Deducting with Occam's Razor

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An English philosopher (William of Occam) is reputed to have said: "*entia non sunt multiplicanda praeter necessitatem*" or "entities ought not to be multiplied beyond what is necessary." That led to the maxim known as Occam's Razor, which provides that the simplest of two or more competing theories is preferable. Judge Guido Calabresi of the Second Circuit Court of Appeals, a legal philosopher in his own right, must have had Occam's Razor in mind when the court was recently presented with the facts of *Robinson Knife Manufacturing Company, Inc.*, CA-2, 2010-1 USTC ¶50,300 (2010).

Sharp Tools

We go from razors to knives, since *Robinson Knife* is a case about consumer kitchenware. Like butter, Judge Calabresi cut his way through the legal bugaboo of capitalizing versus deducting royalty payments. The result is a finely julienned opinion showing that the simpler cost recovery mechanism should apply to certain intellectual property royalty payments.

Custom Cutlery Concern

The facts of the case are relatively simple. Robinson Knife designed and produced innovative—or cutting edge—kitchen utensils. It then entered into licensing agreements with established brand name companies to use their own trademarks on the products. Robinson Knife entered into such agreements with Corning, Inc. to use the trademark "Pyrex" and with Oneida Ltd. to use the trademark "Oneida."

The licensing agreements provided Robinson Knife the exclusive right to manufacture, distribute and sell particular kitchen tools using the licensed brand names. By using such trademarks on its own products, Robinson Knife was able to place the branded products at major retailers more easily.

So far, so good. But the arrangement obviously involved Robinson Knife cutting in the manufacturers for a slice of the profits. Robinson Knife would pay the particular trademark holder a percentage of the net wholesale billing price of the kitchen utensils sold under the owner's trademark. Robinson Knife was only required to make the royalty payment when the products were actually sold.

Cutting Too Fine

Can you guess the controversy? Robinson Knife deducted the royalty payments as ordinary and necessary business expenses under Internal Revenue Code Section ("Code Sec.") 162. The IRS determined that the payments had to be capitalized and accounted for under the Code Sec. 263A rules for inventory. As a result, the Second Circuit (on appeal from the Tax Court) was presented with a perennial problem child of the Internal Revenue Code: the question of capitalization versus immediate deduction of an expense.

However, this case was a different cut from the usual. In fact, this was a matter of first impression concerning the treatment of intellectual property royalties under the uniform capitalization regulations. Perhaps having watched a few episodes of *Iron Chef*, Judge Calabresi chose to fillet the Tax Court's analysis and chopped the IRS's arguments in favor of the taxpayer.

The Second Circuit acknowledged that this case presented a subtle variation on the general capitalize versus deduct debate. For Robinson Knife, the two choices were either an immediate deduction or the complex inventory accounting rules of Reg. §1.263A-1, which require direct and certain indirect costs of property produced by taxpayers to be capitalized. These uniform capitalization regulations are intended to produce an ideal matching system pursuant to which a taxpayer can deduct the cost of producing an inventory item no earlier, and no later, than the taxable year in which the particular inventory item is sold.

However, Judge Calabresi's legal analysis appears to have come pre-cut. The opinion makes clear that allocating the cost of production to particular inventory is difficult under the Code Sec. 263A inventory rules. Indeed, Robinson Knife used the "simplified production method" (rather than the "facts and circumstances" method) for allocating cost to inventory. Because of that, Robinson Knife had "elected the least accurate of the permissible methods" which led to "distortions of income." Before a judge who prefers the simplicity of economic efficiency, the IRS was skewered before the case even began.

Use the Right Knife

Chefs carry their own knives, since using exactly the right one is important. That's not unlike tax lawyer arguments. Robinson Knife made three arguments that the trademark royalty payments should not have to be capitalized.

