[Florida Tax Review](https://scholarship.law.ufl.edu/ftr)

Volume 16 | Article 4

Wrestling Control from the UNICAP Regulations: The Irrelevance of Quality Control in Determining Capitalizable Trademark Royalties

Glenn Walberg
University of Vermont

Follow this and additional works at: https://scholarship.law.ufl.edu/ftr

Recommended Citation

Walberg, Glenn () "Wrestling Control from the UNICAP Regulations: The Irrelevance of Quality Control in Determining Capitalizable Trademark Royalties," *Florida Tax Review*: Vol. 16, Article 4.
Available at: https://scholarship.law.ufl.edu/ftr/vol16/iss1/4

This Article is brought to you for free and open access by UF Law Scholarship Repository. It has been accepted for inclusion in Florida Tax Review by an authorized editor of UF Law Scholarship Repository. For more information, please contact jessicaejoseph@law.ufl.edu.

FLORIDA TAX REVIEW

Volume 16 | *2014* | *Number 4*

WRESTLING CONTROL FROM THE UNICAP REGULATIONS: THE IRRELEVANCE OF QUALITY CONTROL IN DETERMINING CAPITALIZABLE TRADEMARK ROYALTIES

by

Glenn Walberg[*]

Abstract

Taxpayers generally must capitalize direct and indirect costs attributable to their production of inventory. Due to uncertainty about whether this requirement applies to sales-based trademark royalties, the regulations now clarify that these royalties are indeed capitalizable as indirect production costs. However, the regulations also let taxpayers allocate these sales-based costs entirely to cost of goods sold. So, to the relief of taxpayers, the regulations have the practical effect of permitting immediate cost recovery—similar to a business expense deduction—for sales-based royalties.

This Article questions the rationale for treating trademark royalties as capitalizable indirect costs. It argues that the regulations inappropriately rely on a licensor's retention of control over product quality to link a licensed mark with inventory production and hence treat the associated royalties as production costs. The Article finds such reliance inappropriate because every valid trademark license involves a retention of control and the significance of control has diminished in modern trademark law and licensing practices. The Article further explains how this focus on control inadvertently makes all trademark royalties (including minimum and upfront royalties) capitalizable as indirect costs and therefore potentially allocable to ending inventory.

Finally, the Article describes how the unique nature of trademarks complicates efforts to classify many royalties as capitalizable indirect costs. By stressing the actual use of a mark rather than licensing terms, the Article proposes that the regulations illustrate capitalizable indirect costs more narrowly by referencing royalties paid to license trademarked product designs. But the Article also contends that the regulations could appropriately treat trademark royalties as direct costs where, as happens

* Assistant Professor of Accounting, University of Vermont.

with increasing frequency, a licensed mark becomes an integral part of the goods being produced.

I. INTRODUCTION 224
II. INVENTORIABLE COSTS 226
A. *Inventoriable Costs Under the UNICAP Rules* 227
B. *Allocations of Inventoriable Costs Under the UNICAP Rules* 229
III. TRADEMARK LICENSING COSTS UNDER THE UNICAP RULES 231
A. *Judicial Considerations of Sales-Based Trademark Royalties as Inventoriable Costs* 231
B. *Questionable Connections Between Trademarks and Inventory Production* 235
C. *Regulation Amendments Treating Sales-Based Trademark Royalties as Inventoriable Costs* 244
1. *The Irrelevance of Control in Determining Capitalizable Costs* 246
2. *The Declining Significance of Control in Trademark Law and Licensing Practices* 254
IV. CAPITALIZABLE TRADEMARK LICENSING COSTS 265
A. *Trademark Licensing Costs as Inventoriable Indirect Costs* 265
B. *Trademark Licensing Costs as Inventoriable Direct Costs* 269
V. CONCLUSION 276

I. INTRODUCTION

The tax accounting rules for inventory reveal considerable uncertainty about how manufacturers should treat the costs of licensed trademarks. Part of the uncertainty probably reflects the fact that businesses can use trademarks in different ways to market goods. Some trademarks, such as marks on product packaging, simply help consumers identify desired goods on store shelves (e.g., the white scripted Coca-Cola logo on a case of soda).[1] Other trademarks provide the recognizable designs for the goods themselves (e.g., the contoured bottle for Coca-Cola).[2] Still other intangible

---

1. *See* Coca-Cola Co. v. Gemini Rising, Inc., 346 F. Supp. 1183, 1186 (E.D.N.Y. 1972).

2. *See* Coca-Cola Co. v. Alma-Leo U.S.A., Inc., 719 F. Supp. 725, 728 (N.D. Ill. 1989).

marks become valuable and desirable parts of goods independently of the tangible features of the goods (e.g., a shirt displaying the scripted Coca-Cola logo).[3] Given a trademark's unusual connections to the marketing of goods and to the goods themselves, the tax accounting rules understandably lack clarity about whether the cost of produced inventory should include trademark-related costs.

The licensing of an asset with such irregular uses then generates additional uncertainty about the appropriate treatment for these costs. Various terms in licensing agreements can reference inventory production as they grant and reserve rights, establish royalty payments, and specify conditions and covenants. More importantly, licensing agreements contain quality control provisions that, for example, might let a licensor inspect or approve the produced goods bearing a licensed mark.[4] Because any licensing term might suggest possible direct or indirect relationships to inventory production, one cannot readily predict how those terms might affect the inventoriable costs of a manufacturer using a licensed mark. As a result, contract terms add to the general uncertainty about how a manufacturer's actual use of a licensed mark affects the treatment of its costs. Unfortunately, the Internal Revenue Service (the "Service") and the Treasury Department recently amended the section 263A regulations and essentially made royalties inherently capitalizable for trademark licenses with quality control provisions.[5] The amendments do not adequately explain such treatment or account for the different uses of marks even though the substantial trademark licensing fees paid by manufacturers warrant a more thoughtful approach to capitalization.

This Article seeks to address capitalization requirements for the trademark licensing costs of manufacturers and concentrates on the tax implications of having quality control provisions in licensing arrangements. Part II of the Article starts with an overview of relevant capitalization rules for inventory accounting. Part III then examines attempts to capitalize trademark licensing costs as indirect costs, including recent regulation amendments that attribute a licensor's control over product quality to production activities. That part explains why such emphasis on control makes trademark-licensing costs inherently capitalizable and seems misplaced under modern trademark law and licensing practices. Finally, Part IV justifies the capitalization of trademark licensing costs as indirect costs in situations where a mark protects a product design. Part IV argues that, where

---

3. *Cf*. Boston Prof'l Hockey Ass'n v. Dallas Cap & Emblem Mfg., Inc., 510 F.2d 1004 (5th Cir. 1975) (finding trademark infringement from the embroidering of athletic team logos on products without the team's authorization).

4. *See, e.g*., Robinson Knife Mfg. Co. v. Commissioner, 600 F.3d 121, 124 n.3 (2d Cir. 2010).

5. *See* T.D. 9652, 2014-12 I.R.B. 655.

a licensed trademark becomes part of the goods being produced, the regulations could better justify capitalization by characterizing the trademark royalties as direct costs of those goods.

II. INVENTORIABLE COSTS

A taxpayer generally must know the cost of any inventory that it sells.[6] The cost is important because the taxpayer includes only a gain—or gross profit—arising from the sale in gross income.[7] Regardless of whether the taxpayer produces the inventory or acquires it for resale, the taxpayer computes such gain by subtracting its cost of goods sold from total sales.[8] The computation resembles the determination of gains realized from other property dispositions[9] and purports to reflect income clearly by matching sales revenue with the costs attributable to those sales.[10]

The process for determining cost of goods sold often becomes rather involved. As an initial matter, a taxpayer must distinguish those costs properly attributable to its inventory from costs associated with other parts of its business, such as its selling and administrative activities. A wide range of costs attributable to produced or acquired inventory, which are often called inventoriable or capitalizable costs, will form the basis of that inventory.[11] With respect to its total inventoriable costs for a year, the taxpayer must then determine what portion of the costs to treat as basis in its unsold ending inventory and attribute the remaining costs to inventory sold during the year.[12] Essentially, the taxpayer recovers some of its current year inventoriable costs immediately through cost of goods sold but delays

6. This Article uses the terms "inventory," "goods," and "product" to reference an inventory of merchandise where a taxpayer's production, purchase, or sale of the merchandise is an income-producing factor. *See* Reg. § 1.471-1. Certain taxpayers may value inventory at the lower of cost or market or may write down inventory items (e.g., subnormal goods), *see* Reg. § 1.471-2(c), however, this Article's high-level discussion does not address these aspects of inventory accounting.

7. *See* I.R.C. § 61(a)(3); Sullenger v. Commissioner, 11 T.C. 1076, 1077 (1948), *nonacq*. 1976-2 C.B. 4.

8. *See* Reg. § 1.61-3(a).

9. *Cf.* I.R.C. § 1001(a).

10. *See* Hamilton Indus. Inc. v. Commissioner, 97 T.C. 120, 130 (1991).

11. *See generally* Reg. § 1.471-3 (defining the cost of produced and acquired inventory).

12. *See* All-Steel Equip. Inc. v. Commissioner, 54 T.C. 1749, 1750–51 (1970), *aff'd in part and rev'd in part*, 467 F.2d 1184 (7th Cir. 1972). A taxpayer might allocate inventoriable costs to individual items too. The taxpayer would determine costs remaining in ending inventory in a manner consistent with the taxpayer's use of a specific identification method or cost-flow assumption, such as a first-in first-out or last-in first-out method. *See* Reg. § 1.471-2(d).

recovery for the remaining costs until items leave its inventory in future periods.[13]

This process of accounting for inventory often entails navigating rules under two Code provisions and applicable regulations. Section 471 and its regulations provide many rules that establish the foundation for inventory accounting, including the basic obligation to account for inventories.[14] The section 471 regulations generally establish the inventoriable costs of a purchased item as its net invoice price plus costs incurred to acquire possession[15] and the inventoriable costs of a produced item under a full absorption method.[16] Without exploring the details, it is noteworthy that the costs capitalized under section 471 are often comparable to the inventoriable costs determined for financial reporting purposes.[17] Section 263A, enacted in 1986, then adds complexity to inventory accounting by prescribing a more robust and uniform system for determining inventoriable costs and a set of methods for allocating costs between ending inventory and cost of goods sold.[18] Section 263A and the accompanying regulations establish the Uniform Capitalization (UNICAP) rules, which are the focus of this Article.

A. Inventoriable Costs Under the UNICAP Rules

Section 263A generally requires capitalization[19] for the direct and properly allocable indirect costs that a taxpayer incurs to produce inventory or to acquire inventory for resale.[20] Although somewhat duplicative of other capitalization requirements (including section 471), section 263A simply envisions that a taxpayer's total inventoriable costs would include most costs incurred to produce the inventory or to acquire the inventory that the taxpayer intends to sell. However, the UNICAP rules generally require capitalization for more costs than taxpayers have traditionally regarded as attributable to their inventory.[21]

---

13. *See* Rotolo v. Commissioner, 88 T.C. 1500, 1515 (1987).

14. *See* I.R.C. § 471(a).

15. *See* Reg. § 1.471-3(b).

16. *See* Reg. § 1.471-3(c); -11.

17. *See, e.g.,* Reg. § 1.471-11(c)(2)(iii) (referencing a taxpayer's financial reporting treatment of costs to determine its capitalizable indirect production costs).

18. *See* H.R. REP. NO. 99-426, at 625 (1985); S. REP. NO. 99-313, at 140 (1986).

19. In this context, the term "capitalize" means to include in inventoriable costs. *See* Reg. § 1.263A-1(c)(3).

20. *See* I.R.C. § 263A(a).

21. *See* LESLIE J. SCHNEIDER, FEDERAL INCOME TAXATION OF INVENTORIES § 4.01[3] (2005) (noting the nickname "super full absorption method" for the UNICAP rules).

The heightened capitalization implications reflect the broad range of costs subject to capitalization under section 263A. Pursuant to this provision, taxpayers must capitalize all direct costs.[22] As reasonably expected, a producer's direct costs include direct material and direct labor costs[23] and a reseller's direct costs include the costs incurred acquire inventory.[24] Section 263A also requires taxpayers to capitalize certain indirect costs, which consist of all costs in a business other than direct costs.[25] The UNICAP rules consider an indirect cost properly allocable to produced or acquired inventory and thereby capitalizable if the cost directly benefits or the taxpayer incurs the cost by reason of its performance of production or resale activities.[26] Thus a repair to production-line equipment directly benefits the production of inventory, so the accompanying repair cost represents a properly allocable (i.e., capitalizable) indirect cost.[27] Property taxes assessed on the building that houses the production equipment presumably would be incurred by reason of the taxpayer's production, even though the taxes might not directly benefit production, and would be capitalizable too.[28] In contrast, the cost of advertising incurred to promote sales of the taxpayer's already-produced inventory would have no relationship to the taxpayer's production activities. Accordingly, the advertising cost represents an indirect cost that is not properly allocable to produced or acquired inventory and therefore is deductible (i.e., noncapitalizable).[29] This process of identifying properly allocable indirect costs helps ensure that a taxpayer accounts for all production and resale costs as basis in its inventory.[30]

The potential for seemingly far-flung indirect costs to benefit directly or be incurred by reason of production or resale activities establishes the broad capitalization impact of the UNICAP rules. Examples in the

---

22. *See* Reg. § 1.263A-1(e)(1).

23. *See* Reg. § 1.263A-1(e)(2)(i). Direct material costs include the costs of all materials that become an integral part of produced inventory and materials consumed during production that can be identified or associated with particular items of produced inventory (e.g., steel used to produce the blade of a knife). *See id.* § 1.263A-1(e)(2)(i)(A). Direct labor costs include all elements of compensation (such as vacation pay and payroll taxes)—other than employee benefit costs—for labor that can be identified or associated with particular items of produced inventory (e.g., wages paid to production-line employees). *See id.* § 1.263A-1(e)(2)(i)(B).

24. *See* Reg. § 1.263A-1(e)(2)(ii) (referencing the description of acquisition costs in Reg. § 1.471-3(b)).

25. *See* Reg. § 1.263A-1(e)(3)(i).

26. *See id.*

27. *See* Reg. § 1.263A-1(e)(3)(ii)(O).

28. *See* Reg. § 1.263A-1(e)(3)(ii)(L).

29. *See* Reg. § 1.263A-1(e)(3)(iii)(A).

30. *See* STAFF OF THE JOINT COMM. ON TAXATION, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 508 (Comm. Print 1987).

regulations illustrate that a taxpayer's inventoriable costs could include part of the salary paid to a chief executive officer[31] or part of the costs of a legal department[32] to the extent the officer's efforts (e.g., time spent negotiating with a raw material supplier) or the department's efforts (e.g., time spent reviewing a purchase agreement with the supplier) benefit production or resale activities.[33] The capitalization requirements of section 263A can reach almost any cost in a business.[34] The UNICAP rules thus contemplate a more rigorous determination of inventoriable costs than a superficial attempt to identify those costs incurred to make or buy inventory.

B. *Allocations of Inventoriable Costs Under the UNICAP Rules*

With the total pool of inventoriable costs incurred during the year, a taxpayer must determine what portion of those costs to attribute to ending inventory and include the remainder in cost of goods sold.[35] Some taxpayers use facts-and-circumstances allocation methods to allocate their costs to ending inventory.[36] Those methods generally seek to have allocations trace costs or reflect cause-and-effect relationships. For example, a standard cost method might allocate a predetermined variable overhead rate of $.45 for each machine hour budgeted for producing an item in ending inventory.[37] Such cost allocations often reflect assumed relationships between costs and cost drivers; in that example, the number of machine hours used might correlate with the cost of electricity consumed during production. Due to the need to trace costs or consider relationships, a facts-and-circumstances cost allocation method can become quite demanding even though it might produce reasonable results.

The regulations also permit the use of simplified allocation methods as alternatives to using these facts-and-circumstances allocation methods.[38]

---

31. *See* Reg. § 1.263A-1(e)(3)(iii)(B).

32. *See* Reg. § 1.263A-1(e)(3)(iii)(W) & -1(e)(4)(iii)(H).

33. The regulations contemplate that taxpayers will allocate or apportion costs, as necessary, to production and resale activities, *see* Reg. § 1.263A-1(c)(1) & -1(g), after taking into account an elective *de minimis* rule. *See* Reg. § 1.263A-1(g)(4)(ii).

34. The Code explicitly excludes certain costs, such as research and experimental expenditures, from the capitalization requirements. *See* I.R.C. § 263A(c)(2).

35. *See* Reg. § 1.263A-1(c)(1).

36. *See* Reg. § 1.263A-1(f)(1).

