Internal Revenue Service

Number: **201032025**
Release Date: 8/13/2010

Index Number: 263.00-00

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable
Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:ITA:B01
PLR-149509-09
Date:
May 06, 2010

In re:

LEGEND:

Taxpayer =

Product 1 =

Product 2 =

Product 3 =

Dear

This responds to your letter dated October 30, 2009, in which you request rulings under § 263(a) of the Internal Revenue Code.

RULINGS REQUESTED

The following rulings are requested:

(1) Incentive payments made by the Taxpayer relating to Category One supply agreements are not required to be capitalized under the provisions of § 263(a) of the Internal Revenue Code;

(2) Incentive payments made by the Taxpayer relating to Category Two supply agreements are not required to be capitalized under the provisions of § 263(a); and

(3) Incentive payments made by the Taxpayer relating to Category Three supply agreements are required to be capitalized pursuant to § 263(a) and § 1.263(a)-4 of the Income Tax Regulations.

FACTS

Taxpayer is a corporation in the business of manufacturing products. Taxpayer operates manufacturing plants in North America, Europe, Asia, and South America. The manufacturing operations of these plants include three lines of business: Product 1, Product 2, and Product 3. Taxpayer manufactures Product 1 in North America. This ruling request relates only to the Product 1 business line manufactured in North America.

In the course of operating its Product 1 business line, Taxpayer enters into contractual stand-by supply agreements with customers for the supply of Product 1. The supply agreements fall under one of three categories. Under all three categories of supply agreements, Taxpayer is obligated to supply the designated products on an as-needed basis, upon the demand of the customers, and customers are generally obligated to purchase one-hundred percent of their requirements for the designated products from Taxpayer. Also under all three categories, the price of the product is adjusted periodically, usually annually, on the basis of the cost of the underlying raw materials for the product. Taxpayer determines the product price on the day of a customer's purchase order and applies any appropriate volume discounts to that price.

Category One supply agreements do not contain a minimum purchase requirement and do not require the customer to retain the Taxpayer as its supplier for products not specifically designated in the supply agreement. Customers are not obligated to use Taxpayer as their supplier if the customer: (1) replaces the product designated in the supply agreement with another type of product; (2) replaces the product designated in the contract with product that incorporates new technologies, (3) acquires a new business line that uses products offered by Taxpayer, or (4) sells or otherwise discontinues its business line for which Taxpayer supplies products.

Category Two supply agreements also do not contain a minimum purchase requirement but do require the customer to retain Taxpayer as its supplier for products not specifically designated (should such products arise) in the supply agreement. Unlike Category One supply agreements, customers may be under obligation to use Taxpayer as their supplier if the customer: (1) replaces products designated in the contract with another type of product, (2) replaces the products designated in the contract with a product that incorporates new technologies, (3) acquires a new business line that uses products offered by Taxpayer, or (4) sells its business line for which Taxpayer supplies products (i.e., the customer is required to use Taxpayer for the duration of the original supply agreement as its exclusive supplier of the designated products or is obligated to secure the consent of its purchaser/transferee to continue the terms of the supply agreement with respect to the business line purchased/transferred).

With respect to one particular Category Two supply agreement, Taxpayer may recover a portion of its investment in manufacturing technologies during the course of the agreement if the contract is terminated early. The recovery, however, is limited to the extent of Taxpayer's investment in machinery and equipment purchased from third parties, the costs of which are capitalized and depreciated. It does not involve manufacture of equipment by Taxpayer, nor does it involve any activities that constitute research and experimentation.

Category Three supply agreements contain a minimum purchase requirement.

In order to entice customers to enter into one of three categories of supply agreements or to extend the term of a previously executed supply agreement, Taxpayer may offer an incentive payment or signing bonus to its customers. These payments are one-time, up-front, non-refundable payments that are due to customers within a short period of time following the execution of the supply agreement. The amounts of the incentive payments vary by customer and are usually based on the volume of products Taxpayer expects to be purchased by the customer.

LAW AND ANALYSIS

Taxpayer in this case asks whether incentive payments made with respect to Category One and Category Two supply agreements constitute capital expenditures. Section 263(a) generally prohibits deductions for capital expenditures. Section 1.263(a)-4 provides rules for applying § 263(a) to amounts paid to acquire or create intangibles.

Section 1.263(a)-4(b)(1) provides that, in general, a taxpayer must capitalize: (1) an amount paid to acquire an intangible, (2) an amount paid to create an intangible, (3) an amount paid to create or enhance a separate and distinct intangible asset, (4) an amount paid to create or enhance a future benefit identified in the Federal Register or in the Internal Revenue Bulletin as an intangible for which capitalized is required under this section, or (5) an amount paid to facilitate the acquisition or creation of an intangible, whether the taxpayer is the acquirer or the target. Section 1.263(a)-4(b)(3)(ii) provides that amounts paid to another party to create, originate, enter into, renew, renegotiate, or facilitate an agreement with that party are not treated as amounts that create or facilitate a separate and distinct intangible asset.

