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VALUING TRADEMARKS IN THE CONTEXT OF A §482 INCOME RE-ALLOCATION: DHL CORPORATION AND SUBSIDIARIES V. COMMISSIONER OF INTERNAL REVENUE 76 T.C.M. (CCH) 1122, 1998 WL 906788 (U.S.Tax Ct.)

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Taxation of international business transactions is a complex proposition at best. But, in *DHL Corporation and Subsidiaries v. Commissioner of Internal Revenue*, the Tax Court confused the issue further by disregarding the applicable regulations and fashioning its own method of valuation.

Issues:

How should the sale of a trademark between commonly controlled companies be valued for the purpose of a §482 income re-allocation?[1]

Rules:

Under §1.482 of the Treasury Regulations, the court should choose the 'best method' from among the four possible methods: (1) comparable uncontrolled transaction method, (2) the comparable profits method, (3) the profit split method, or (4) the unspecified

[1] In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible. I.R.C. § 482.

method.[2]

Analysis:

In *DHL* there was a sale of a trademark from the US corporation DHL to its commonly controlled Hong Kong sister corporation DHLI.[3] In transactions of this nature there is the potential to evade US income taxes by charging a below market price and shifting income to a foreign jurisdiction. Section 482 of the Internal Revenue Code allows the IRS to combat this type of tax evasion by allocating the income as if the sale had occurred at an arms length price.[4] In this case, the Service disagreed with the value that DHL and DHLI set on the trademark and made a reallocation. DHL objected and the matter came before the tax court to determine the proper value.[5]

The treasury regulations provide substantial guidance on the proper way to determine value for intangible assets. The court, however, chose to invent a method of its own. Furthermore, in applying its new method, the court made some very questionable financial assumptions. Based on this novel method the court held that DHL was liable for tax on an additional $80 million of income.[6] The court also imposed penalties under §6662 of the Internal Revenue Code. This penalty is in the amount of 40% of the additional taxable income.[7]

I. Introduction

When domestic and foreign companies have common ownership, income shifting between the companies can potentially be a tax subterfuge. Typically this involves recognizing income in low tax foreign jurisdictions that was really earned in the United States. Section 482 of the Internal Revenue Code allows the IRS to reallocate the income and tax the US company appropriately.[8]

A simple example will help to illustrate the application of §482:

A California corporation, (Calco) and a Taiwanese company,

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[2] *See* Treas. Reg. §1.482-4(a) (1994).

[3] *See DHL Corporation and Subsidiaries v. Commissioner of Internal Revenue*, 76 T.C.M. (CCH) 1122, 1998 WL 906788 *13-20 (U.S.Tax Ct.) (Publication page references not available).

[4] *See* I.R.C. § 482.

[5] See *DHL* 1998 WL 906788.

[6] *See id.* at *40.

[7] *See id.* at *52-53.

[8] *See* I.R.C. § 482.

(Taico) are owned by the same individual, (Owner). Taico manufactures electronic components and transfers them to Calco, which distributes them in the US. The components cost Taico $1 to manufacture and ship to the US. Calco incurs $1 each in selling expenses. The components are sold to the customer for $3. If Taico transfers the components to Calco for $2, Taico will realize $1 in profit. If Taico transfers the components to Calco for $1, Calco will realize the $1 profit. Owner gets the profit either way, so he chooses to realize it in Taiwan where he pays minimal tax.

In the above example the US government would be deprived of all income tax revenue from Calco's operations because it allocated profits in a commonly controlled group. If Taico and Calco were unrelated companies they would have agreed on a price, through an arms length negotiation that would have allowed each of them to realize some of the profit. The purpose of §482 is to allow the Service to tax Calco on the profit it should have realized by paying an arms length price.[9]

This paper describes a tax court decision involving the valuation of a trademark transferred between companies under common control and thus subject to §482. In, DHL sold its trademark to its offshore sister company DHLI. Although the trademark was not resold to produce a profit, its use in the business of the DHLI generated profits.[10]

II. DHL v. Commissioner

A. *Background*

1. History of DHL Companies

In 1969 DHL was incorporated in California and entered the document and small package courier business. In 1972 DHLI was incorporated in Hong Kong and conducted a similar business in conjunction with DHL. DHL and DHLI worked together to deliver packages in the US and abroad. DHL handled US operations, and DHLI handled international operations. To the customer the companies acted as a single seamless network under the trademark DHL. From the beginning until the time of the transaction at issue both companies were owned and controlled by the same group of four

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[9] *See* Treas. Reg. § 1.482-1(a) (1994).