37. *See generally* Reg. § 1.263A-1(f)(3)(ii)(A). A taxpayer must also allocate any significant variance, which would arise from a difference between the actual and standard price paid for an input or the actual and allowed quantity used of an input. *See* Reg. § 1.263A-1(f)(3)(ii)(B).

38. *See* Reg. § 1.263A-1(f)(1).

The simplified methods recognize that a taxpayer usually has already determined inventory values for financial reporting (commonly called "book") purposes and that the capitalization requirements of section 471 would establish similar inventoriable costs for tax purposes.[39] The costs reflected in its book inventory value are frequently treated as "section 471 costs"[40] and represent amounts capitalizable for tax purposes irrespective of the UNICAP rules.[41] Because section 263A often requires the capitalization of more costs than section 471, the simplified methods focus on those additional capitalizable costs[42] without demanding that a taxpayer re-compute its entire ending inventory value from scratch.[43] More specifically, the simplified methods determine an amount that the taxpayer could add to its book inventory value (i.e., the section 471 costs already in ending inventory) in order to account for all capitalizable costs under the UNICAP rules.[44]

The regulations offer the simplified production method and simplified resale method as the alternative means for determining how much of the additional capitalizable costs to add to an ending book/section 471 inventory value.[45] At a high level, these methods require a taxpayer to compute the ratio of its total additional capitalizable costs for the year relative to its total section 471 costs for the year.[46] The taxpayer multiplies the resulting ratio against those section 471 costs already included in the taxpayer's ending book inventory value[47] and then adds that product to the inventory value.[48] The simplified methods thereby effectively allocate the additional capitalizable costs to ending inventory in the same proportion as the taxpayer has already included other inventoriable costs in its ending inventory value. Significantly, under these simplified methods, a portion of

---

39. *See supra* note 17 and accompanying text.

40. *Cf. AICPA Disagrees with Proposed Guidance on Certain Capitalization Costs*, 2006 TAX NOTES TODAY 144-27 (July 27, 2006) ("[F]or the vast majority of manufacturers, section 471 costs and methods are synonymous with book costs and methods.").

41. *See* Reg. § 1.263A-1(d)(2).

42. *See* Reg. § 1.263A-1(d)(3) (defining "additional section 263A costs").

43. *See* S. REP. NO. 99-313, at 142 (1986) ("The committee expects . . . allocations of costs among numerous items produced or held for resale by a taxpayer to be made on the basis of burden rates or other appropriate methods similar to those provided under present law.").

44. *See* T.A.M. 2001-44-003 (July 11, 2001) ("[s]implified methods are often referred to as 'add-on' methods").

45. *See* Reg. § 1.263A-1(f)(1).

46. *See* Reg. § 1.263A-2(b)(3)(ii)(A) (absorption ratio for the simplified production method); Reg. § 1.263A-3(d)(3)(i)(C)(1) (combined absorption ratio for the simplified retail method).

47. *See* Reg. § 1.263A-2(b)(3)(i)(A); Reg. § 1.263A-3(d)(3)(i)(A).

48. *See* Reg. § 1.263A-2(b)(3)(i)(B); Reg. § 1.263A-3(d)(3)(i)(B).

the additional capitalizable costs are perfunctorily allocated to ending inventory without considering whether any relationship exists between those costs and the items in ending inventory.[49]

Regardless of whether a taxpayer uses a facts-and-circumstances or a simplified method to allocate inventoriable costs to ending inventory, the taxpayer treats any remaining costs as being allocable to inventory sold during the year. Those remaining costs comprise part of the basis in the sold inventory, and the taxpayer immediately recovers the costs through its computation of gross profit arising from those sales.[50]

III. TRADEMARK LICENSING COSTS UNDER THE UNICAP RULES

Not surprisingly, trademark royalties fit within the broad range of indirect costs potentially subject to capitalization under section 263A. The UNICAP regulations confirm that result by including an example of trademark licensing costs on a nonexclusive list of costs,[51] which a taxpayer must capitalize to the extent they directly benefit or are incurred by reason of production or resale activities.[52] The example states that potentially capitalizable 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."[53] Unfortunately, other than confirming the broad reach of the UNICAP rules, the example provides little guidance about how to distinguish a capitalizable trademark royalty (i.e., one that directly benefits or is incurred by reason of production or resale activities) from a noncapitalizable royalty.

A. *Judicial Considerations of Sales-Based Trademark Royalties as Inventoriable Costs*

The question about which trademark costs a manufacturer should capitalize eventually arose in the context of sales-based royalties. The UNICAP rules generally do not contemplate temporal limitations and can require capitalization, for example, of costs incurred before, during, or after production.[54] Accordingly, capitalization has been required for sales-based

---

49. *See* T.A.M. 2001-44-003 (July 11, 2001).

50. *See* Reg. § 1.263A-1(c)(4); *see also supra* notes 6–10 and accompanying text.

51. *See* Reg. § 1.263A-1(e)(3)(ii)(U).

52. *See* Reg. § 1.263A-1(e)(3)(ii).

53. Reg. § 1.263A-1(e)(3)(ii)(U). The regulations clarify that "[t]hese costs include the otherwise deductible portion (e.g., amortization) of the initial fees incurred to obtain the license . . . and any minimum annual payments and royalties that are incurred by a licensee . . . ." *Id.*

54. *See* Reg. § 1.263A-2(a)(3)(i).

(i.e., post-production) costs attributable to the use of other intangible assets, such as patents.[55] For instance, royalties paid to utilize a patented manufacturing process were regarded as properly allocable to manufactured items despite being paid after the items were manufactured.[56] One might naturally question whether that result suggests capitalization is also required for comparable trademark-related costs.

The most notable considerations of how the UNICAP rules apply to sales-based trademark royalties appeared in the Tax Court and Second Circuit Court of Appeals opinions in *Robinson Knife Manufacturing Co. v. Commissioner*.[57] In that case, the taxpayer produced[58] and sold kitchen products labeled with the well-known trademarks Pyrex and Oneida.[59] In marketing its products to customers, the taxpayer relied on the trademarks and its designs to differentiate its products, which otherwise function in the same manner as its competitors' products.[60] The taxpayer found selling products under the Pyrex or Oneida brand much easier than selling identical products without using those brands because Corning, Inc. and Oneida Ltd., the respective owners of the trademarks, have advertised and marketed extensively to develop awareness and goodwill related to their marks.[61] Accordingly, the taxpayer entered into licensing agreements whereby it agreed to pay a trademark owner a percentage of the price at which the taxpayer sold marked products (i.e., sales-based royalties) in exchange for receiving the exclusive right to manufacture, distribute, and sell certain products under the mark.[62] However, in order to preserve the value of the trademarks, the agreements also contained quality control measures that required the taxpayer to obtain an owner's approval of the design, packaging, and promotional materials for a branded product before its sale and to refrain from damaging goodwill or value related to the trademarks.[63]

---

55. *See* Plastic Eng'g & Technological Servs., Inc. v. Commissioner, 82 T.C.M. (CCH) 1017, 1019, 2001 T.C.M. (RIA) 2001-324, at 2343; *see also* T.A.M. 2006-30-019 (Mar. 31, 2006).

56. *See Plastic Eng'g*, 82 T.C.M. (CCH) at 1018, 2001 T.C.M. (RIA) 2001-324 at 2342.

57. 600 F.3d 121 (2d Cir. 2010), *nonacq*. 2011-1 C.B. 528, *corrected*, Announcement 2011-32, 2011-1 C.B. 836, *rev'g* 97 T.C.M. (CCH) 1037, 2009 T.C.M. (RIA) 2009-9.

58. Although the taxpayer's production occurred through contract manufacturing arrangements, *see Robinson Knife*, 600 F.3d at 123, the taxpayer was regarded as the producer of the kitchen products for purposes of applying the UNICAP rules. *See* Reg. § 1.263A-2(a)(1)(ii)(B)(*1*).

59. *See Robinson Knife*, 600 F.3d at 122–23.

60. *See id*. at 123.

61. *See id*.

62. *See id*.

63. *See id*. at 124 n.3.

After the Service rejected its deduction of the royalties as ordinary and necessary business expenses, the taxpayer asked the Tax Court to re-determine whether the sales-based royalties were capitalizable and potentially allocable to its ending inventory.[64] The Tax Court held that the royalties were indeed capitalizable under the UNICAP rules because they were indirect costs that directly benefited and/or were incurred by reason of the taxpayer's production activities.[65] In finding that link between the taxpayer's acquired trademark rights and its production process, the court noted that the taxpayer needed the licenses to manufacture the marked products legally and that the quality control measures made securing the owners' approvals an integral part of developing and producing the marked products.[66] The court further concluded that, in accordance with the UNICAP rules, the taxpayer had to allocate a portion of those capitalizable royalties to ending inventory under the taxpayer's existing simplified method for making such allocations.[67] The court recognized that a facts-and-circumstances based method might reasonably treat the royalties, which were incurred only upon the sale of items, as being entirely attributable to the cost of those goods actually sold during the year.[68] However, the court explained that the taxpayer's prior adoption of a simplified method committed the taxpayer to allocating a portion of its total additional capitalizable costs, including the royalties, to ending inventory based solely on the ratio prescribed by the regulations.[69]

On appeal, the Second Circuit reversed the Tax Court's decision in *Robinson Knife*. In its reversal, the appellate court initially rejected, as being overly broad, certain arguments advanced by the taxpayer to support its deduction of the sales-based royalties.[70] Significantly, the court considered whether the royalties were properly regarded as deductible marketing or selling expenses, rather than as production costs, given that the taxpayer used the trademarks to differentiate its products in the marketplace.[71] The court rejected that premise because, contrary to the example of capitalizable trademark licensing costs in the regulations, the taxpayer's position would permit a deduction for all such costs insofar as any trademark might facilitate product differentiation.[72] In addition, the court believed the taxpayer's premise would inappropriately disregard the significance of licensing

64. *See* Robinson Knife Mfg. Co. v. Commissioner, 97 T.C.M. (CCH) 1037, 2009 T.C.M. (RIA) 2009-9, *rev'd*, 600 F.3d 121 (2d Cir. 2010).

65. *See id*. at 57.

66. *See id*.

67. *See id*. at 58.

68. *See id*.

69. *See id*.

70. *See Robinson Knife*, 600 F.3d at 129.

71. *See id*.

72. *See id*.

terms—such as required minimum or production-based payments—in permitting a deduction for all trademark royalties.[73]

Nevertheless, the Second Circuit held that the taxpayer's particular royalty costs were not capitalizable under the UNICAP rules. Unlike the Tax Court, which believed the relationship between the taxpayer's acquired trademark rights and its production process made capitalization appropriate, the appellate court focused on the literal requirement in the section 263A regulations to capitalize indirect costs where such "*costs* directly benefit or are incurred by reason of the performance of production … activities."[74] The court thus emphasized the royalty costs rather than the licensed rights.[75] In this regard, the court noted that the taxpayer could freely manufacture marked products without incurring any royalty costs, as long as the products remained unsold.[76] The court then reasoned that these royalties, which became payable only upon a sale, neither directly benefited nor were incurred by reason of the production of the marked products.[77] The court instead concluded that the royalties were incurred only upon a sale.[78] Accordingly, the court held that the taxpayer's royalty costs fell outside the capitalization requirements of the UNICAP rules and were immediate deductible.[79]

Not surprisingly, the Service disagreed with the appellate court's taxpayer-favorable holding and expressed an unwillingness to follow it outside the Second Circuit.[80] The Service thought the appellate court confused the timing with the purpose of the payments.[81] The Service believed the Tax Court correctly identified the sale-based royalties as costs incurred by reason of production insofar as they were incurred to produce the marked goods that the taxpayer would then sell.[82] The Service nevertheless expressed its willing to allocate sales-royalties entirely to cost of goods sold, as discussed below;[83] however, the Service refused to characterize sales-based trademark royalties as something other than production costs.[84]

---

73. *See id*. at 130.

74. *See id*. at 131 (quoting Reg. § 1.263A-1(e)(3)(i)) (alteration in original).

75. *See id*. ("[T]he Tax Court's reasoning confuses the *license agreements* with the *royalty costs*.").

76. *See id*.

77. *See id.*

78. *See id*. at 134.

79. *See id*. at 131–32.

80. *See* A.O.D. 2011-01, 2011-1 C.B. 528, *corrected*, Announcement 2011-32, 2011-1 C.B. 836.

81. *See id.*

82. *See id*.

83. *See infra* Part III.C.

84. *See* A.O.D. 2011-1, 2011-1 I.R.B. 528, *corrected*, Announcement 2011-32, 2011-1 C.B. 836; *Field Guidance on the Planning & Examination of Sales-*

B. *Questionable Connections Between Trademarks and Inventory Production*

The *Robinson Knife* opinions never explained what connection might exist between a trademark and inventory production despite ruling on whether trademark licensing royalties constitute inventory production costs. For example, the Tax Court found capitalization appropriate by construing the taxpayer's production process as encompassing the taxpayer's acquisition of manufacturing rights and the licensors' authority to approve and inspect products.[85] On the other hand, the Second Circuit focused on the triggering events for royalty payments under the agreements rather than the use of the trademarks.[86] But, with so much focus on agreement terms, neither court asked a basic question: What connection could a trademark, whether licensed or owned, have with inventory production?

The taxpayer in *Robinson Knife* essentially raised that question without having it satisfactorily answered. By arguing that its costs were deductible as marketing or selling expenses, the taxpayer emphasized that it used the licensed trademarks to differentiate its products for consumers, which creates an inference of marketing rather than production activities.[87] The Tax Court disagreed and described the taxpayer as having used the marks to produce—rather than to market—differentiated products, without explaining how such use might have occurred.[88] Without addressing the taxpayer's particular use of the marks, the appellate court simply deemed the prospect of deducting any royalties for marks used to differentiate products—which is how all trademarks function—as being contrary to the illustration of capitalizable trademark royalties in the regulations.[89] As a result, neither court really connected the trademarks with inventory production. Unless a strong "but for" test were to attribute marketing and selling costs to inventory production because a company would not incur costs to market goods without having first manufactured the goods, [90] a more

---

Based Royalty Payments and Sales-Based Vendor Allowances (Mar. 1, 2011), *reprinted in IRS Issues LB&I Memorandum on Examination of Cases Involving Sales-Based Royalties, Vendor Allowances*, 2011 TAX NOTES TODAY 42–20 (Mar. 3, 2011).

85. *See Robinson Knife*, 97 T.C.M. (CCH) at 1041, 2009 T.C.M (RIA) 2009-9, at 57.

86. *See Robinson Knife*, 600 F.3d at 131–32.

87. *See id*. at 129.

88. *See Robinson Knife*, 97 T.C.M. (CCH) at 1041, 2009 T.C.M (RIA) 2009-9, at 58 n.15.

89. *See Robinson Knife*, 600 F.3d at 129.

90. *See* A.O.D. 2011-1, 2011-1 I.R.B. 528 ("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

clear explanation of the capitalization implications of using trademarks in a business is needed under the UNICAP rules. Unfortunately, the unique nature of trademarks and evolving licensing practices complicate the process of determining any capitalizable costs.

Any requirement to capitalize trademark licensing costs should, at a minimum, comport with the unique nature of a mark. A trademark is a "word, name, symbol, or device … used [by a business] … to identify and distinguish … [its] goods … from those manufactured or sold by others and to indicate the source of the goods."[91] Trademarks thus help consumers choose between goods being offered by competitors because the marks allow consumers to identify and select goods originating from businesses with known reputations.[92] Therefore, a trademark can provide a competitive advantage in the marketplace that trademark law has recognized and protects.

The notion of granting protectable rights in certain trademarks originally grew out of the law governing unfair competition.[93] Trademark law accordingly reflects a goal of preventing marks from being used unfairly to cause confusion about the source or origin of goods.[94] For instance, trademark law might keep an infringer from placing another person's mark on the infringer's goods because an unauthorized use of the mark might create a false impression that the goods were produced by that other person. Thus, trademark law strives both to protect consumers from being misled through an infringing use of a mark and to protect a trademark owner from having a competitor divert business away from the owner through such

correctly held that Robinson incurred the royalty expenses 'by reason of' its production activities . . . ."); F.S.A. 2011-4703F (Sept. 27, 2011) (requiring capitalization under section 263A for costs attributable to a license that allowed the taxpayer to "market and sell" products because the products "would not be produced if they could not be marketed and sold"). The "incurred by reason of" standard in the UNICAP regulations, *see supra* text accompanying notes 26–28, generally takes into account a proximate connection between a cost and inventory production. *See* P.L.R. 94-26-004 (Mar. 22, 1994) (regarding all costs of unclassified time for employees, who were normally engaged in production, as costs incurred by reason of production, but acknowledging that the result would differ if the employees had regular nonproduction-related responsibilities).

