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# Controversies overapplying Section 263A capitalization rules

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## IRS scrutiny of uniform capitalization issues increases the need for taxpayers to review their Section 263A computations, particularly with respect to such items as contingent royalties and negative costs.

The IRS, taxpayers, and tax professionals have recently devoted increased attention to the uniform capitalization rules under Section 263A. This heightened focus is due to various factors, including increased IRS exam activity, the Section 199 consistency requirement, and the implementation of FIN 48, and is best evidenced by two issues involving Section 263A that are included in the Treasury-IRS Priority Guidance Plan:[1]

1. The first issue, designated by the IRS as a Tier II audit issue, involves the application of Section 263A to royalties contingent on sales (contingent royalties).[2]

2. The second issue involves the treatment of "negative" additional Section 263A costs (negative costs), where taxpayers remove costs capitalized for book purposes through their Section 263A calculation.

This article analyzes these two Section 263A issues and proposes solutions. In particular, the authors believe that the current Section 263A regulations permit the entire allocation of contingent royalties to the cost of goods that have been sold, rather than to ending inventory, when the taxpayer does not use a simplified allocation method. The IRS should, however, promulgate guidance providing for such treatment in all cases in the interest of sound tax policy. The authors believe that the regulations currently permit the inclusion of negative costs when determining total additional Section 263A costs, but guidance should be published confirming this treatment.

1. Office of Tax Policy and Internal Revenue Service 2008-2009 Priority Guidance Plan, 2008 WL 4287827.
2. See LMSB-04-0407-037, 2007 WL 2807363.

# Contingent royalties

Under Section 263A, taxpayers that produce property or acquire property for resale must capitalize all direct and indirect costs allocable to the property. Costs capitalized under Section 263A usually are recovered through cost of goods sold if the property is held for sale, or through depreciation if the property is used in the taxpayer's business.[3] This treatment results in the proper matching of income and expenses because the capitalized costs are recovered as the related income is earned from the property.

Examples in the regulations of indirect costs that must be capitalized include licensing and franchise costs that directly benefit, or are incurred by reason of, a production or resale activity.[4] Specifically, the Section 263A regulations provide that costs subject to capitalization include fees incurred in securing the contractual right to use a trademark, corporate plan, manufacturing procedure, or special recipe. Costs subject to capitalization under Section 263A also include other similar rights associated with property produced or property acquired for resale, including minimum annual payments and royalties incurred by a licensee.[5]

The requirement to capitalize licensing and franchise costs, however, should not apply if the costs do not relate to production or resale activities. For example, royalties solely related to marketing, selling, or advertising arguably should not be required to be capitalized.[6]

The Section 263A regulations provide various facts-and-circumstances-based allocation methods that a taxpayer may use to allocate identified capitalizable costs, including any royalties related to production, between cost of goods sold and ending inventory. Alternatively, the regulations provide certain simplified methods (i.e., the simplified production method and the simplified resale method) under which capitalizable costs are allocated between ending inventory and cost of goods sold based on an inventory turnover-type ratio. These simplified methods require costs to be allocated evenly among all items of property produced or acquired for resale regardless of whether the costs factually relate to the property.

In *Plastic Engineering & Technical Services, Inc.,*[7] the Tax Court held that a taxpayer was not permitted a current deduction for certain royalties paid in connection with the right to manufacture and sell assembly systems. Instead, the court ruled that the royalties were indirect production costs that should have been treated as inventoriable costs under Section 263A and recovered through cost of goods sold. Moreover, because the taxpayer used the simplified production method, which allocates additional Section 263A costs evenly to all items purchased or produced during the year, the Tax Court concluded that the royalties must be partially allocated to the taxpayer's ending inventory, even though the royalties were contingent on sales of assembly systems and, thus, factually related to only the goods sold.

3. Reg. 1.263A-1(c)(4).
4. Reg. 1.263A-1(e)(3)(ii)(U).
5. Id.
6. See Regs. 1.263A-1(e)(3)(iii)(A) and 1.263A-1(j)(2)(ii). But see FSA 200036015 (IRS National Office held that royalties paid in connection with "the right to sell a full line of [Trademark] products in adequate quantities" must be capitalized in the inventory basis of imported merchandise pursuant to Section 263A).
7. TC Memo 2001-324, RIA TC Memo ¶2001-324, 82 CCH TCM 1017.

Similarly, the Tax Court recently held in Robinson Knife Manufacturing Company, Inc. Section 263A. In doing so, the Tax Court concluded that the right to use the trademarks was part of the taxpayer's production process and, therefore, directly benefited the taxpayer's production activities. The Tax Court also rejected the taxpayer's argument that the royalties were marketing expenses that were exempt from capitalization under Section 263A. Finally, the Tax Court held that the IRS properly allocated a portion of the royalties to ending inventory using the simplified production method.