[10] See *DHL* 1998 WL 906788 at *13-20

individuals.[11]

2. Transaction with Foreign Investors

In the late 1980's the owners began seeking a merger partner for strategic reasons, and as a way to monetize some of their assets. In 1988 they received an initial offer from a consortium of international investors consisting of Japan Air Lines Co., Nissho Iwai Corp., and the German airline Lufthansa.[12] After extensive negotiations, the following transaction was agreed upon.

The owners of DHL/DHLI transferred all of the assets of DHLI and the worldwide DHL trademark (subject to a 15-year reservation of the US rights) to Newco. In exchange they received 42.5% of Newco stock. The foreign investors paid $284 million to acquire a 57.5% interest in Newco. This means that DHLI and the DHL trademark were valued at approximately $500 million in total. For tax purposes, $20 million of the price was allocated to trademark value, and DHL recognized revenue in this amount in 1992.[13]

Newco and DHLI continued to work together as a single network for package delivery. The original owners retained full ownership and control over DHL and were actively involved as directors in Newco.[14]

3. Issues at trial

The main issue presented at trial was the value of the DHL trademark.[15] The court had to analyze the value of the DHL trademark sold by DHL to Newco to see if the price paid for it fairly represented an arms length price. Section 482 authorized the Secretary to reallocate income among controlled corporations where he determines that it is "necessary in order to prevent evasion of taxes."[16] If DHL received less than the full value, than it failed to recognize the appropriate amount of taxable income. As in the Calco example above, a sale for less than full value would have the effect of shifting income to an offshore company and evading US tax.

While the case also decided other issues, they do not bear directly on trademark value and will not be addressed in this paper.

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[11] See *id.* at *2-8.
[12] See *id.* at *13.
[13] See *id.* at *16-18.
[14] See *id.* at *19-20.
[15] See *id.* at *24.
[16] I.R.C. § 482.

B. Regulations

The statute states specifically that "in the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible."[17] Further standards for determining value are contained in the regulations.[18]

1. The 1968 and 1994 Regulations

The regulations interpreting §482 are divided in two sections. §1.482-1A, 2A are the controlling regulations for transactions prior to 1993.[19] As the tax year at issue is 1992, it is these regulations to which the court cites in the opinion. The regulations promulgated in 1994 are contained in §1.482-1-8.[20]These regulations are relevant because, §1.482-1(j)(2) allows the taxpayer to elect to apply the 1994 regulations retroactively to tax years prior to 1993. Also, as the statute had not been amended, the subsequent regulations can be read as a clarification of the 1968 regulations. Both sets of regulations are based on the premise that the purpose of §482 is to ensure that transactions between commonly controlled entities receive the same tax treatment as similar transactions between uncontrolled entities.[21]The appropriate standard for evaluating transactions is the "arms length standard."[22] This means that the transaction should have the same result as if an uncontrolled entity had negotiated the terms with another uncontrolled entity in an arms length transaction. For this reason the regulatory methods of valuation all draw on data from actual uncontrolled market transactions as much as possible.