91. Lanham Act of 1946, 15 U.S.C. § 1127 (2012).

92. *See* S. REP. NO. 1333, at 4 (1946) ("Trade-marks, indeed, are the essence of competition, because they make possible a choice between competing articles by enabling the buyer to distinguish one from the other."), *reprinted in* 1946 U.S.C.C.A.N. 1274, 1277.

93. *See* Hanover Star Milling Co. v. Metcalf, 240 U.S. 403, 413 (1916) ("[T]he common law of trade-marks is but a part of the broader law of unfair competition.").

94. *See* Moseley v. V Secret Catalogue, Inc., 537 U.S. 418, 428 (2003).

infringing use.[95] So trademark protection basically exists to stop consumer deception and improper trade diversion, which represent forms of unfair competition.[96]

This origin in unfair competition law places unique limitations on trademark rights. Traditionally, trademarks have been regarded as primarily functioning to safeguard consumers and market welfare.[97] As a result, the rights of trademark owners were protected only insofar as necessary to safeguard consumers from being misled about the source of products while also being limited to ensure that, with protectable rights, the owners did not gain unfair advantages in the marketplace.[98] At the same time, trademark protection has been used to prevent competitors from improperly using an established mark to divert trade away from the mark's owner.[99] However, such protection has also required limits because legitimate competition depends on trade diversion.[100] Courts accordingly were willing to extend trademark protection only so far as necessary to prevent a competitor from copying a mark to deceive consumers and thereby divert trade.[101] As a consequence, trademark law does not grant absolute monopolies over marks. The limited scope of protectable rights distinguishes trademarks from other property used in a business. A trademark owner essentially has qualified

---

95. *See id.*; *see also* Dreamwerks Prod. Grp., Inc. v. SKG Studio, 142 F.3d 1127, 1132 (9th Cir. 1998) ("A clever new trademark diversifies both the marketplace and the marketplace of ideas; a takeoff or copy of a mark, even if accidental, adds nothing but confusion.").

96. *See* S. REP. NO. 1333, at 3–4 (1946), *reprinted in* 1946 U.S.C.C.A.N. 1274, 1277.

97. *See* Irene Calboli, *The Case for a Limited Protection of Trademark Merchandising*, 2011 U. ILL. L. REV. 865, 875–76 [hereinafter Calboli, *Limited Protection*].

98. *See id.*; Mark A. Lemley, *The Modern Lanham Act and the Death of Common Sense*, 108 YALE L.J. 1687, 1695 (1999) [hereinafter Lemley, *Modern Lanham Act*] ("We give protection to trademarks for one basic reason: to enable the public to identify easily a particular product from a particular source."). *But see* Mark P. McKenna, *The Normative Foundations of Trademark Law*, 82 NOTRE DAME L. REV. 1839, 1848 (2007) (arguing that trademark law primarily sought to prevent trade diversion and that any consumer benefits were secondary).

99. *See* Mark P. McKenna, *Trademark Use and the Problem of Source*, 2009 U. ILL. L. REV. 773, 782 [hereinafter McKenna, *Trademark Use*]; *cf.* Int'l News Serv. v. Associated Press, 248 U.S. 215, 239 (1918) (noting how, through misappropriation, a defendant "is endeavoring to reap where it has not sown").

100. *See* McKenna, *Trademark Use*, *supra* note 99, at 782; *id.* at 783 ("Deceptiveness was the point of demarcation" between legitimate and illegitimate trade diversion).

101. *See id.* at 782–83.

property rights in a mark.[102] A trademark owner's rights primarily enable it to prevent other parties from using similar marks that might otherwise cause wrongful consumer confusion or trade diversion.[103] Exclusivity is thus qualified insofar as the owner's rights extend only so far as to promote fair competition.[104] Therefore, an unauthorized use of a trademark in noncompetitive setting, which neither confuses consumers nor diverts trade, would not infringe on the trademark owner's rights.[105] For example, a person might place a trademark on a produced item, without infringing on the trademark owner's rights, if the person never offers to sell the item. Such qualified rights in trademarks arguably keep businesses from having exclusive rights over language and other means of expression, but they differ from the rights owners have to exclude competing and noncompeting uses of other property. Trademarks lack the innovative or creative features of other *intellectual* property,[106] so they do not carry extensive rights like patents and copyrights that receive greater protection to encourage their development.[107] So a person could infringe on a patent owner's rights by following a patented design to make an item even if the person never offers to sell it.

These qualified property rights reflect a strong connection between a trademark and the goodwill of a business. Goodwill generally represents the value attributable to expectations of continued customer patronage.[108] But a business needs to identify itself or its products in order for customers to patronize it. So a trademark serves as the mechanism a business uses for

---

102. *See* 1 J. THOMAS MCCARTHY, MCCARTHY ON TRADEMARKS AND UNFAIR COMPETITION § 2:14 (4th ed. 2013) [hereinafter MCCARTHY ON TRADEMARKS].

103. *See id*. at § 2:10 ("[T]he scope of exclusivity of a trademark is coextensive with the prevention of confusion of consumers.").

104. *See* Indus. Rayon Corp. v. Dutchess Underwear Corp., 92 F.2d 33, 35 (2d Cir. 1937) ("A trade-mark is not property in the ordinary sense . . . . The owner of the mark acquires the right to prevent . . . confus[ion] . . . and to prevent . . . trade from being diverted . . . . There are no rights in a trade-mark beyond these.").

105. *See* Katya Assaf, *Brand Fetishism*, 43 CONN. L. REV. 83, 104 (2010) ("[O]ne of the basic principles of trademark law is that a trademark is not taboo—not every reproduction of a trademark is forbidden.").

106. *See* Ann Bartow, *Likelihood of Confusion*, 41 SAN. DIEGO L. REV. 721, 725 (2004).

107. Although the Progress Clause in the U.S. Constitution protects patents and copyrights to encourage the pursuit of additional useful inventions and creative works, "[w]e don't protect trademarks to encourage the creation of more trademarks." Lemley, *Modern Lanham Act*, *supra*, note 98, at 1694. Congressional power to register trademarks arises only from its ability to regulate commerce under the Commerce Clause. *See* 2 MCCARTHY ON TRADEMARKS, *supra* note 102, at § 19:117.

108. *See* Newark Morning Ledger Co. v. United States, 507 U.S. 546, 555-56 (1993).

identification in order to benefit from its goodwill. This connection to goodwill has prevented trademarks from conferring rights in gross like other property.[109] In fact, trademarks have not been "protected as commodities per se, but only as conveyers of commercial information and as symbols of business goodwill."[110] Courts regard trademarks and goodwill as being inseparable and have refused to allow trademark owners to assign their marks independently of the goodwill of a business.[111] Trademark law accordingly has assumed that trademarks have no intrinsic value; instead, they derive their significance from the goodwill they symbolize.[112] Thus, in granting protection to trademarks as symbols of goodwill, courts have sought to protect the goodwill of businesses from the effects of unfair competition rather than to establish absolute rights in trademark owners over the use of their marks.[113] As the Supreme Court explained:

> The redress that is accorded in trade-mark [infringement] cases is based upon the party's right to be protected in the good-will of a trade or business. The primary and proper function of a trade-mark is to identify the origin or ownership of the article to which it is affixed. … Courts afford redress or relief upon the ground that a party has a valuable interest in the good-will of his trade or business, and in the trade-marks adopted to maintain and extend it. The essence of the wrong consists in the sale of the goods of one manufacturer or vendor for those of another.[114]

---

109. *See* United Drug Co. v. Theodore Rectanus Co., 248 U.S. 90, 97 (1918) ("There is no such thing as property in a trade-mark except as a right appurtenant to an established business or trade in connection with which the mark is employed."). Courts had originally regarded trademarks as property. *See* Robert G. Bone, *Hunting Goodwill: A History of the Concept of Goodwill in Trademark Law*, 86 B.U. L. REV. 547, 561–62 (2006) [hereinafter Bone, *Hunting Goodwill*]. But that approach became problematic insofar as property ownership confers an absolute right to exclude others from the property and yet words and symbols used as trademarks are considered *publici juris* and incapable of private ownership. *See id*. at 563. This problem was often resolved by regarding the goodwill of a business as the relevant, protectable property interest and a trademark as the mechanism used to benefit from expectations of consumer patronage. *See id*. at 568-69.

110. Irene Calboli, *What If, After All, Trademarks Were "Traded in Gross"?*, 2008 MICH. ST. L. REV. 345, 346 [hereinafter Calboli, *Traded in Gross*].

111. *See id*. at 349–50; *cf.* Lanham Act of 1946, 15 U.S.C. § 1060(1)(1) (2012) (requiring an assignment with goodwill).

112. *See* Assaf, *Brand Fetishism*, *supra* note 105, at 104.

113. *See* Calboli, *Traded in Gross*, *supra* note 110, at 349.

114. Hanover Star Milling Co. v. Metcalf, 240 U.S. 403, 412–13 (1916).

A trademark's ability to identify the source of goods thus enables a business to realize any expectation of continued patronage.

This source-identifying function of a trademark thus establishes its purpose and its defining characteristic. As noted above, a business uses a trademark to identify and distinguish its products in the marketplace and to assist consumers determine the source of those products.[115] The source information conveyed by the trademark helps reduce consumers' search costs "for it quickly and easily assures a potential customer that *this* item—the item with this mark—is made by the same producer as other similarly marked items that he or she liked (or disliked) in the past."[116] A trademark's source-identifying function thereby reinforces its connection to goodwill because "[t]he consumer[,] who knows at a glance whose brand he is being asked to buy[,] knows whom to hold responsible if the brand disappoints and whose product to buy in the future if the brand pleases."[117] The protectable rights in a trademark consequently originate from the goal of preventing confusion or deception about the *source of goods*. But those rights cannot exist unless a mark actually conveys source information.[118]

Trademark law categorizes marks as either inherently distinctive or descriptive based on their ability to convey source information. Inherently distinctive trademarks almost automatically reveal the source of goods to consumers[119] whereas descriptive trademarks rely on consumers' beliefs that all goods bearing a particular mark originate from a single source.[120] Inherently distinctive marks, which were historically known as "technical

---

115. *See* Lanham Act of 1946, 15 U.S.C. § 1127 (2012).

116. *See* Qualitex Co. v. Jacobson Prods. Co., 514 U.S. 159, 164 (1995) (alternation in original).

117. Ty Inc. v. Perryman, 306 F.3d 509, 510 (7th Cir. 2002). Because trademark law protects a trademark owner from having others use its mark, the source-identifying function also encourages manufacturers to produce items of high quality. *See Qualitex*, 514 U.S. at 164. "Trademarks fix responsibility. Without marks, a seller's mistakes or low quality products would be untraceable to their source. Therefore, trademarks create an incentive to keep up a good reputation for a predictable quality of goods." 1 MCCARTHY ON TRADEMARKS, *supra* note 102, at § 2:4.

118. *See* Bone, *Hunting Goodwill*, *supra* note 109, at 558. In order to establish protectable rights, descriptive trademarks must possess secondary meaning and inherently distinctive trademarks, which have no other meaning to consumers, must possess the capacity to provide source information. *See id*. at 557–58.

119. *See Qualitex*, 514 U.S. at 162–63 (noting that inherently distinctive marks "tell a customer" the source).

120. *See* Bone, *Hunting Goodwill*, *supra* note 109, at 554–55 (describing how a descriptive mark takes "the meaning given it by consumers").

trademarks," include the arbitrary,[121] fanciful,[122] or suggestive[123] marks companies make up or use to distinguish their products in the marketplace.[124] Because those marks employ new words or symbols (or new meanings for existing words or symbols) without merely describing products, a competitor would lack a legitimate excuse for its use of an inherently distinctive mark of another business.[125] Historically, that competitor could have then been held liable for the tort of trademark infringement due to the presumed likelihood of deceiving consumers.[126]

Conversely, descriptive marks, which were historically known as "trade names," included terms about characteristics and functions[127] that might describe the product of a business as well as the product of its competitor without readily identifying a source.[128] Because these marks could fairly describe either product, courts were unwilling to deem a competitor's use of a descriptive mark as being necessarily improper. Instead, courts required a trademark owner to demonstrate that the competitor intended to use the mark to deceive customers and divert trade away from the owner, which constitutes unfair competition.[129] Owners made those demonstrations by showing that consumers attached secondary

---

121. *See* U.S. Search, LLC v. U.S. Search.com Inc., 300 F.3d, 517, 523 (4th Cir. 2002) (explaining arbitrary marks as including "common words applied in unfamiliar ways," such as using the term "Apple" to describe computers).

122. *See id*. (describing fancy marks as including made-up words, such as "Exxon").

123. *See* Univ. of Ga. Athletic Ass'n v. Laite, 756 F.2d 1535, 1540-41 (11th Cir. 1985) (noting that a suggestive mark "'subtly connotes something about'" a product, such as images of an English bulldog used to symbolize athletic teams) (quoting Sun Banks of Fla., Inc. v. Sun Federal Sav. & Loan Ass'n, 651 F.2d 311, 315 (5th Cir.1981)).

124. *See* Bone, *Hunting Goodwill*, *supra* note 109, at 563–64. To the extent a person created a new word/symbol or meaning, the trademark would not have been common property of the public and was therefore capable of private ownership. *See id*.

125. *See* McKenna, *Trademark* Use, *supra* note 99, at 783.

126. *See id*. The tort essentially involved a taking of property, *see supra* note 124, and did not require proof of consumer confusion. *See* Bone, *Hunting Goodwill*, *supra* note 109, at 564–65.

127. *See, e.g*., Ralston Purina Co. v. Thomas J. Lipton, Inc., 341 F. Supp. 129, 133 (S.D.N.Y. 1972) (noting how the "Tender Vittles" product name characterizes "soft, juicy and easily chewed" food without indicating the product source).

128. *See* McKenna, *Trademark Use*, *supra* note 99, at 783.

129. *See* Bone, *Hunting Goodwill*, *supra* note 109, at 565–66 (describing a connection to fraud whereby a defendant would have intended to deceive consumers by "palming off" or "passing off" the defendant's products as those of the plaintiff).

meaning to descriptive marks such that consumers understood that the owner was the source of the marked goods.[130]

So, historically, a tort claim would have been based on a competitor using something similar to a plaintiff's inherently distinctive mark whereas an unfair competition claim would have been based on a competitor using a plaintiff's descriptive mark to falsely represent the plaintiff as the source of a product.[131] Today, the concept of trademark infringement includes both wrongful acts.[132] Nevertheless, trademarks are still classified based on their degree of distinctiveness, and all trademarks must indicate the source of products.[133]

As source identifiers, trademarks help businesses sell their products. As the Supreme Court explained:

> The protection of trade-marks is the law's recognition of the psychological function of symbols. If it is true that we live by symbols, it is no less true that we purchase goods by them. A trade-mark is a merchandising short-cut which induces a purchaser to select what he wants, or what he has been led to believe he wants. The owner of a mark exploits this human propensity by making every effort to impregnate the atmosphere of the market with the drawing power of a congenial symbol. Whatever the means employed, the aim is the same—to convey through the mark, in the minds of potential customers, the desirability of the commodity upon which it appears. Once this is attained, the trade-mark owner has something of value. . . .[134]

---

130. *See* McKenna, *Trademark Use*, *supra* note 99, at 788–89. Prior to adopting broader constructions of source, *see infra* text accompanying note 162, courts often remedied "trade name" infringements by having infringers use disclaimers or other visual means to identify clearly the true source of products. *See* McKenna, *Trademark Use*, *supra* note 99, at 788–89.

131. *See* Glynn S. Lunney, Jr., *Trademark Monopolies*, 48 EMORY L.J. 367, 373–76 (1999) [hereinafter Lunney, *Trademark Monopolies*].

132. *See* S. REP. NO. 1333, at 4 (1946), *reprinted in* 1946 U.S.C.C.A.N. 1274, 1277; RESTATEMENT (THIRD) OF UNFAIR COMPETITION § 20 cmt. b (1995); 1 MCCARTHY ON TRADEMARKS, *supra* note 102, at § 2:8 (describing trademark law as seeking to prevent acts likely to cause confusion).

133. *See* RESTATEMENT (THIRD) OF UNFAIR COMPETITION, *supra* note 132, at § 13 & § 18 cmt. d.

134. Mishawaka Rubber & Woolen Mfg. Co. v. S.S. Kresge Co., 316 U.S. 203, 205 (1942).

The unique role of these symbols in commerce should accordingly determine what connection, if any, exists between the use of a trademark and the production activities of a taxpayer.

