Tax Advantages for Sales-Based Royalties

By *Alice A. Joseffer*

Should a manufacturer's expenses for sales-based royalties be currently deductible or should they be capitalized to inventory under Internal Revenue Code (IRC) section 263A? A recent court case, proposed regulations, and an IRS directive all indicate that manufacturers and producers should now be able to get the equivalent of a current deduction for expenses they incur in paying sales-based royalties.

Proposed Regulations

The IRS formerly asserted that sales-based trademark royalties paid by a manufacturer were indirect costs that must be capitalized under the uniform capitalization rules of IRC section 263A and Treasury Regulations section 1.263A-1(e)(3). But a 2010 decision by the Second Circuit Court of Appeals (*Robinson Knife Manufacturing Co. Inc. v. Comm'r*, 600 F.3d 121, 2d Cir. 2010), found otherwise. *Robinson*, on which the author served as lead tax counsel in both the Tax Court and the Second Circuit Court, is the first Court of Appeals decision that addresses the treatment of intellectual property royalties under the uniform capitalization regulations. The Court of Appeals overturned a Tax Court decision, ruling that a manufacturer's royalty payments are immediately deductible if they are 1) calculated as a percentage of revenue from the sale of inventory and 2) incurred only upon the sale of that inventory.

In January 2011, following the wake of the *Robinson* decision, the IRS issued proposed regulations to address the sales-based royalty issue (Proposed Treasury Regulation, section 1.263A-1[c][5];[e][3]). The regulations provide that otherwise capitalizable sales-based royalties are properly allocable to property sold during the taxable year. They require a two-step process in which royalty costs are first capitalized and then allocated to property sold during the year. In February 2011, the IRS followed the proposed regulations with an announcement that it would not adhere to the decision in *Robinson* except in the Second Circuit, which encompasses New York, Vermont, and Connecticut.

In March 2011, the IRS directed its examining agents not to challenge sales-based royalties if the treatment used by the taxpayer achieves a result similar to that achieved under the proposed regulations. Although the treatment of sales-based royalties in *Robinson* achieves a result similar to the treatment now provided for in the proposed regulations, the IRS's litigating position remains different from its examining position. It is unclear why the proposed regulations, which are intended to obtain the same result as the method in *Robinson*, handle the treatment of sales-based royalties in such a convoluted way.

Background

The Robinson Knife Manufacturing Company designs, develops, manufactures, and markets kitchen tools and gadgets such as spatulas, spoons, and cooking thermometers. Robinson differentiates its products from those sold by its competitors by using well-known brand names such as

Pyrex and Oneida to market them. Robinson licensed the use of the names Oneida and Pyrex under agreements requiring Robinson to pay a percentage of net sales occurring in the calendar quarter preceding the payment date. No payment obligation arose under the agreements until Robinson sold a product making use of the name Pyrex or Oneida. Robinson did not have to make any minimum royalty payments for use of the Oneida and Pyrex names, and the license agreements did not provide for any payments other than those based on actual sales.

IRC section 263A requires that both direct and indirect costs of producing property covered by the section be capitalized; however, Treasury Regulations section 1.263A-1(e)(3)(iii)(A) provides that marketing, selling, advertising, and distribution costs are indirect costs that are not required to be capitalized under IRC section 263A. Robinson treated its sales-based royalty expenses as period costs in the nature of advertising or selling expenses and did not capitalize them to inventory. Under this approach, the royalty cost of selling an item was deducted in the same period that the revenue from selling the item was included in income. The IRS argued that the royalty costs should have been capitalized. Under the IRS's approach, only a portion of the royalty expense would match the income from the sale of the items that caused the royalty expense. The remainder of the royalty costs, even though they were attributable only to sold items, would have been included in the cost of ending inventory under the simplified production method of accounting. This approach would have increased Robinson's taxable income.