2. Valuation Methods Under the 1968 regulations

The 1968 regulations state that comparison to a transaction between uncontrolled parties is the preferred method , and should be used whenever possible.[23] In this method, an arms length price is determined by comparing the transaction at issue to a transaction

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17 *Id.*
18 *See* Treas. Reg. § 1.482 (1968 and 1994)
19 Treas. Reg. § 1.482-1A, 2A (1968).
20 Treas. Reg. § 1.482-1, 4 (1994).
21 *See* § 1.482-1A(b)(1) (1968), § 1.482-1(a)(1) (1994).
22 *See id.*
23 *See* § 1.482-2A(d)(2) (1968).

between uncontrolled parties where a similar item of intangible property was sold. Adjustments can be made to correct for imperfect comparability.[24] This is the preferred method because it is most closely tied to the market. A price negotiated in a market transaction is presumed to be more reliable than one determined purely by analysis.[25]

The regulations provide other factors to use in determining the price unrelated parties would have charged when there is no directly comparable transaction. The factor approach takes data from relevant but not comparable transactions to estimate a market price for the transaction at issue. The factors are:

a) The prevailing rates in the same industry or for similar property,
b) The offers of competing transferors or the bids of competing transferees,
c) The terms of the transfer, including limitations on the geographic area covered and the exclusive or nonexclusive character of any rights granted,
d) The uniqueness of the property and the period for which it is likely to remain unique,
e) The degree and duration of protection afforded to the property under the laws of the relevant countries,
f) Value of services rendered by the transferor to the transferee in connection with the transfer within the meaning of paragraph (b)(8) of this section,
g) Prospective profits to be realized or costs to be saved by the transferee through its use or subsequent transfer of the property,
h) The capital investment and starting up expenses required of the transferee,
i) The next subdivision is (j),
j) The availability of substitutes for the property transferred,
k) The arm's length rates and prices paid by unrelated parties where the property is resold or sublicensed to such parties,
l) The costs incurred by the transferor in

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[24] *See* § 1.482-2A(d)(2)(iii) (1968).
[25] *See* § 1.482-2A(d)(2)(ii) (1968).

developing the property, and

m) Any other fact or circumstance which unrelated parties would have been likely to consider in determining the amount of an arm's length consideration for the property.[26]

3. Valuation Methods Under the 1994 regulations

The 1994 regulations set out three specific methods for determining value, plus the unspecified method which provides guidance for developing a method appropriate to the facts of a particular case.[27] The "best method rule" at §1.482-1(c) requires that the arms length result be determined using the method that provides the most reliable result. Factors to consider include comparability of compared transactions, completeness and accuracy of data, and reliability of assumptions.

Two of the specific methods, the comparable profits method and the profit split method, do not apply to the facts of this case. The remaining specific method is the comparable uncontrolled transaction method. Similar to the 1968 regulations, this method calls for comparing the transaction at issue to a similar transaction between uncontrolled parties.[28]

Under the unspecified method, the court can infer an arms length price from evidence on the value of market alternatives.[29] This makes sense because business transactions are evaluated in the context of their alternatives. The profit from the transaction at issue must be at least as great as the profit available from alternative transactions involving the same intangible property. Otherwise the alternatives would have been exercised instead.

C. Positions of the Parties

1. DHL

DHL argued that the $20 million allocated to trademark in the final transaction should be given effect because it was *in fact* an arms length price negotiated between uncontrolled parties.[30] They relied on the adversarial nature of the negotiation with the international

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[26] § 1.482-2A(d)(2)(iii) (1968).
[27] *See* § 1.482-4(a) (1994).
[28] *See* § 1.482-4(c) (1994).
[29] *See* § 1.482-4(d) (1994).
[30] *See DHL*, 1998 WL 906788 at *33.

investors to establish the validity of the transaction price. Had this argument succeeded there would have been no basis for the service to make a §482 reallocation at all.

Essentially, DHL rested its entire case on this threshold issue. It did not make arguments that would have given the court procedural or quantitative guidance in making independent findings on the issue of value.

DHL did offer expert testimony based on a relief from royalty methodology.[31] This method is based on the fact that the price paid by DHLI to purchase the trademark would have been consistent with the present value of royalty payments to license it. DHLI paid the purchase price to *relieve* itself from future royalty payments.

The is evidence was presented only to bolster DHL's transactional valuation argument by showing that valuation reached a similar result. The expert testimony evidence was not developed into a coherent argument for valuation based on a regulatory method. The analysis below will address the ways in which DHL could have done so.

