Originally published in:
Journal of Taxation **July 1, 2010**

Sales-Based Contingent Royalties Are Not a Production Cost Capitalized Under Section 263A

By: Elliot Pisem and Jason K. Binder

The issue of whether royalties paid to the licensor of a trademark or brand name, based on sales of the associated products, should be capitalized under Section 263A recently resulted in a taxpayer-favorable reversal of the Tax Court. It remains to be seen if other courts of appeals, which may be confronted with arguments about the deference due to IRS determinations with regard to methods of accounting, will adopt the interpretation espoused by the Second Circuit.

Who actually makes the Corning cookware or Oneida tableware that you may have used for dinner last night? Readers of the recent decision in *Robinson Knife Mfg. Co., Inc.,* 105 AFTR 2d 2010-1467, 600 F3d 121 (CA-2, 2010), *rev'g* TC Memo 2009-9, RIA TC Memo ¶2009-009 , will have discovered that the design and manufacturing of some kitchen products sold under those brand names are done by third parties who license national trade names from the names' owners under royalty agreements. Those readers also will have discovered quite how difficult it is to determine the federal income tax treatment of royalties paid under such agreements, when the applicable Regulations draw fine conceptual distinctions between, for example, trademark "licensing and franchise costs," treated in one way for tax purposes, and "marketing, selling, advertising, and distribution costs," treated in quite another.

In reversing a Tax Court decision in favor of the Service, the Second Circuit held that the particular royalties at issue were not "properly allocable" to the production of kitchen tools manufactured by Robinson Knife but sold under the trade names of Corning and Oneida.

BACKGROUND

One of the great conceptual divides in the tax law is that between deductible expenses and capital expenditures. Current deduction will generally provide an immediate tax benefit, while capitalization often results in a tax benefit that is realized only over time. [1]

Section 162(a) provides that "[t]there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." This language seems to allow the deduction of a great variety of expenditures, but other provisions of the Code impose significant limitations on deductibility and require the capitalization of some costs.

In any business in which the production, purchase, or sale of merchandise is an income-producing factor, these limiting provisions include Section 263A(a)(1), added to the Code in 1986: "In the case of any property to which this section applies, any costs described in paragraph (2) ... in the case of property which is inventory in the hands of the taxpayer, shall be included in inventory costs...."

The requirement to maintain inventories is found in Section 471(a), which states: "Whenever in the opinion of the Secretary the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income." At the end of each year, a portion of the taxpayer's inventory costs is included in cost of goods sold, thereby effectively reducing the taxpayer's income for the year, but the remaining costs are treated as part of a "closing inventory" asset on the taxpayer's balance sheet and will not give rise to a reduction in income or gain until a future year.

The IRS with increasing frequency has been challenging deductions claimed by taxpayers for many costs that relate, however peripherally, to the production and sale of inventory. [2] Indeed, the Service was successful in persuading the Tax Court that Robinson Knife should be required to capitalize the royalties that it paid to Corning and Oneida. On Robinson Knife's appeal from the Tax Court's decision—and in the first appellate guidance with respect to the application of the Section 263A inventory capitalization rules to royalty costs—the Second Circuit held that at least some royalties are not "properly allocable" to production activities and thus may be deducted on a current basis.

WHY 263A?

Congress added the uniform capitalization rules of Section 263A to the Code as part of TRA '86 to address two perceived deficiencies in the rules regarding the capitalization of costs incurred in producing property.

The first was a "timing" problem. The existing rules permitted costs that were "costs of producing, acquiring, or carrying property to be deducted currently, rather than capitalized into the basis of the property and recovered when the property is sold or as it is used by the taxpayer." In turn, the current deduction of such costs engendered "a mismatching of expenses and the related income and an unwarranted deferral of taxes." [3]

The second deficiency was a "neutrality" issue. Applying different capitalization rules "depending on the nature of the property and its intended use" could "create distortions in the allocation of economic resources and the manner in which certain economic activity is organized." [4]

By providing a single, comprehensive set of "uniform" capitalization rules relating to costs of producing, acquiring, or carrying property, Congress hoped "to more accurately reflect income and make the income tax system more neutral." [5]

With respect to tangible personal property that is inventory in the hands of the taxpayer, all "direct costs" must be capitalized by inclusion in inventory costs, [6] as must certain "indirect costs" properly allocable to property "produced" by the taxpayer. [7] Definitions of "direct costs" and "indirect costs" are not provided in Section 263A, but Treasury was instructed to prescribe such Regulations "as may be necessary or appropriate to carry out the purposes of this section." [8] In 1987, Treasury issued Temporary Regulations, [9] and final Regulations under Section 263A were promulgated in 1993. [10]

The Section 263A Regulations divide the universe of costs that may be subject to capitalization into two categories, "direct" and "indirect." Direct costs of real or tangible personal property produced by the taxpayer include "direct material costs" and "direct labor costs." Direct material costs are the costs of those materials that become an integral part of specific property produced and those materials that are consumed in the ordinary course of production and that can be identified or associated with particular units or groups of units of property produced. [11] Direct labor costs include the costs of labor that can be identified or associated with particular units or groups of units of specific property produced, and generally include all elements of compensation, other than employee benefit costs. [12] All direct costs must be capitalized.

