

Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **20145101F**
Release Date: 12/19/2014

CC:LM:HMP:NEW:2:AHTTravis
POSTF-123036-12

UILC: 263A.03-02

date: May 8, 2014

to: Rima Mukherjee
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from: Andrew H. Travis
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subject: 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

Patent No. _____ issued in _____ was first disclosed in the U.S.

Soon after being brought to market, it was discovered that

a _____ . A _____ is _____ . 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 _____ . The preparation and use of _____ as _____ is disclosed in U.S. Patent No. _____ , issued in _____ . According to _____ Patent No. _____ is _____

¹ which describes the _____ , but which _____ .²

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 _____, and rights under the Patent were licensed to _____.³ _____ was formed on _____ by _____ and _____ original capital contribution to _____ (the "Contribution"). Since the formation of _____, _____ has been a partner in _____.

On _____, _____ entered into an "Amended and Restated _____ License Agreement" with _____ (the "Agreement"), whereby _____ granted _____ an exclusive license _____.

_____ See Section _____ of the _____ Agreement.

In exchange for the license and rights granted in the _____ Agreement, _____ agreed to pay to _____ royalty payments in the amount of _____ (the "Royalties") for the term of the _____ Agreement.^{4,5} See Section _____ of the _____.

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

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

<u>Payee</u>	<u>Description</u>
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⁵ On _____, the Parties to the _____ Agreement executed an amendment (notwithstanding the _____ Agreement) entitled "_____ (the "Amendment"), effective as of _____. 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 _____ of the then remaining useful life of the Patent, and replaced the fixed royalty amount of _____ yearly with a sales-based royalty, which set the variable royalty rate at _____ of the net sales in _____.

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 a 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 _____, and must be capitalized under I.R.C. §263A and Treas. Reg. §1.263A-1.

Although _____ argues that the Patent is not necessary for the physical production of _____, 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 _____, 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 _____ by the _____ Agreement, the _____ Royalties directly benefit or are incurred by reason of the production of _____.

_____ 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 decision⁶, _____ 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

⁶ 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.

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.

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By: _____
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