The basic nature of a trademark gave the taxpayer in *Robinson Knife* legitimate reasons to question whether the costs to license a trademark qualify as deductible marketing or selling expenses. As discussed above, a trademark identifies the source of goods for consumers, as its primary function; receives protection to prevent confusing and deceiving marketing practices; extends qualified rights to stop misleading and deceptive uses of the mark with respect to competitive product sales; symbolizes the goodwill of a business and provides the means to derive benefit from it; and depends on consumers to give the mark—unless it is inherently distinctive—its secondary meaning. These consumer-orientated features reflect the fact that a trademark works as a marketing tool, which helps consumers select products when they recognize the mark from advertisements or prior purchases. A trademark distinguishes products in an otherwise crowed marketplace. But a mark has no obvious link to inventory production. With such a strong connection to marketing and selling activities, one might reasonably infer that the UNICAP rules would not treat the costs of a trademark—whether owned or licensed—as amounts incurred to produce marked goods.

However, the *Robinson Knife* opinions, perhaps justifiably, conclude that such an inference of deductibility extends too far. In the context of a trademark license, the courts cautioned against ignoring contract terms while assessing deductibility.[135] Although the sales-based royalties in *Robinson Knife* led to concerns about the consequences of payment terms, other terms of an agreement could conceivably grant a licensee explicit rights to use a licensed trademark in manufacturing.[136] Arguably, a licensee needs the licensor's permission only to distribute, but not to make, marked goods due to the licensor's qualified right of exclusivity.[137] However, in a litigious society, a licensee might cautiously agree to pay a licensor for

---

135. *See* Robinson Knife Mfg. Co. v. Commissioner, 600 F.3d 121, 130 (2d Cir. 2010), *rev'g* 97 T.C.M. (CCH) 1037, 2009 T.C.M. (RIA) 2009-9 ("The … license agreements gave petitioner the right to manufacture the … branded kitchen tools, and without the license agreements, petitioner could not have legally manufactured them.").

136. *See, e.g., Robinson Knife*, 600 F.3d at 123 ("The agreements gave Robinson the exclusive right to manufacture, distribute, and sell certain types of kitchen tools using the licensed brand names.").

137. See Margreth Barrett, *Finding Trademark Use: The Historical Foundation for Limiting Infringement Liability to Uses "In the Manner of a Mark*," 43 WAKE FOREST L. REV. 893, 943 (2008) ("[Trademark infringement] clearly requires two things. First, it requires trademark use - close association of the mark with the sale or distribution of goods or services. . . . Second, the goods or services must be sold, distributed, or rendered in interstate commerce.").

comprehensive rights—regardless of whether the licensor could actually stop the unauthorized production of marked goods—in order to minimize the possibility of infringement claims.[138] Contract terms therefore might create a sufficient link for capitalization purposes between a licensed trademark and production activities. If a licensee purports to secure a right to manufacture marked goods under a license, then perhaps the UNICAP rules should treat the licensing costs as inventoriable costs.

Although one might wonder how to balance the consumer-orientated nature of a trademark with licensing terms in determining inventoriable costs, recent amendments to the UNICAP regulations appear to resolve the issue by making a single contract term definitive.[139] Surprisingly, the amendments elevate the importance of a licensor's retention of control over quality, which exists in every trademark license, by effectively requiring capitalization when such control exists. Unfortunately, with that approach, the amendments missed an opportunity to more thoughtfully address the interaction of modern trademark law and licensing practices with the UNICAP rules.

C. Regulation Amendments Treating Sales-Based Trademark Royalties as Inventoriable Costs

In response to *Robinson Knife*, the Service and the Treasury Department recently amended the UNICAP regulations to address the capitalization and allocation of sales-based costs. Unlike the Second Circuit opinion, the regulations do not treat sales-based costs as inherently deductible expenses. Instead the regulations now permit a taxpayer to allocate any capitalizable amount entirely to the cost of goods sold during the year.[140] The Service and the Treasury Department hoped that allocation

---

138. *See* James Gibson, *Risk Aversion and Rights Accretion in Intellectual Property Law*, 116 YALE L.J. 882, 913–15 (2007) ("It should therefore come as no surprise when trademark users who could mount a decent defense against an infringement claim nevertheless choose to seek a license. . . . [R]isk aversion and promotional opportunities combine to create markets for trademark licenses when no license is needed."); Calboli, *Limited Protection*, *supra* note 97, at 893.

139. *See also Robinson Knife*, 600 F.3d at 134 n.11 ("Because we are interpreting the § 263A regulations and not § 263A itself, the Treasury remains free to issue guidance contrary to our holding in the form of new regulations or of amendments to existing regulations."). Accordingly, the remainder of this Article proceeds without exploring the various ways licensing agreements might incorporate manufacturing rights in order to focus on the impact of provisions governing quality control, which do not necessarily convey rights to manufacture, and to examine the substantive relationship between trademark usage and inventory production.

140. *See* Reg. § 1.263A-1(e)(3)(ii)(U), -2(b)(3)(ii)(C). The proposed regulations would have required an allocation of sales-based royalties entirely to cost

method would let taxpayers avoid improperly attributing sales-based costs to any unsold items remaining in ending inventory at year-end.[141] Accordingly, the amended regulations permit allocations of capitalizable sale-based royalties to cost of goods sold under either a facts-and-circumstances or a simplified allocation method, which is an approach that the Service and the Treasury Department characterize as achieving results similar to *Robinson Knife*.[142]

In addition to addressing cost allocations, the regulation amendments clarify that sales-based costs remain subject to capitalization under section 263A.[143] Thus, the regulations find capitalization appropriate for certain indirect costs "even if the costs are calculated as a percentage of revenue or gross profit from the sale of inventory, are determined by reference to the number of units of property sold, or are incurred only upon the sale of inventory."[144] A taxpayer would consequently capitalize those indirect costs,[145] but could allocate them entirely to cost of goods sold.[146] The regulation amendments and *Robinson Knife* both contemplate immediate recovery for sales-based costs; however, the regulations permit taxpayers to treat those costs as capitalizable amounts that run through cost of goods sold but do not allow taxpayers to deduct them as business expenses.

Unfortunately, an ill-chosen example attempts to illustrate how the regulations might require capitalization for sales-based costs. Reminiscent of *Robinson Knife*, the example describes a tablecloth manufacturer that enters into a licensing agreement whereby it agrees to pay a sales-based royalty to a trademark owner in exchange for the right to label its tablecloths, which meet certain quality standards, with the mark.[147] The example concludes that the royalty directly benefits and is incurred by reason of the manufacturer's production activities because the licensed right is "directly related" to tablecloth production.[148] The example attributes the direct relationship to

---

of goods sold; however, the final regulations made the allocation optional to avoid unduly burdening those taxpayers using simplified allocation methods. *See* T.D. 9652, 2014-12 I.R.B. 655, 656.

141. *See* Notice of Proposed Rulemaking, *Sales-Based Royalties and Vendor Allowances*, 75 Fed. Reg. 78,940, 78,941 (2010).

142. *See id*.

143. *See* T.D. 9652, 2014-12 I.R.B. 655, 656; Notice of Proposed Rulemaking, *Sales-Based Royalties and Vendor Allowances*, 75 Fed. Reg. 78,940, 78,941 (2010). Although the preambles to the proposed and final regulations explain the regulation provisions in the context of sales-based *royalties*, the regulations more broadly reference sales-based *costs*. *See* Reg. § 1.263A-1(e)(3)(1)(A).

144. Reg. § 1.263A-1(e)(3)(1)(A).

145. *See generally supra* Part II.A.

146. *See generally supra* Part II.B.

147. *See* Reg. § 1.263A-1(e)(3)(i)(B)(i).

148. Reg. § 1.263A-1(e)(3)(i)(B)(ii).

having a licensing agreement that conditions the right to use the trademark on the manufacturer "conduct[ing] its production activities according to certain [quality] standards."[149] Basically, the example requires capitalization for the sales-based royalty due to the fact that the trademark owner retains control over the quality of produced tablecloths bearing the mark.

This focus on control produces notable, albeit likely unintended, implications under the UNICAP rules. The Service and the Treasury Department could have highlighted capitalization for sales-based costs by selecting an intangible asset more clearly related to production activities. In fact, the preamble to the proposed regulations had mentioned copyrighted works and patented inventions in this context.[150] An example of a sale-based royalty incurred to use a patented method for weaving tablecloths would have nicely illustrated the potential for capitalization.

Instead the Service and the Treasury Department sought to clarify their position by revisiting trademark royalties. As a result, the example had to justify capitalization by establishing an otherwise nonobvious connection between a trademark and production activities. The Service and the Treasury Department found a direct relationship in the trademark owner's control over quality, as established through production standards. With that finding, the example changed from merely illustrating capitalization for sales-based costs to subtlety asserting that control matters in determining what indirect costs directly benefit or are incurred by reason of production or resale activities, within the meaning of the regulations. Unfortunately, this focus on control permits an irrelevant factor to influence capitalization determinations and ignores the declining significance of control in modern trademark law and licensing practices.

1. *The Irrelevance of Control in Determining Capitalizable Costs*

By making control significant for capitalization purposes, the regulations overlooked the historical reason for having trademark owners retain control over quality in licensing arrangements. Trademark licensing had originally been prohibited under common law based on the traditional notion that trademarks protect consumers and fair competition.[151] Courts had

---

149. *Id.*

150. *See* Notice of Proposed Rulemaking, *Sales-Based Royalties and Vendor Allowances*, 75 Fed. Reg. at 78,941.

151. *See* Dawn Donut Co. v. Hart's Food Stores, Inc., 267 F.2d 358, 366 (2d Cir. 1959). *See also* Irene Calboli, *The Sunset of "Quality Control" in Modern Trademark Licensing*, 57 AM. U.L. REV. 341, 351 (2007) [hereinafter Calboli, *Quality Control*]; *supra* text accompanying notes 93–96.

found trademark licensing deceptive[152] because a distinctive mark primarily informs consumers about the source of the goods.[153] Those courts had reasoned that if a manufacturer were to produce goods that display a trademark owned by another person the mark would mislead consumers into believing that those goods were produced by the trademark owner rather than the manufacturer.[154] In order to avoid such deception, courts prohibited trademark licensing altogether (and held that attempts to license trademarks resulted in abandonments of the marks).[155] This focus on the actual source of the goods made sense years ago, especially before the expansion of the national economy when local businesses dominated trade and consumers were quite familiar with nearby manufacturers.[156] The prohibition against licensing thus allowed trademarks to function as reliable indicators of known manufacturers in close physical proximity.

Yet, as business practices changed and products started coming from distant and unfamiliar manufacturers, courts became more willing to accept trademark licensing. Improvements in mass production techniques and nationwide distribution channels made licensing necessary for companies that sought to diversity their product offerings while outsourcing production.[157] Courts responded to this need by recognizing that consumers found information about a product's attributes, particularly its unobservable attributes, more helpful than knowing who physically manufactured the product. Trademarks help convey attribute information by indicating that all products sold under a particular mark share a consistent level of quality.[158]

---

152. *See, e.g.*, American Broad. Co. v. Wahl Co., 121 F.2d 412, 413 (2d Cir. 1941). An owner could only assign or transfer its mark with rest of its business, including the goodwill. *See supra* text accompanying note 111.

153. *See Hanover Star Milling Co.*, 240 U.S. at 412; *supra* text accompanying notes 115–118.

154. *See, e.g.,* MacMahan Pharmacal Co. v. Denver Chem. Mfg. Co., 113 F. 468, 474–75 (8th Cir. 1901).

155. *See, e.g.*, Everett O. Fisk & Co. v. Fisk Teachers' Agency, 3 F.2d 7, 8–9 (8th Cir. 1924) ("[U]nder the sanction of contracts made by the plaintiff assuming to license the use of the trade-name, has caused the name to lose its distinctiveness as the trade-name of the plaintiff.").

156. *See* Patricia K. Fletcher, *Joint Registration of Trademarks and the Economic Value of a Trademark System*, 36 U. MIAMI L. REV. 297, 302 (1982); Bone, *Hunting Goodwill*, *supra* note 109, at 575–76 (noting the importance of personal reputation and the relative insignificance of trademarks in rural communities).

157. *See* David J. Franklyn, *The Apparent Manufacturer Doctrine, Trademark Licensors and the Third Restatement of Torts*, 49 CASE W. RES. L. REV. 671, 681 (1999) [hereinafter Franklyn, *Apparent Manufacturer Doctrine*].

158. *See* Societe Des Produits Nestle, S.A. v. Casa Helvetia, Inc., 982 F.2d 633, 636 (1st Cir. 1992) ("Every product is composed of a bundle of special

Accordingly, a customer who was satisfied with the quality of previously purchased goods would expect to find equal satisfaction from (and might seek out) goods bearing the same trademark.[159] For example, for at least 100 years, restaurant patrons have known what level of quality to expect from ordering Coca-Cola marked beverages with their meals.[160] The courts thus began to recognize that goods produced under a licensed trademark created expectations about a consistent level of quality irrespective of the person responsible for physically manufacturing the goods.[161] So the Coca-Cola trademark provides customers with assurance that a marked beverage produced by an independent bottler will have a quality consistent with a marked beverage produced by the trademark owner. In order to reconcile this quality assurance aspect of trademarks with their prior emphasis on physical source, courts began construing "source" as broadly referring to an origin of quality standards as well as the location of manufacture.[162] Consequently, the judiciary began tolerating the use of licensed trademarks where such use supported expectations about product quality.

Courts accordingly started upholding trademark licensing arrangements as long as trademark owners retained control over the quality of items displaying those marks. Thus, the courts, at least initially, imposed an affirmative duty on trademark owners to police the activities of their licensees in order to ensure consistent quality across all goods sold under a single mark.[163] This duty was considered necessary to protect consumers from being misled, given that they often cannot uncover variations in product quality prior to a sale.[164] The courts further believed a trademark would lose

---

characteristics. The consumer who purchases what he believes is the same product expects to receive those special characteristics on every occasion.").

159. *See* Frank I. Schechter, *The Rational Basis of Trademark Protection*, 40 HARV. L. REV. 813, 818–19 (1927) [hereinafter Schechter, *Rational Basis*].

160. *See* Coca-Cola Co. v. Koke Co., 254 U.S. 143, 146 (1920) ("It hardly would be too much to say that the drink characterizes the name as much as the name the drink. In other words 'Coca-Cola' probably means to most persons the plaintiff's familiar product to be had everywhere . . . .").

161. *See* Assaf, *Brand Fetishism*, *supra* note 105, at 88, 91 (describing a gradual recognition of trademarks as communicating that marked goods are "somehow linked with or sponsored by a single" anonymous source).

162. *See* Taco Cabana Int'l, Inc. v. Two Pesos, Inc., 932 F.2d 1113, 1121 (5th Cir. 1991), *aff'd*, 505 U.S. 763 (1992). Courts also began construing "source" more broadly to protect an owner from having another company use its mark to sell unrelated products. *See* McKenna, *Trademark Use*, *supra* note 99, at 789. Although such use would not divert trade away from the owner, courts were willing to find "source confusion," which could justify infringement claims, from the inference consumers could draw about a relationship between the owner and the other company based on the use of the mark. *See id*. at 789–90, 797.

163. *See Dawn Donut Co.*, 267 F.2d at 367.

164. *See id*.

its significance through uncontrolled or so-called "naked" licensing, where a licensee could place the licensed mark on products of varying quality.[165] As a result, the courts regarded uncontrolled licensing as an inherently deceptive practice resulting in an invalid license with the licensor forfeiting all rights in the mark.[166] Control accordingly became an essential part of a valid license. Judicial acceptance of licensing trademarks therefore occurred through viewing trademark owners as the sources of quality standards and requiring them to control their licensees in order to protect consumer expectations about product quality.

Consistent with this judicial development, the Lanham Act has similarly regarded a trademark owner's retention of control as a prerequisite for a valid license. In particular, the Lanham Act provides that a related company may legitimately use a registered trademark without affecting the mark's validity.[167] The Lanham Act defines a related company as "any person whose use of a mark is controlled by the owner of the mark with respect to the nature and quality of the goods or services on or in connection with which the mark is used."[168] A manufacturer could accordingly become a related company through a contractual relationship, such as a trademark licensing agreement.[169] As noted above, without such control, a purported licensee could manufacture goods of diverse quality frustrating consumer expectations and potentially damaging the associated goodwill. Therefore, the Lanham Act indicates that a failure to control licensees could justify the cancellation of the licensed mark or cause its abandonment.[170] Accordingly, the Lanham Act, much like the common law before it, has made an owner's control over quality a necessary part of every valid trademark license.

Unfortunately, by using a licensor's control over quality to justify capitalization, the UNICAP regulations effectively regard trademark licensing royalties as inherently capitalizable costs. As noted above, the regulations establish that a right to use a trademark is directly related to production and thereby directly benefits or is incurred by reason of production activities—within the meaning of the regulations—where the licensing agreement conditions such use on compliance with production

165. *See, e.g.,* Stanfield v. Osborne Indus., Inc., 52 F.3d 867, 871 (10th Cir. 1995).

