# Licensing As a Profit Center

*Developing and licensing intellectual property between related companies can turn department into profit center*

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Organizing a trademark and identity function for a global company and focusing its marketing image offer rare opportunities and challenges. If this corporate restructuring can produce a profit center, what could be better?

Trademarks present something of a paradox. On the one hand, trademarks and trade names are the most familiar forms of intellectual property. As legal symbols of reputation and goodwill they are indispensable to identification. This function makes them one of the prime tools in any marketing and commercial effort. On the other hand, most businessmen, including lawyers, view trademarks as a narrow, esoteric legal area.

Trademarks, however, like other intellectual property, touch upon and transcend various corporate functions. As a result, corporate planners have many options including the means to create a profit center based on licensing even in related company transactions. The checklist at the end of the article seeks to survey promising backgrounds for the intercompany licensing of intellectual property.

Although, factually, the checklist is based on trademark use, it can apply *mutatis mutandis* to other species of intellectual property. But, first of all, the intellectual property must be developed. Following is an approach TRW Inc. used to pull together a corporate trademark and identity program.

## BUILDING A FAMOUS MARK: THE TRW BACKGROUND

TRW Inc. is a diversified multinational company providing high-technology products and services to transportation, electronics, aerospace, and industrial and energy markets. The company has more than 300 facilities in 25 countries and employs about 93,000 people worldwide. In 1984 company sales were approximately $6 billion.

Although the company goes back to 1901, the TRW mark is of more recent vintage. The TRW name and mark was first used in the early 1960s.

At first it was used informally as the acronym of Thompson Ramo Wooldridge Inc., which was the former name of the corporate predecessor arising out of the merger of the Ramo Wooldridge Corporation with Thompson Products. In 1965 the company formally changed its name to TRW Inc. This encouraged broader use of the overbrand TRW in conjunction with the various secondary marks.

To reach its broadened constituencies, the company also developed a landmark corporate advertising campaign which portrayed TRW as a high-technology, future-oriented company. As a result of these promotional activities, recognition in the United States increased to the point where TRW has been cited as an example of a well-known company name. Successful as it has been, however, the advertising campaign has been comparatively modest in scope and cost. What is more, the greater part of the promotional budget was traditionally spent on divisional and product promotions often featuring secondary marks to the exclusion of "TRW."

## MARKETING, IDENTITY AND LEGAL ISSUES

To move successfully into the 1980s, the company needed a comprehensive marketing and identity strategy. Several factors had been projecting a blurred corporate image.

TRW's decentralized corporate structure acted like a double-edged sword: it allowed the company to enjoy the benefits of strong, front-line decision making, but it hindered a unified and distinctive worldwide marketing image.

The diversity and fragmentation in divisional and subsidiary names and brands is a good example. Over the years, TRW bought a number of U.S. and foreign companies each of which had its own history and identity, as well as individual names and brands. A number of these were well established in limited markets. The confusing array of names used by the many operating units obscured the company's overall identity and prevented individual units from making the most of their connection with TRW.

Many operating units had no clear philosophy, no set of objectives or guidelines to ensure that the company's identity was clearly focused. In fact, the units seldom attempted to sell products under the TRW name. For the most part, they relied on secondary marks for product advertising and unit identification.

### Lack Style

Even when it was used, the company logo lacked the style associated with a high-technology company and was not sufficiently well known to acquire distinctiveness in some overseas countries. To make matters worse, the in-

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consistent and often poor-quality graphics produced by various operating units contrasted with the image established by the corporate advertising campaign.

The company's traditional focus on engineering and production presented another obstacle. In many cases, attention was focused on manufacturing rather than marketing. Indeed, for many years there seemed to be little need to actively promote TRW. The company enjoyed the advantage of being a market leader in many of its businesses and was well known to key customers. As a result, working hard to market TRW as a single entity was not regarded as a high priority. Besides, it was argued, why tout a company that sells to a few original equipment manufacturers and produces many complex, high-technology products?

Because the overall corporate marketing and identity discussion revolved around the TRW name and mark, it was necessary to review and enhance the protection of this intellectual property. Basically, more effective use of the mark was required to promote recognition and consolidate protection. It was also desirable to standardize legal requirements throughout the company and to secure additional trademark registration coverage in expanding markets. The most serious challenge was to raise trademark consciousness.

As other legal entities, primarily foreign subsidiaries, also wanted to come under the TRW marketing umbrella, formal trademark license agreements had to be considered. This raised an additional set of fiscal law issues, such as whether to charge royalties between related companies, how to price those royalties, and how to handle the inevitable tax and royalty repatriation questions.



## REGULATING ROYALTIES BETWEEN RELATED COMPANIES

A multinational corporation with a number of subsidiaries, including foreign ones, must set intercompany pricing policies to properly allocate the use of its resources. Since pricing reflects the financial impact of the business transaction, documentation is necessary for legal purposes such as where disclosure to governmental authorities is required.

Through price planning, multinational corporations have the incentive to shift income between jurisdictions to take advantage of different corporate tax rates to minimize their taxes. This does not necessarily result in abuse. Indeed, a study by the U.S. General Accounting Office found that only 11 of 403 adjustments accounted for more than half of the adjusted total. Still, this represents an area of concern and lends itself to audits.