2. IRS Position at Trial

The Service also based its argument on expert valuations using the relief from royalty method. The Service's experts came up with values of approximately $300 million. The record shows that a classic battle of the experts ensued as each side argued its relief from royalty based valuation.[32]

The Service also supported this value by pointing out that the purchase price included $300 million that was not attributable to tangible assets. They argued that this entire sum should be allocated to the trademark.[33]

D. Holding of the Case

1. Method used

Starting with the total sale price in the actual transaction ($500 million), the court subtracted the value of the tangible assets ($200 million) to determine the total amount of intangible assets included in the sale. The court found a total intangible value of $300 million using this method.[34] The court then allocated the intangible assets in a

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[31] *See id.* at *34, 37-38.
[32] *See id.* at *34-38.
[33] *See id.* at *34.
[34] *See id.* at *35.

discretionary manner to determine how much of the intangibles should be attributed to trademark.

2. Application and result

After the lengthy analysis discussed below, the court found that the DHL trademark that DHL sold should have been valued at $100 million dollars.[35] The difference between this amount and the $20 million allocated at the time of the transaction was added to DHL's taxable income for 1992.

E. Analysis

The analysis below will address the method that the court used in arriving at its holding and the two regulatory methods applicable to the facts of the case.

1. Court Method

This court's allocation of intangibles method is not entirely without merit. Finding the total value of intangibles seems to be a reasonable starting point for valuing the trademark. But, the ruling creates problematic precedent.

The main problem with the court's method is that it cannot be used prospectively to set an appropriate transfer price. Because the regulatory methods focus on independent market factors, they can be used by controlled corporations to set allocate value in a way that will withstand review. The court's after the fact analysis cannot serve this function. Additionally, the court's application of its method is technically flawed as addressed below. Subsequent courts will have difficulty applying this method in a fair and consistent method.

Below is an analysis of the factors the court did or should have considered in allocating the total value of intangibles.

a. Value of Non-Trademark Intangible Assets

Starting from its $300 million price for all intangible assets, the court split the amount in half.[36] Although the opinion was not explicit, it appears that one half was assigned to the value of the DHL network.

As part of their general argument in support of a low trademark

[35] *See DHL*, 1998 WL 906788 at *40.
[36] *See id* . at *38.

valuation, DHL offered evidence that the intangible value was attributable to the "network." [37] This refers to the systems, organizational structure, working relationships and know-how that enable the company to use its physical assets to deliver customers' packages efficiently. This is part of the going concern value that causes a functioning business to be worth more than the sum of its assets.

The court agreed with DHL that this was indeed a valuable asset. But, the court does not go on to make specific findings about the value of the network.[38] Although there is significant evidence on this issue from both parties, the court seems unwilling to wade in and address individual assumptions and calculations. It holds simply that the network is "at least as important as the name 'DHL.'"[39] Given the sparse finding of fact, it is hard to know how subsequent courts would apply the court's new method.

b. Value of Trademark

The other half of the price paid for intangible assets was allocated to the worldwide DHL trademark.[40] The value of the trademark represents the customer relationships and goodwill built up by DHL and DHLI over their history. The court went on to sub-divide the $150 million in trademark value between the international and domestic rights to the trademark.[41] Although the trademark itself was the same, the right to use it in a defined geographic region can be separated.

(i). International Trademark

The court found that two-thirds of the worldwide trademark value was attributable to the value of the trademark outside the United States. The court said this division was based on the relative profits of DHL and DHLI, but did not address the issue in detail.[42] Taking two-thirds of the $150 worldwide trademark value gives a $100 million value for the international trademark rights.

The court's analysis up to this point indicated that the international investors had actually paid $100 million dollars for the international rights to the DHL trademark. Although the analysis had

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[37] *See id.* at *36.
[38] *See id.* at *35-38.
[39] *DHL*, 1998 WL 906788 at *35.
[40] *See id.* at *39.
[41] *See id.* at *40.
[42] *See id.* at *40.

some weaknesses and some gaps, it was essentially logically sound. The court's next step was to discount the $100 million by 50% to reflect marketability issues related to a cloud on DHL's ownership of the international rights.[43] This is blatantly inconsistent with the method the court had chosen to apply.

