IRS Ordered To Help Trademark Licensor Reduce Tax Liability

By Rod S. Berman and Kristi L. Kirksey

Companies regularly enter into trademark licenses to obtain the right to use a trademark in connection with the production, sale, marketing or distribution of goods. In a typical license agreement,[1] the owner of a trademark, *i.e.*, the licensor, will permit a licensee to use its trademark or "brand" in return for the payment of a royalty. Essentially, licensing a trademark allows the licensee to take advantage of already established goodwill or brand identification created by or for the trademark owner.

Trademark royalties may be assessed and divided in a variety of ways, but are often expressed as a percentage of gross or net sales, as appropriately defined, or as a fixed fee per unit sold or produced. The tax treatment of such payments (i.e., to capitalize or to expense) varies, but usually depends on the terms of the licensing agreement. Many taxpayer licensees will allocate royalty expenses between expenses that can be immediately deducted and expenses that must be capitalized.

Sales-Based Royalty Payments

The U.S. Court of Appeals for the Second Circuit recently issued an opinion in *Robinson Knife Manufacturing Co. v. Commissioner of Internal Revenue,* No. 09-1496-ag, 2010 WL 986532 (2dCir. March 19, 2010), addressing whether sales-based royalty payments must be capitalized as inventory costs under IRS Code Section 263A. The Second Circuit reversed the Tax Court's decision that a manufacturing company using a simplified production method was required to capitalize costs associated with trademark royalty payments and thus, include a portion of such costs in inventory under its simplified production method.

Under the capitalization rules of Code Section 263A, a taxpayer must include in inventory costs all direct costs and certain indirect costs of producing property that is part of the taxpayer's ending inventory. Direct costs include labor costs and material costs [Reg. § 1.263A-1(e)(2)(i)(A)]. Indirect costs include all costs other than direct costs; however, only some indirect costs must be capitalized [Reg. § 1.263A-1(e)(3)(i)].

Licensing costs incurred in securing the contractual right to use a trademark or other similar rights associated with property produced are indirect costs that must be capitalized, to the extent such costs are allocable to property produced [Reg. § 1.263A-1(e)(3)(ii)]. On the other hand, marketing, selling, advertising and distribution costs are indirect costs that are specifically excluded from Section 263A capitalization rules.

Robinson Knife Manufacturing Co. designs, manufactures and markets kitchen tools. As part of its business, Robinson enters into license agreements for the right to use certain trademarks in connection with the production and sale of its products. In exchange for the right to use the trademarks, Robinson pays the licensors royalties based on a percentage of net sales of the products bearing the licensor's trademark.

Robinson deducted the royalty payments as ordinary business expenses under Section 162 on its federal income tax returns. The IRS issued a notice of deficiency based on its position that the expenditures are subject to the capitalization rules of Section 263A, and as a result, must be made part of Robinson's ending inventory.

Before the Tax Court (T.C. Memo 2009-9), Robinson argued that the royalties were not properly allocable to property produced since the royalties did not directly benefit its production activities. The Tax Court, however, agreed with the IRS and concluded that Robinson's acquisition of the right to use the trademarks was part of its production process, and that within the meaning of the Treasury Regulations, the royalty payments should be treated as indirect costs under Reg. § 1.263A-1(e)(3)(ii)(U). Thus, Robinson would be required to capitalize such expenditures. Robinson appealed the Tax Court decision.

On appeal before the Second Circuit, Robinson made the following three arguments against capitalization:

(1) The royalty payments are deductible as marketing, selling or distribution costs under Reg. § 1.263A-1(e)(3)(iii)(A);

(2) The royalty payments that were not "incurred in securing the contractual right to use a trademark,

1. On the other hand, if the license agreement is really an assignment, then the Service may treat the license as an assignment triggering a variety of tax issues.

corporate plan, manufacturing procedure, special recipe, or other similar right associated with property produced" under Reg. § 1.263A-1(e)93)(ii)(U) are always deductible; and

(3) The royalty payments are not "properly allocable to property produced" under Reg. § 1.263A-1(e)(3)(i).

The first two arguments were rejected by the Second Circuit as addressing situations that go beyond the case presented. However, the third argument was accepted by the court.

The Second Circuit found that the Tax Court's reasoning confused license agreements with royalty costs. The Treasury Regulations provide that "indirect costs are properly allocable to property produced when the costs directly benefit or are incurred by reason of the performance of production activities" [§ 1.263A-1(e)(3)(i)]. The Tax Court did not ask whether the royalty costs directly benefitted or were incurred by reason of the performance of production activities; instead, the Tax Court asked whether the license agreements did so.

In the decision, the Second Circuit emphasized the intent behind section 263A, including matching income against expenses and treating all property uniformly. Because Robinson Knife paid royalties based on sales rather than on production, recognizing the royalties as current expenses at the time of sale achieves better matching of income against expenses.

The Second Circuit further noted that Robinson could have manufactured exactly the same quantity and type of kitchen tools—that is, it could have performed its production activities in exactly the same way it did—and so long as none of this inventory was ever sold bearing the licensed trademarks, Robinson would have owed no royalties whatsoever. Accordingly, Robinson's royalties were not "incurred by reason of" production activities, and did not "directly benefit" such activities. Under the plain text of the Regulations, it is the costs, not the agreements pursuant to which such costs are paid, that must be a "but-for" cause of the taxpayers' production activities in order for the costs to be properly allocable to those activities.

Implications

So what does the decision of the Second Circuit in Robinson Knife decision mean for the treatment of royalty payments in general? Read in its narrowest sense, the case provides that the only royalty payments that should be immune from capitalization under section 263A are those which are calculated as a percentage of sales revenue from certain inventory, and which are incurred only upon the sale of such inventory. Application of the holding in a more broad sense, however, may result in taxpayers attempting to structure license agreements in such a way as to take advantage of the holding.

The requirements set forth by the Second Circuit - that the royalties must be calculated based on sales, and that the royalties must be incurred only upon those sales—should prevent most abusive deductions in this context. For example, if a manufacturer entered an agreement whereby no royalties were to be paid unless at least one unit of licensed-trademark inventory were sold (similar to the Robinson agreement), but the amount of royalties would then be a lump sump, this agreement might fail the requirement that the royalties be calculated based on sales. Similarly, a minimum guaranteed percentage might also fail the requirement that royalties be calculated based on sales, since the licensor would be guaranteed payment even if zero units were actually sold.

Even though the language contained in the case is relatively clear as to the tax treatment of royalty costs, license agreements are highly factual in nature and the actual tax treatment may continue to depend on the nature and terms of the costs incurred. In a footnote, the Second Circuit states that in the future, although a taxpayer may successfully structure a licensing transaction in such a way that it formally meets the two requirements discussed above, if in economic substance the royalties are for inventory items that have not yet been sold, an immediate deduction should not be permitted. This seems to imply that the facts and circumstances test may continue to apply in the determination of the treatment of royalty costs, even when such royalties appear to be purely sales based.

The IRS has not yet announced if it will appeal the Second Circuit's opinion in Robinson Knife. In any event, commentators anticipate that the Treasury will soon issue guidance regarding the treatment of post-production costs, such as sales-based royalties. The Second Circuit's reasoning in Robinson Knife is expected have an influence on the forthcoming guidance under 263A. ■

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