Indirect costs are defined as costs that are neither direct material costs nor direct labor costs. [13] Unlike the clear mandate of Section 263A that all direct costs of production be capitalized, the rules regarding indirect costs are muddled by the statute's use of the term "properly allocable" to describe the indirect costs that must be capitalized, thereby suggesting that it would be "improper" to allocate *certain* indirect costs to production and thus to require their capitalization. Under the Regulations, some indirect costs are required to be capitalized "to the extent they are properly allocable to property produced"; the Regulations offer 23 examples of these. [14] Other indirect costs—those that neither directly benefit nor are incurred by reason of the performance of production activities—never have to be capitalized; the Regulations offer 11 examples of these. [15]

One example of indirect cost required to be capitalized when "properly allocable" to the produced property is found in Reg. 1.263A-1(e)(3)(ii)(U) ("subparagraph (U)"):

"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 licensee or a franchisee."

By contrast, Reg. 1.263A-1(e)(3)(iii)(A) provides that "marketing, selling, advertising, and distribution costs" are not required to be capitalized into the cost of the property produced.

PRIOR AUTHORITY

Before the Second Circuit's decision in *Robinson Knife,* there had been a few administrative and judicial decisions that considered the application of the uniform capitalization rules to royalty payments.

Plastic Engineering & Technical Services

The first case involving subparagraph (U), *Plastic Engineering & Technical Services, Inc.,* TC Memo 2001-324, RIA TC Memo ¶2001-324 , was decided eight years after the issuance of the final Regulations under Section 263A.

At issue in *Plastic Engineering* was whether a corporation was required under Section 263A to capitalize royalty payments it made as the exclusive licensee of a patented "hot manifold assembly system." The licensor was the taxpayer's sole shareholder and president. Under the licensing agreement, the royalties equaled a percentage of the net sales price of all end products manufactured through the use of the patented assembly system.

The taxpayer deducted royalty costs paid under the licensing agreement as ordinary and necessary business expenses, rather than capitalizing them into the cost of goods that it produced, including inventory remaining on hand at the end of the year. The IRS issued a notice of deficiency in which it determined that a portion of the royalties paid by the taxpayer was allocable to ending inventory and should be capitalized and included in the taxpayer's cost of inventory. [16]

The taxpayer's argument in *Plastic Engineering* was fundamentally one of regulatory interpretation. The taxpayer argued that the last sentence of subparagraph (U) [17] mandated that only two types of license-related payments were required to be capitalized—initial fees incurred to obtain the license and minimum annual royalties. Because the contingent royalty payments at issue in *Plastic Engineering* ("royalty payments derived from a percentage of the licensee's net sales of products manufactured through the patent process") fell into neither of those categories, the taxpayer argued that they were not required to be capitalized under the Regulations.

The Tax Court rejected the taxpayer's reading of the relevant line in the Regulations as having been made "in a vacuum." The court concluded that the last sentence of subparagraph (U) "merely gives examples of 'licensing and franchise costs' that are classified as indirect costs." (After all, "includes," at least when used in the Code, is specifically stated "not [to] be deemed to exclude other things otherwise within the meaning of the term defined." [18]) Accordingly, contingent royalties were not excluded from the operation of the uniform capitalization rules, and Plastic Engineering was required to capitalize the royalties at issue.

Letter Rulings

Buttressed by its victory in *Plastic Engineering,* the IRS continued to assert that sales-based royalty payments are an indirect cost of production allocable to property produced under Section 263A by virtue of their inclusion in subparagraph (U).

2003 rulings. TAM 200310001 concerned a taxpayer that, over the course of many years, had sold units of an item it produced. A patentholder filed a patent infringement lawsuit against the taxpayer. The patentholder prevailed in the lawsuit, and the taxpayer paid the patentholder an amount of damages "based upon a reasonable royalty." The taxpayer claimed a deduction in the year of payment and computed its income tax liability for that year by applying Section 1341(a)(5). Under that section, the tax benefit of a deduction allocable to the years of infringement, for which tax rates were higher than the rate for the year of payment, could be computed at those higher rates. For Section 1341 to apply, however, the payment by the taxpayer had to give rise to a "deduction" rather than, for example, to an increase in the taxpayer's cost of goods sold.

The IRS concluded that the taxpayer was not entitled to a "deduction" with respect to the patent infringement damages it paid. Since the damages were "analogous to a royalty for the use of a manufacturing procedure" associated with property produced—an amount that must be capitalized under subparagraph (U) and the holding in *Plastic Engineering*—they were a cost to be "recovered" through cost of goods sold, rather than "deducted" under Section 162(a) or otherwise. Accordingly, Section 1341 was inapplicable, even to the extent that an increase in cost of goods sold would have had a result identical in amount and timing of income to the allowance of a deduction. [19]

In CCA 200331002, the Service addressed supplemental issues related to TAM 200310001. The taxpayer challenged the Service's conclusion that the patent infringement damages taken into account only when paid many years after the inventory in question had been produced were nevertheless includable in the costs of the taxpayer's inventory, asserting that "such inclusion is inconsistent with the matching principles underlying section 263A." The taxpayer sought to convince the IRS that an exception should be read into Section 263A for "indirect costs to the extent inclusion of those costs in inventory would not result in what Taxpayer considers a proper matching of income and expense." The IRS, however, was not willing to do so because:

"Neither the statute nor the regulations contain an exception to capitalization in circumstances where capitalization would not yield a satisfactory matching of income and expense. Section 263A and the regulations thereunder produce a better matching of income and expense than was required under prior law, but those provisions may not produce a perfect matching of income and expense in all cases. ... The nature of a cost, in terms of whether it is an indirect cost because incurred by reason of the performance of a production activity, does not change simply because the production activity was completed before the cost was incurred for federal income tax purposes."

2006 ruling. The IRS again followed *Plastic Engineering* in TAM 200630019. A corporate taxpayer owned nearly all the stock of a subsidiary. The taxpayer's foreign parent had granted the subsidiary certain intellectual property rights and the rights to use certain technical information related to the foreign parent's products, which the subsidiary also had the right to produce. The subsidiary sold the products to the taxpayer, and the taxpayer had the exclusive right to distribute the products.