A discount for marketability is appropriate when using comparables. If the DHL trademark were being compared to a trademark that did not have marketability issues, it would be appropriate to make the adjustment to improve comparability. But, under its stated method the court accepted the total actual purchase price as valid, with the only issue being the proper allocation of price among the various assets.

The "marketability discount" as applied by the court essentially disregards a portion of the purchase price it had initially accepted as valid in total. When the court's allocated values are added up, the total is short by $50 million.[44] Not only does the court's method demonstrate a failure to understand the concept of marketability discount, it fails to comport with basic arithmetic.

(ii). Domestic Trademark

The Service argued that DHL's right to use the domestic trademark for 15 years constituted additional taxable income.[45] This is known as the Alstores problem.[46] In the Alstores case, Steinway was attempting to sell a building for $1 million. Alstores purchased the building for $750,000 and allowed Steinway to continue to occupy the

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[43] *See id.* at *40.

[44]

Total value of intangibles = $300 million

Network	$150 million
International Trademark	+ $50 million
Domestic Trademark	+ $50 million
Total allocated	$250 million

$300 (paid) - $250 (allocated by court) = $50 million (?)

This amount is not allocated to specified or unspecified assets, it is simply removed from the calculation in a mathematically untenable manner.

[45] See *DHL* 1998 WL 906788 *at 42-43.

[46] *See Alstores Realty Corp. v. C. I. R.*, 46 T.C. 363 (1966).

building for two years. The court held that Steinway had received total compensation of $750,00 in cash and $250,000 of lease, all of which was taxable.

In the case at hand, the Service argued that the transaction consisted of an immediate sale of all worldwide trademark rights. The compensation received by DHL included cash and a 15year royalty free license of the domestic rights, both of which were taxable.[47]

The transaction can also be viewed as a sale of international rights effective immediately, and a sale of domestic rights effective after a 15-year reservation. This was the treatment DHL was seeking, and the transaction documents were drafted in the form of a "reservation of rights"[48] If the court found the transaction to be a reservation of rights, there is no Alstores problem. The foreign investors would have paid cash for the package of current and future rights that they received. The §482 allocation would have fixed the amount of cash to be attributed to the trademark.

Unfortunately the court fails to fully grasp this issue and address it in a logically consistent manner. The court accepts the Service's contention that the transaction was an immediate sale of all rights.[49] This means that the 15-year royalty free lease must be accounted for as income to DHL. It then states the Alstores problem does not exist because the§482 income adjustment will take into account the full value of the trademark sale and tax DHL accordingly.

This would be true if the trademark value was set independently of the transaction. Unfortunately, the court forgets that its valuation of the trademark is based on an allocation of the cash payment made by the foreign investors. The royalty free lease remains an additional and untaxed item. Again, the court's lack of understanding creates an inaccurate valuation in this case, and an unworkable precedent for the future.

2. Control Premium

The court's allocation of intangibles should have taken into account the portion of the purchase price that represented "control premium." A control premium represents the additional price a buyer is willing to pay for control of a company. It is above and beyond the value of the assets, tangible and intangible. Therefore the portion of price attributable to control premium should be subtracted from the total price before addressing allocation of asset price. Failing to

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[47] See *DHL* 1998 WL 906788 *at 43-44.
[48] *Id.* at *17.
[49] *See id.* at *45.

consider the effect of a control premium flaws the court's application of its own method.

It would appear that the price of the transaction at issue included a control premium. A buyer is willing to pay a premium for control because it believes that it can increase the value of the company by the decisions it makes, or through synergy with its existing operations. The foreign investors were acting in concert, with the intention of leveraging their existing airline business to add value to DHLI's package delivery business.[50] They would have been willing to pay a premium over the value of the assets as currently employed. Additionally, the case cited by the court defined control premium as the additional price current owners require in exchange for relinquishing control.[51] The court's own findings of fact show that the DHL owners repeatedly insisted on a premium for giving up control of DHLI.[52]

While the percentage allocable to control premium is debatable, the general applicability of the concept seems clear. Several of the expert valuations indicated that a control premium of at least 40% of the asset value would be appropriate.[53] This analysis would lead to the conclusion that $143 million of the $500 million total price was for control. That would leave $357 million in value to be allocated among the assets. Subtracting the $200 million for tangible assets would leave $157 million to be allocated among the intangible assets. This is about half the value the court assigned to intangible assets.