Robinson based its arguments on the rule that advertising and other selling expenses are deductible as ordinary, reasonable, and necessary business expenses in the year incurred under IRC section 162(a). Treasury Regulations section 1.162-1(a) provides that advertising and other selling expenses qualify as such deductible business expenses. Similarly, under Treasury Regulations section 1.471-3(c), the costs of selling are not includable in the cost of inventory produced by a taxpayer. Robinson argued that its sales-based royalty costs were not incurred by—and did not directly benefit—production of the items within the meaning of the IRC section 263A regulations. Therefore, the royalty costs were not properly allocable to property produced by Robinson. Robinson also contended that if the Tax Court determined that the royalty costs were not deductible as marketing or selling costs, the costs and the related sales income should still be matched in the same tax period under the accrual method in order to clearly reflect income.

The IRS claimed that the royalty costs were indirect costs that must be capitalized under Treasury Regulations section 1.263A-1(e)(3)(U), which treats licensing costs as indirect costs that must be capitalized to the extent that they are properly allocable to property produced or property acquired for resale:

> *"Licensing and franchise costs*—Licensing and franchise costs include fees incurred in securing the contractual right to use a trademark, corporate plan, manufacturing procedure, special recipe, or other similar right associated with property produced or property acquired for resale. These costs include the otherwise deductible portion (e.g., amortization) of the initial fees incurred to obtain the license or franchise and any minimum annual payments and royalties that are incurred by a license or a franchisee."

The IRS read this regulation as requiring capitalization of all trademark royalties: "To conclude some royalties incurred and paid for the right to use a trademark directly benefit or are incurred by reason of a product or resale activity while others do not requires a strained reading of what are straightforward regulations" (opening brief for respondent, p. 33). The IRS also relied on *Plastic Engineering & Technical Services, Inc. v. Comm'r.* (TC Memo 2001-324), a case involving royalties paid for rights to use a patented assembly system in the manufacture of plastic molded products.

Tax Court Decision, Factual Problems

The Tax Court held that Robinson was required to capitalize its royalty costs, even though this result stood at odds with the court's findings of fact, which directly supported Robinson's position that the royalty fees at issue are marketing and selling costs. The court argued that only marketing and selling expenses incurred after production are exempt from capitalization under IRC section 263A. This position should have resulted in a ruling in favor of Robinson because it was undisputed that the royalties at issue were incurred at the time each individual unit was sold—well after its production. The court's attempt to distinguish between marketing or selling expenses incurred before or during production and those incurred after production is unsupported in the regulation.

The court also based its decision, in part, on Treasury Regulations section 1.263A-1(e)(ii)(U), which provides that licensing costs "to obtain" the license are potentially indirect costs for which capitalization is required. The court stated that Robinson paid royalties "for the right to use the Pyrex and Oneida trademarks in producing" the branded kitchen tools and that Robinson "incurred royalties for licensing the right to use the Pyrex and Oneida trademarks in manufacturing" products. The court concluded that Robinson's royalties were incurred during the production process and were, therefore, properly capitalized under Treasury Regulations section 1.263A-1(e)(3)(i), which applies to indirect costs that "are incurred by reason of the performance of production."

The Appeal

Robinson raised three arguments on appeal. First, Robinson contended that the parties' stipulations of fact and the Tax Court's own findings of fact required a decision that the fees at issue were in the nature of marketing or selling expenses, and that Treasury Regulations section 1.263A-1(e)(3)(iii) provides that "marketing, selling, advertising" expenses "are not required to be capitalized under Section 263A."

Second, Robinson argued that its royalty costs were not within the scope of the example of licensing costs incurred in securing the right to use intellectual property. Third, Robinson contended the Tax Court was mistaken in determining, without factual support, that Robinson's royalty expense benefitted or was incurred by reason of production. The court's conclusion ran contrary to the evidence that Robinson did not incur any royalty expense upon production of the items; such expenses were incurred only upon sale.

On appeal, the Justice Department avoided any discussion of the nature of trade-

marks, their purpose, or their use. Instead, it argued that the royalties were incurred by reason of, or for the benefit of, the performance of production.