In a number of countries, principally in Latin American, royalty payments between related companies have been severely restricted and even prohibited. Governmental policy views technology transfers as exploitative and the pejorative phrase "transfer pricing" typifies this attitude.

Even more alarming, however, is the fact that this trend is not confined to Latin America. In the majority of countries there are a number of fiscal devices such as exchange, tariff, and tax controls that regulate such payments. For example, the OECD Fiscal Affairs Committee published a report in 1979 entitled "Transfer Pricing and Multinational Enterprises," which called for an arm's-length approach to intercompany pricing. Because such a relationship may not in fact exist, various methods of ascertaining an arm's-length price are explored. But in the modern economic system of multinational corporate business, a true arm's-length price can rarely be identified.

Even though the recommendations are somewhat academic, the OECD report was a milestone. German tax authorities, for example, viewed it as an official expert opinion that reflected the understanding of various tax authorities and adopted written auditing instructions.

### Reminiscent

In many ways the OECD report is reminiscent of U.S. tax rules. Under Section 482 of the Internal Revenue Code, taxes may be imputed in the event that intellectual property is licensed without an appropriate royalty. This section was adopted back in 1934 and can be called the grandfather of intercompany royalty regulation. The regulations under Section 482 were published in 1978. They outline methods for taxpayers to determine the price of property transferred to affiliates whenever the transaction is not at arm's length. These methods, which the OECD generally follows, are in descending order of preference: the comparable uncontrolled price method, the resale price method, the cost-plus method, and if all else fails, any other ad hoc method that yields a constructive price.

The basic criticism to constructive pricing in royalty regulation has been the uncertainty and the administrative burdens it has fostered. What's more, because few transactions are alike, these methods do not offer concrete help, let alone a safe haven. Experts have suggested that the U.S. Treasury Department reconsider the appropriateness of the arm's-length standard since today's economic world is more complex than in 1934. It is significant that the GAO study found that only 3%, or 12 out of 403 transactions, were based on a true arm's-length price.

The net effect is that this regime fosters discrepancies from jurisdiction to jurisdiction. A licensor may find itself facing an imputed tax at home at the same time that another country is denying the payment of the corresponding royalty. Even when the royalty is allowed abroad, it is expected that various authorities will price the transaction differently.

## COMPLIANCE COMPLICATIONS

Considering that various tax authorities may not agree on pricing the transfer and are hard pressed to disagree in order to raise additional revenues, the taxpayer is caught in a difficult position. If the right balance is not struck and if, in everyone's view, the full price is not charged, a company can use competent authority proceedings to harmonize matters. However, this presents additional complications that lead to escalation, bringing into the same case a number of foreign governmental authorities.

The basic challenge is to plan and defend against allegations of royalty underpricing at home and overpricing abroad. Although the tax reduction mechanism varies, the allegations emanate from the same theoretical charge: that the property is undervalued at home to minimize the tax on its transfer and overvalued abroad to maximize the deduction for its use.

Clearly, compliance requires careful planning and im-

plementation of the intercompany intellectual property royalty. And in this regard, a complete company effort is needed to reflect the views of the corporate departments involved. Furthermore, the record should be clear. Good documentation is an administrative burden, but it is indispensable to chronicle legal and pricing history.

Throughout this process, the role of the intellectual property lawyer as the in-house expert is a central one. This also puts the intellectual property lawyer in a position of seeing and implementing opportunities that may be available. So, there may be a bright side after all.

## INTERCOMPANY PRICING OF INTELLECTUAL PROPERTY: PLANNING OPPORTUNITIES

Depending on the particular facts, royalties may allow the company to use foreign tax credits provided under the U.S. Internal Revenue Code to offset double taxation in international operations.

Let's review a hypothetical case to see how this process works. The basic assumptions here are that there are foreign excess tax credits, the foreign jurisdiction has a withholding tax on dividends, and we are considering a 1% royalty rate for the intercompany licensing of the intellectual property.

| | HYPOTHETICAL Before 1% Royalty | | After 1% Royalty |
|---|---|---|---|
| FOREIGN SUB. | | | |
| Sales | 100.00 | | 100.00 |
| Costs | 80.00 | (+$1.00 Royalty) | 81.00 |
| Profit before tax | 20.00 | | 19.00 |
| Tax-48% | 9.60 | | 9.12 |
| Profit after tax | 10.40 | | 9.88 |
| Dividend to U.S. | 10.40 | | 9.88 |
| W/H tax on dividend-15% | 1.56 | | 1.48 |
| | | | 8.40 |
| | | Add Royalty | 1.00 |
| Net Cash to U.S. | 8.84 | | 9.40 |
| U.S. PARENT | | | |
| Dividend Grossed-Up | 20.00 | Add Royalty | 20.00 |
| U.S. taxes before credit | 9.20 | | 9.20 |
| Foreign taxes pd 11.16 | | 10.60 | |
| Maximum credit 9.20 | 9.20 | 9.20 | 9.20 |
| U.S. taxes paid | -0- | | -0- |
| Excess foreign Cr. 1.96 | | 1.40 | |
| Taxes Paid | | | |
| Foreign | 11.16 | | 10.60 |
| U.S. | -0- | | -0- |
| Total Tax Burden | 11.16 | | 10.60 |

The bottom line is that the new deduction lessens foreign taxes. The fact that royalties receive more favorable treatment than dividends, which would otherwise be paid, also results in less taxation. The net effect is increased cash flow to the parent, which can now use its excess foreign tax credits.