Under these circumstances it is hard to understand why the court did not assign any of the purchase price value to control premium, or at least fully discuss its decision not to. It appears that the court simply did not understand the issue.

3. Result

The purchase price allocation method as applied by the court yielded a $100 million value for the DHL trademark. The total purchase price of $500 million was reduced by the $200 million of tangible assets. The resulting $300 million was allocated equally to the operating network and the trademark. The $150 million of trademark value was allocated 2/3 to international and 1/3 to domestic rights. The value of international rights were reduced by on half to account for a "marketability discount." The remaining $50 million of international value was combined with the $50 million of domestic

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[50] *See id.* at *13-14.
[51] *Phillip Morris Inc. v. Commissioner*, 96 T.C. 606, 628 (1991).
[52] *See DHL*, 1998 WL 906788 at *13-20.
[53] *See id.* at *14.

value to yield the $100 million of value for the worldwide trademark rights.[54]

Had the method been applied free from the technical errors addressed above it might have yielded a lower value. Subtracting for a 40% control premium would have yielded a total value of intangibles of $157 million. Using the court's 50/50 allocation of intangible value, the trademark would have held a value of $78.5 million. Using the $150 million dollar value of the network inferable from the court's holding, the trademark value would have been $7 million. In neither case is the court's marketability discount properly applicable.

As shown by the analysis above, the court's holding was not only harmful to DHL, but created flawed precedent.

F. Comparable Uncontrolled Transaction Method

Both the 1968 and 1994 regulations state that the preferred way to find the arms length result is to look at the result of a similar transaction between uncontrolled parties.[55]

The record shows at least one comparable transaction that could (and should) have been used as a basis for valuation.[56] The record does not indicate that the evidence was presented in conjunction with a coherent argument for a comparable transaction method of valuation. DHL offered the evidence on the UPS offer to support a generally low valuation as part of their primary argument that the contract price was in fact arms length.[57] Nevertheless, the information was sufficient to form the basis of a valuation had the court chosen to do so.

From 1986 through 1989 DHL was engaged in negotiations with UPS. UPS was seeking to incorporate the international part of the DHL network into their own business. They wanted to use the DHL assets and network relationships under their own name. In 1987, UPS made a final offer to acquire a majority of the assets of DHL.[58] This is solid market-based evidence of what a willing buyer would have paid for the specific assets involved in the transaction at issue. It is particularly compelling to note that the comparables approach is the preferred method even though it usually involves a similar transaction involving a completely different company and set of assets. Here a firm offer on the assets in question was disregarded as a source of

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[54] *See id.* at *40.

[55] *See* Treas. Reg. § 1.482-2A(d)(2)(ii) (1968), Treas. Reg. § 1.482-4(c)(2)(ii) (1994).

[56] *See DHL*, 1998 WL 906788 at *13, 36.

[57] *See id.* at *35-36.

[58] *See id.* at *13.

evidence.

The court completely dismissed the arms length UPS offer as not comparable. Because UPS planned to substitute its own trademark for that of DHL in ongoing operations, the court reasoned that the offer price essentially disregarded the value of the DHL trademark.[59] Apparently the court failed to recognize the implications of this finding. The UPS offer presented an arms length value for all assets (tangible and intangible) with the exception of the trademark. The total price paid by the foreign investors in the actual DHL transaction was an arms length price for all assets including the trademark. By subtracting the UPS offer price from the foreign investors' price one can determine precisely the amount that can be attributed to the trademark. The additional price paid by the foreign investors must be allocated to trademark.

Of course adjustments would have to be made to get a directly comparable price. Section 1.482-1(d)(2) states that adjustments to improve comparability should be made. In this case, the adjustments would be to separate from the total UPS offer the portion that encompassed the international assets and network purchased by the foreign investors, and adjust the price to reflect changes between 1987 and 1990. Although these adjustments are simple, the opinion does not provide the necessary information to engage in the calculations in this paper.