**IRS position.** TAM 200630019 provides the primary insight into the IRS' current thinking. In that TAM, a foreign corporation (parent) licensed to an indirectly owned U.S. subsidiary (subsidiary) the rights to manufacture, produce, and assemble products and related parts in the U.S. The license agreement required the subsidiary to pay a contingent royalty to the parent, calculated by reference to the number of units sold by the subsidiary. The subsidiary used a facts-and-circumstances allocation method to allocate additional Section 263A costs to units produced, including units in ending inventory.[9] However, the subsidiary excluded the royalties from its facts-and-circumstances allocation method and, instead, treated the royalties paid as "other deductions" in years one and two under audit, and as "other costs" in cost of goods sold in years three and four under audit.

The IRS analyzed whether the subsidiary was required to capitalize the royalties under Section 263A and concluded that the royalties paid by the subsidiary to the parent were licensing and franchise costs required to be treated as indirect production costs under the regulations[10] and Plastic Engineering.

The IRS then considered whether the subsidiary's method of accounting for the royalty expenses treated them as a production cost under Section 263A or as a period expense. Significantly, the TAM states that "a taxpayer including a cost in inventory is capitalizing that cost, even if the cost is allocated entirely to cost of goods sold." Accordingly, the TAM recognizes that a taxpayer using a facts and circumstances allocation method can fully allocate a production cost to cost of goods sold, assuming that such allocation meets the reasonableness standard in the regulations.[11] However, the IRS also argued that, while it is possible to have a reasonable capitalization method that allocates the entire amount of a cost to cost of goods sold, capitalization in the vast majority of cases involves the allocation of some portion of the cost to items in ending inventory.

The IRS concluded that the subsidiary treated the royalties as a period expense and that such treatment was improper. The IRS appears to have based its decision on the subsidiary's treatment of the royalties as a period expense in years one and two and as not includable in its facts-and-circumstances allocation method in any year. Because the IRS based its decision on the subsidiary's presentation, it did not analyze whether the allocation of contingent royalties entirely to cost of goods sold would have been reasonable in this case.

8. TC Memo 2009-9, RIA TC Memo ¶2009-009, 97 CCH TCM 103 .
9. Reg. 1.263A-1(f)(4) (use of a reasonable allocation method).
10. Reg. 1.263A-1(e)(3)(ii)(U).
11. Reg. 1.263A-1(f)(4).

**Observations.** There may be several possible arguments to avoid capitalization of contingent royalties. Thus, taxpayers should familiarize themselves with the potential issues, analyze the relevant facts, and select tax-efficient allocation methodologies.

First, a taxpayer must determine if the contingent royalty is directly related to, or incurred by reason of, the taxpayer's production or resale activities (e.g., the license of production know-how) such that the contingent royalty must be treated as an indirect cost for purposes of Section 263A. In analyzing this issue, the taxpayer should consider to what extent, if any, the value of the licensed property relates to excludable selling and marketing intangibles.

Given the Tax Court's recent holding in Robinson Knife, the Service is unlikely to concede that royalties paid for the use of trademarks are marketing expenses that are exempt from capitalization under Section 263A. However, it should not be blindly assumed that all royalties are related to production or resale activities that are subject to Section 263A. Instead, the specific facts giving rise to the royalty must be examined to determine whether the royalty is in fact related to production or resale activities.

To the extent the contingent royalty is an indirect cost, the taxpayer then should determine whether the contingent royalty currently is treated, or may be treated, as an inventoriable cost for book purposes (i.e., as a Section 471 cost) that is allocated entirely to cost of goods sold under the taxpayer's Section 471 allocation methodology. Cost accounting policies, financial statement presentation, and consistent treatment to establish a method of accounting are critical to support such a position. The taxpayer in the TAM was unable to support the argument that its costs were capitalized as Section 471 costs when the costs were presented as period costs in years one and two, and as cost of goods sold in years three and four as a result of an unauthorized method change.

If the contingent royalty is an indirect cost under Section 263A (and not a Section 471 cost), the taxpayer must allocate the cost between ending inventory and cost of goods sold using its Section 263A allocation method. If the taxpayer employs a simplified method, for example, the royalty will be partially allocated to ending inventory, as was the case in Plastic Engineering and Robinson Knife, instead of completely to cost of goods sold. Alternatively, if the taxpayer uses a facts-and-circumstances method (such as a burden rate method), additional Section 263A costs generally may be allocated to the specific items to which the costs relate.[12] As a result, the contingent royalty arguably could be allocated entirely to cost of goods sold and not included in ending inventory.

