

# ROYALTY RATES

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## KEY POINTS

- ◆ Factors that influence the setting of royalty rates
- ◆ Royalty rates in uncontrolled and controlled transactions
- ◆ Factors to look for in finding and adjusting comparables
- ◆ Royalty rates and the centralised management of intellectual property
- ◆ The need for independent advice

## ESTABLISHMENT AND FUNCTION OF ROYALTY RATES (I)

- ◆ Intellectual property normally generates future economic benefits when combined with other business assets
- ◆ A royalty rate is established by isolating the required rate of return directly attributable to the IP component of the business
- ◆ The royalty, or rate of return is agreed after considering the risks each party must bear

## ESTABLISHMENT AND FUNCTION OF ROYALTY RATES (II)

- ◆ The party bearing the higher risk should receive the higher rate of return
- ◆ The more risk eliminated, the more value created
- ◆ The higher the margin, the higher the royalty

## FACTORS THAT INFLUENCE THE SETTING OF ROYALTY RATES (I)

- ◆ The industry
- ◆ The nature of the intellectual property
- ◆ The rights in the property
- ◆ The level of incremental profits or cost savings through the use of the IPR
- ◆ The strength of protection
- ◆ Exclusivity
- ◆ Competition

## FACTORS THAT INFLUENCE THE SETTING OF ROYALTY RATES (II)

- ◆ Barriers to entry
- ◆ Investment requirements
- ◆ Ability to sub license
- ◆ Risk of technological obsolescence
- ◆ Government regulations
- ◆ Compulsory licenses
- ◆ Counterfeiting
- ◆ Prevailing economic conditions

## ROYALTY PAYMENT STRUCTURES

- ◆ Flat percentage of X for the term of the agreement
- ◆ Descending percentage of X when certain targets are achieved
- ◆ Ascending percentage of X when certain targets are achieved
- ◆ One time flat fee
- ◆ Flat fee plus X percentage
- ◆ No direct payment (royalty free) usually in exchange for credibility, public service or some other non-monetary payment

## FIVE PER CENT OF WHAT?

- ◆ Wholesale price
- ◆ Gross sales
- ◆ Gross turnover
- ◆ Net sales
- ◆ Hectolitres

## SOME DEFINITIONS

- ◆ **Gross sales invoices** less Sales Tax or VAT, logistical discounts, invoice/retroactive rebates, cash discounts
- ◆ **Net invoice price.** The actual invoiced price of product less transport, freight and VAT

## WHERE DO YOU FIND THEM?

**There is very little published data on the makeup of deals. Companies rightly feel that this competitive edge information must be kept firmly in house**

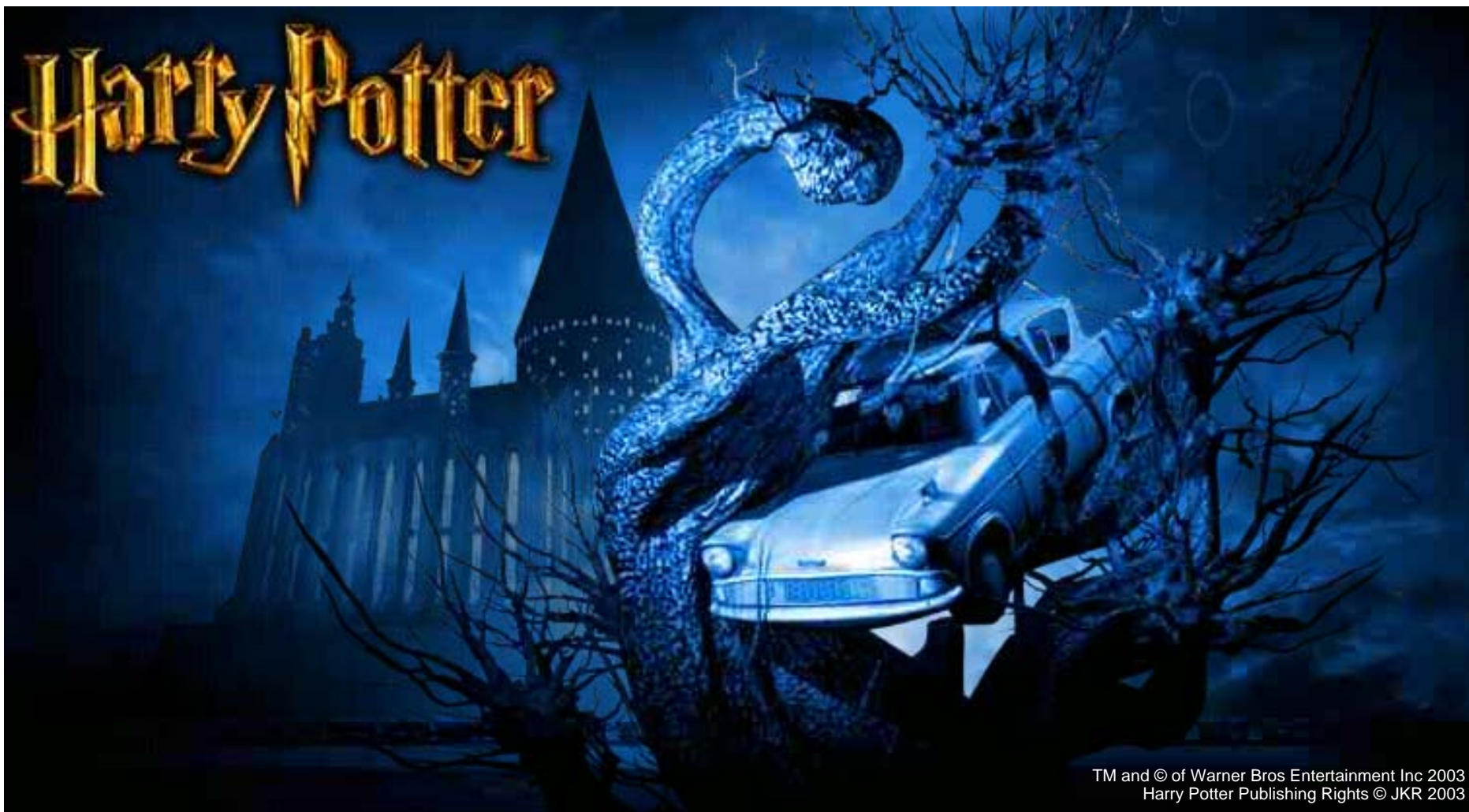
- ◆ Personal experience
- ◆ Organisations that sell information from their data bases
- ◆ In house data that either everyone has forgotten or no-one thought of
- ◆ Mergers and acquisitions
- ◆ Litigation
- ◆ You can always ask

