Capitalization of Royalties – 263A COGS

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

ISSUE

Whether is required under I.R.C. §263A to capitalize royalty payments in the amount of paid pursuant to the license of a patent, rather than deducting such payments currently?

CONCLUSION

Under I.R.C. §263A and Treas. Reg. §1.263A-1, royalties paid pursuant to the license of such patent are indirect costs which are properly allocable to the production of property, and must be capitalized.

FACTS

are a , first marketed in the United States in under the brand name , was
was first disclosed in the U.S.

Soon after being brought to market, it was discovered that

A is a

Generally speaking, which does not produce the same as may be produced by which.

often refers to a reaction, which usually takes place within a, in which a certain to create a

are the product of these . When

, it undergoes extensive into

, marketed in the United States as , is the disclosed in U.S. Patent No. , issued in . According to

Patent No. is 1 which describes the , but which

In , upon

was

U.S. Patent No. (the “Patent”) was issued on . characterizes the Patent as

1 patents generally fall into categories of patents:

2 Subsequent patents for include U.S. Patent No , a “.” Subsequent patents for the include U.S. Patent Nos. and . Subsequent include U.S. Patent Nos. and . Subsequent (other than the ) include patents for the , U.S. Patent Nos. and , and a patent for the , U.S. Patent No. .
During the years in issue, the Patent was held by [Redacted], and rights under the Patent were licensed to [Redacted] and [Redacted].

3 The Patent was originally issued to [Redacted], which licensed certain rights under the Patent to [Redacted] pursuant to an agreement dated [Redacted]. [Redacted] contributed the Patent to [Redacted] and assigned its rights under such license agreement to [Redacted] via a Contribution Agreement and an Assignment of Licensor Interest, respectively, both also dated [Redacted]. The relevant terms of the license agreement are substantially similar to the agreement.

4 In addition to the Royalties paid to [Redacted], other third parties are paid royalties with respect to related license agreements. As opposed to the payments made to [Redacted] totaling [Redacted], these royalty payments are based on [Redacted] and have been represented to total as follows:

<table>
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<tr>
<th>Payee</th>
<th>Description</th>
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5 On [Redacted], the Parties to the Agreement executed an amendment (notwithstanding the Agreement) entitled "[Redacted]" (the "Amendment"), effective as of [Redacted]. The terms and conditions as set forth in the Agreement were unchanged, but for the provisions of the Amendment. Pertinent provisions extended the term of the grant of rights to [Redacted] of the then remaining useful life of the Patent, and replaced the fixed royalty amount of [Redacted] yearly with a sales-based royalty, which set the variable royalty rate at [Redacted] of the net sales in [Redacted].
Agreement. In order to determine the amount of the Royalties, retained a consulting company, projected net sales of through and applied an “appropriate royalty rate” to these estimated net sales to arrive at an expected net present value of royalties due; the fixed royalty payments in of the Agreement are based on this expected net present value of royalties due.

During the years in issue, imported unfinished to the United States from an Affiliate, performed the “secondary manufacturing process” required to sell , and distributed and marketed as a finished product, pursuant to its rights under the Agreement. is not produced or sold in the United States for any purpose other than .

**LAW AND ANALYSIS**

I.R.C. §263A(a) provides that certain direct and indirect costs of producing inventory must be included in the cost of inventory. Section 263A(b)(1) provides that §263A applies to tangible personal property produced by . See also §§ 1.263A-1(a)(3)(i)(A) and 1.263A-2.

Treas. Reg. §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). Taxpayers subject to 263A must capitalize all indirect costs properly allocable to property produced. Indirect costs are properly allocable to property produced when the costs directly benefit or are incurred by reason of the performance of production activities.

Treas. Reg. §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. Section 1.263A-1(e)(3)(ii)(U) states that 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, and that these costs include the otherwise deductible portion 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.

Under Section of the Agreement, was granted an exclusive license , which covers . Therefore, the Royalties paid under Section of the Agreement are incurred to secure contractual rights associated with the production of property. Thus, the Royalties are indirect costs that directly benefit or are
incurred by reason of the production of $\text{production}$, and must be capitalized under I.R.C. §263A and Treas. Reg. §1.263A-1.