In summary, a 1% royalty on $100 million in sales would result in a $460,000 profit after tax, and on sales of $1 billion, the result would be $4.6 million. Depending on the corporate net return, such amounts can be quite significant. At the very least, they might cover the costs of the intellectual property function.

## THE TRW TRADEMARK AND IDENTITY PROGRAM

The TRW program was market driven. Over the years the company had started to move into global markets that required corporate backing, worldwide sourcing, and marketing synergism. As the company's vision broadened and it began to serve new constituencies, it needed to become better known in financial and international markets. What's more, the identity and brand fragmentation that had developed had to be eliminated.

To enter the global marketing arena and to achieve these goals in an integrated fashion, the company established a comprehensive trademark and identity program. The solution to marketing and legal issues was to achieve maximum use of the TRW mark by employing it as broadly as possible, including licensing and extending its use to foreign subsidiaries.

The identity program has three basic objectives. First, it adopted company wide a new corporate logo, which more accurately reflected the company's modern image. Second, a new company-wide naming system was developed to take advantage of the TRW name and to make businesses more readily identifiable both inside and outside the company by using TRW as the prefix of all related company names. Finally, the identity program seeks to gradually eliminate non-established secondary marks. This will help relieve identity fragmentation and enable the company to concentrate on marketing through its key brands. The extension of the institutional advertising print program abroad complements the program.

The legal side of the program provides the framework to protect the TRW name and mark. Essentially, protection boils down to authorized and proper use. The manner in which the logo is used by all authorized legal entities, including subsidiaries, is regulated comprehensively through a series of written agreements.

All divisions are automatically authorized to use the trademark. Other legal entities that want to use the mark, either as part of their names or in connection with the goods and services they produce, must be formally licensed. In all cases, the logo is used under the guidelines established by the company identity manual, which spells out the precise manner of use. This is important because when the trademark is used correctly, the company's message is reinforced and multiplied many times throughout the world. And that benefits everyone connected with TRW. Needless to say, unauthorized users are prosecuted vigilantly.

The worldwide reorganization of TRW's marketing effort has resulted in considerable cooperation as each unit raises the corporate marketing banner. Toward that end, the company is now focusing its promotional barrage and harnessing its marketing forces. As all of the company's marketing has come under a single masthead the value of the trademark is growing at a more rapid pace. Beyond that, the trademark symbolizes TRW's reputation and goodwill, and, as such, its real value is incalculable. Recognition pays off not only in the customer's perception of TRW as a high-quality manufacturer, but also among other interested parties who consider the com-

pany a good investment, a good corporate citizen, or a reliable supplier.

THE BOTTOM LINE

Integrated goals can only be reached through comprehensive and long-range corporate planning. This requires coordinated and timely implementation that can be intensive at times. Laborious as it is, good documentation in the legal and fiscal area is indispensable. Above all, teamwork is vital as marketing and royalty regulation pose complex interdisciplinary issues for the various corporate functions involved. In these activities the role of the intellectual property lawyer, who is most familiar with the property that is being developed and licensed, is challenging and rewarding.

## BASIC INTERCOMPANY INTELLECTUAL PROPERTY LICENSING CHECKLIST FOCUSING ON TRADEMARKS

- Is the U.S. parent or are the foreign subsidiaries the owner(s) of the name, mark and logo?
- Is the mark registered as a trademark in each key operating country, and, if so, in what form is it registered?
- Are there any other co-existing and unrelated usages or registrations anywhere?
- Are there any legal judgments prohibiting others to use the mark?
- Was the mark ever recognized by a court or a publication as "famous" or "notorious"?
- Does the company use secondary names, marks, and related logos in its worldwide operations together or apart from the primary name, mark and logo?
- Is the mark used corporatewide and worldwide?
- Are subsidiaries using the mark under written license agreements with the parent-owner?
- Are there any unrelated legal entities licensed to use the name, mark or logo?
- Are there effective quality control programs in place in all licensing arrangements with respect to the nature of the product and the usage of the mark?
- What is the historical cost basis of the mark including all other promotional efforts over the years?
- Are there any other related intangibles such as copyrights?
- Which legal entity has paid for such costs?
- What trademark royalties, if any, are paid by the related users of the mark to the owner?
- By the unrelated users?
- What other intellectual property royalties, if any, are paid to the owner by its related companies?
- By unrelated ones?
- What intellectual property royalties does the owner pay for similar properties to its related companies?
- To the unrelated ones?
- What are comparable industry norms for such royalty rates?
- What are the total foreign annual sales and where are they derived from on a country-by-country basis?
- How high are the foreign excess tax credits each year and are they all utilized?