166. *See* First Interstate Bancorp v. Stenquist, No. C-89-4106 MHP, 1990 U.S. Dist. LEXIS 19426, at *7 (N.D. Cal. 1990).

167. *See* Lanham Act of 1946, ch. 540, § 5, 60 Stat. 427, 429 (permitting a related company to use a registered mark, "provided such mark is not used in such manner as to deceive the public").

168. 15 U.S.C. § 1127.

169. *See* McKenna, *Trademark Use*, *supra* note 99, at 790.

170. *See* 15 U.S.C. § 1064(3) (cancellation occurs when use of mark misrepresents the source of goods). *See also* 15 U.S.C. § 1127 (abandonment where an omission of control causes a mark to lose its significance).

standards.[171] In other words, the regulations consider a licensor's control over quality as sufficient to require capitalization. Yet such control is a *sine qua non* of a valid trademark license. As a result, the regulations effectively characterize royalties payable under any valid trademark license as capitalizable costs irrespective of whether a genuine relationship exists between the trademark and production activities. The regulations therefore inappropriately make capitalization depend on the existence of control, which any license necessarily must possess. The practical import is that trademark royalties have become inherently capitalizable even though the Service and the Treasury Department, as well as the Second Circuit, have recently eschewed categorical approaches for identifying capitalizable royalties.[172]

The UNICAP regulations' use of control in determining capitalizable costs appears problematic insofar as it would affect more than sales-based royalties. The regulations found trademark royalty costs properly allocable to produced items (i.e., capitalizable) as a result of a licensor's control rather than as a result of the products' sales-based nature.[173] The UNICAP regulations only make the sales-based nature of royalties significant in recovering capitalizable costs. In particular, the UNICAP regulations would permit a taxpayer to attribute capitalizable sales-based costs entirely to those goods deemed sold during the year.[174] For other (i.e., non-sales based) trademark royalties, the UNICAP regulations presumably contemplate that a taxpayer would allocate capitalizable royalties between its ending inventory value and its cost of goods sold.[175] However, as costs incurred under a license, the royalties are necessarily capitalizable under the regulations. As a result, taxpayers paying certain royalties under trademark licensing agreements, such as minimum royalties, might find some of the royalties treated as inventoriable production costs attributable to unsold goods[176] even

171. *See supra* text accompanying notes 147–49.

172. *See* Notice of Proposed Rulemaking, *Sales-Based Royalties and Vendor Allowances*, 75 Fed. Reg. at 78,941 (proposing an allocation of otherwise capitalizable royalties to cost of goods sold "rather than determining that sales-based royalty costs are inherently non-capitalizable" as in *Robinson Knife*); *Robinson Knife*, 600 F.3d at 130 ("[W]e reject the contention that *all* trademark royalties are immediately deductible.").

173. *See* Reg. § 1.263A-1(e)(3)(i)(B)(i). Significantly, the sales-based royalty example in the regulations provides the only illustration of what is meant by the phrase "costs directly benefit or are incurred by reason of." Reg. § 1.263A-1(e)(3)(i).

174. *See* Reg. § 1.263A-1(e)(3)(ii)(U)(2).

175. *See supra* Part II.B.

176. *See* F.S.A. 2012-44-01F (Oct. 2, 2012) (distinguishing the tax treatment of minimum royalties, which were allocable to ending inventory and the

though the trademarks merely help consumers identify which goods to buy in a crowded marketplace.[177]

For example, consider a manufacturer that seeks to label its goods with the trademark of a well-regarded company in order to take advantage of established goodwill and customer loyalty. The manufacturer might agree to make a single, up-front royalty payment in exchange for the right to use the trademark under a licensing agreement that includes customary provisions regarding quality standards for production. For tax purposes, the manufacturer would initially capitalize the entire payment as an amount incurred to acquire the license[178] and subsequently amortize the capitalized amount under section 197.[179] The UNICAP rules should then seemingly regard the amortization for a year, like any other indirect cost in the manufacturer's business, as an inventoriable cost to the extent that it directly benefits or is incurred by reason of the production activities.[180] However, the example in the regulations suggests the amortization becomes an inventoriable cost simply by virtue of having quality control standards in the license. The manufacturer probably has no stake in this result as long as all of its amortization runs through the cost of goods sold for that year because it would produce immediate cost recovery just like a deductible expense. However, the manufacturer should care about the amortization included in its ending inventory, which postpones cost recovery until the deemed sale of the inventory. Postponed cost recovery seems appropriate for costs reasonably attributable to inventory production activities; however, it remains puzzling why a licensor's control over quality would turn costs attributable to the use of a trademark into inventoriable costs.

The puzzling aspect of the regulations' assumed relationship between quality control and inventory production becomes apparent where a taxpayer owns a trademark as opposed to licenses. Assume the manufacturer in the example above purchased the trademark and the related business[181] from the company in order to label its products with the mark and take advantage of the associated goodwill and customer loyalty. For tax purposes, the manufacturer generally could amortize under section 197 any purchase

---

cost of goods sold like other production-related costs, from the treatment of sales-based royalties, which were attributable entirely to the cost of goods sold).

177. *See supra* text accompanying notes 115–33.

178. *See* I.R.C. § 1253(d)(2).

179. *See* Reg. § 1.197-2(g)(6); *see also* Reg. § 1.197-2(b)(11) (characterizing the right to use a trademark under a license as a section 197 intangible); Reg. § 1.197-2(d)(2)(ii)(B) (excluding a taxpayer's entry into a contract to use a section 197 intangible, such as a license to use a trademark, from a group of non-amortizable, self-created intangibles).

180. *See* Reg. § 1.263A-1(e)(3)(ii)(U).

181. *See supra* text accompanying notes 109–11 (describing the prohibition against assigning trademarks in gross).

price allocated to the trademark.[182] But the manufacturer would still need to determine whether the amortization qualifies as an immediately deductible expense or a capitalizable production cost. The manufacturer would use the trademark—whether licensed or owned—to identify its goods in the marketplace. However, as a trademark owner, the manufacturer would have the option of producing inferior goods bearing the mark[183] and thereby risking confusion among consumers and destroying the value of the acquired goodwill. Like most taxpayers, the manufacturer would presumably deduct any trademark or goodwill amortization or both because it is unclear how a mark used by consumers for source identification plays any role in inventory production. Yet, as discussed above, the UNICAP regulations suggest a different tax treatment is appropriate for the costs of a *licensed* mark due to controls over quality. It appears difficult to reconcile the differential treatment with respect to costs attributable to the same use of an asset.

Control only legitimately affects the tax treatment of royalties insofar as control distinguishes purchased trademarks from licensed trademarks. Congress enacted section 1253 in part to help resolve questions about whether a wide variety of transactions resulted in trademarks being sold, exchanged, or licensed. The varying conditions and payment terms used in agreements had often made it difficult to rely on case law in discerning transfers that produced capital gains from those that produced ordinary income for transferors.[184] Currently, section 1253 differentiates transfers by restricting sale or exchange treatment to those transactions in which transferors retain no significant power, right, or continuing interest in the trademarks.[185] As a result, a transferor's retained control over product quality standards would prevent a transfer from receiving sale or exchange treatment.[186] Instead, such control signifies that the arrangement constitutes a license generating ordinary income for the transferor.[187] Section 1253 accordingly reflects a reasonable assertion that a transferor cannot assert

182. *See* I.R.C. § 197(a), (c)(1), (d)(1)(F).

183. The manufacturer could also produce marked goods of a consistent or better quality.

184. *See* S. REP. NO. 91-552, at 207 (1969).

185. *See* I.R.C. § 1253(a).

186. *See* I.R.C. § 1253(b)(2)(C).

187. A transferor's retention of a significant power, right, or continuing interest without the retention of control over quality would still result in characterization as a license for tax purposes; however, an attempted license without retained control over quality might result in the transferor's legal abandonment of the mark. *See* William A. Drennan, *It Does Not Compute: Copyright Restriction on Tax Deduction for Developer's Donation of Software*, 5 FLA. TAX REV. 547, 590 n.215 (2002).

control over the use of a mark while simultaneously claiming to have sold or exchanged it.[188]

Despite being a *sine qua non* of a valid license, a transferor's retained control over quality has no comparable relevance in determining whether royalty payments are properly allocable to produced goods. Section 1253 generally requires a transferee to capitalize payments (such as up-front or minimum royalties) made to purchase or license a trademark, where the sale or license characterization for a transferee mirrors that of the transferor.[189] Congress had originally envisioned that the transferee would amortize the capitalized amounts over the mark's life or the license's term, as appropriate.[190] The transferee would thereby rationally account for the cost of the acquired asset or licensed right commensurate with the period over which the rights in the mark were exploitable. Section 1253 correspondingly made any serial payments contingent on a mark's use (e.g., sales-based royalties) deductible—in either a sale or license transaction—in order to account for the costs as those rights were exploited.[191] Although section 197 now provides uniform amortization methods for acquired and licensed trademarks,[192] thus reducing the significance of the characterization for the transaction, control still dictates whether a transferee is classified as an owner or a licensee.

The UNICAP regulations improperly suggest that retained control—apart from signifying licensing arrangements—inherently connects licensed rights with production activities. However, neither a licensing arrangement nor control within that arrangement demonstrates any relationship to inventory production. A transferor's retained control indicates that a transferee possesses fewer than all rights in a trademark, which is irrelevant for capitalization purposes. The UNICAP rules should instead focus on the transferee's use of the mark—whether owned or licensed—in determining any inventoriable costs.

Section 263A could properly capitalize a trademark royalty that is otherwise treated as a deductible or amortizable amount under sections 197 or 1253. However, capitalization for that amount, as an indirect cost under

---

188. *See* S. REP. NO. 91-552, at 208 ("[I]f the transferor exercises continuing, active, operational control of a franchise, trademark, or trade name, . . . this exercise of control is inconsistent with a sale or exchange of property.").

189. *See* I.R.C. § 1253(d)(2).

190. *See* H.R. REP. NO. 101-247, at 1349–50 (1989).

191. *See* I.R.C. § 1253(d)(1). The transferor would report the contingent payments as ordinary income, even if the transfer were otherwise characterized as a sale or exchange. *See* I.R.C. § 1253(c).

192. *See supra* notes 179, 182. Congress granted the Treasury Department authority to permit alternative amortization methods for certain trademark licenses; however, the Treasury Department has not yet exercised that authority. *See* I.R.C. § 197(e)(4)(D).

section 263A, is appropriate only where the cost directly benefits or is incurred by reason of production activities. The regulations cannot assume this requirement is met whenever a transferor retains control over quality in a trademark license. The transferor's control is sufficient to establish that the transfer constitutes a license, but the transferor's control cannot unilaterally support the capitalization of the licensing costs.

2. *The Declining Significance of Control in Trademark Law and Licensing Practices*

In some respects, a trademark owner's control over production standards might seem to establish a natural connection between the use of a licensed mark and the production of inventory. With control, the owner would ostensibly have its hand in the licensee's production activities. However, the strength of that connection appears dependent upon whether the owner actually asserts control over production or simply inserts control language into a licensing agreement. In that regard, modern trademark law and licensing practices suggest that the control language operates as a mere formality in many arrangements.

Ironically, the UNICAP regulations now focus on a trademark owner's control even though the significance of such control in licensing arrangements has continued to decline in trademark law. An apparent trend has emerged whereby the degree of control required for a valid license has diminished and, in some instances, has been inserted artificially or deemed to exist.[193] In addition to responding to the practical difficulty of exercising meaningful control in modern commercial arrangements,[194] this trend of deemphasizing control reflects a judicial reluctance to invalidate trademarks. As noted above, the uncontrolled use of a mark causes a loss of its distinctiveness and consequently abandonment by its owner.[195] As questions about control frequently arise when a trademark owner sues an alleged infringer, a court might become reluctant to reward the alleged infringer with a finding of deficient control (i.e., resulting in the owner's abandonment of the mark) if the court believes the alleged infringer has unclean hands.[196] By

193. *See* Calboli, *Quality Control*, *supra* note 151, at 364–71.

194. *See infra* text accompanying notes 209–32.

195. *See supra* text accompanying notes 165–66, 170.

196. *See* Franklyn, *Apparent Manufacturer Doctrine*, *supra* note 157, at 689. Some courts have accordingly followed a doctrine of licensee estoppel prohibiting a licensee from asserting that the licensed mark is abandoned due to the licensor's lack of control. *See* MCCARTHY ON TRADEMARKS, *supra* note 102, at § 18:63; *see also* Assaf, *Brand Fetishism*, *supra* note 105, at 114 (noting how licensee estoppel "essentially treats trademarks as purely private rights rather than as public informational devices" that "prefers the dubious concerns with fairness in the licensor-licensee relations over the public interest in the accuracy of information

applying lower expectations of acceptable control, a court can avoid the potential inequity of a deemed abandonment. This reluctance to find naked licensing explains, in part, the trend of heightened expectations of control—which courts originally viewed as necessary mechanisms for avoiding consumer deception[197]—giving way to minimal expectations.

This trend should make the Service and the Treasury Department cautious about inferring too much about the actual control of licensors based on the inclusion of quality control standards in licensing agreements. Prior to the enactment of the Lanham Act, courts had required strict enforcement of quality control standards for valid licenses.[198] After the Lanham Act's enactment, courts initially began upholding licenses as long as licensors exercised adequate or sufficient control.[199] More recently, courts have expected only minimal control in licensing arrangements and have accepted nearly any evidence of that control.[200] As control requirements loosened, some courts even upheld licenses in the absence of explicit quality control provisions in licensing agreements,[201] particularly where the quality of marked products remained consistent and consumers were not deceived.[202]

---

embedded in trademarks"). One might question whether that doctrine should similarly preclude a licensee from arguing that the licensor lacked control such that royalties incurred under the license were outside the scope of the UNICAP regulations and therefore not properly capitalizable.

197. *See supra* text accompanying notes 163–66.

198. *See, e.g.*, Broeg v. Duchaine, 67 N.E.2d 466, 468 (Mass. 1946) ("There was nothing in the licensing agreements that required that [products] sold by the defendant conform to any fixed standards.").

199. *See, e.g.*, Joseph Bancroft & Sons Co. v. Shelley Knitting Mills, Inc., 212 F. Supp. 715, 740 (E.D. Pa. 1962) (noting that a quality control program did not result in "any failure or inability to exercise adequate control and supervision over its licensees"); *Dawn Donut Co.*, 267 F.2d at 367 (questioning "whether the plaintiff sufficiently policed and inspected its licensees' operations to guarantee the quality of the products").

200. *See, e.g.*, Kentucky Fried Chicken Corp. v. Diversified Packaging Corp., 549 F.2d 368, 387 (5th Cir. 1977) ("Retention of a trademark requires only minimal quality control . . . ; the consuming public must be the judge of whether the quality control efforts have been ineffectual.").

201. *See, e.g.*, Miller v. Glenn Miller Prods., 318 F. Supp. 2d 923, 936 (C.D. Cal. 2004) ("A license agreement need not contain an express quality control provision because trademark law, rather than the contract itself, confers on the licensor the right and obligation to exercise quality control."), *aff'd in part*, 454 F.3d 975 (9th Cir. 2006).

202. *See, e.g.*, *Taco Cabana Int'l, Inc.*, 932 F.2d at 1121 ("Where the particular circumstances of the licensing arrangement persuade us that the public will not be deceived, we need not elevate form over substance and require the same policing rigor appropriate to more formal licensing and franchising transactions."), *aff'd*, 505 U.S. 763 (1992); Land O'Lakes Creameries, Inc. v. Oconomowoc

Other courts have even found valid licenses from a simple reciting of contractual rights to control or the self-monitoring by a licensee.[203] Courts have not forsaken the control requirement, but their increasing tendency to find satisfactory control in a plethora of licensing arrangements indicates that quality control has become nearly meaningless in trademark law.[204] As a result, control remains a formality in trademark licensing agreements rather than a practical reality.