The subsidiary had agreed to pay a royalty as consideration for the rights and licenses granted to it by the foreign parent. The amount of the royalty was calculated using the number of units of the products sold by the subsidiary to the taxpayer. The subsidiary deducted all of the royalties it paid during the years under audit.

The Service ruled that the subsidiary used the rights granted to it in its production activities. Accordingly, the royalties paid by the subsidiary fell within subparagraph (U). Citing *Plastic Engineering,* the IRS concluded that the sales-based contingent royalties were direct costs properly allocable to property produced and had to be capitalized under Section 263A.

IRS Tries a Broader Approach

The Service's victory in *Plastic Engineering* and its issuance of the 2003 and 2006 rulings did not produce consistent treatment of sales-based royalties by taxpayers and IRS exam personnel, and accordingly the IRS issued an Industry Director Directive on 5/7/07 [20] that elevated the treatment of such royalties, particularly in the pharmaceuticals industry, to a "Tier II" issue. [21]

The Directive identified as a potential issue whether sales-based contingent royalties paid by a taxpayer represent a capital expenditure under Section 263A. In issuing the Directive, the IRS intended to provide a uniform format and approach for examiners to evaluate potential compliance risk related to, among other things, the treatment of such royalties under Section 263A, to outline the issue management and oversight process that had been established, and to introduce an initial set of audit guidelines. Treasury and the Service also added a new project to the 2007-2008 Priority Guidance Plan, entitled, "Guidance under section 263A regarding the treatment of post-production costs, such as sales-based royalties." [22]

Most recently, the IRS in October 2007 issued a Coordinated Issues Paper that addressed the tax treatment of "royalty payments pursuant to collaboration agreements that are between unrelated domestic parties in the pharmaceutical and biotechnology industries, generally for drug development." [23] The Coordinated Issues Paper addresses, among other items, whether royalties paid or incurred under a collaboration agreement are deductible under Section 162(a) or must be capitalized under Section 263A. Unlike the language in some of the Service's earlier pronouncements, the Coordinated Issues Paper suggests that the answer to that question cannot be determined on a knee-jerk basis:

"The determination of whether royalties are an expense or are subject to the capitalization rules of I.R.C. §263A is based on a careful examination of the particular facts and circumstances of each situation. The examiner should read *Plastic Engineering*.... In *Plastic Engineering* ..., the U.S. Tax Court held that royalty payments made by a taxpayer for certain assembly systems covered by patent were indirect costs to the production of the end products, and, thus, capitalized and included in inventory, pursuant to the UNICAP rules. The case is a good source for an examiner to quickly obtain the applicable law and analysis in this area....

"In conclusion, one would expect that, *generally,* the costs are to be capitalized under I.R.C. §263A." (Emphasis added.)

Nevertheless, the Service continued to insist in many cases that royalties be capitalized, and, with *Robinson Knife,* the courts again entered the fray.

THE KITCHEN TOOLS BATTLE

Robinson Knife designed, developed, manufactured, and marketed various kitchen tools, which it then sold to large retailers. In order to obtain a premium at the ultimate customer point of sale by branding these tools with the trademark of an established brand, Robinson Knife entered into licensing agreements with two well-known manufacturers, Corning, Inc., and Oneida, Ltd. (collectively, the "Licensors"), for the right to use the Licensors' trademarks. Robinson Knife agreed to pay to the Licensors royalties based on a percentage of net sales of the trademark-bearing tools it produced and sold.

The Licensors had some involvement in the production process. For example, their agreement that a particular trademark was appropriate was obtained at the design stage, and, after manufacture but before Robinson Knife was permitted to market and sell the tools to retailers, the Licensors had the right to inspect and approve the trademark-bearing tools.

During the tax years at issue, Robinson Knife incurred and paid royalties to Corning and Oneida for the use of their trademarks, and Robinson Knife deducted the royalty payments as ordinary and necessary business expenses. The IRS determined that Robinson Knife should have capitalized the royalties under Section 263A and that a portion of the capitalized costs were properly allocable to Robinson Knife's closing inventory each year, rather than to the cost of goods sold during the year. Accordingly, the Service increased Robinson Knife's income by that portion of the costs. [24]

Tax Court's Opinion

The Tax Court agreed with the IRS that Robinson Knife was required to capitalize under Section 263A the royalties it paid to Corning and Oneida. [25]

The Section 263A Regulations provide that a taxpayer must capitalize "all indirect costs properly allocable to property produced," and then state that "[i]ndirect costs are properly allocable to property produced ... when the costs directly benefit or are incurred by reason of the performance of production ... activities." Applying these tests to the facts before it, the Tax Court emphasized that Robinson Knife could not legally engage in the production activities of the Corning and Oneida trademark-branded kitchen tools without payment of the royalties, and that the Licensors themselves engaged in production activities—issuing their approval at the design stage and inspecting and approving the manufactured kitchen tools before Robinson Knife marketed and sold them to retailers. [26]

Thus, in the Tax Court's view, the royalties paid by Robinson Knife directly benefited and were incurred by reason of the performance of production activities, [27] and those royalties were required to be capitalized as part of the cost of Robinson Knife's inventory. The court focused its discussion on the application of the "properly allocable" standard and discussed only briefly whether *sales-based contingent* royalties were properly *includable* in the broad category of

indirect costs, which includes licensing and franchise costs listed in subparagraph (U), that must be capitalized if they are "properly allocable to production." [28]

The Tax Court did consider at some length Robinson Knife's argument that the royalties it paid to the Licensors helped it obtain a market advantage, retain costumers, and attract new customers, and that such expenses were, accordingly, marketing expenses specifically *exempted* from capitalization under Reg. 1.263A-1(e)(3)(iii)(A). In support of this argument, Robinson Knife cited Rev. Rul. 2000-4, 2000-1 CB 331, in which the IRS determined that ISO 9000 certification-related costs [29] were exempted from capitalization under Section 263A because they were like advertising or training expenses—costs that do "not result in future benefits that are more than incidental."

