

**Office of Chief Counsel
Internal Revenue Service
Memorandum**

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subject: Capitalization of minimum royalties under Section 263A

This memorandum responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =
Licensor =
State =
Amount =

ISSUES

Whether minimum royalties paid for the use of licensed patents must be capitalized to ending inventory under Section 263A.

CONCLUSIONS

The minimum royalties are required to be capitalized under Section 263A.

FACTS

Taxpayer is a State corporation that develops manufactures, markets and sells . Licensor owns certain patented technology. Taxpayer entered into a license agreement with Licensor which granted Taxpayer an exclusive license to use the Licensed Patents to “make, have made, use, sell and otherwise distribute Products anywhere in the world.” License Agreement, section 2(A). The Taxpayer may grant nonexclusive sublicenses to third parties.¹ License Agreement, section 2(B). The License Agreement provides for several types of compensation for the rights conveyed, including two types of royalties: the Earned Royalty and the Minimum Royalty.

The Earned Royalty is computed using a specified dollar amount per product unit sold or leased.² The per-unit royalty amount varies based on the range of cumulative product units sold or leased. License Agreement, section D(i). A royalty is deemed earned under the License Agreement when a product unit is deemed sold or leased. License Agreement, section 3(D)(ii). A deemed sale occurs when the product unit is actually sold and at least one third of the total purchase price is received; a deemed lease occurs when one third of the annual lease payments for the first year of a lease have been received. License Agreement, section 3(D)(ii).

The Minimum Royalty is a fixed annual amount, described as follows:

[Taxpayer] further agrees to pay to [Licensor] a minimum royalty per calendar year or part thereof during which this Agreement is in effect starting in calendar year 2000, against which any earned royalty paid by [Taxpayer] or [Licensor's] share of [Taxpayer's] sublicensee(s) payments for the same calendar year will be credited.

License Agreement, section 3(E). For the years at issue, the minimum royalty was \$Amount per year. In addition, the License Agreement provides:

The minimum royalty for a given year shall be due at the time payments are due for the calendar quarter ending December 31. It is understood that the minimum royalties will apply on a calendar year basis and that sales of Products requiring the payment of earned royalties made during a prior or subsequent calendar year shall have no effect on the annual minimum royalty due [Licensor] for any given calendar year.

License Agreement, section 3(E). The Minimum Royalty for a given year is due to be paid by January 31 of the following year. Any Earned Royalties paid for the same

¹ Taxpayer is required to pay Licensor 50% of all fees, royalties and other payments received from such sublicenses. The proper treatment of payments received from sublicensees will not be addressed in this memorandum.

² The treatment of royalties paid on leased units will not be addressed in this memorandum.

calendar year are credited against the Minimum Royalty. Upon termination of the License Agreement, any minimum royalties will be prorated as of the date of termination. License Agreement, section 6(D).

Taxpayer deducted \$Amount in Minimum Royalty costs related to the License Agreement on Form 1120, Schedule A, line 5 as "Other Cost". In each of the years at issue, the Earned Royalty exceeded the Minimum Royalty.

LAW AND ANALYSIS

We have reviewed the draft 5701 and agree with the proposed adjustment to capitalize the minimum royalties under I.R.C. Section 263A. The following comments are offered to assist in finalizing this case for Appeals.

Section 263A requires taxpayers to capitalize the direct costs and indirect costs that are properly allocable to tangible personal property the taxpayer produces. Section 263A(b).

Section 1.263A-1(e)(3)(i) defines indirect costs as all costs other than direct material costs and direct labor costs (in the case of property produced) or acquisition costs (in the case of property acquired for resale). Indirect costs are properly allocable to property produced or acquired for resale when the costs directly benefit or are incurred by reason of the performance of production or resale activities. *Id.*

To capitalize a cost under section 263A means, in the case of inventory, to include in inventory costs and, in the case of other property, to charge to a capital account or basis. Section 1.263A-1(c)(3). Costs 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. Section 1.263A-1(c)(4).

Section 1.263A-1(e)(3)(ii) provides a non-exclusive list of indirect costs that must be capitalized to the extent they are properly allocable to property produced or property acquired for resale. Among the items listed are licensing costs associated with property produced. Current Treas. Reg. Section 1.263A-1(e)(3)(ii)(U) specifically provides:

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.

Treasury Regulation section 1.263A-1(e)(3)(ii)(U) has been analyzed with mixed results by the courts. Plastic Engineering & Technical Services, Inc. v. Commissioner, TC

Memo. 2001-324 and Robinson Knife Manufacturing Co. v. Commissioner, T.C. Memo 2009-9 each held that sales-based royalties were required to be capitalized as production costs; but the Second Circuit reversed the Tax Court's decision in Robinson Knife Manufacturing Co. v. Commissioner, 600 F.3d 121 (2d Cir. 2010). The Service disagrees with the Second Circuit's reasoning in Robinson Knife, particularly that Court's holding that sales-based royalties are deductible expenses rather than production costs. See AOD 2011-01.