The trend of accepting minimal control in trademark law undercuts the notion that such control connects trademark usage with inventory production. Whereas strict enforcement of control provisions in licensing agreements might suggest an active monitoring and involvement by trademark owners in the operations of their licensees, the inclusion of a control provision does not create an expectation that a trademark owner will actually undertake those efforts. Instead, trademark owners can often support the validity of a license by exercising only minimal control usually accomplished through careful drafting of contracts or self-monitoring by licensees. With such minimal efforts in controlling inventory production, any inferred connection between trademark usage and production activities appears suspect. Nonetheless, the example in the UNICAP regulations does not question the extent of control. The example simply requires capitalization where the terms of a license condition the use of a mark on the taxpayer's compliance with quality standards.[205]

Canning Co., 330 F.2d 667, 670–71 (7th Cir. 1964) (deeming a trademark owner to have sufficient control where it relied on the integrity of a licensee because such reliance developed over the 40-year license term during which the owner's name appeared on the licensee's labels and no complaints were received from customers); Embedded Moments, Inc. v. International Silver Co., 648 F. Supp. 187, 194 (E.D.N.Y. 1986) (noting that, despite the absence of a written provision in an agreement, having an opportunity to review products and a willingness to continue to a licensing arrangement would support the finding of supervisory control); Westco Group, Inc. v. K.B. & Assocs., 128 F. Supp. 2d 1082, 1091 (N.D. Ohio 2001) (finding an exercise of sufficient control "by monitoring . . . operation[s] through industry sources and name brand . . . product sales representatives").

203. *See* Franklyn, *Apparent Manufacturer Doctrine*, *supra* note 157, at 689.

204. *See id*. ("[C]ourts have diluted the quality control requirement to the point where its meaning is no longer clear, if it even has any meaning at all."); Calboli, *Quality Control*, *supra* note 151, at 364 (noting how "this [judicial] approach has profoundly eroded the practical impact of quality control").

205. The example does not describe whether the taxpayer's compliance with the standards is determinable by the taxpayer (e.g., through self-monitoring) or the licensor (e.g., through inspection). The omission of that detail suggests that the regulations follow a minimal control approach where the existence of quality control provisions (the arrangement's form) is more significant for capitalization purposes than an exercise of actual control (the agreement's substance).

The prospect of deemed control further obscures the relationship between trademark usage and inventory production. The deemed existence of control—as derived, for example, from a licensor's reliance on licensee integrity, product consistency, or consumer satisfaction[206]—does not readily suggest the licensor's active involvement in the licensee's operations. However, courts have effectively equated deemed control with explicit control in upholding licenses. As deemed and explicit control can both validate a license, one might question whether they can similarly justify the capitalization of trademark royalties. The example in the UNICAP regulations at least suggests that, where an agreement explicitly conditions the use of a trademark on meeting product quality standards,[207] the condition connects the use with production and justifies the capitalization of the associated royalties. In other words, the arrangement's form (i.e., a use conditioned on meeting quality standards) alone establishes the necessary connection.

However, any connection between trademark usage and production becomes more questionable where no such condition exists but control over quality is implied, for example, from evidence of consumer satisfaction. Evidence of consumer satisfaction with the consistency of product quality does not clearly link trademark usage with inventory production sufficient for capitalization. Although one might expect the same tax implications regardless of whether explicit conditions or deemed relationships are used to satisfy minimal control requirements, deemed control makes capitalization harder to justify.[208] More importantly, if deemed control does not warrant capitalization, then one must ask whether actions consistent with the licensor's control are less relevant in finding a connection between trademark usage and production than a formal condition that could potentially limit such use depending on the results of production. Surprisingly, in this context the regulations focus on the formality of a condition as opposed to indications of control.

---

206. *See supra* note 202 and accompanying text.

207. Explicit control provisions incorporated into agreements as mere formalities, perhaps in the nature of boilerplate language, appear to fall within the scope of the UNICAP regulation example. *See infra* text accompanying note 230.

208. Perhaps the substance of a license might justify capitalization even though a retention of control is lacking in its form; however, taxpayers and the Service would likely struggle to determine, for example, whether production activities sufficiently benefit from a trademark owner's deemed control. Thus, considerations of deemed control might make the UNICAP regulations difficult to administer. On the other hand, if trademark royalties payable under licenses are inherently capitalizable, then the distinction between deemed and explicit control would not matter for tax purposes as long as a valid license exists. *See supra* Part III.C.1.

In any event, the declining role of control in trademark law has accompanied an evolution in trademark licensing practices.[209] The concept of control grew out of so-called classical or traditional licensing arrangements where a licensor, which had historically manufactured certain products, outsourced future production to a licensee.[210] Through outsourcing, the licensor could avoid the manufacturing costs and risks of production yet share in the profits from product sales through the receipt of royalty payments.[211] The licensee could similarly benefit from utilizing the goodwill associated with the licensed trademark to sell products while avoiding the risk and effort of marketing products under an unknown name.[212] Thus, a classical licensing arrangement simply contemplates shifting the licensor's existing production to the licensee, which can often manufacture the same product more efficiently or cheaply, while using the trademark to promote future sales of the product.[213] Under these circumstances, one could reasonably expect a licensor to assert control because the licensor has its own prior production experience and knowledge through which it can demand compliance with its own product standards and can monitor the consistency of its licensee's product quality.[214]

In recent decades, collateral product licensing has evolved into a significant commercial practice. A collateral product licensing arrangement occurs where a licensor authorizes the use of a trademark with goods that differ from the products that originally established the mark.[215] Accordingly, the arrangement can involve placing a mark on unrelated products. This practice, particularly in the context of the promotional licensing discussed below, has led commentators to question whether the mark could legitimately inform consumers about the source of unrelated products in

209. *See* Franklyn, *Apparent Manufacturer Doctrine*, *supra* note 157, at 683.

210. *See* Calboli, *Quality Control*, *supra* note 151, at 348–49. Franchise licensing has also become commonplace as a licensor grants multiple nonexclusive licenses to authorize production of trademarked goods under standards and specifications designated by the licensor. In the context of a franchise, a licensor usually licenses its technologies and methods of operations in addition to any trademark. *See id*. at 378. Although a franchise is beyond the intended scope of this Article, it is noteworthy that the UNICAP regulations treat franchise and trademark costs similarly. *See* Reg. § 1.263A-1(e)(3)(ii)(U).

211. *See* Calboli, *Quality Control*, *supra* note 151, at 377.

212. *See id*.

213. *See* David J. Franklyn, *Toward a Coherent Theory of Strict Tort Liability for Trademark Licensors*, 72 S. CAL. L. REV. 1, 12 (1998) [hereinafter Franklyn, *Coherent Theory*].

214. *See id*.; Alfred M. Marks, *Trademark Licensing—Towards a More Flexible Standard*, 78 TRADEMARK REP. 641, 646 (1988) [hereinafter Marks, *Trademark Licensing*].

215. *See* Calboli, *Quality Control*, *supra* note 151, at 349.

order to justify legal protection of the mark.[216] Nevertheless, trademark owners have been largely successful in treating trademarks as de facto property over which they can control all uses of such marks. The owners have been supported to the extent they could show that an unauthorized use could likely cause confusion about sponsorship or affiliation[217] or cause dilution of a famous mark.[218] In any case, as with classical licensing, collateral product licensing arrangements often arise as parties seek to take advantage of a licensee's economies of scale.[219] However, collateral product licensing also helps create and satisfy demand for new products, which the licensor has not traditionally manufactured, by exploiting the value of the trademark.[220]

Promotional trademark licensing or trademark merchandising [hereinafter "promotional licensing"] arrangements represent a subset of collateral product licensing arrangements. In promotional licensing, a licensee promotes the sales of unrelated, but marked, products primarily through consumer identification and affiliation with the owner of the trademark.[221] By purchasing a marked product, a customer can proclaim "loyalty, admiration or sympathy with the organization represented by the trademark. . . ."[222] For example, consumers initially sought out shoes under

---

216. *See* Calboli, *Limited Protection*, *supra* note 97, at 888–89; Lemley, *Modern Lanham Act*, *supra* note 98, at 1708 ("The point of trademark law has never been to maximize profits for trademark owners at the expense of competitors and consumers.").

217. *See* McKenna, *Trademark Use*, *supra* note 99, at 798–99 (describing modern trademark law as determining "source confusion" from confusion about a product's actual origin as well as the product's sponsorship or affiliation with a trademark owner); Mark A. Lemley & Mark McKenna, *Irrelevant Confusion*, 62 STAN. L. REV. 413, 424 (2010) (noting a broader interpretation of source confusion, which allowed for findings of infringement outside the traditional confines of preventing trade diversion, without supplying an obvious scope limitation).

218. *See Moseley*, 537 U.S. at 429 (describing how concerns about diluting famous marks seem to contemplate protecting trademark owners rather than consumers).

219. *See* Calboli, *Quality Control*, *supra* note 151, at 349.

220. *See id*.

221. *See* Marks, *Trademark Licensing*, *supra* note 214, at 652. This Article focuses on promotional licensing that seeks to exploit famous or luxury trademarks, as opposed to a license permitting a manufacturer's placement of trademarks on products used as a form of advertising (e.g., printing a company's logo on key chains, which are later distributed as freebies at a convention in the company's industry), due to the potential application of the UNICAP regulations to any royalties payable in the former context. *See* Calboli, *Limited Protection*, *supra* note 97, at 872–73.

222. Marks, *Trademark Licensing*, *supra* note 214, at 652; *see also* Tracy Reilly, *Betty Boop Almost Lost Her "Bling-Bling:" Fleischer Studios v. A.V.E.L.A.*

the Michael Jordan brand to "be like Mike," rather than as a result of any assurance of product quality implied by the Jordan name. Licensors and licensees primarily use these arrangements to exploit the value of trademarks rather than to profit from sales of the underlying products.[223] Accordingly, unlike other licensing arrangements intended to take advantage of production efficiencies, promotional licensing often enables the parties to seek selling prices that are higher for marked products than they are for identical, unmarked products.[224]

As collateral product licensing has evolved into a more substantial commercial practice, the concept of licensors maintaining control over quality has become difficult to rationalize. As discussed above, a licensor has both the knowledge and incentive to ensure consistent quality in classical licensing arrangements. In contrast, a licensor's lack of expertise in unrelated products limits its practical ability to establish quality standards and specifications in order to assess the conformity of a licensee's products.[225] As a commenter described:

> This difficulty has left collateral and promotional licensors in a bind. Because they have never manufactured the product they now wish to produce through a licensee, they are not in a position to point to a relevant and controlling quality standard for the new product line. Nor are they in a position to supply their licensees with specifications or designs for the new product. For these reasons, collateral and promotional licensors frequently cannot control the quality of the licensed goods in any meaningful sense.[226]

Licensors still care about quality because it impacts the value of their trademarks and brands. However, in order to deal within their practical limitations, licensors delegate production details—including quality control technicalities—to their more knowledgeable licensees.[227]

---

and the Re-emergence of Aesthetic Functionality in Trademark Merchandising Cases, 94 J. PAT. & TRADEMARK OFF. SOC'Y 95, 106 (2012) (describing the use of trademarks to fulfill needs to express "religion, sports affiliations, and group membership experiences").

223. *See* Marks, *Trademark Licensing*, *supra* note 214, at 652; Assaf, *Brand Fetishism*, *supra* note 105, at 88 (describing the primary function of trademarks in collateral markets as being "merely to exploit its psychological influence on the consumer").

224. *See* Assaf, *Brand Fetishism*, *supra* note 105, at 96.

225. *See* Calboli, *Quality Control*, *supra* note 151, at 392.

226. Franklyn, *Coherent Theory*, *supra* note 213, at 17 (citations omitted).

227. *See* Calboli, *Quality Control*, *supra* note 151, at 383.

Irrespective of any practical impediments to exercising control, licensors in collateral product and promotional licensing arrangements will risk their trademarks being deemed abandoned unless they satisfy the control requirement of the Lanham Act. As a result, advisors routinely recommend that licensors include explicit quality control provisions in agreements and perhaps cautiously suggest a need to exercise actual control over licensees.[228] In reality, the licensors—especially those in collateral product and promotional licensing arrangements—make no effort to control quality.[229] Many licensing arrangements accordingly are regarded as operating under "illusory or 'minimalist' quality control programs" based on "magic" contractual language that gives the licensors rights to establish product specifications, specify quality standards, and inspect marked goods.[230] Licensors thereby seek to preserve formal rights without actually carrying out those quality control programs provided under the formal rights.[231]

---

228. *See id*. at 374–75. However, licensors must remain aware that they walk a "control tightrope" as they strive to maintain acceptable control under the Lanham Act while simultaneously avoiding significant participation in the production of goods that could subject them to strict product liability claims. Franklyn, *Coherent Theory*, *supra* note 213, at 5 ("If they exercise too little control, they risk a finding of abandonment, but if they exercise too much control, they risk a finding that they are strictly liable for their licensees' defective goods.").

229. *See* Franklyn, *Coherent Theory*, *supra* note 213, at 19. One commentator observed:

> After the agreement is executed, samples will be furnished by the licensee, advertising and labeling will be prepared and approved. Proper trademark notices will be specified and utilized on the samples. Thereafter, active control over the licensee will be likely to cease. The business people will be concerned with their next business deal and will not be likely to continue reviewing the licensee's activities, so long as the royalty checks continue to arrive on time.

Marks, *Trademark Licensing*, *supra* note 214, at 649; *see also* Deven R. Desai, *From Trademarks to Brands*, 64 FLA. L. REV. 981, 1014 (2012) [hereinafter Desai, *Trademarks to Brands*] ("Trademark law ostensibly prohibits pure merchandising or naked licensing of a mark . . . . In practice, however, trademark law permits precisely these behaviors.").

230. *See* Franklyn, *Apparent Manufacturer Doctrine*, *supra* note 157, at 691; Franklyn, *Coherent Theory*, *supra* note 213, at 19 ("[B]eyond reserving such contractual rights, it appears that many collateral and promotion licensors do little to fulfill the quality control requirement."); Calboli, *Quality Control*, *supra* note 151, at 383 ("Notably, even if most agreements included standard quality control provisions, licensors have usually relied on their licensees, and their knowledge of the promotional products, to ensure the quality of the marked goods.").

231. *See* Assaf, *Brand Fetishism*, *supra* note 105, at 131 ("[A]s a matter of fact, collateral trademark licensors do not engage in quality control programs, but

Moreover, consumers apparently recognize this reality insofar as they assume a trademark indicates that a licensor has authorized the sale of marked products without regarding the licensor as having vouched for products sold in collateral markets.[232]

These developments in trademark licensing practices further illustrate how retained control is a poor indication of the need to capitalize royalty payments. As discussed above, licensors often lack the knowledge and experience necessary to assert meaningful control over the production activities of licensees, especially in collateral product and promotional licensing arrangements. Quality standards incorporated into licenses, usually on the advice of the licensor's counsel, superficially protect the licensors' trademarks, brands, and goodwill.[233]
However, designated standards do not indicate the licensors' ability or willingness to get involved with production. As the UNICAP rules strive to identify costs that directly benefit or are incurred by reason of production, the regulations would mistakenly construe these standards as revealing a relationship between trademark usage and inventory production. Contract provisions governing product standards do not guide or direct production; instead, the provisions identify acceptable products for affixing licensed marks.

For example, consider a university's expertise in production techniques, manufacturing processes, material selection, and product design with respect to goods displaying the university's trademarks (e.g., sweatshirts, mugs, and notebooks). With insufficient expertise, the university could not realistically assess product quality or designate production standards and specifications for the manufacturers. Instead, the university would likely incorporate illusionary quality control provisions into its agreements with manufacturers as a means to avoid naked licensing and preserve its options to terminate arrangements that go awry. The university, like other trademark owners involved in promotional licensing arrangements, would not ignore product quality and consistency. "On the contrary, because promotional products aim precisely at building brand image, product quality

---

merely preserve formal contractual rights to control in order to satisfy the Lanham Act requirement.").

232. *See* Franklyn, *Apparent Manufacturer Doctrine*, *supra* note 157, at 691; Assaf, *Brand Fetishism*, *supra* note 105, at 138–39.

233. Most licensors who enter into licensing arrangements have their agreements reviewed by competent counsel to ensure that they include adequate quality control provisions. *See* Marks, *Trademark Licensing*, *supra* note 214, at 648. However, in dealing with a collateral product or merchandising arrangement, a licensor usually cannot specify appropriate standards for an unfamiliar industry. *See id*. As a result, the quality control provisions might resort to objective standards that reflect the quality of products already being produced by the licensee or its competitors. *See id*. at 648–49.

has always been of utmost importance for trademark owners, who just choose to delegate the details of the production process, and thus the technicalities of quality control, to licensees."[234] Due to this practical reality in many licensing arrangements, the capitalization regulations should not regard a licensor's formal retention of control as being indicative of a connection between the licensee's trademark usage and its inventory production.

The misplaced emphasis on control provisions in the UNICAP regulations should raise similar concerns about other transactions, including business acquisitions involving earnouts. An asset acquisition could foreseeably require a buyer to allocate the purchase price to various business assets, including an acquired trademark and goodwill.[235] A portion of the allocable purchase price might consist of earnout payments where the payment obligations and amounts depend, for example, on the post-acquisition performance of the business.[236] In order to retain some control during the earnout period, a seller would routinely seek covenants that "require the buyer to continue to operate the company in the 'ordinary course of business consistent with past practice.'"[237] Notably, the seller would not cede complete operational control of the business to the buyer.