Since the royalties paid by Robinson Knife "were not in connection with implementing a quality control policy," however, the Tax Court found that the Revenue Ruling did not aid Robinson Knife's case. Moreover, the Tax Court indicated that Robinson Knife had confused marketing costs, not required to be capitalized under Section 263A, with costs of production incurred to make a more marketable product, which are required to be capitalized under Section 263A.

Second Circuit's Opinion

Robinson Knife appealed the Tax Court decision. As a result, we have the first appellate-level guidance with respect to the application of the inventory capitalization rules of Section 263A to sales-based contingent royalty payments. On appeal, Robinson Knife presented three major contentions in favor of the conclusion that it should be permitted to deduct, and should not be required to capitalize, the sales-based contingent royalty payments it paid to the Licensors:

(1) Royalties paid for the use of trademarks were "marketing costs," exempt from capitalization under Reg. 1.263A-1(e)(3)(iii)(A).

(2) Royalty payments not "incurred in securing the contractual rights to use a trademark" are deductible.

(3) Robinson Knife's royalty payments were not "properly allocable" to the kitchen tools it produced.

Marketing costs. In support of its first contention, that trademark royalty costs were properly considered deductible marketing expenses rather than licensing costs that might have to be capitalized, [30] the taxpayer in Robinson Knife advanced two specific arguments.

Customer enticement. First, Robinson Knife argued that the purpose of its payment of trademark royalties was to entice customers to purchase its products as opposed to the otherwise identical products of its competitors. The Second Circuit was chary of that argument, however, because all trademarks serve the purpose of product differentiation, so that Robinson Knife's argument could "effectively read the word 'trademark' out of the relevant regulation" requiring the capitalization of at least some royalties. [31]

The Second Circuit's analysis of the customer enticement argument reflects a concern that, if accepted, the argument could lead down a slippery slope toward the conclusion that all trademark royalty payments constitute deductible marketing costs, a conclusion at odds with the intent of the Regulations under Section 263A. Thus, the Second Circuit, in rejecting Robinson Knife's argument, reasoned that a deduction for either lump-sum minimum or production-based royalty payments would allow such costs to be immediately deducted even if the trademarked items were not sold until a later tax year, resulting in "a mismatching of expenses and the related income and an unwarranted deferral of taxes."[32]

The appellate court indicated that it rejected the taxpayer's customer enticement argument because it addressed "situations that go far beyond the case presented." To your authors, however, it appears to have been the court, and not Robinson Knife, that was going beyond the bounds of the case presented. The Second Circuit's opinion itself twice clearly indicates that Robinson Knife's argument was referring only to the sales-based contingent royalties *it paid to the Licensors*—referring in one place to "*the* royalty payments" and in another to "*its* royalty payments" (emphasis added). There was no reason for the Second Circuit to suppose that accepting that argument would compel it to apply the same rule of deductibility to trademark royalty payments computed on some other basis. The Second Circuit should have considered only whether sales-based contingent royalty payments are, in fact, closer in nature to marketing costs than they are to the other types of royalty payments (upfront and minimum) specifically enumerated in subparagraph (U).

ISO 9000 certification analogy. Second, the taxpayer again argued that the Revenue Ruling on ISO 9000 certification compelled the conclusion that Robinson Knife's sales-based contingent royalty payments were deductible marketing costs. The Second Circuit, however, felt that ISO 9000 certification costs were "wholly distinguishable" from sales-based contingent royalties. Because the Regulations implementing the uniform capitalization rules were silent with respect to ISO 9000 certification costs, it was appropriate for the IRS, by a Revenue Ruling, to analyze by analogy where such costs fit into the regime. Trademark royalties, however, "are on the capitalization list." Accordingly, the court concluded that analogizing trademark royalties to ISO 9000 certification costs was inappropriate.

Incurred in securing the contractual right. Robinson Knife's second contention was akin to the position taken unsuccessfully by the taxpayer in *Plastic Engineering,* i.e., that subparagraph (U), by its plain language, includes only upfront and minimum annual royalty payments and that any other types of royalty payments are not considered "incurred in securing the contractual right to use a trademark ... associated with property produced." Unlike the Tax Court in *Plastic Engineering,* which concluded that all trademark royalties were described in subparagraph (U), the Second Circuit in *Robinson Knife* concluded that the scope of subparagraph (U) was irrelevant.

In the view of the court of appeals, all of the subparagraphs that enumerate indirect costs that may have to be capitalized are merely a nonexclusive list of examples. Even if the royalties paid by Robinson Knife did not fit into any of the enumerated categories, they still might have to be capitalized under the general rule applicable to indirect costs that are "properly allocable" to production activities and are not specifically exempted from capitalization by the Regulations.

Properly allocable to property produced. At this point in the opinion, things were not looking well for the taxpayer, but "all's well that ends well." The Second Circuit agreed with Robinson Knife's final contention, to the effect that its sales-based contingent royalty payments, although perhaps "indirect costs" not automatically entitled to be deducted, were nevertheless not "properly allocable to property produced." Accordingly, the court of appeals reversed the decision of the Tax Court.

