(c_p^p + c_p^d)$. Implicit in equation [2] are the assumptions that nominal production and distribution costs are fully deductible and that the MNE is 100 percent equity financed.

The allocation of the total taxable profit between the parent and the U.S. subsidiary depends on the allocation of the production and distribution functions under the terms of the license agreement (Table 1). If, as in license agreement 1, the parent agrees to perform the production function and the subsidiary agrees to perform the distribution function, then the return to both functions should be attributed to the subsidiary, $r(c_p^p + c_p^d)$. If, instead, the subsidiary agrees to produce and to distribute the goods in the U.S. market, as is the case in license agreement 2, then the return to both functions should be attributed to it, $r(c_p^p + c_p^d)$. In either case, as is suggested in the OECD guidelines, the subsidiary should receive a normal return as compensation for its activities when actual sales and costs are the same as projected sales and costs. The value of the
business opportunity, \( b \), under either allocation of the production and distribution functions, should be attributed to the parent since it incurred investments prior to the agreement to generate worldwide recognition for the trademark.

If actual costs and sales are as projected, the net arm’s length royalty payment that U.S. sub should pay to foreign parent as compensation for the right to exploit the trademark is the amount that when subtracted from U.S. sales provides the sub with a routine return for its functions.

Under license agreement 1 in Table 1, U.S. sub performs only the distribution function. It follows that a royalty payment of sales less the cost of production and distribution, the value of the business opportunity, \( s_p - (c_p^p + c_p^d) - b - r c_p^p \), leaves the U.S. sub with the expected return to distribution, \( r c_p^d \).

Under license agreement 2, U.S. sub performs both the distribution and production function. Since the royalty payment is negatively correlated with the number of functions performed by the licensee, it follows that U.S. sub should pay a smaller amount. A royalty payment of sales less the cost of production and distribution and the value of the business opportunity, \( s_p - (c_p^p + c_p^d) - b \), leaves U.S. sub with expected return to both functions, \( r(c_p^p + c_p^d) \).

Routine Return and Fraction of Non–Routine Return Attributed to U.S. Sub

The total taxable income of the MNE can also be determined from equation [1] when actual distribution costs and actual sales differ from projections. Let the actual value of distribution costs and the actual value of sales be characterized by \( c_d^a \) and \( s_a \), respectively. Also continue to assume that the MNE is 100 percent equity financed and that actual production and distribution costs are 100 percent deductible. Under these assumptions, manipulation of equation [1] yields:

\[
[3] \quad s_a - c_p^p - c_d^a = r(c_p^p + c_p^d) + b + c_d^a - c_d^p + s_a - s_p^d.
\]

This equation suggests that total taxable income of the MNE now stems from four sources. The first two are the same as in the previous section, the expected return to the two functions and the value of the business opportunity. The expected returns to the two functions are routine.

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**TABLE 1**

**ALLOCATION OF TAXABLE PROFIT WHEN ACTUAL COSTS AND SALES ARE AS EXPECTED**

<table>
<thead>
<tr>
<th>License agreement</th>
<th>Functions performed</th>
<th>Risk assumed</th>
<th>Taxable income</th>
<th>Net royalty payment</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Parent</td>
<td>Subsidiary</td>
<td>Parent</td>
<td>Subsidiary</td>
</tr>
<tr>
<td></td>
<td>Production</td>
<td>Distribution</td>
<td>( r c_p^p + b )</td>
<td>( s_p^d - r c_p^d )</td>
</tr>
<tr>
<td></td>
<td>Production &amp; distribution</td>
<td>Unexpected distribution costs</td>
<td>( b )</td>
<td>( s_p^d - r c_p^d )</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Unexpected sales</td>
<td>( r c_p^d )</td>
<td>( s_p^d - r c_p^d )</td>
</tr>
</tbody>
</table>

Key to notation:

U.S. MNEs weighted average cost of capital (\( r \)), projected production costs (\( c_p^p \)), projected distribution costs (\( c_p^d \)), projected sales (\( s_p \)), and projected value of business opportunity (\( b \)).
returns. The value of the business opportunity is part of the non–routine return associated with the trademark. The third and fourth sources of income are the risky return to distribution, \( c_p^d - c_a^d \), and the risky return to sales, \( s_p - s_p' \). Like the value of the business opportunity, these latter two sources are non–routine returns generally attributed to the value of the trademark.

The allocation of the total taxable income between the parent and the U.S. subsidiary depends on the allocation of the responsibility for the two functions and for the two risks under the license agreement. If, for example as in the two license agreements characterized in Table 2, responsibility for both functions is assigned to the subsidiary, then the expected return to both, \( r(c_p^p + c_p^d) \), should be attributed to it. The value of the business opportunity, \( b \), should always be attributed to the parent since it is the legal owner of the trademark and the party responsible for making it widely known prior to the agreement. The returns to the distribution cost risk and the sales risk should be attributed to the party assigned responsibility for them in the agreement. If, as in license agreement 1 in Table 2, the parent undertakes the risk of unexpected distribution costs and the subsidiary undertakes the risk of unexpected sales, then the risky return to distribution, the difference between projected and actual distribution costs \( (c_p^p - c_p^d) \), should be attributed to the parent and the risky return to sales, the difference between actual and projected sales \( (s_p - s_p') \), should be attributed to the subsidiary. If, as in license agreement 2, the subsidiary is assigned responsibility for both risks, then it should be attributed the risky return to both, \( (c_p^p - c_p^d) + (s_p - s_p') \).