Although $\text{argues}$ argues that the Patent is not necessary for the physical production of $\text{production}$, no facts have been provided to support this claim. Furthermore, even if it were assumed that the Patent was not necessary for the physical production of $\text{production}$, this alone would not change the result that the Royalties paid pursuant to the Agreement are required to be capitalized under §263A. Based on the rights granted to $\text{by the Agreement}$, the Royalties directly benefit or are incurred by reason of the production of $\text{production}$.

also argues that Robinson Knife Mfg. Co., Inc., 600 F.3d 121 (2nd Cir. 2010), nonacq., 2011-1 C.B. 836, allows for a current deduction of the royalties paid under the Agreement. In Robinson Knife, the Court of Appeals for the Second Circuit held that royalties paid for the right to use certain trademarks in the manufacturing of kitchen tools were not allocable to the property produced because they were sales-based royalties. These royalties were calculated as a percentage of net sales and only incurred upon the sale of the products.

Notwithstanding the Service’s non-acquiescence in the Robinson Knife decision, position would greatly expand the holding of the case. Robinson Knife only provided for the deduction of royalty payments that are (1) calculated as a percentage of sales revenue from certain inventory, and (2) incurred only upon the sale of such inventory. Robinson Knife, 600 F.3d at 135. The Royalties meet neither

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*Subsequent to the decision in Robinson Knife, the Treasury issued proposed regulations, clarifying that sales-based royalties may be capitalizable to property a taxpayer produces, but also providing that sales-based royalties are allocable only to property that a taxpayer has sold. The proposed regulations have been finalized, to be effective January 13, 2014. Sales Based Royalties and Vendor Allowances, 79 Fed.Reg. 2094 (Dec. 13, 2013). The Notice of Proposed Rulemaking states that:

Robinson Knife misconstrued the nature of costs required to be capitalized. Royalties are the costs associated with the right to use intellectual property such as copyrighted works or patented inventions. If the use of those rights directly benefits or is incurred by reason of production activities, then the cost of securing those rights do as well. The fact that the amount of sales-based royalties is determined by reference to the number of units of property a taxpayer sells or is calculated as a percentage of revenue from the sale of inventory affects when a taxpayer incurs (within the meaning of section 461) that amount but does not change an otherwise capitalizable production or resale cost into a non-capitalizable cost. ...Sales-based royalties, like other costs that directly benefit or are incurred by reason of production or resale activities, are capitalizable licensing and franchise costs within the meaning of §1.263A-1(e)(3)(ii)(U).

The proposed regulations achieve a similar result to that in Robinson Knife, but rather than determining that sales-based royalty costs are inherently non-capitalizable, the proposed regulations provide that otherwise capitalizable sales-based royalty costs are properly allocable to property sold during the year.

Sales-Based Royalties and Vendor Allowances, 75 Red. Reg. 78940-01 (Dec. 17, 2010).
requirement. Section of the Agreement outlines the Royalty payment structure. Payment is due . The Agreement makes no reference to any sales based payment structure. Although the amount of the Royalties are determined by reference to projected net sales of , the royalties are a fixed amount that are neither calculated as a percentage of actual sales revenue nor incurred only upon actual sales of .

Moreover, the Second Circuit recognized the broad scope of Section 263A in the Robinson Knife opinion, stating that:

[The description in §1.263A-1(e)(3)(ii)(U)] does not include all costs, or even all trademark costs, that must be capitalized. The costs incurred by Robinson are still indirect costs, and they are, therefore, required to be capitalized to the extent they are properly allocable to property produced. As §1.263A-1(e)(3)(i) explains, “[i]ndirect costs are defined as all costs other than direct material costs and direct labor costs (in the case of property produced).” (emphasis added). The royalties are costs. They are not direct costs. Hence, they are indirect costs, and such costs are not exempt from the capitalization requirement merely because they are absent from the list … found in §1.263A-1(e)(3)(ii).

Robinson Knife, 600 F.3d at 130.

Accordingly, the decision in Robinson Knife has no bearing on the case at issue. The royalty payments must be capitalized under I.R.C. §263A and Treas. Reg. §1.263A-1.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call Andrew Travis at 973-645-3656 if you have any further questions.

MICHAEL P. CORRADO
Area Counsel
(Heavy Manufacturing & Pharmaceuticals)

By: ____________________________
Andrew H. Travis
General Attorney (Newark, Group 2)
(Large Business & International)