Thus, a taxpayer with contingent royalties that uses a simplified method may want to request to change to a facts-and-circumstances method in order to allocate the contingent royalties

12. See TAMs 9717002, 9821001, and 200144003.

to the goods to which they relate (e.g., to the goods that were sold). However, the additional administrative burden often required to develop and apply a facts-and-circumstances method may make it impractical for some taxpayers to change methods.

Alternatively, the IRS could determine from a tax policy perspective that it is not appropriate to capitalize contingent royalties to ending inventory and clarify that although contingent royalties are capitalized under Section 263A, the contingent royalties are properly allocable to property that has been sold. This result would be similar to the rule provided for depletion, which is also a cost that factually relates to cost of goods sold.[13] We believe that this rule for contingent royalties would be sound tax policy for several reasons.

First, proper matching of income and related deductions—the goal of capitalization—can be achieved only when the royalty cost is matched against the income to which it relates. In this case, the inclusion of the contingent royalty entirely in cost of goods sold is necessary to achieve proper matching with the income that generated that royalty payment.

Second, a specific exclusion would avoid the need for taxpayers with significant contingent royalties to change from a simplified method. Without a specific exclusion, these taxpayers will be forced to change to non-simplified methods, which likely will create additional complexities and IRS controversy and be inconsistent with the government's overall mission of simplification.

Third, a specific exclusion would avoid a trap for uninformed taxpayers and allow similarly situated taxpayers to be treated the same. Under the current regulatory construction, only taxpayers that are informed of the need to use a non-simplified method and that are able to use such a method may avoid the capitalization of contingent royalties. On the other hand, taxpayers that either blindly use a simplified method, or are required to use such a method because they do not have the sophisticated systems necessary to develop a non-simplified method, will be required to capitalize the contingent royalties.

For all of these reasons, it would be sound tax policy for the IRS to provide a specific exclusion for contingent royalties under Section 263A.

Even if the contingent royalty is fully allocated to cost of goods sold, taxpayers must still be mindful that if the contingent royalty arises in the context of an intercompany sale, the contingent royalty, along with the intercompany sales revenues and the other costs comprising cost of goods sold, will be deferred to the extent the sold property continues to be held by the buying member.[14]

13. E.g., Reg. 1.263A-1(e)(3)(ii)(J).
14. See Reg. 1.1502-13(c).

# Negative additional Section 263A costs

In addition to requiring taxpayers to capitalize direct and indirect costs that directly benefit, or are incurred by reason of, production or resale activities, Section 263A states that, for tax purposes, certain costs either are not required or, in some cases, not permitted to be capitalized.

In order to understand the concept of negative costs, it is important to be familiar with the regulatory construction of "additional section 263A costs." Specifically, the Section 263A regulations define the costs that must be capitalized for tax purposes as "section 263A costs," which are determined by taking the sum of the taxpayer's Section 471 costs and additional Section 263A costs. Section 471 costs are defined as costs that were capitalized for tax purposes prior to the enactment of Section 263A.

Because taxpayers generally followed their book methods when determining the costs required to be capitalized for tax purposes before the enactment of Section 263A, taxpayers typically treat the costs capitalized for book purposes as their "section 471 costs." In comparison, the regulations define "the costs … that were not capitalized under the taxpayer's method of accounting immediately prior to the effective date of section 263A … but that are required to be capitalized under section 263A" as additional Section 263A costs.

Accordingly, when determining the costs that must be capitalized for tax purposes under Section 263A, taxpayers first must analyze the costs capitalized for book purposes (i.e., their Section 471 costs) to determine whether additional costs must be capitalized and whether any of the book costs must or may be removed from ending inventory. (For purposes of this article, the discussion of negative costs is only in the context of inventory property; however, a similar analysis could be applied to self-constructed property, which also is subject to capitalization under Section 263A.) In light of the regulatory definitions, taxpayers typically treat the difference between the costs capitalized for book purposes and the costs required to be capitalized for tax purposes as additional Section 263A costs, whether those costs are positive or negative.

When costs must or may be removed from book inventories, negative costs arise. For example, negative costs often result when book depreciation exceeds the tax depreciation required to be capitalized under Section 263A. In this situation, it is necessary to reduce the book depreciation capitalized to reflect the amount that is properly capitalized under Section 263A (i.e., tax depreciation).

Negative costs also result when a taxpayer using a standard cost method does not reallocate significant favorable variances (i.e., the excess of total standard costs over total actual costs) to its ending inventory for book purposes. The Section 263A regulations require the reallocation of significant variances.[15] Accordingly, if a taxpayer under its method of accounting prior to the effective date of Section 263A did not reallocate significant variances, the variances by definition are additional Section 263A costs, whether positive or negative.