What is the test? The Second Circuit began its analysis of this argument by going to great lengths to correct what it perceived to be the Tax Court's misapplication of the two tests for determining whether an indirect cost is "properly allocable to property produced." As described above, Reg. 1.263A-1(e)(3)(i) states that indirect costs are properly allocable to property produced when *the costs* (1) directly benefit, or (2) are incurred by reason of the performance of, production activities. The Second Circuit felt that "the Tax Court's reasoning confuse[d] the *license agreements* with the *royalty costs*" paid pursuant thereto (emphasis in original). Thus, the appellate court said the Tax Court had erroneously analyzed whether the *license agreements* directly benefited or were incurred by reason of the performance of production activities.

It is difficult to know what point the Second Circuit was making with this quibbling about whether the license agreements, rather than the royalties, directly benefited or were incurred by reason of the performance of production activities. Even if there is some substantive difference between the "correct" and "incorrect" applications of the test, the Tax Court seems to have done the right thing on this specific question.

The Tax Court opinion devoted an entire paragraph to the "properly allocable" issue. In the first two sentences of that paragraph, in which the Tax Court refers to the two alternative means by which the "properly allocable to property produced" standard may be satisfied, the subject of the test is "the royalties."[33] The Tax Court then, over several sentences, restated the facts that it found were relevant to determining whether that standard had been satisfied in the case before it, and, in the final sentence of the paragraph, provided its conclusion:

"Consequently, the *royalties paid* to Corning and Oneida directly benefited petitioner's production activities and/or were incurred by reason of petitioner's producing the Pyrex- and Oneida-branded kitchen tools and are therefore indirect costs properly allocable to the Pyrex- and Oneida-branded kitchen tools petitioner produced." (Emphasis added.)

While one of the facts that the Tax Court emphasized in the paragraph was the license agreements' granting to Robinson Knife the right to manufacture the trademark-branded kitchen tools, without which it could not have legally manufactured them, it is a distortion of the Tax Court opinion to state it applied the "properly allocable to property produced" standard by reference to the license agreements, rather than by reference to the royalties paid pursuant thereto.

Notwithstanding its criticism of the Tax Court's opinion, the Second Circuit went on to agree with "the Tax Court's implicit conclusion that 'directly benefit or are incurred by reason of' boils down to a but-for causation test." Nevertheless, the Second Circuit disagreed with how the Tax

Court had applied that test. Under the Second Circuit's "but-for" analysis, "[r]oyalties like Robinson's in this case do not 'directly benefit,' and 'are not incurred by reason of[,]' the performance of production ... activities" because the taxpayer might have performed the production activities without paying the royalty costs. For example, the royalties would not have been paid if the Licensors had disapproved of the kitchen tools after they had been produced, so that they were never sold to retail customers, [34] or the taxpayer failed to sell the tools for any other reason. [35]

Analogy to treatment of sales-based commissions on books. After devoting but one brief paragraph to articulating what it viewed as the proper test for determining whether or not the royalties paid by Robinson Knife were "properly allocable" to production activities, the Second Circuit discussed at far greater length an example found in the portion of the Regulations that distinguishes between the rules for tangible property (which are subject to uniform capitalization), such as books, and those for intangible property (to which the uniform capitalization rules do not apply). [36] The portion of that example dealing with accounting for the payment of sales-based commissions on books concludes that "the costs of producing and developing books include prepublication expenditures incurred by publishers, including payments made to authors (other than commissions for sales of books that have already taken place), as well as costs incurred by publishers in writing, editing, compiling, illustrating, designing, and developing the books."

The parenthetical clause in this example, relating to commissions for books already sold, was intended to distinguish books the sales of which "have already taken place" from books that have been published but which remain in the book publisher's inventory and are available for future sale. [37] In the Second Circuit's view, the combination of this example and Congress's clearly expressed intention in the legislative history of the uniform capitalization rules to support capital income neutrality [38] "corroborated" its conclusion regarding the treatment of Robinson Knife's royalty payments, since "the uniform capitalization rules would not be very uniform if they were to treat books and spatulas differently."

Deference to agency interpretations. In a footnote at the end of the final paragraph of the "Discussion" section of its opinion, the Second Circuit considered at some length "whether some level of deference ought to be given to the Commissioner's interpretation of the Treasury's own regulations," under, among other sources of authority, *Auer v. Robbins,* 519 US 452, 137 L Ed 2d 79 (1997) (holding that an agency's interpretation of its own regulations is "controlling unless plainly erroneous or inconsistent with the regulation"). [39]

The Second Circuit, however, declined to apply *Auer* deference to the case before it for two reasons. First, the IRS had not raised the argument and therefore had waived it. Second, the Service's position in *Robinson Knife* was not consistent with "the Commissioner's interpretation of the Treasury's own regulations" in other areas, such as, according to the Second Circuit, the Preamble to the 1993 final Regulations under Section 263A, [40] the sales-based commissions on books example in Reg. 1.263A-2(a)(2)(ii)(A)(*1*), and Notice 88-86, 1988-2 CB 401, [41] all of which contradicted the Service's position on brief in *Robinson Knife.*

The Second Circuit, however, appears to have neglected to consider the Supreme Court's mandate in *Thor Power Tool Co.,* 43 AFTR 2d 79-362, 439 US 522, 58 L Ed 2d 785, 1979-1 CB 167 (1979), to the effect that IRS determinations on matters of tax accounting "should not be interfered with [by the courts] unless clearly unlawful."[42] This doctrine is grounded in Section 446(b), which provides that if the "method of accounting" used by the taxpayer "does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the [IRS], does clearly reflect income." Reg. 1.446-1(a)(1) defines "method of accounting" to include "not only the over-all method of accounting of the taxpayer *but also the accounting treatment of any item*" (emphasis added). The Supreme Court stated in *Thor Power Tool* that the IRS has been vested "with wide discretion in determining whether a particular method of inventory accounting should be disallowed as not clearly reflective of income."

