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Commercial

Guide to royalties and licence fees

Often when negotiating an IP licence, it can be difficult to know what the payments should be, or how they should be calculated. This information sheet provides a brief summary of the issues that arise when negotiating royalties and licence fees, and some potential solutions to those issues.

Type of royalties and licence fees

Most IP licences will state that the licensee will pay one or more of the following:

- an up-front licence fee
- ongoing lump sum licence fee payments
- rolling royalties.

In some cases, there may be a good reason for granting a royalty-free licence where the IP owner is receiving some other benefit. For example, the IP owner may also be supplying research services for payment, or may be selling a product.

It may sometimes be possible to treat up-front payments as capital payments under a restraint of trade agreement, rather than as licence fees. But in most cases, licence fees will be income in the hands of the IP owner and will incur tax.

What should the royalty rate be?

It is common for the licensee to pay a rolling royalty based on its performance. Royalties are usually either a percentage of the licensee's net sales, or an amount per unit of licensed product sold.

But what should that percentage rate or per unit amount be? This is a common question and it's often hard for a party involved in a licensing negotiation to know where to begin.

To avoid simply guessing a figure, it's best to apply a royalty valuation methodology. The three main methodologies are summarised below briefly.

The cost approach

The royalty is set at a level that will reimburse the IP owner for its costs (eg, R&D and patenting costs) over the life of the licence.

For obvious reasons, the cost approach has only limited use. It takes no account of the actual market value of the IP.

The income approach

The royalty is a share of the profit the licensee will receive as a result of taking the licence and selling the licensed products.

The '25% rule'

The most common type of income approach is the '25% rule'. This rule of thumb states that the IP owner is entitled to 25% of the licensee's long term pre-tax operating profit made from sales of the licensed products.

The 25% share should be expressed in the licence as a percentage of net sales, or a price per unit of licensed product sold.

Royalties should never be expressed in the licence as a percentage of profits. Profits can often be manipulated by use of creative accountancy methods.

For the '25% rule' to be useful, the IP owner needs to know what the licensee's projected revenues and expenses are. A prudent IP owner will always ask a prospective licensee to submit a business plan that includes revenue and expense projections for the life of the licence. Those projections may need to be discounted to take into account various risks, such as market indifference, technological changes and competition in the market.

Example of the '25% rule'

Party A licenses Party B to make, use and sell a new type of office chair. Party A has a patent for the chair.

Party B's long term projections show that:

- Party B expects to sell the chairs for $100 plus GST each;
- Party B's projected costs per unit over the long term are approximately $60, leaving a pre-tax operating profit per unit of $40.

Under the '25% rule', 25% of Party B's $40 per unit profit should go to Party A. That is 10% of the unit's $100 sale price.

So Party A and Party B agree that Party B will pay a royalty of 10% of Party B's net sales.

Discounting or putting a premium on royalties

Any market-based methodology must also consider factors that might increase or decrease the value of the technology in the hands of the licensee. Such factors include:

- the type of IP being licensed. For example, unregistered know-how is usually less valuable than a granted patent
- where the technology is at in the technology life cycle. For example, a proven technology that is ready for market will be more valuable than an early stage technology, because there is less work for the licensee to do to get the technology to market
- the degree to which competing technologies are available or useful in the market
- the scope of the rights granted under the licence. For example, a worldwide, exclusive licence may be more valuable to a licensee than a non-exclusive licence that is limited to a narrow territory or field of use
- the strength of the IP protection. For example, a provisional patent application will be of lesser value than an application that has been examined. A granted patent is more valuable still
- the size of the market for the technology, and market conditions.

Other things to consider

If you are an IP owner negotiating a licence, you should consider some other things about payment.

- Make sure the licence contains detailed reporting and auditing provisions, so you can track what you are owed.
- If royalties are based on net sales, ensure the royalties payable reflect the market value for the product. For example, if the licensee sells the licensed product for less than the true market price, make sure the licence requires the licensee to pay a royalty based on the true market price.
- Be aware that if the licensee is based in a different country to the licensor, they will usually have to deduct withholding taxes from their payments to you. If the licensee's country doesn't have a tax treaty with the licensor's country, you may find yourself being taxed at the full rate in your country on top of the withholding taxes.
- If royalties are based on net sales, be careful to specify how the net sales are calculated and what deductions are permitted.
- If the licence is an exclusive one, it is standard to impose a minimum sales or royalties target on the licensee.

Call AJ Park's commercial team to get the best advice about royalties and licence fees.