First, it argued that *all* royalty payments are deductible as marketing, selling, advertising or distribution costs under Reg. §1.263A-1(e)(3)(iii)(A). Second, it asserted that royalty payments that are not incurred in securing the contractual right to use a trademark should be deductible pursuant to Reg. §1.263A-1(e)(3)(ii)(U). Finally, Robinson Knife argued that the royalty payments were deductible since they were not costs properly allocable to property it had produced or costs incurred by reason of the performance of production activities, as described in Reg. §1.263A-1(e)(3)(i).

Dull-Edged Appeal

The Second Circuit easily dismissed Robinson Knife's first two arguments as overbroad readings of the regulations. Reg. §1.263A-1(e)(3)(iii)(A) provides generally that selling, advertising, or distribution costs of produced property do not need to be capitalized. However, the court was not persuaded that *all* trademark royalty payments were selling, advertising or distribution costs. After all, certain royalty payments (lump-sum minimums) are fixed and do not vary with the number of products actually sold. Similarly, manufacturing-based royalty payments are made at the time of production. This is so despite the fact that the products may actually be sold in a subsequent year. Thus, a broad rule allowing for an immediate deduction for *all* royalty payments would defeat the goal of Code Sec. 263A to match expenses and related income.

Robinson Knife's second argument also didn't make the cut. Reg. §1.263A-1(e)(3)(ii)(U) provides that licensing and franchise costs, including costs incurred in securing a contractual right to use a trademark, must always be capitalized. Robinson Knife argued that this rule applies only to lump sum minimum (fixed) royalty payments. Unfortunately, the court was not persuaded.

As with Robinson Knife's first argument, the Second Circuit found the cutlery maker's reading of Reg. §1.263A-1(e)(3)(ii)(U) too broad. It also seemed contrary to the matching principle that underlies Code Sec. 263A. If the cited regulation only applied to particular fixed royalty payments, other royalty payments might be deductible in years prior to the actual sale of the product.

Cut to the Chase

Robinson Knife's third argument finally allowed the Second Circuit to trim away the Tax Court's analysis. The Tax Court had ruled that Robinson Knife acquired the right to use the Pyrex and Oneida trademarks as part of its production process. Therefore, pursuant to Reg. §1.263A-1(e)(3)(i), the royalty payments had to be capitalized. The Tax Court believed such costs were incurred by reason of Robinson's producing the Pyrex- and Oneida-branded kitchen tools.

However, the Second Circuit pointed out that the Tax Court had confused the taxpayer's licensing agreement with its royalty payments, which were as different as a paring and a boning knife. The Tax Court focused on whether Robinson Knife's licensing agreements "directly benefited or were incurred by reason of the performance of production activities." In contrast, the Second Circuit recognized that the payments at issue were the royalty payments, which were made *after* the branded items were sold. This was not about the licensing agreement initially signed by Robinson Knife and the trademark holders by which the costs were paid.

Based on this distinction, the court found that the royalty payments were not incurred by reason of the performance of production activities. Given its contract, Robinson Knife could have manufactured, *i.e.,* performed production activity on, as many utensils as it wanted. However, unless it actually *sold* the inventory bearing the licensed trademark, the clever custom cutlery concern would owe no royalties whatsoever.

That was a critical distinction. It meant these sale-based royalties could be immediately deducted. They were ordinary and necessary business expenses under Code Sec. 162 since the royalty payment were not costs incurred in the *production* of the kitchen utensils.

Calabresi's Custom Cut

Ultimately, the holding of *Robinson Knife* is based on an important factual distinction. There is clearly a difference between costs incurred in the production process versus costs incurred upon the actual sale of a product. Nevertheless, how finely can you slice it?

It seems hard to imagine that Judge Calabresi did not simply see the rules imposed by the uniform capitalization regulations as unduly inefficient for taxpayers like Robinson Knife. Indeed, the opinion, at its core, seems to suggest that the immediate deduction provided at Code Sec. 162 is often the simpler solution to the question of cost recovery. In this respect, Occam's Razor may be the best cutting utensil a taxpayer could ask for.