Although taxpayers have been successful in some more recent cases in persuading courts to distinguish *Thor Power Tool* and not to defer to the Service's accounting determinations,[43] the lower courts continue at least to pay lip service to the Supreme Court's statements. Moreover, while the Tax Court in *Robinson Knife* did not cite *Thor Power Tool,* its conclusions that the IRS "properly determined that the royalties paid to Corning and Oneida were indirect costs that petitioner was required to capitalize under [Reg.] 1.262A-1(e)(3)(i)" and "appropriately allocated the royalties to petitioner's ending inventory under the simplified production method," were fully consistent with it.

On the other hand, the Second Circuit, in ruling against the Service and overturning the Tax Court's conclusions, failed even to address the Supreme Court's mandate to avoid interfering with IRS determinations with respect to income tax accounting issues "unless clearly unlawful." The Second Circuit in *Robinson Knife* should perhaps have dug a little deeper when considering the appropriate amount of deference to apply to the Service's determinations with respect to income tax accounting issues. If it had done so, it might well have affirmed the Tax Court, regardless of the Second Circuit's own views on "proper" inventory accounting.[44]

CONCLUSION

Taxpayers arguing against the capitalization of sales-based contingent royalty payments, previously unsuccessful in bids before the Tax Court and in requests for private rulings, were handed a victory for the first time by the Second Circuit. While the circuit court's holding may be technically correct, taxpayers can take only limited comfort, because the Second Circuit's opinion neither follows nor distinguishes a Supreme Court doctrine mandating heightened deference to the Service's determinations with respect to matters of tax accounting. The IRS may have been fooled once, but it is very unlikely that the IRS will be fooled again.

Practice Notes

Taxpayers—or at least those taxpayers in the Second Circuit—who pay sales-based royalties under licenses to use trademarks or brand names may be able to avoid capitalizing such payments under Section 263A. Other types of royalty payments, however, will continue to fall within the uniform capitalization rules. Taxpayers should note that the Second Circuit was

sensitive to the possibility of abuse by licensees who might try to manipulate their royalty arrangements so as to bolster claims to deductibility for expenses that truly should be capitalized.

[1] The period over which the taxpayer *will* be entitled to take a capitalized cost into account may vary greatly depending on the circumstances. Thus, Reg. 1.263A-1(c)(4) states: "Costs that are capitalized under section 263A are recovered through depreciation, amortization, cost of goods sold, or by an adjustment to basis at the time the property is used, sold, placed in service, or otherwise disposed of by the taxpayer." Compare Regs. 1.263(a)-5(g)(1) and 1.263(a)-5(g)(2)(ii)(B), dealing with treatment of capitalized costs incurred in connection with acquisition of a trade or business and certain other transactions, which are "reserved" to deal with the treatment of costs incurred in tax-free acquisitive transactions and of costs incurred by the target in a taxable stock acquisition.

[2] See Turgeon, Rabinowitz and Jones, "Controversies Over Applying Section 263A Capitalization Rules," 83 Practical Tax Strategies 98 (August 2009), listing "increased IRS exam activity, the Section 199 consistency requirement, and the implementation of FIN 48" as the causes of the recently increased attention generally afforded the uniform capitalization rules of Section 263A.

[3] S. Rep't No. 99-313, 99th Cong., 2d Sess. 140 (1986).

[4] *Id.*.

[5] *Id.*.

[6] Reg. 1.263A-1(c)(3).

[7] See also Reg. 1.263A-1(a)(3)(i)(A).

[8] Section 263A(i).

[9] TD 8131, 3/30/87.

[10] TD 8482, 8/9/93. See Schneider, Solomon, and Smith, "Final UNICAP Regulations Expand Some Exceptions but Eliminate Others," 80 JTAX 74 (February 1994), and "Final UNICAP Regulations Build on Cost Allocation Methods in Temporary Rules," 80 JTAX 140 (March 1994).

[11] Reg. 1.263A-1(e)(2)(i)(A).

[12] Reg. 1.263A-1(e)(2)(i)(B).

[13] Reg. 1.263A-1(e)(3)(i).

[14] See Regs. 1.263A-1(e)(3)(ii)(A) through (W).

[15] See Regs. 1.263A-1(e)(3)(iii)(A) through (K).

[16] To the extent that the costs, if capitalized, would have been allocated to goods sold *during* the year, and thus included in cost of goods sold, it would make little or no difference if the costs were deductible, as contended by the taxpayer, or required to be capitalized under Section 263A, as contended by the Service.

[17] Stating, in relevant part, that licensing costs "include the otherwise deductible portion (e.g., amortization) of the *initial fees* incurred to obtain the license ... and any *minimum annual ... royalties* that are incurred by a licensee...." (Emphasis added.)

[18] Section 7701(c).

[19] See Letter Rulings, "Tax Relief From Claim of Right Doctrine Inapplicable to Patent Infringement Damages Paid by Taxpayer," 98 JTAX 376 (June 2003).

[20] John Risacher, Industry Director, Retailers, Food, Pharmaceuticals, and Healthcare, "Industry Director Directive on the Proper Treatment of Upfront Fees, Milestone Payments, Royalties, and Deferred Income," Large and Mid-Size Business (LMSB) Control No. LMSB:04-0407-037 (5/7/07), available at www.irs.gov/businesses/article/0,,id=170719,00.html (last visited 3/29/10) (the "Directive").

