

WNTS Insight



Key implications of IRS nonacquiescence in Second Circuit analysis of manufacturer's royalty payments

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The IRS recently announced (Action on Decision 2011-01) that it will not follow the analysis in the Second Circuit's decision in *Robinson Knife Manufacturing Company Inc.*, other than in litigating cases appealable to the Second Circuit. In *Robinson Knife*, the Second Circuit held that a manufacturer's royalty payments are currently deductible under section 162 if they are (1) calculated as a percentage of sales revenue from inventory and (2) incurred only upon the sale of that inventory.

The IRS issued proposed regulations in December that would follow the result of the Second Circuit's decision in that sales-based royalties would be taken into account currently, albeit under the regulations as cost of goods sold rather than as a section 162 deduction. Thus, the significance of this AOD relates primarily to the characterization of the costs as opposed to timing.

Background

Historically, the IRS has taken the position that taxpayers using a simplified method to allocate additional section 263A costs to inventory must capitalize certain sales-based royalty payments, i.e., royalties that are calculated as a percentage of sales revenue from inventory and that are incurred only on the sale of that inventory.

In *Robinson Knife*, the taxpayer was in the business of designing, manufacturing, marketing, and selling kitchen tools, and treated its sales-based royalty payments as direct sales expenses that were deductible under section 162. The IRS and the Tax Court disagreed with Robinson Knife's characterization, concluding that the sales-based royalty expenses were production costs because the royalties directly benefited and were incurred by reason of the performance of production. Therefore, under the Tax Court's decision, Robinson Knife was required to capitalize the royalty costs to the trademarked items it produced under its simplified method.

On appeal, the Second Circuit reversed and held that Robinson Knife's royalty payments were expenses deductible under section 162. The court observed that under the agreements, Robinson Knife did not have

to pay the royalties when it manufactured the tools; the royalty payments were not due unless and until Robinson Knife sold the tools. Based on that distinction, the court reasoned that Robinson Knife incurred the royalty expenses by reason of the sale, not the production, of the tools.

After the Second Circuit decision, the IRS issued proposed regulations that addressed sales-based royalties. The proposed regulations agree with the result, but not the reasoning, of the Second Circuit decision that section 263A does not require capitalization of sales-based royalty costs to ending inventory. While the court's ruling was that sales-based royalties are treated as deductible costs for purposes of section 263A, the proposed regulations would provide that sales-based royalties are capitalizable indirect costs, but are allocable only to property that has been sold.

For prior discussion of the proposed regulations, see WNTS Insight, "Long anticipated proposed regulations provide favorable treatment for sales-based royalties, but require consistent position for sales-based vendor allowances," December 20, 2010. For prior discussion of the Second Circuit decision, see WNTS Insight, "Second Circuit rules that sales-based royalties are not capitalizable under section 263A," March 25, 2010.

Observations: Impact of Action on Decision

The AOD does not disagree with the result in the Second Circuit's decision in *Robinson Knife* -- just the analysis that the sales-based royalties are not production costs. In fact, the result in *Robinson Knife* was followed by the IRS in the proposed section 263A regulations. The difference in methodology between the Second Circuit holding and the proposed regulations generally should not have a direct impact on the total costs capitalized to ending inventory under section 263A. That is, the IRS agrees that sales-based royalties may be taken into account currently, although as cost of goods sold instead of as a section 162 deduction.

However, treating sales-based royalties as production costs, as under the proposed regulations, could have the effect of increasing the numerator of the production cost-based simplified service cost method, which in turn would increase the amount of mixed service costs capitalized into ending inventory. To avoid this negative impact, taxpayers with significant sales-based royalties should consider changing to the labor-based simplified service cost method to allocate mixed service costs.

The IRS's position that sales-based royalties are production costs and part of cost of goods sold, rather than deductions under section 162, also may have an impact on other areas of the tax law, including section 199, the extraterritorial income (ETI) rules, the foreign tax credit rules, and Subpart F. This impact may be favorable or unfavorable depending on the taxpayer's specific facts and should be addressed on a case-by-case basis.

Finally, the AOD could indicate that the IRS is not willing to accept method changes to exclude sales-based royalties from ending inventory under the simplified production method for taxpayers outside the Second Circuit prior to the effective date of the regulations. (The regulations are proposed to apply for tax years ending on or after the date the regulations are published as final regulations in the Federal Register.) Moreover, the AOD also indicates that the IRS likely will not be willing to accept the reasoning of the Second Circuit's decision to allow taxpayers to exclude other similar "post-production" type costs (such as environmental remediation) from ending inventory.

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