As the costs allocated to the acquired trademark and goodwill are amortized, the buyer must consider how the covenant affects its inventoriable costs for goods displaying the trademark. Most buyers would deduct the amortization under the assertion that trademarks and goodwill provide no benefit to production. However, the covenant governing post-acquisition operations, including production activities, resembles the quality control standards used in trademark licenses. Both mechanisms ultimately seek consistency in order to protect the continuing interests of a seller or licensor without contemplating the seller's or licensor's actual involvement in the business. Given that the UNICAP regulations require capitalization for sales-

---

234. Calboli, *Quality Control*, *supra* note 151, at 383; *see id*. ("Notably, even if most [promotional licensing] agreements included standard quality control provisions, licensors have usually relied on their licensees, and their knowledge of the promotional products, to ensure the quality of the marked goods.").

235. *See, e.g.*, I.R.C. § 1060(a) (requiring an allocation for an applicable asset acquisition).

236. *See, e.g.*, Reg. § 1.1060-1(c)(2) (referencing use of the residual method for applicable asset acquisitions); Reg. § 1.338-7(e), Ex. 3 (illustrating an allocation under the residual method for a redetermined amount as a result of having payments contingent on a target corporation's future earnings).

237. Gerald T. Nowak et al., *Earnouts Raise Issues Over Control*, NAT'L L.J., Nov. 7, 2005, at 1, 2; *see, e.g.*, Davis v. PMA Cos., No. CIV-11-359-C, 2013 U.S. Dist. LEXIS 31435, at *2 (W.D. Okla. Mar. 7, 2013) (quoting a covenant obligating the buyer "to continue to operate [the target] in a manner consistent with its past practice, policies and operations prior to the Closing Date").

based royalties due to the presence of quality control standards, one might expect comparable treatment for earnout payments allocable to trademarks where acquisition covenants establish standards for ongoing business operations. The prospect of using contractual conditions and covenants, as opposed to the use of an asset, as the basis for capitalization seems inappropriate. Nevertheless, the regulations make control provisions relevant for capitalization purposes so comparable provisions in acquisition agreements and other contracts could similarly affect whether additional costs are capitalized.[238]

With the significance of control declining with respect to the legal implications for and practical operations of licensing arrangements, the UNICAP regulations need to consider other factors in determining which indirect costs are properly allocable to produced goods. Neither the minimal control expectations for licensors nor their inexperience in manufacturing unrelated goods provides credible support for the capitalization requirements illustrated in the UNICAP regulations. The UNICAP regulations should instead consider the actual use of licensed trademarks relative to production activities in determining capitalizable costs. The UNICAP regulations cannot

---

238. Control provisions with potential capitalization implications could arise in many situations. For example, in the context of trademarks, consider an assignment and license-back through which the owner of a trademark assigns the mark to another person and then receives a license to continue using the mark. Although often used as a means to settle infringement claims, these arrangements also facilitate transfers of trademarks to intellectual property holding companies. S*ee* Calboli, *Quality Control*, *supra* note 151, at 384. *See also* A & F Trademark, Inc. v. Tolson, 605 S.E.2d 187, 189 (N.C. App. 2004) (describing royalties, computed as a percentage of sales, payable under licenses to use trademarks, which were assigned by the licensees to holding companies). For valid licenses, the holding companies would need to control the quality of marked goods produced by the operating companies. *See* Visa, U.S.A., Inc. v. Birmingham Trust Nat'l Bank, 696 F.2d 1371, 1377 (Fed. Cir. 1982). As a result, a manufacturer that transferred a trademark to a holding company—perhaps for state tax or asset protection purposes—would need to consider whether the UNICAP regulations require capitalization of royalties paid to the holding company for the right to continue using the mark.
Consider beyond the context of trademarks, for example, a lease of retail space by a socially conscious landlord to a tenant with offsite manufacturing operations. The lease might subject the right to use the property to a condition that the tenant avoids the use of certain chemicals in producing goods or requires the tenant to adopt safety measures or livable wage standards at overseas production facilities. In that situation, the tenant's ability to exercise its right to use the property is conditioned on producing goods in accordance with certain standards. The UNICAP regulations imply that this condition establishes a direct relationship between the use of the property and inventory production. Therefore, the UNICAP regulations suggest that the rent payments are capitalizable production costs.

rely on the presence of control provisions in agreements as their sole justification for capitalization.

IV. CAPITALIZABLE TRADEMARK LICENSING COSTS

Trademark royalties and section 263A do not mesh well, making it difficult to articulate a rationale for capitalizing licensing costs. Traditional views about trademarks might suggest that a mark aids consumers in identifying the source of goods more than it benefits a manufacturer in producing those goods. Nevertheless, that suggestion would not always support the deduction of trademark licensing costs as selling or marketing expenses. Instead, how costs are treated for tax purposes should ultimately depend on how a taxpayer uses a particular mark. Accordingly, the UNICAP regulations should continue to require capitalization for trademark royalties as indirect costs where a mark actually provides a direct benefit to production. However, the Service and the Treasury Department should also amend the regulations to start recognizing that certain trademark royalties represent capitalizable *direct* costs where a mark becomes an integral part of a produced good.

A. Trademark Licensing Costs as Inventoriable Indirect Costs

Despite the source-identifying function of trademarks,[239] the original UNICAP regulations, which were finalized in 1993, reasonably cited trademark licensing costs to illustrate certain capitalizable indirect costs. By the 1980s, developments in trademark and unfair competition law had resulted in some companies securing protection against the unauthorized copying of their product designs.[240] Protection was increasingly granted under trademark and unfair competition law—as opposed to patent or copyright law—even though competitors had historically been permitted to copy freely any unpatented or non-copyrighted product designs, provided such copying was not used to mislead consumers about the sources of products.[241] This extension of trademark protection occurred as the concept of "trade dress" grew to encompass certain product designs and

---

239. *See supra* Part III.B.

240. *See* Amy B. Cohen, *Following the Direction of TrafFix: Trade Dress Law and Functionality Revisited*, 50 IDEA 593, 596, 621–35 (2010) [hereinafter Cohen, *Trade Dress Law*]; *see also* Pub. L. No. 100-667, 102 Stat. 3946 (1988) (amending the Lanham Act to address trade dress infringement).

241. *See* Cohen, *Trade Dress Law*, *supra* note 240, at 596. In some instances, competitors prominently labeled the copied products as their own and thereby did not mislead consumers about the true source of the products. *See supra* note 130.

configurations.[242] Significantly, "[w]hat started as [trademark] protection for the packaging and containers used to sell products—i.e., 'trade dress'—eventually turned into protection of the designs of the products themselves."[243] Regardless of any actual intention to do so, the UNICAP regulations captured these emerging legal developments insofar as the regulations would logically treat costs incurred to secure a right to use a trademarked (i.e., protected) product design as costs that directly benefit or are incurred by reason of the production of that product.

However, trademark law has not protected all product designs and arguably has provided less protection since the issuance of the UNICAP regulations. For example, the functionality doctrine in trademark law denies trademark protection for designs of functional product features.[244] Since the UNICAP regulations were finalized, the Supreme Court has clarified that a feature is "functional when it is essential to the use or purpose of the device or when it affects the cost or quality of the device."[245] Basically, a functional feature "is the reason the device works."[246] By excluding designs for functional product features from trademark protection—even though they identify the source of goods—the doctrine "both promotes competition in advantageous design features and channels protection for useful features to patent law."[247] The doctrine thereby effectively limits trademark protection to designs of aesthetic product features. However, the Court has also clarified that an aesthetic feature is considered functional (i.e., not protectable) where consumers find the feature important enough to constitute an ingredient in

---

242. *See* Cohen, *Trade Dress Law*, *supra* note 240, at 596 (noting that a trademark might prevent a competitor from "providing consumers with a better or cheaper version of [an] object").

243. *Id*.

244. *See Qualitex Co.*, 514 U.S. at 164.

245. TrafFix Devices, Inc. v. Mktg. Displays, Inc., 532 U.S. 23, 33 (2001).

246. *Id*. at 34 (noting that a design is functional, even if there are other alternative designs, where "it is the reason the device works").

247. McKenna, *Trademark Use*, *supra* note 99, at 785; *see also TrafFix*, 532 U.S. at 34–35.

> The Lanham Act does not exist to reward manufacturers for their innovation in creating a particular device; that is the purpose of the patent law and its period of exclusivity. The Lanham Act, furthermore, does not protect trade dress in a functional design simply because an investment has been made to encourage the public to associate a particular functional feature with a single manufacturer or seller.

Id.; Viva R. Moffat, *Mutant Copyrights and Backdoor Patents: The Problem of Overlapping Intellectual Property Protection*, 19 BERKELEY TECH. L.J. 1473, 1525 (2004) (noting that the Supreme Court in *TrafFix* averted "backdoor patents" which would have arisen if indefinite trademark protection were granted for a functional design after a patent, which had originally protected the design, had expired).

the product's commercial success.[248] For example, consumers expect—or at least my wife expects—to see heart-shaped candy boxes before Valentine's Day so a trademark presumably cannot protect the aesthetic design of the boxes.[249] As a result, the scope of trademark protection is presently limited to designs for other aesthetic features that have acquired secondary meaning, which occurs when consumers primarily identify the design with the product source rather than with the product itself.[250] Consequently, notwithstanding some variability in its application,[251] trademark law arguably has matured since the UNICAP regulations were finalized as it currently limits protection to designs only for "incidental, arbitrary or ornamental product features which identify the source of the product."[252]

To the extent a trademark protects an aesthetic product design, the UNICAP regulations sensibly treat costs to license that trademark as capitalizable indirect costs. A design necessarily benefits the production of a product such that the costs of developing[253] or licensing the design constitute inventoriable costs. As trademarked designs identify a product's source while simultaneously protecting the design from unauthorized duplication, the UNICAP regulations reasonably treat fees incurred to license the design as production costs. The UNICAP regulations presumably find capitalization appropriate due to the trademark's significance as the prototypical design in producing a good as opposed to helping consumers identify the source of an already produced good. In fact, the UNICAP regulations illustrate capitalization by referencing fees incurred for contractual rights to use any

248. *See Qualitex*, 514 U.S. at 165 (explaining that a design is functional "if exclusive use of the feature would put competitors at a significant non-reputation-related disadvantage"). *Id.*; Cohen, *Trade Dress Law*, *supra* note 240, at 597; Mark P. McKenna, *(Dys)Functionality*, 48 HOUS. L. REV. 823, 851 (2011) [hereinafter McKenna, *(Dys)Functionality*].

249. *See* McKenna, *(Dys)Functionality*, *supra* note 248, at 853–54 ("[T]he point of aesthetic functionality is to capture cases in which the need for a feature is dictated by market expectations rather than engineering problems.").

250. *See* Wal-Mart Stores, Inc. v. Samara Bros., Inc., 529 U.S. 205, 210-14 (2000).

> It seems to us that design . . . is not inherently distinctive. . . . In the case of product design, . . . we think consumer predisposition to equate the feature with the source does not exist. Consumers are aware of the reality that, almost invariably, even the most unusual of product designs . . . is intended not to identify the source, but to render the product itself more useful or more appealing.

Id.

251. *See* McKenna, *(Dys)Functionality*, *supra* note 248, at 848–50.

252. Eppendorf-Netheler-Hinz GMBH v. Ritter GMBH, 289 F.3d 351, 355 (5th Cir. 2002).

253. *But see* Reg. § 1.263A-1(e)(3)(ii)(P) (excluding research and experimental expenditures, as described in section 174, from capitalization).

item in a group consisting of "a trademark, corporate plan, manufacturing procedure, special recipe, or other similar right associated with" produced goods.[254] Insofar as "a trademark" references a protected design, these items commonly describe methodologies for producing goods.[255]

In contrast, a trademark is the only item in the aforementioned group with a readily suggestive source-identifying function for consumers. Therefore, trademark licensing costs reasonably fit within the description of capitalizable indirect costs where a trademark is understood to protect the design for a product in addition to identifying its source. The UNICAP regulations should accordingly clarify that this "trademark" reference illustrates the need to capitalize costs attributable to licensed product designs.

However, where a mark serves only a source-identifying function, the treatment of licensing fees as capitalizable indirect costs becomes difficult to justify. As discussed previously, a trademark primarily helps consumers distinguish products in the marketplace and, with that post-production use, would have only a tenuous relationship to inventory production.[256] As indirect costs, the fees incurred to license non-design trademarks would neither directly benefit production nor be incurred by reason of production, as required for capitalization by the UNICAP regulations.[257] Given that few trademarks protect product designs, it appears most trademark licensing costs would be incompatible with the notion of capitalizable indirect costs.

The UNICAP regulations, which were introduced when trademark law more readily protected product designs, creates confusion because it illustrates capitalizable indirect costs by generically referencing trademark licensing costs. The contrary notions of using trademarks to help consumers identify product sources while simultaneously treating trademark royalties as production-related costs has caused awkward reconciliation attempts, as evidenced by the *Robinson Knife* decisions[258] and the misplaced emphasis on control in recent amendments to the UNICAP regulations.[259] Unfortunately, this problem results from trying to fit trademark royalties within the "directly benefit or . . . incurred by reason of" construct used in the regulations to identify capitalizable indirect costs.[260] Although that approach works for licensing costs of trademarked designs, it struggles with costs attributable to other marks. Instead of implying that the costs of those other marks are

---

254. Reg. § 1.263A-1(e)(3)(ii)(U)(1).

255. Without having methodologies for producing goods as a common reference point, it would become difficult to discern what might make an "other similar right," as mentioned in the UNICAP regulations, similar to the other items.

256. *See supra* Part III.B.

257. *See supra* text accompanying notes 25–26.

258. *See supra* Part III.A.

259. *See supra* Part III.C.

260. Reg. § 1.263A-1(e)(3)(i); *see supra* text accompanying notes 27–34.

inherently deductible, that shortcoming suggests that the regulations should more appropriately address some royalties as direct, rather than indirect, costs. In other words, the UNICAP regulations should recognize that, rather than being used in the production of goods, certain licensed trademarks become part of the goods themselves.

B. Trademark Licensing Costs as Inventoriable Direct Costs

Modern commercial practices increasingly rely on licensed trademarks to enhance product values. In particular, collateral product and promotional licensing arrangements have enabled businesses to exploit the value of well-regarded trademarks by placing them on goods unrelated to the products that originally made the marks known. When used in this manner, a trademark can become an integral part of and add value to the goods being sold rather serve as a mere identifier of their source, especially where the mark represents a known brand.

In many licensing arrangements, part of the value protected by a trademark is actually attributable to a brand. From a business perspective, brands are distinguishable from trademarks. Brands, as broad commercial constructs, often simultaneously perform multiple functions such as supplying product information to consumers and establishing image-based connections with them.[261] As a subset of brands, trademarks narrowly communicate the product quality and source information to consumers.[262] The brands as a whole might then separately suggest images about status or power, value, and personality.[263] Therefore, an overall brand image might draw a consumer to goods for reasons unrelated to the quality and source information conveyed by a specific mark.[264] For example, a consumer might buy a sweatshirt displaying an athletic team logo due to a bond with the team fostered through a brand rather than as a result of information about the sweatshirt gleaned from the mark.

Despite their different business functions, trademark law protects both brands and marks as trademarks.[265] The realm of protectable trademarks accordingly has evolved to accommodate an increased reliance by businesses on various brand management strategies, such as shifts from offering goods under product-specific marks (e.g., Ivory soap) to offering them under corporate-wide brands (e.g., GE products). Product-specific marks had been granted protection largely to support consumer expectations about consistency (e.g., consumers expect consistent quality among bars of soap

---

261. *See* Desai, *Trademarks to Brands*, *supra* note 229, at 988–92.
262. *See id*. at 988.
263. *See id*.
264. *See id*. 992–99.
265. *See id*. at 987.

displaying the Ivory mark).[266] However, a corporate brand placed on new products cannot reduce consumer search costs in a comparable way (e.g., consumers might not know what to expect from GE locomotives based on their experiences with GE refrigerators).[267] Nonetheless, just as courts had eventually construed "source" to include the origin of quality standards as well as the location of physical manufacture,[268] trademark law has similarly evolved to extend protection to the marks of brands placed on unrelated goods as long as such placement does not confuse consumers.[269] Thus, a legally protected trademark can support the marketing of a diverse product offering under a single brand. Significantly with regard to this Article, collateral product and promotional licensing arrangements have then facilitated these branding strategies by permitting manufacturers to place licensed trademarks representing brands on unrelated goods.