The adoption of FAS 123 to account for stock options also has led to the need for negative costs because the taxpayer must remove the book capitalization of stock option expense prior to replacing it with the tax stock option expense.

Once additional Section 263A costs have been determined, the regulations provide a number of allocation methods, including several facts-and-circumstances methods and the simplified methods, that may be used to allocate those costs to ending inventory. Generally, producers of property may use the simplified production method, and resellers may use the simplified resale method. Under the simplified production method, a taxpayer's ending inventory is multiplied by an absorption ratio calculated as additional Section 263A costs divided by total purchases or production costs, the result of which will approximate an inventory turnover-type calculation. (The absorption ratios that are used under the simplified resale method differ, but those differences are not germane to this discussion.)

**IRS position.** In TAM 200607021, the IRS concluded that a taxpayer had not properly implemented its change in method of accounting for Section 263A costs when it treated negative costs as additional Section 263A costs in the numerator of the simplified production method absorption ratio. (Treating certain costs as negative additional Section 263A costs in the numerator of the absorption ratio results in the removal of the costs from ending inventory.) The TAM further concluded that the removal of costs in this manner resulted in more costs being removed from ending inventory than were originally included.

Following public comment on the TAM, the IRS released Notice 2007-29, Section 263A costs might result in significant distortions to income. That is, the simplified methods typically overcapitalize positive costs because the costs are allocated to all items purchased or produced regardless of whether the costs relate to such goods. By the same token, the use of simplified methods with negative costs arguably would have the same effect, resulting in undercapitalization by pulling out more costs than were originally capitalized for books.

15. Reg. 1.263A-1(f)(3)(ii)(B).
16. 2007-14 IRB 881.

Notice 2007-29 requests public comments related to certain specific issues surrounding the use of negative costs. Significantly, the Notice also indicates that, pending further guidance, the IRS will not challenge the use of negative costs in computing additional Section 263A costs on exam and will not deny consent to an accounting method change solely for including negative costs in determining additional Section 263A costs. Interestingly, the IRS is considering addressing its concerns about negative costs by modifying the simplified methods so they produce more accurate results for both positive and negative costs.

**Observations.** The IRS should continue to allow negative costs to be removed from ending inventory using the taxpayer's Section 263A allocation methods for several reasons:

1. The current Section 263A regulations properly allow the use of negative additional Section 263A costs. In particular, the current structure of the Section 263A regulations (as embodied in the definitions of Section 263A costs, additional Section 263A costs, and Section 471 costs) not only contemplates the use of negative costs, but requires the use of negative costs in order to properly determine Section 263A costs when a taxpayer's book inventory includes costs not required or allowed to be capitalized to ending inventory for tax purposes.

2. The underlying goal of simplification further supports the use of negative costs. If a taxpayer was not permitted to use negative costs to remove costs not required or permitted to be capitalized under Section 263A, a taxpayer would be forced to remove the costs by reducing its Section 471 (book) costs. Reducing Section 471 costs would require a taxpayer to determine the amount of the negative cost that is allocable to (and thus removable from) ending inventory, either by using the complicated and often very detailed book allocation system or by developing a separate tax allocation system under Section 471. Because negative costs inevitably result from book-tax differences (e.g., depreciation) and variances, virtually every taxpayer would be forced to develop a separate Section 471 cost allocation method for tax purposes. This result would be counterproductive and overly burdensome.

3. It is inappropriate tax policy to allow the use of simplified methods for positive costs and not negative costs. It is generally accepted by the government and practitioners that the simplified methods overcapitalize costs. That is, the simplified methods were designed to accomplish rough justice with regard to capitalization, and that rough justice should apply equally to the government (with respect to negative costs) and taxpayers (with respect to positive costs). If the government is concerned with the distortion resulting from the simplified methods, then those methods should be changed to yield more accurate results for both positive and negative costs, as the government currently is contemplating in Notice 2007-29.

# Conclusion

In light of the increased scrutiny of Section 263A compliance, a review of taxpayers' existing Section 263A methodologies would help ensure appropriate and favorable treatment of Section 263A costs, including contingent royalties and negative costs. While present guidance under Section 263A appears to support the allocation of contingent royalties entirely to cost of goods sold and the inclusion of negative costs as additional Section 263A costs, recent interest by the IRS supports the need for additional guidance. The authors further believe that any new guidance, at the very least, should confirm that contingent royalties may be fully allocated to cost of goods sold and that negative costs may be treated as additional Section 263A costs.

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