The Second Circuit Decision

In its decision on *Robinson*, the Second Circuit Court of Appeals held that when a producer's royalty payments are 1) calculated as a percentage of sales revenue from inventory and 2) incurred only upon the sale of that inventory, they are immediately deductible as a matter of law because they are not "properly allocable to property produced" within the meaning of Treasury Regulations section 1.263A-1(e). The court viewed the case as presenting a pure question of law—the interpretation of a regulation.

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The court did not agree that all trademark royalty costs are deductible marketing, selling, advertising, and distribution costs. The court also rejected the IRS's position that Robinson's sales-based costs were within the scope of the regulatory example because such a position would lead to the treatment of all royalties as "incurred in securing the contractual right to use a trademark." The language limiting the requirement to licensing costs "incurred in securing the contractual right to use a trademark" would be superfluous, as would the reference to "minimum annual payments and royalties." The court noted, however, that even if the scope of the example did not include the royalties paid by Robinson, they were, nevertheless, indirect costs that were not exempt from the capitalization requirement merely because they were absent from the list of examples.

The court agreed with Robinson's argument that the Tax Court erred in ruling that the fees indirectly benefitted or were incurred by reason of production and are allocable to property produced. The court ruled that "under the plain text of the regulation it is the costs, and not the contracts pursuant to which those costs are paid, that must be a but-for cause of the taxpayer's production activities in order for the costs to be properly allocable to those activities and subject to the capitalization requirement." In Robinson's case, when a product bearing a licensed name was manufactured, no royalty expense was incurred; when a product bearing a licensed name was sold, a royalty was incurred. The court agreed with Robinson that denying its deductions for the royalties at issue would distort Robinson's income.

The court found support for its reading of the regulation in Treasury Regulations section 1.263A-2(a)(2)(ii)(A)(1), which states that commissions paid to authors for sales of books that have already taken place are not costs of production that need to be capitalized under IRC section 263A. The court declared that the position taken by the Tax Court and the IRS would result in the very problem that IRC section 263A was intended to fix: "the uniform capitalization rules would not be very uniform if they were to treat books and spatulas differently."

Aftermath

After the court's decision in *Robinson*, the IRS issued the aforementioned proposed regulations dealing with sales-based royalty expenses. The explanation of the regulations expressly states that they are consistent with the Second Circuit's conclusion in *Robinson* and achieve a similar result by providing that otherwise capitalizable sales-based royalties are properly allocable to property sold during the taxable year. But the explanation disputes the Second Circuit's determination that the royalty costs did not directly benefit and were not incurred by reason of performance of production activities. As a result, the proposed regulations require a two-step process of capitalizing the costs and then allocating them to property sold during the year (Proposed Treasury Regulations section 1.263A-1[c][5];[e][3]). The proposed regulations also set up two meanings for "incurred," which has no practical effect but preserves the position of the IRS in the Second Circuit.

In an "Action on Decision" document, the IRS announced that it will not acquiesce to the Second Circuit's analysis. The announcement states that the Tax Court correctly held that Robinson incurred the royalty expenses by reason of its production activities and that the expenses were capitalizable. As a result, the IRS's litigating position outside the Second Circuit is that sales-based royalty costs are not deductible, even though as a practical matter, the proposed regulations provide the same result.

The IRS then issued a directive advising examining agents not to spend further resources challenging taxpayers' reporting of sales-based royalties if their treatment achieves substantially the same result as the result in the proposed regulations, which would be the case for a taxpayer using the treatment used by Robinson. This seemingly contradictory position leads the author to question what might be next: directives to the Appeals and District Counsel offices? Will the IRS withdraw its nonacquiescence? Is the IRS activity like a rhyme without a reason?

Practical Effects

Considering the IRS's position following the *Robinson* decision, a manufacturer or producer should review its tax accounting for all sales-based expenses to determine whether a change would be appropriate and benefit the bottom line. If costs such as royalty expenses are not sales-based, a manufacturer or producer should also review its contractual arrangements to determine whether they could be renegotiated to obtain better tax treatment. Because the IRS position appears to be a work in progress, developments in the law on capitalization of indirect costs and postproduction costs should also be monitored. ❑

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