Manufacturers often find that brands, represented by licensed trademarks, comprise a substantial portion of product values.[270] Some marketing experts caution that manufacturers should not strive to compete through product differentiation—given that many manufacturers offer good products and most innovative products have less expensive alternatives—or low prices, neither of which promotes sustainable market positions.[271] Instead, these experts encourage manufacturers to develop strong brands "that offer an opportunity to charge premium prices without offering superior products."[272] For example, a company might charge high prices based on the

266. *See supra* text accompanying notes 115–17.

267. *See* Desai, *Trademarks to Brands*, *supra* note 229, at 995 ("Insofar as one claims that the corporate brand reduces search costs, it does so only in a thin way. One relies on the brand to indicate that a new product will be high quality, even if that product is something the company has not made before. Or at the extreme, one may rely on the brand when the company is entering a market in which the company has never been before.").

268. *See supra* text accompanying note 162.

269. *See* Desai, *Trademarks to Brands*, *supra* note 229, at 1013; *see also supra* text accompanying notes 216–18 (noting concerns about what legitimate "source" information a trademark could convey about unrelated goods).

270. The distinction that businesses make between trademarks and brands thus creates an inconsistency within trademark law. As noted above, trademark law assumes any value lies in the goodwill of a business and not in a trademark used to symbolize that goodwill. *See supra* text accompanying notes 109–13. Accordingly, when a product is sold under a trademark, trademark law views the mark as providing information and the product as providing the substantive value to consumers. *See* Assaf, *Brand Fetishism*, *supra* note 105, at 105. Conversely, businesses perceive and market their brands, which are represented by trademarks, as having substantial independent value, which indicates that trademark law has not caught up to modern commercial practices. *See id.*

271. *See* Assaf, *Brand Fetishism*, *supra* note 105, at 96.

272. *Id*.

reputation of its brand irrespective of the quality of its products. In some instances, manufacturers are perhaps even more concerned about selling brands than selling physical articles.[273] For example, consider how the marks on clothing labels migrated from inside shirt collars to conspicuous locations on shirt fronts.[274] That migration occurred because manufacturers sought to sell the brand names displayed on the shirts (e.g., Nike and Tommy Hilfiger), indicating that "[p]roducts and brands sometimes even change roles. . . . Brands, once merely a symbolic extension of products, become in such cases the essence, and the products become secondary, material extensions of the brands."[275] Manufacturers thus frequently market the brands protected by trademarks rather than use those marks to inform consumers about the quality and source of goods.[276] Consequently, one might expect a manufacturer to license a trademarked brand name—through a collateral product or promotional licensing arrangement—due to the value that the brand lends to its goods irrespective of the mark's ability to identify their source.

Consumers similarly regard some trademarks as providing value apart from the physical goods to which they are affixed. Although trademarks were originally distinct from the articles being sold,[277] that distinction has become less clear. Rather than rely on trademarks solely as indicia of product quality, consumers often seek out marks to identify or

---

273. *See* Geraldine E. Willigan, *High Performance Marketing: An Interview with Nike's Phil Knight*, HARV. BUS. REV. July-Aug. 1992, at 91, 92 (quoting Nike CEO Phil Knight: "For years, we thought of ourselves as a production-oriented company, meaning we put all our emphasis on designing and manufacturing the product. But now we understand that the most important thing we do is market the product. We've come around to saying that Nike is a marketing-oriented company, and the product is our most important marketing tool."); BENJAMIN R. BARBER, CON$UMED: HOW MARKETS CORRUPT CHILDREN, INFANTILIZE ADULTS, AND SWALLOW CITIZENS WHOLE 179 (1st ed. 2007) ("The economics of late consumer capitalism would seem to mandate a system . . . in which brands are to be understood in terms of experience, lifestyle, and emotion, and it is these qualities that must be sold, which the products themselves remain either wholly unnecessary in themselves or differentiated from similar products by marketing alone."). *Id.*

274. *See* Assaf, *Brand Fetishism*, *supra* note 105, at 98.

275. *Id*. (citations omitted).

276. *Cf.* Schechter, *Rational Basis*, *supra* note 159, at 822 ("[T]he *creation and retention of custom*, rather than the designation of source, is the primary purpose of the trademark today . . . .").

277. *See, e.g.*, Moorman v. Hoge, 17 F. Cas. 715, 718 (C.C.D. Cal. 1871) (describing a trademark "as something independent of the article [of merchandise] itself, or the package used to contain it" such that the mark was capable of being affixed to the merchandise).

associate with the owners of the marks.[278] Thus, a consumer might seek a shirt displaying a trademark on its front to impart social information or to satisfy psychological needs, such as where a consumer sports a luxury brand to signal his or her social status or wealth.[279] For example, many consumers are drawn to the powerful Harley-Davidson brand, which inspires a religious-like following that even prompts some consumers to tattoo the brand's logo on their bodies.[280] These consumers buy shirts with Harley-Davidson trademarks because the shirts display the marks rather than to satisfy clothing needs.[281] The trademarks do little to identify a source or reduce the consumers' search costs; instead, the marks create the actual value being sought by the consumers.[282] As a result, a mark, whether owned or

278. *See* Marks, *Trademark Licensing*, *supra* note 214, at 652; Desai, *Trademarks to Brands*, *supra* note 229, at 986 ("Consumers often buy branded goods not for their quality but as badges of loyalty, ways to express identity, and items to alter and interpret for self-expression.").

279. *See* Daniel E. Newman, *Portraying a Branded World*, 2008 U. ILL. J.L. TECH. & POL'Y 357, 361–62 [hereinafter Newman, *Branded World*] (referencing conspicuous consumption of Veblen goods, which consumers purchase "in order to signal their social status, and not for mere utilitarian concerns").

280. *See* Assaf, *Brand Fetishism*, *supra* note 105, at 95.

281. Similarly,

> the purchaser and wearer of a purple and gold sweatshirt prominently displaying the symbolized LSU insignia likewise identifies himself as a fan or supporter of LSU. One of the essential purposes, if not the primary purpose, for displaying the institutional name or symbol is to communicate the wearer's allegiance. The institutional name, the logo, and even the color scheme are all essential to the use of the article. They are not arbitrary embellishments; they are the actual benefit the consumer wishes to purchase . . . . Critical to this analysis is the incontrovertible fact that no competitive substitute exists for that benefit. A plain gray sweatshirt is not a substitute for a purple sweatshirt emblazoned with the letters LSU. A crimson sweatshirt bearing the name "ALABAMA" is likewise and most assuredly not a substitute. True, they may all keep the purchaser warm, but that is not the only function, and likely not the essential function of the shirt.

Gerald T. Tschura, *Likelihood of Confusion and Expressive Functionality: A Fresh Look at the Ornamental Use of Institutional Colors, Names and Emblems on Apparel and Other Goods*, 53 WAYNE L. REV. 873, 893 (2007).

282. *See* Au-Tomotive Gold, Inc. v. Volkswagen of Am., Inc., 457 F.3d 1062, 1067 (9th Cir. 2006) ("Consumers sometimes buy products bearing marks such as the Nike Swoosh, the Playboy bunny ears, the Mercedes tri-point star, the Ferrari stallion, and countless sports franchise logos, for the appeal of the mark itself, without regard to whether it signifies the origin or sponsorship of the product."); Robert C. Denicola, *Institutional Publicity Rights: An Analysis of the*

licensed by a manufacturer, might constitute a significant portion of the "good" being sold.[283]

A trademark's ability to enhance product value and create product attributes sought by consumers readily suggests that certain trademark licensing costs more closely resemble direct costs of goods than indirect costs of producing those goods. The UNICAP regulations incorporate the concept that the direct costs of inventory consist of the cost of materials and the cost of labor necessary to convert those materials into finished goods.[284] All other costs of the business, which comprise its indirect costs, are then treated as inventoriable costs only to the extent they are properly allocable to the goods.[285] In a general sense, given that certain licensed trademarks might add value or attributes to a product, it seems reasonable to infer that the product's inventoriable costs should include royalties incurred to use the trademarks. How that result can be achieved depends on whether the UNICAP regulations define the royalties as direct or indirect costs. A single reference to trademark royalties appears in the UNICAP regulations in the context of indirect costs, which are capitalizable only to the extent they directly benefit or are incurred by reason of production activities.[286] As discussed above, the intangible benefits of trademarks often lack any connection to production, so few royalty payments seem properly capitalizable as indirect costs.[287] However, that single reference cannot mean that trademark royalties are capitalizable, if at all, only as indirect costs. Instead, the UNICAP regulations should clarify that certain trademark royalties—particularly those arising from collateral product or promotional licensing arrangements—represent capitalizable direct material costs.

Merchandising of Famous Trade Symbols, 62 N.C. L. REV. 603, 603–04 (1984) (noting that some consumers willingly pay higher prices for goods marked, for example, with sport team logos despite the existence of similar unmarked goods at substantially lower prices); Newman, *Branded World*, *supra* note 279, at 361 ("The multibillion-dollar brand merchandise market owes its existence to the fact that people derive value from owning and displaying logos, above and beyond the mere utilitarian value of the underlying object to which the logo is attached."); Lunney, *Trademark Monopolies*, *supra* note 131, at 397 ("[C]onsumers value the mark's presence on the product apart from its role in conveying any [quality] information.").

283. *See* Stacey L. Dogan & Mark A. Lemley, *The Merchandising Right: Fragile Theory or Fait Accompli?*, 54 EMORY L.J. 461, 472 (2005) ("[T]he mark is the product—or at least is a critical part of what makes the product attractive. . . . [T]he marks are more product features than brands."); Desai, *Trademarks to Brands*, *supra* note 229, at 1018 ("[T]rademark law now protects the mark being bought and sold as a commodity.").

284. *See supra* text accompanying note 23.

285. *See supra* text accompanying notes 25–26.

286. *See* Reg. § 1.263A-1(e)(3)(ii)(U).

287. *See supra* Part IV.A (urging clarification concerning the need to capitalize licensing costs for marks that protect product designs).

Trademark royalties admittedly seem like unnatural candidates for inclusion among the direct material costs of a business. The UNICAP regulations generally contemplate that direct material costs should include the cost of items that become an integral part of produced goods and the cost of items identified or associated with produced goods despite their consumption during the production process.[288] Like the full absorption rules of section 471, the UNICAP regulations simply refer to these items as materials.[289] Although items that become an integral part of produced goods certainly describe tangible materials (e.g., raw materials of steel and wood), the UNICAP regulations do not restrict direct materials to tangible items.[290] More importantly, certain trademarks seem to be as integrated into marked goods as much as many tangible materials. The Harley-Davidson trademarks appearing on a shirt, for example, seem as integral to the product, in terms of establishing its value and attributes, as the fabric that composes the shirt.[291] As trademarks have become vital in defining parts of certain products, the direct material costs of those products should include any royalty costs incurred to use the marks. Therefore, the Service and the Treasury Department should update the UNICAP regulations to clarify that the costs of intangibles can represent direct material costs for purposes of applying the overall UNICAP rules.

By addressing how direct material costs can include trademark royalties, the UNICAP regulations could appropriately address the evolution of trademarks. A trademark's source-identifying function and association with goodwill have long prevented its costs from fitting neatly within the production-orientated framework of the UNICAP rules.[292] Unfortunately, this fit has become less clear as trademark law and commercial practices have continued to evolve. The UNICAP regulations must find ways to accommodate a trademark that at times portrays a product design that indirectly benefits production, sometimes becomes a direct part of the produced goods, and other times does nothing more than identify the source of goods for consumers. These various roles make determining the appropriate tax treatment for trademark royalties complex.

---

288. *See* Reg. § 1.263A-1(e)(2)(i)(A).

289. *See id*.; Reg. § 1.471-11(b)(2)(i); *see also Capitalization and Inclusion in Inventory of Certain Costs*, 58 Fed. Reg. 42,198 (1993) (expressing a desire for conformity in defining "direct material costs").

290. *Cf.* Reg. § 1.162-3(c)(1) (referencing tangible property in defining "materials and supplies" for purposes of section 162).

291. *Cf.* F.S.A. 2002-07-006 n.2 (Nov. 1, 2001) ("There is an argument that, at least in certain circumstances, software-related costs are potentially subject to capitalization under section 263A, especially to the extent they are embodied in, or allocable to tangible property. However, this issue is generally moot . . . .").

292. *See supra* Part III.B.

Therefore, the UNICAP regulations should aid in these determinations by clarifying that the cost of a trademark that becomes part of the produced goods can represent a direct cost. Perhaps the distinction between direct and indirect costs might not matter for most costs that are capitalizable under either characterization. However, the distinction matters for trademark royalties insofar as a trademark that becomes integrated into a product might not directly benefit or be incurred by reason of production as required of capitalizable indirect costs.[293] Additionally, cost recovery might depend on whether the royalties are classified as direct or indirect costs.[294] Thus, the UNICAP regulations should be updated to accommodate modern trademark usage.

Updating the UNICAP regulations to align capitalization requirements with modern trademark usage for all taxpayers seems more appropriate than the recent amendments that, perhaps inadvertently, make capitalization the default treatment only for licensees. As discussed above, the UNICAP regulations make a licensee's royalties inherently capitalizable due to the legal requirement that the trademark owner retain control over product quality.[295] By effectively linking capitalization to an essential term in licensing agreements, the UNICAP regulations established potentially different outcomes for the costs of licensed and owned trademarks. However, ownership cannot serve as the means for identifying production-related costs. Rather than distinguishing between licensees and owners for capitalization purposes, the UNICAP regulations should emphasize that capitalization depends on the particular use of a trademark and could result in any trademark cost being classified as a direct, indirect, or deductible cost.

Although accounting for a licensee's use of a trademark requires more effort than simply assessing the existence of quality control, such an approach demands no more effort than is required in accounting for other costs. Due to the various operating and cost structures of taxpayers, the UNICAP regulations generally avoid categorical approaches to capitalization and instead depend largely on facts-and-circumstances based inquiries. Even though trademarks might have unique roles in business arrangements, the UNICAP regulations can address royalties incurred to license trademarks in the same manner as other costs.

---

293. *See supra* Part IV.A.

294. The UNICAP regulations permit a taxpayer to allocate sales-based royalties to its cost of goods sold only if they qualify as capitalizable *indirect* costs, even though a taxpayer could presumably achieve the same result through a facts-and-circumstances based allocation method. *See* Reg. § 1.263A-1(e)(3)(ii)(U)(2). However, a taxpayer using the simplified production method could not exclude sales-based costs treated as direct costs from its additional section 263A costs, thus the taxpayer might find certain sales-based royalties treated as *direct* costs and perfunctorily capitalized to its ending inventory. *See* Reg. § 1.263A-2(b)(3)(ii)(C).

295. *See supra* Part III.C.1.

As a result, one might generally expect any proposed update in the UNICAP regulations to treat royalties incurred under classical licensing arrangements as indirect costs, which taxpayers would seldom capitalize (other than costs incurred to use trademarked designs) due to the lack of any connection to production activities. In contrast, one might expect any proposed update in the UNICAP regulations to treat royalties incurred under collateral product licensing arrangements, particularly amounts incurred under promotional licensing agreements, as capitalizable direct material costs whenever trademarks become integral parts of the produced goods. However, a taxpayer's particular use of a licensed trademark, like its use of any other asset, could alter those capitalization expectations.

Initially, it might seem odd to treat trademark royalties as direct material costs, but that approach would reasonably account for modern uses of certain licensed marks. With that treatment, the UNICAP regulations would recognize that manufacturers and consumers regard certain trademarks as integral parts of products because they substantially contribute to the products' values and attributes. Therefore, the Service and the Treasury Department should amend the UNICAP regulations to clarify that capitalizable direct material costs can include trademark royalties thereby preventing further misguided attempts to justify their capitalization solely as indirect costs.

V. CONCLUSION

Rather than illustrate the appropriateness of capitalization for sales-based costs, recent amendments to the UNICAP regulations subtlety and inappropriately make control over product quality significant in requiring capitalization of trademark licensing costs. Unfortunately, that emphasis makes such costs inherently capitalizable because every trademark license involves a licensor's retention of control. Moreover, instead of reflecting modern developments, the UNICAP regulations have emphasized control at a time when its importance in trademark law and licensing practices has already diminished.

The amendments presumably emphasize control because the source-identifying function of trademarks makes it otherwise difficult to justify treating most trademark royalties as capitalizable indirect costs. In order to more appropriately address capitalization questions, the amendments should have instead clarified that royalties are generally capitalizable as indirect costs where a licensed mark protects a product design. In addition, following trends of using certain trademarks to enhance product values and attributes, the UNICAP regulations should be further amended to clarify that trademark licensing costs can also represent capitalizable direct material costs of produced goods.