On the Cutting Edge of Capitalization

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We at the M&A TAX REPORT don't talk about the dreaded topic of capitalization as much as we might. Ever since the Supreme Court decided *INDOPCO*, SCt, 92-1 USTC ¶50,113, 503 US 79, capitalization has almost been a four-letter word. Of course, one can't intelligently talk about the dreaded capitalization concept without addressing the period of time over which the asset needs to be capitalized. Sometimes, one can placate the *INDOPCO* gods with capitalization, yet only delay the expense by a year or two if the asset is the subject of a disposition.

One of the latest cases in the capitalization hit parade is *Robinson Knife Manufacturing Co., Inc.*, 97 TCM 1037, Dec. 57,710(M), TC Memo. 2009-9. There, the Tax Court held that a corporation manufacturing kitchen knives and tools had to capitalize the royalties it paid under trademark licensing agreements. The IRS also prevailed on the point that it had properly allocated the royalties to the corporation's ending inventory using the simplified production method set forth in the regulations under Code Sec. 263A.

Robinson Knife designed, developed, manufactured and marketed kitchen tools and gadgets. You may have seen them at Walmart, Target, Bed Bath & Beyond, Kohl's or Sears. Robinson had licensing agreements for using trademarks with Corning (which owns the Pyrex brand) and Oneida. In fact, Robinson paid out millions of dollars in royalties. It deducted the royalty payments as ordinary and necessary business expenses.

The IRS determined that it had to capitalize the royalties under Code Sec. 263A. Robinson Knife argued that these royalties didn't directly benefit its production activities, and thus were not properly allocable to any property produced. In fact, these were deductible marketing expenses, claimed Robinson Knife, and therefore were exempt from the capitalization rules. I rather liked this argument, relying on Rev. Rul. 2000-4, 2000-1 CB 331, in which the IRS ruled that indirect costs incurred to obtain, maintain and renew ISO 9000 certification did not have to be capitalized. (ISO 9000 was a voluntary certification intended to ensure quality products or services.)

Without much discussion, the Tax Court sided with the IRS, concluding that Robinson Knife's acquisition of the right to use the Pyrex and Oneida trademarks were part of its production process. That meant royalties paid to the two companies directly benefited the Robinson production.

One lesson of *Robinson Knife* is that Rev. Rul. 2000-4 is probably unlikely to be extended. The Tax Court went to pains to point out that Rev. Rul. 2000-4 concerned quality control policies, and that the Code Sec. 263A regulations specifically require licensing costs to be capitalized. Concluding that capitalization was required for Robinson Knife's royalty payments, the Tax Court also had an easy time noting that capitalizing the royalties and allocating them to ending inventory under the simplified production method fit the regulations.