DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF THE CHIEF COUNSEL

IRB No. 2011-9
February 8, 2011

ACTION ON DECISION

Subject: Robinson Knife Manufacturing Company and Subsidiaries v. Commissioner 600 F.3d 121 (2d Cir. 2010), rev'g T.C. Memo 2009-9

Issue:

Whether sales-based royalties that taxpayer paid for the right to use trademarks on the kitchen tools that it manufactures and sells are production costs "allocable to property produced" (inventory) within the meaning of Treas. Reg. § 1.263A-1(e).

Discussion:

Robinson Knife Manufacturing Company and its Subsidiaries (Robinson) are engaged in the business of designing, manufacturing, marketing, and selling kitchen tools. Robinson entered into licensing agreements for the right to use well-known trademarks on some of the kitchen tools that it manufactures. Under the agreements, Robinson paid the trademark licensors a percentage of net sales of the trade-marked kitchen tools. These royalties are commonly called 'sales-based royalties' or 'contingent royalties' in the trade.

Robinson is an accrual method taxpayer that uses the first-in, first-out inventory method and the simplified production method under Treas. Reg. § 1.263A-2(b)(1) to allocate costs to inventory. However, Robinson did not treat its sales-based royalty payments as production costs allocable to inventory. Instead, Robinson treated the royalty payments as direct sales expenses and deducted them as ordinary and necessary business expenses under § 162.

The Service disagreed with Robinson's characterization of the royalties as sales expenses and denied the deductions. The Service determined that the royalties were production costs that Robinson must capitalize to inventory under § 263A. Robinson challenged that determination in Tax Court. The Court held that Robinson's royalty expenses were production costs under § 1.263A-1(e)(3)(i) because the royalty expenses directly benefitted and "were incurred by reason of the performance of production…" Therefore, Robinson was required to capitalize the royalty costs to the trade-marked items it produced (inventory).

On appeal, the Second Circuit reversed the Tax Court decision and held that

Robinson's royalty payments were expenses deductible under § 162. The court observed that, under the agreements, Robinson did not have to pay the royalties when it manufactured the kitchen tools; the royalty payments were not due unless and until Robinson sold the tools. Based on that distinction, the court reasoned that Robinson incurred the royalty expenses "by reason of" the sale not the production of the tools. Consequently, the court concluded that the royalty payments were not production costs within the meaning of § 1.263A-1(e)(3)(i).

We disagree with the Second Circuit's analysis. We think that the court confused the timing with the purpose of the payments. Robinson incurred the royalty expenses to first produce then sell the trade-marked items. Like all manufacturers, Robinson had to manufacture the tools to sell them. We think that the Tax Court correctly held that Robinson incurred the royalty expenses "by reason of" its production activities, and the royalty payments were production costs within the meaning of § 1.263A-1(e)(3)(i).

The Service and Treasury Department published proposed regulations stating that sales-based royalties are production costs required to be capitalized under § 263A and are allocated to inventory sold during the taxable year. 75 F.R. 78940 (December 17, 2010). The Service will not follow the Second Circuit's holding that sales-based royalty payments are deductible expenses except in litigating cases appealable to the Second Circuit.

Recommendation: Nonacquiescence.

____

John Roman Faron
Attorney, Branch 6
(Income Tax & Accounting)

Reviewers:

Approved:

WILLIAM J. WILKINS
Chief Counsel
Internal Revenue Service

By: __________________________________

George J. Blaine
Associate Chief Counsel
(Income Tax & Accounting)