[21] Tier II issues are defined in Internal Revenue Manual 4.51.5.1 as those that involve "areas of potential high noncompliance and/or significant risk to the LMSB Division in general or a particular industry." Tier II issues include emerging issues where the law is fairly well established, but there is need for further development, clarification, direction, and guidance on the Service's position.

[22] Office of Tax Policy and IRS, "2007-2008 Priority Guidance Plan" (8/13/07), page 16, available at www.treas.gov/press/releases/reports/0708_gpl_(2).pdf (last visited 4/2/10). See also Office of Tax Policy and IRS, "Update to 2007-2008 Priority Guidance Plan" (4/22/08), page 29, available at www.irs.gov/pub/irs-utl/2007-2008pgp.pdf (last visited 4/2/10); Office of Tax Policy and IRS, "2008-2009 Priority Guidance Plan" (9/10/08), page 18, available at www.irs.gov/pub/irs-utl/2008-2009_gpl.pdf (last visited 4/9/10); Office of Tax Policy and IRS, "2009-2010 Priority Guidance Plan" (11/24/09), available at www.irs.gov/pub/irs-utl/2009_-_2010_priority_guidance_plan_initial.pdf (last visited 4/9/10); Office of Tax Policy and IRS, "First Periodic Update of the 2009-2010 Priority Guidance Plan" (3/16/10), page 26, available at www.irs.gov/pub/irs-utl/2009_-_2010_priority_guidance_plan.pdf (last visited 4/9/10).

A Treasury official on a panel at the May 2010 ABA Section of Taxation meeting in Washington, D.C., indicated that the guidance project regarding capitalization of post-production costs, specifically particular sales-based amounts, should be issued soon. See "Carlton Says Capitalization Guidance Project Expected Soon Despite Recent Court Decision," BNA Daily Tax Report, 5/12/10, page G-3 (quoting Brandon Carlton, attorney-adviser, Office of Tax Legislative Counsel, Department of the Treasury).

[23] "Collaboration Agreements" are "agreements for joint research, experimentation, or development, as well as agreements for the sharing of know-how or patents for the purpose of research, experimentation, or development. Collaboration Agreements can take the form of a *license agreement,* an alliance agreement, a co-marketing agreement, or a functional equivalent of such." Coordinated Issue Paper: Biotech and Pharmaceuticals Industries, "Non Refundable Upfront Fees, Technology Access Fees, Milestone Payments, Royalties and Deferred Income under a Collaboration Agreement," Issue #2, UIL 263.13-02 (10/18/07), available at www.irs.gov/businesses/article/0,,id=174934,00.html (last visited 3/29/10) (emphasis added).

[24] One might fairly ask why the question of deduction or capitalization was material to Robinson Knife's bottom-line tax consequences. After all, the royalties payable to the Licensors each year were computed by reference to Robinson Knife's sales during that year, so that it would seem logical that the entire royalty, even if capitalized, would be includable in Robinson Knife's cost of goods sold for the year, with the same effect as a current deduction. The answer is that Robinson Knife had elected use of the "simplified production method," see Reg. 1.263A-2(b)(1), under which a portion of the taxpayer's indirect costs incurred during a year are always allocated for income tax purposes to closing inventory, rather than to cost of goods sold, even if as a factual matter those costs relate solely to inventory sold during the year. (A similar indirect effect of a requirement of capitalization can be seen in TAM 200310001, discussed in the text, above. In the TAM there would appear to have been little difference between the effects of capitalization and those of deduction on the taxpayer's tax liability if it had paid its royalties on a current basis, but the taxpayer lost the benefits of Section 1341, a provision applicable only to "deductions," when it paid the royalties in a lump-sum in a later year.)

[25] The Tax Court also held that the IRS had properly applied the "simplified production method" to allocate royalties to Robinson Knife's ending inventory (see note 24, *supra*). We focus only on the broader issue of capitalization or deduction of the sales-based contingent royalty costs, on which the Tax Court's decision was reversed by the Second Circuit, and not on the technical computational issue of the proper application of the simplified production method, which was not reached by the Second Circuit.

[26] In view of Reg. 1.263A-1(e)(3)(i)'s focus on the *taxpayer-licensee's* "performance of production activities," it is hard to understand why the Tax Court accorded any significance to the *Licensors'* performance of production activities.

[27] The Tax Court chided the taxpayer for focusing its arguments solely on the "directly benefit production activities" prong of the test and ignoring the "incurred by reason of production activities" prong.

[28] The Tax Court did indicate in a footnote that its analysis was "not altered" by the presence of this type of royalty arrangement and cited Plastic Engineering & Technical Services, Inc., TC Memo 2001-324, RIA TC Memo ¶2001-324 , with approval.

[29] ISO 9000 is a voluntary certification comprising several specific requirements intended to ensure a quality process in providing products or services. ISO 9000 certification differentiates a provider from noncertified competitors and allows certified providers to conduct business with customers who require such certification.

[30] According to the Tax Court opinion, Robinson Knife had contended that the royalties paid to Corning and Oneida were deductible marketing expenses because they were "expenditures to obtain a marketing advantage, to retain customers, and to attract new customers," and in support of this argument, Robinson Knife had relied on Rev. Rul. 2000-4, 2000-1 CB 331. The Second Circuit characterized Robinson Knife's "trademarks as customer enticement" argument and Robinson Knife's reliance on Rev. Rul. 2000-4 as two separate arguments for the position that "all trademark royalty payments are [deductible marketing] costs."

