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# *Minimum royalties must be capitalized to ending inventory, IRS concludes*

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## ***In brief***

The IRS concluded in recently released field attorney advice (FAA 20124401F) that minimum royalties paid for the use of licensed patents must be capitalized to ending inventory under Section 263A. The conclusions reached in the FAA could impact any taxpayer with a minimum royalty arrangement.

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## ***In detail***

### ***Background***

In the FAA, Taxpayer develops, manufactures, markets, and sells a product. Taxpayer requires the use of certain patented technology in order to manufacture the product. Taxpayer entered into a licensing agreement that provides for several types of compensation, including two types of royalties -- the earned royalty and the minimum royalty. The earned royalty is computed using a specified dollar amount for each unit sold or leased; the minimum royalty is a fixed annual amount against which any earned royalty for the same year is credited.

During the years in question, the earned royalties exceeded the minimum royalty. Taxpayer argued that, based on this fact, the minimum royalty was never

triggered, and only earned royalties were paid. As a result, Taxpayer deducted all the royalty payments as cost of goods sold. The IRS disagreed and asserted that the minimum royalty paid for the use of the licensed patents must be capitalized to ending inventory under Section 263A.

### ***Law and analysis***

Section 263A requires a taxpayer to capitalize direct and indirect costs that are properly allocable to tangible personal property produced by the taxpayer. Indirect costs are properly allocable to the property produced when the costs directly benefit or are incurred by reason of the performance of production activities. The regulations specifically include licensing and franchising costs (including minimum annual payments and

royalties) as an example of capitalizable indirect costs.

However, proposed regulations under Section 263A would provide that if a taxpayer incurs a royalty only upon the sale of property produced (a sales-based royalty), then the cost is allocable only to the property that has been sold under the inventory cost flow assumption the taxpayer uses to identify the costs in ending inventory. In addition, an IRS Industry Director's Directive (IDD) currently instructs revenue agents not to challenge a taxpayer's treatment of sales-based royalties if the taxpayer accounts for sales-based royalties using the method described in the proposed regulations or a method that reaches a similar result.

**Discussion**

In the FAA, the IRS did not dispute that the earned royalties in excess of the minimum royalty should be allowed as cost of goods sold. The earned royalties were calculated based on the number of units sold and became due only upon sale, so the IRS agreed that the earned royalties should be considered sales-based royalties within the meaning of the proposed regulations. Similarly, Taxpayer did not dispute the clear authority under both the current and proposed regulations that minimum royalties must be capitalized.

The disagreement between the IRS and Taxpayer pertained to

characterization of the royalties paid. Taxpayer argued that the minimum royalty was never paid because the earned royalties exceeded the minimum royalty and, thus, only earned royalties were paid. The IRS argued that both minimum and earned royalties were paid. The license agreement provided that the minimum royalty was incurred and payable for each year (or partial year) in which the license agreement was in effect, regardless of sales. Although the earned royalties were credited against the minimum royalty, Taxpayer's liability for the minimum royalty was unaffected by the amount of earned royalties or the number of units sold.

**IRS conclusion**

The IRS concluded that the minimum royalty was incurred and paid for the right to produce the products. Based on the law and its analysis, the IRS concluded that the minimum royalty paid for the use of licensed patents must be capitalized to ending inventory under Section 263A.

**The takeaway**

In light of the conclusions reached in this FAA, taxpayers should review their royalty agreements with regard to the proper treatment of any minimum royalties.

**Let's talk**

For a deeper discussion, please contact:

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