## ROYALTY RATES IN UNCONTROLLED TRANSACTIONS

- ◆ Royalty payments are normally expressed in a manner that provides a fair rate of return on the investment made by the owner of the IP being transferred
- ◆ In an uncontrolled transaction the royalty rates are negotiated between unrelated parties
- ◆ Each party is attempting to maximise the respective benefits
- ◆ Royalty rates are often the most flexible part of the deal because they are being taken from a revenue stream

## PRICE ELASTICITY

- ◆ A 2% higher price on a commodity is usually sufficient to put the product out of 99% of the sales category and virtually shut it out of the market in which it competes
- ◆ This applies to paper products, plastic resins, metals, fruit and vegetables, bread and milk



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## SPLIT ROYALTIES

- ◆ In 1992, 1 million Americans voted to decide which image of Elvis would be used on the stamp to be released in 1993
- ◆ The royalties were 15% of the wholesale price
- ◆ EPE received 60%, the USPS 40%





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## EXAMPLES OF ROYALTY RATES

- ◆ Yoghurts UK 2% - 3% of wholesale price
- ◆ Biscuits UK 4% - 5% of wholesale price
- ◆ Chocolate UK 5% of wholesale price
- ◆ Designer perfume 6% - 15%
- ◆ Harry Potter 10% - 15%
- ◆ Toys 5% - 15%
- ◆ Homewares 1% - 7%
- ◆ Car accessories 3% - 8%
- ◆ Michael Jordan 17%

## ROYALTY RATES IN CONTROLLED TRANSACTIONS (I)

- ◆ Section 1.482-2 (d) Income Tax Regs (IRS) provides a framework for determining an arm's length consideration for the transfer, sale, assignment or loan of intangible property or an interest therein between related entities

## ROYALTY RATES IN CONTROLLED TRANSACTIONS (II)

- ◆ Arm's length consideration is specifically defined as “the amount that would have been paid by an unrelated party for the same intangible property under the same circumstances”

## ROYALTY RATES IN CONTROLLED TRANSACTIONS (III)

- ◆ Section 1.482 - 2(d) (2) (ii) The best evidence of such arm's length consideration is the amount actually paid by unrelated parties for the same or similar intangible property under the same or similar circumstances

## ROYALTY RATES IN CONTROLLED TRANSACTIONS (IV)

- ◆ In the absence of sufficiently similar transactions involving an unrelated party, Section 1.482-2 (d) (2) (iii) lists several factors as relevant in determining the amount of an arm's length consideration

## ROYALTY RATES IN CONTROLLED TRANSACTIONS (V)

- ◆ Standard of comparability 1.482-1(d)(2) An uncontrolled transaction need not be *identical* to the controlled transaction, but must be sufficiently similar that it provides a reliable measure of an arm's length result

**If the royalty is seen merely as a means of moving profits between companies and not justified by the commercial circumstances the deductibility could be challenged**

## FACTORS TO LOOK FOR IN FINDING AND ADJUSTING COMPARABLES

- ◆ The prevailing rates in the same industry or for similar property
- ◆ The terms of the transfer (the License Agreement)
- ◆ The uniqueness of the property and the period it is likely to remain unique
- ◆ The degree and duration of protection afforded to the property under the laws of the relevant country
- ◆ Capital investment and start up costs
- ◆ Availability of substitutes
- ◆ Prospective profits to be made and costs to be saved

## CENTRALISED IP MANAGEMENT

- ◆ Many future dramas can be avoided or managed more effectively if the Intellectual Property portfolio is managed centrally
- ◆ Tax disputes are costly, time consuming and stressful. CIPM makes it much easier to deal with investigations
- ◆ CIPM reinforces the concept that the company's IP is a shared resource
- ◆ CIPM ensures that the IP is managed for the whole group and not just one part of it which may have a narrow or particular focus

## THE NEED FOR INDEPENDENT ADVICE

- ◆ Royalty rate due diligence should not be carried out by the auditors or lawyers of the owner of the intellectual property that has been licensed
- ◆ Companies that license IP to subsidiaries must carry out regular independent audits
- ◆ Following any M&A or other transaction the newly acquired IP should be swiftly subjected to an independent study



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