[31] The Second Circuit apparently did not consider that, in some cases, the same expenditure might be included within two definitions—one of a category of costs required to be capitalized, and the other of a category exempted from capitalization—and that, in such event, allocation of the expenditure may be appropriate. The Section 263A Regulations, however, do require the allocation of an expenditure that is included within two *functions,* one of a category of costs required to be capitalized, and the other of a category exempted from capitalization. Specifically, Reg. 1.263A-3(c)(5)(iii)(A) provides that storage costs associated with a "dual-function storage facility" must be allocated between the production function and the sales function, and "[t]o the extent that the dual-function storage facility's storage costs are allocable to the [production] function, they must be capitalized. To the extent that the dual-function storage facility's storage costs are allocable to the [sales] function, they are not required to be capitalized."

The Second Circuit's analysis of trademark royalty costs implies that since those costs are included within subparagraph (U), the *entire* expenditure must be capitalized. As Robinson Knife argued, though, the expenditure also could be reasonably considered a marketing cost. Perhaps a future taxpayer will successfully draw an analogy between an expenditure with two functions, like a dual-function storage facility expenditure, and an expenditure, like trademark royalty costs, that arguably falls within *two definitions,* one of a category of costs required to be capitalized, and the other of a category exempted from capitalization, in support of the exemption of some portion of the trademark royalty costs from capitalization.

[32] Quoting S. Rep't No. 99-313, *supra* note 3.

[33] Although the Second Circuit in its opinion included a lengthy quote of the conclusion of this paragraph from the Tax Court opinion, that quote did not include these first two sentences.

[34] The appellate court cryptically states: "None of the product approval terms of the license agreements referenced by the Tax Court relates to Robinson's obligation to pay the royalty costs." Since both of the license agreements provided for the payment of sales-based contingent royalties, it is unclear why the court would think that there also should or would be reference to Robinson's obligation to pay the royalty costs in the product approval terms. In any event, the court's application of the "but for" test is not entirely clear. "But for" the production of the kitchen tools, the taxpayer would not have paid the royalties, since the tools could not have been sold without having first been produced. On the other hand, if one looks at the situation from the "other side of the mirror," it is true that "but for" the payment of the royalties, the taxpayer could have produced—but not sold—the kitchen tools, but there would not appear to have been much point in doing so. Should the theoretical possibility of production without sale be sufficient to relieve the taxpayer of the obligation to capitalize the royalties?

[35] The Second Circuit was sensitive to the possibility that future taxpayers could manipulate their royalty arrangements so as to bolster claims to deductibility for expenses that truly should be capitalized under Section 263A. In footnote 10 of the opinion, the Second Circuit addressed the Service's "justified concern about the possibility of abuse," but concluded that "there is no suggestion that *Robinson's* royalty payments are, in economic substance, anything other than true sales-based royalties" for which a deduction is allowable.

[36] Reg. 1.263A-2(a)(2)(ii)(A)(*1*).

[37] The Proposed Regulations under Section 263A had included an analogous example but without any exception for sales-based, post-sale payments to authors. In response to these Proposed Regulations, and on behalf of the Association of American Publishers (AAP), Arthur Andersen & Co. submitted a comment letter, pointing out that royalties tied to the sales of books should not be capitalized to inventory under Section 263A. Specifically, AAP explained that expensing royalties tied to sales as they are paid was consistent with generally accepted accounting principles and was generally used for financial accounting. AAP also stated that deducting payments to authors based on sales "provides a more precise matching of expense for authors' payments with income from the sale of a book than would be true if the inventory capitalization rules ... are followed because the mechanics of the simplified production method formula might not result in proper matching." AAP concluded by stating that sales-based payments to authors should be treated as selling expenses not subject to capitalization. In response to AAP's comment letter, the final Regulation's example was modified to provide that payments made to authors "other than commissions for sales of books that have already taken place" are to be capitalized.

[38] S. Rep't No. 99-313, *supra* note 3.

[39] An extensive discussion of deference under this and other Supreme Court precedents is found in the majority and concurring opinions in the Tax Court's very recent decision in Intermountain Insurance Service of Vail, LLC, 134 TC No 11, 2010 WL 1838297 , which will be the subject of an article in an upcoming issue of The Journal.

[40] TD 8482, *supra* note 10.

[41] In which IRS announced that it was going to include the sales-based commissions on books example in the final Regulations.

[42] Quoting Lucas v. American Code Co., 8 AFTR 10278, 280 US 445, 74 L Ed 538, 1930-1 CB 314 (1930), *rev'g* 7 AFTR 8420, 30 F2d 222 (CA-2, 1929). We are unaware of any quantitative studies that have been undertaken to show the rate at which such deference is actually given by the courts, and leave it to others to undertake this potentially interesting and important quantitative research.

[43] See, e.g., Wal-Mart Stores, Inc., 82 AFTR 2d 98-5601, 153 F3d 650, 98-2 USTC ¶50645 (CA-8, 1998); Osteopathic Medical Oncology and Hematology, P.C., 113 TC 376 (1999). See also generally Devitt, "Accrual vs. Cash Accounting for Health-Care Providers: Tax Court Fashions a New Test," 92 JTAX 79 (February 2000).

[44] There is also authority to the effect that the courts of appeals should review Tax Court decisions on tax accounting matters in a deferential manner. See Resnik, 40 AFTR 2d 77-5066, 555 F2d 634 (CA-7, 1977). While this doctrine does not have the imprimatur of the Supreme Court and has not been broadly endorsed by other

circuits, it does provide an additional reason that the Second Circuit should perhaps have been a bit more wary of staking out a position contrary to the Service's in Robinson Knife.