Subsequent to Robinson Knife, the Service published proposed regulations reflecting a change in position with respect to sales-based royalties. The proposed regulations are consistent with the result, but not the reasoning, espoused in Robinson Knife. Proposed section 1.263A-1(e)(3)(ii)(U) provides:

(U) Licensing and franchise costs. (1) * * * These costs also include fees, payments, and royalties otherwise described in this paragraph (e)(3)(ii)(U) that a taxpayer incurs (within the meaning of section 461) only upon the sale of property produced or acquired for resale.

(2) If a taxpayer incurs (within the meaning of section 461) a fee, payment, or royalty described in this paragraph (e)(3)(ii)(U) only upon the sale of property produced or acquired for resale and the cost is required to be capitalized under this paragraph (e)(3), the cost is allocable only to the property that has been sold or, for inventory property, deemed to be sold under the inventory cost flow assumption (such as first-in, first-out; last-in, first-out; or a specific-goods method) the taxpayer uses to identify the costs in ending inventory.

These proposed regulations clarify that sales-based royalties, although required to be capitalized, are entirely allocated to sold goods, and thus flow through cost of goods sold ("COGS") for the year. See Prop. Treas. Reg. Section 1.263A-1(e)(3)(ii)(U)(2). As defined in the preamble to the proposed regulations, "Sales-based royalties are royalty costs that become due only upon the sale of property. Thus, the fact of the liability arises, and the royalty is incurred within the meaning of section 461, only upon sale."

Pending publication of final regulations, an 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. Field Guidance on the Planning & Examination of Sales-Based Royalty Payments and Sales-Based Vendor Allowances (March 1, 2011). Thus, any sales-based royalties the taxpayer treated as COGS for the year should not be challenged.

The Earned Royalties (in excess of the minimum royalties) payable with respect to units sold are calculated based on the number of units sold, and become due only upon sale, and so should be considered sales-based royalties within the meaning of the proposed regulations. Thus, the taxpayer's deduction of these amounts should not be challenged pursuant to the IDD.

The requirement to capitalize production-related minimum royalties, however, remains quite clear under both the regulations and case law, and is not addressed in the IDD.

Under both the current and proposed versions of section 1.263A-1(e)(3)(ii)(U), capitalizable costs include “any minimum annual payments” incurred by a licensee. Even the Robinson Knife court acknowledged that non-sales-based royalties, such as minimum royalties, should be capitalized. 600 F.3d at 133. Thus, contrary to Taxpayer’s assertion, neither Robinson Knife nor the IDD support current deduction of the Minimum Royalties.

The Service does not dispute that sales-based royalties should be allowed as COGS, and similarly the taxpayer has not disputed the clear authority requiring capitalization of minimum royalties. The disagreement in this case derives from differing characterizations of the royalties paid in this case. The Service’s view is that both minimum and sales-based royalties were paid; Taxpayer denies that any Minimum Royalty was in fact paid. Taxpayer argues that the Minimum Royalty provision was never invoked because in each year the Earned Royalties exceeded the Minimum Royalty threshold. This argument is contradicted by the terms of the License Agreement.

The License Agreement provides that the Minimum Royalty is incurred and payable for each year (or partial year) in which the License Agreement is in effect, which includes each of the years under examination. The Minimum Royalty is a lump-sum amount which is not based on a percentage of sales or dependent on actual units sold. Although Earned Royalties are computed (in part) based on units sold, and any payments of Earned Royalties are credited against the Minimum Royalty, Taxpayer’s liability for the Minimum Royalty is unaffected by either the amount of the Earned Royalty or the number of units sold for a given calendar year. The Earned Royalty payments are applied towards the Minimum Royalty liability until that liability is satisfied. The application of quarterly payments computed with reference to sales does not transform the Minimum Royalty liability into a cost which is incurred “only upon sale.”

The taxpayer could not have used the Licensed Patents to produce the Products without the License Agreement being in effect. The Minimum Royalty was incurred ratably during each year the License Agreement was in effect. Thus, it is clear that the Minimum Royalty was incurred in each of the years at issue. Further, the Minimum Royalty liability was in fact paid through the credit mechanism established in the License Agreement, whereby Earned Royalty payments were credited towards the Minimum Royalty liability until satisfied. Thus, the royalties paid necessarily included Minimum Royalties.

The License Agreement terms similarly support treatment of the Minimum Royalties as production costs. The License Agreement conveys the right to make, have made, sell and distribute Products that employ the Licensed Patents. Taxpayer incurred the royalty expenses to first produce then sell the Products developed from the Licensed Patents. Because the Minimum Royalties compensate for the right to produce the Products, these royalty costs clearly directly benefit or are incurred by reason of production activities within the meaning of section 1.263A-1(e)(3)(i).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS



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Please call (313) 628-3113 if you have any further questions.

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