As Table 2 indicates, the fraction of non–routine return that should be attributed to the subsidiary depends on the number of risks assigned to it in the license agreement and the outcome of those risks. The total non–routine return associated with the trademark when actual costs and actual sales differ from projections is: \( b + (c_p^p - c_p^d) + (s_p - s_p') \). The value of the business opportunity should always be attributed to the parent. The remainder should be allocated between the parent and the subsidiary based on the assignment of risk under the license agreement. If, as in license agreement 2 in Table 2, responsibility for all risks are assigned to the subsidiary, then all the remainder of the non–routine return should be attributed to it.

<table>
<thead>
<tr>
<th>License agreement</th>
<th>1</th>
<th>2</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Functions performed</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Parent</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Subsidiary</strong></td>
<td>Distribution &amp; production</td>
<td>Distribution &amp; production</td>
</tr>
<tr>
<td><strong>Risk undertaken</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Parent</strong></td>
<td>Unexpected distribution costs</td>
<td>( b )</td>
</tr>
<tr>
<td><strong>Subsidiary</strong></td>
<td>Unexpected sales</td>
<td>Unexpected distribution costs &amp; unexpected sales</td>
</tr>
<tr>
<td><strong>Taxable income</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Parent</strong></td>
<td>( b + (c_p^p - c_p^d) )</td>
<td>( b )</td>
</tr>
<tr>
<td><strong>Subsidiary</strong></td>
<td>( r(c_s^p - c_s^d) + (s_p - s_p') )</td>
<td>( r(c_s^p - c_s^d) + (c_s^p + c_s^d) + (s_p - s_p') )</td>
</tr>
<tr>
<td><strong>Royalty payment</strong></td>
<td>( s_p - (c_s^p + c_s^d) - b - (c_p^p - c_p^d) )</td>
<td>( s_p - (c_s^p + c_s^d) - b )</td>
</tr>
</tbody>
</table>

**Key to notation:**

U.S. MNEs weighted average cost of capital \( (r) \), projected production costs \( (c_p^p) \), projected distribution costs \( (c_p^d) \), projected sales \( (s_p) \), projected value of business opportunity \( (b) \), and actual distribution costs \( (c_p^d) \).
The relative magnitude of the business opportunity and the remainder depends on the actual outcome of costs and sales. If actual distribution costs are lower than expected and actual sales are higher than expected, then the remainder will be positive and possibly large relative to the value of the business opportunity.

The net arm’s length royalty payment that U.S. sub should pay to foreign parent as compensation for the right to exploit the trademark is the amount that when subtracted from U.S. sales provides the sub with a routine return for its functions and the appropriate fraction of non-routine return associated with the trademark. Under license agreement 1, U.S. sub performs both functions and bears responsibility for unexpected sales risk. It follows that a royalty payment of actual sales less the actual cost of both functions, the value of the business opportunity, and the risky return to distribution, \( s - (c_p^r + c_a^d) - b - (c_p^d - c_a^d) \), leaves the U.S. sub with the expected return to the two functions and the risky return to sales. Under license agreement 2, U.S. sub is responsible for both functions and both risks. A royalty payment of actual sales less the actual cost of both functions and the value of the business opportunity, \( s - (c_p^r + c_a^d) - b \), leaves U.S. sub with expected return to both functions and the risky return to both distribution and sales.

**CONCLUDING REMARKS**

Published commentaries by Mentz and Carlisle (1997), Ossi (1999), and de Hosson (2000) suggest that there is no consensus in the legal community about the proper principle for attributing taxable income from marketing intangibles (like the trademark for a fancy cheese) among related entities of a MNE. Some advocate use of the arm’s length standard fosters neutrality in the tax treatment of multinational and national companies. However, in the case of marketing intangibles, it is difficult to administer because transactions between independent companies cannot be used reliably to price transactions between related taxpayers. Independent licensees, unlike related licensees, generally do not invest significant amounts to advertise an intangible that they do not own. In contrast, the principle of legal ownership is simple to administer. Tax authorities attribute profit from an intangible to its legal owner. However, under the principle of legal ownership, a company that operates in multiple jurisdictions can avoid taxes by assigning legal title to all of its intangibles to an entity in a no tax jurisdiction.

The objective of this paper is to propose that tax authorities use the net present value method to determine the royalty that related taxpayers would agree to if they were independently rather than commonly owned. This method is consistent with the arm’s length principle since it is a tool that independent companies in similar circumstances would likely use to determine a mutually acceptable royalty payment. In addition, the method is consistent with the principle of legal ownership because it provides an avenue for valuing the property rights of the legal owner of an intangible.

A simple model was presented in this paper to illustrate how the net present value method could be used to determine the royalty payment that a licensee would pay a related licensor at arm’s length for a marketing intangible. In the model, royalty payments were determined such that a licensee received compensation for any functions it performed under the license agreement, like advertising, and the licensor received compensation for any business opportunities that it forewent by entering into the agreement rather than exploiting the intangible on its own. Unfortunately, it is not obvious how the
simple model can be used to value the net royalty payment in all real world complex transactions. In future work, the model should be extended to deal with the following possible complexities: a licensor can exercise the right to terminate a license agreement, tax authorities may apply the commensurate with income standard, the licensee and the licensor share the risk that sales may differ from expectations, and the related parties are financed with both equity and debt.

Acknowledgments

I would like to thank without implicating Russell Kwiat, William Randolph, Donald Kiefer, Randall Weiss, and Rocco Femia for helpful comments and suggestions. The views expressed in this paper are my own and should not be construed to be those of the U.S. Treasury Department.

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