G. Unspecified Method

The other applicable regulatory method is the unspecified method.[60] This is not so much a method, as a set of guidelines for developing a method applicable to the specific facts of a case when no specific method is applicable. If the court did not find a comparable uncontrolled transaction, it could have developed a method in accordance with the regulations.

The unspecified method "should provide information on the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled transaction."[61] The 'relief from royalty' method meets these criteria because it values DHLI's purchase of the trademark by discounting to present value the royalties DHLI would have had to pay to license the trademark from DHL. It is also consistent with the 1968 regulations' option of basing value on "prospective profits to be realized or costs to be saved by the

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[59] *See id.* at *36.
[60] *See* § 1.482-4(d) (1994).
[61] § 1.482-4(d)(1) (1994).

transferee by its use" of the trademark.[62]

This method is also favored in valuing intangibles because it is consistent with statutory language known as the "super royalty" provision.[63] §482 states, "[i]n the case of any transfer (or license) of intangible property … the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible."[64] The relief from royalty method complies with this by basing the price DHLI should have paid on the royalty income DHL would have received had they retained ownership and licensed the trademark.

The method employed by the court does not comply with the standards of either the 1994 or 1968 regulations is that it does not reference market values.

Both DHL and the Service offered extensive expert testimony giving valuations based on the 'relief from royalty' method. Needless to say, the conclusions of the experts differed dramatically. The court examined these expert valuations and concluded that the wide disparity in value was the result of differing assumptions about growth of revenue, royalty rate and discount rate.[65] (The opinion does not present enough detail to permit an independent analysis in this paper but the assumptions are summarized below.)[66] The court then concluded that it was not bound to accept the conclusions of one side or the other. It was free to make specific findings and draw its own conclusions. It is appropriate for the court to make its own assumptions and run the calculations for itself.

In this case the court did something else entirely. The court stated that it found the Service's assumptions reasonable, and accepted their estimate of the present value to DHLI of future royalty payments. But it did "not agree that the value they have determined could be

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[62] § 1.482-2A(d)(2)(iii)(g) (1968).

[63] *See Leonard Schneidman, On the Mark: Transfers of Trademarks and Their Tax Consequences*. 14 NO. 3 Prac. Tax Law. 5 (Spring 2000)

[64] I.R.C. § 482.

[65] *See DHL*, 1998 WL 906788 at *37-38.

[66]

Expert		Growth Rate	Discount Rate	Royalty Rate
Service 1	6%	12.5%	1%	
Service 2	3.6%	12.21%		1.15%
DHL	7.6%	14.10%		.75%

isolated as being attributable to the trademark."[67] In holding thusly, the court is saying that income from trademark royalties is not attributable to the licensing of the trademark. It is difficult even to speculate on what the court could have meant by this statement.

II. CONCLUSION

In this case, DHL chose to rely entirely on a single argument. They argued forcefully that the $20 million allocated in the transaction was a valid arms length price for the trademark.[68] By failing to fully develop other arguments for valuation based on the regulatory methods DHL offered the court little guidance in attempting an independent valuation.

The owners of DHL were involved with Newco both as owners and because of the intention of preserving the operating relationship between the two companies. Although the total price paid by the foreign investors was the subject of intense negotiation, the record showed that the allocation decision was based on the owners' desire to minimize tax burdens.[69] They should have expected to fail on this argument

In developing and applying its own method, the court ignored both the regulations and the basic principals of finance. The resulting precedent is unworkable in two major ways. First, by ignoring the regulations the court has reduced predictability. Corporations engaging in similar trademark sales in the future cannot be confident that adherence to the standard set by the regulations. Second, the method that the court invented is internally flawed. Because of the court's questionable grasp of the situation, it created a method that cannot possibly yield a correct value by anything other than coincidence. One can only hope that the Service and subsequent courts will simply ignore this flawed ruling.

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[67] *See DHL*, 1998 WL 906788 at *38.
[68] *See id.* at *33.
[69] *See id.* at *17.