

Observers Divided on Second Circuit's Licensing Fee Decision

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The Second Circuit's reversal of the Tax Court on capitalization of licensing fees has observers divided, with some favoring the Tax Court's analysis and others saying the Second Circuit's approach is the correct interpretation of the code.

In *Robinson Knife*, the Second Circuit ruled that licensing payments Robinson made to Oneida Ltd. and Corning Inc. were not incurred as a result of production and therefore should be deducted immediately, rather than capitalized under section 263A. The circuit court reasoned that because the costs of the licenses were calculated based on sales rather than production, they should be matched with the income resulting from those sales. If the licenses were a flat fee or based on production, they would be capitalized, the court said. (For the Second Circuit's opinion in *Robinson Knife Manufacturing Co. Inc. et al. v. Commissioner*, No. 09-1496 (Mar. 19, 2010), see *Doc 2010-6029* or *2010 TNT 54-15*.)

The ruling reversed last year's Tax Court decision concluding that although the use of Oneida's and Corning's brand names made Robinson's products more marketable, they should be capitalized with production costs because the licensing agreements were required for production to legally take place. (For the Tax Court's opinion in *Robinson Knife Manufacturing Co. Inc. et al. v. Commissioner*, T.C. Memo. 2009-9 (Jan. 14, 2009), see *Doc 2009-827* or *2009 TNT 9-19*.)

Prof. Calvin H. Johnson of the University of Texas School of Law agreed with the earlier ruling. "I think the Tax Court did a better job of reflecting income," he said.

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According to Johnson, the core concept in inventory accounting is that costs not lost aren't deducted. The Oneida and Corning names "enhanced the value of the inventory Robinson Knife had on hand at the end of the year," he said. As a result, the Second Circuit understated the value of the closing inventory, according to Johnson. "Royalties paid to [Corning] and Oneida for the names were in fact measured by sales, but I think the Second Circuit is unduly formalistic in concluding that the payments affected the value only of sold products," Johnson said.

Jan Skelton of Deloitte & Touche LLP and Leslie J. Schneider of Ivins, Phillips & Barker said they preferred the Second Circuit's reasoning. According to Skelton, the circuit court appropriately emphasized the intent behind section 263A, including matching income against expenses and treating all property uniformly. Because Robinson Knife paid royalties based on sales rather than on production, recognizing the royalties as current expenses at the time of sale achieves better matching, she said.

Schneider noted that the approach taken by the Second Circuit invites Treasury to reconsider the section 263A regs. In footnote 11 to its decision, the Second Circuit stated that "the Commissioner's reading of the regulation is contrary to the plain meaning of its text."

In the same footnote, the Second Circuit observed that "guidance under section 263A regarding the treatment of post-production costs, such as sales-based royalties" — listed on the 2009-2010 IRS priority guidance plan — does not have to adopt its reasoning. The court cautioned, however, that the guidance will be subject to judicial review and that "the appropriate deference standard for Treasury Regulations is arguably unsettled in this Circuit." (For the priority guidance plan, see *Doc 2010-5720* or *2010 TNT 51-28*.)

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Schneider said he expects any new guidance under section 263A to conform to the Second Circuit's decision.

Skelton noted that the approach taken by the Second Circuit also clashes with Rev. Rul. 2005-42, in which the IRS ruled that environmental remediation expenses from past production activities must be capitalized with future production costs. She argued that the correct result is for the environmental remediation costs to be currently deductible. (For Rev. Rul. 2005-42, 2005-2 C.B. 67, see *Doc 2005-13391* or *2005 TNT 118-14*.)

Schneider said he does not expect the IRS to appeal the Second Circuit's decision, adding that the ruling will "make it tough on the IRS" to maintain its current litigation position. "It doesn't leave a lot of holes in its reasoning," he said. ■