Under § 1.263(a)-4(b)(3)(ii) the supply agreements in this case are not amounts paid to create or enhance a separate and distinct intangible asset within the meaning of § 1.263(a)-4(b)(3). As a result, the payments are not required to be capitalized under § 1.263(a)-4(b)(1)(iii). Further, the payments are not a "future benefit" identified in published guidance. Accordingly, § 1.263(a)-4(b)(1)(iv) does not apply in this case. However, the incentive payments in this case constitute capital expenditures if they are amounts paid to: (1) acquire an intangible; (2) create an intangible; or (3) facilitate

acquisition or creation of an intangible. Section 1.263(a)-4(b)(1)(i), (ii) and (v). These provisions are examined below.

A. Amount paid to acquire an intangible

Section 1.263(a)-4(b)(1)(i) provides that, in general, a taxpayer must capitalize amounts paid to acquire an intangible as provided in § 1.263(a)-4(c). Section 1.263(a)-4(c) provides that, in general, a taxpayer must capitalize amounts paid to another party to acquire any intangible from that party in a purchase or similar transaction. An intangible within the scope of § 1.263(a)-4(c) includes a financial instrument such as a forward contract or an option. None of the supply agreements in this case are acquired by Taxpayer; instead, incentive payments are made in connection with the creation of the supply agreements. As a result, the incentive payments made by Taxpayer in this case do not constitute amounts paid to acquire an intangible within the meaning of § 1.263(a)-4(b)(1)(i).

B. Amount paid to create an intangible

Section 1.263(a)-4(b)(1)(ii) provides that, in general, a taxpayer must capitalize an amount paid to create an intangible described in § 1.263(a)-4(d). Section 1.263(a)-4(d)(1) provides that (unless the 12-month rule applies) a taxpayer must capitalize amounts paid to create certain specified intangibles. As noted above, § 1.263(a)-4(b)(4)(ii) provides that amounts paid to another party to create, originate, enter into, renew, renegotiate, or facilitate an agreement with that party are not treated as amounts that create or facilitate a separate and distinct intangible asset. However, § 1.263(a)-4(b)(3)(ii) provides a cross-reference to §§ 1.263(a)-4(d)(2), (6), and (7), which have rules that specifically require capitalization of amounts paid to create or terminate certain agreements. For the reasons described below, the payments in this case are not required to be capitalized under these provisions.

1. Section 1.263(a)-4(d)(2)

Section 1.263(a)-4(d)(2)(i) provides that a taxpayer must capitalize amounts paid to another party to create, originate, enter into, renew or renegotiate with that party any of the financial interests enumerated in § 1.263(a)-4(d)(2)(i). Section 1.263(a)-4(d)(2)(i) generally provides that a taxpayer must capitalize amounts paid to another party to create, originate, enter into, renew or renegotiate with that party any of certain financial interests. The payments in this case do not involve any of the items described in § 1.263(a)-4(d)(2)(i) except, possibly, forward contracts or options described in § 1.263(a)-4(d)(2)(i)(C)(6) & (7).

The incentive payments in this case are amounts paid to create an intangible if they are either a forward contract or an option. A forward contract includes an agreement under which the taxpayer has the right and obligation to provide or to acquire property (or to be compensated for such property, regardless of whether the taxpayer provides or

acquires the property). Section 1.263(a)-4(d)(2)(i)(C)(6). A forward contract is a contract to purchase or sell a security, financial instrument, commodity, or other property at a designated interest rate, on a fixed future date (settlement date), and at a fixed price. See Kline v. First Western Government Securities, Inc., 24 F.3d 480, 482 (3d Cir. 1994), cert. denied Arvey, Hodes, Costello & Burman v. Kline, 513 U.S. 1032 (1994); Yosha v. Commissioner, 861 F.2d 494, 496 (7th Cir. 1988); Freytag v. Commissioner, 89 T.C. 849, 851-52 (1987), aff'd 904 F.2d 1011 (5th Cir. 1990), aff'd 501 U.S. 868 (1991). An option includes an agreement under which the taxpayer has the right to provide or to acquire property (or to be compensated for such property, regardless of whether the taxpayer provides or acquires the property). An option is the right, but not the obligation, to purchase or sell a security or property at a fixed price (strike price) and by a specified time (expiration date). See Federal Home Loan Mortg. Corp. v. Commissioner, 125 T.C. 248, 259-60 (2005); Estate of Franklin v. Commissioner, 64 T.C. 752, 762 (1975), aff'd on other grounds Franklin's Estate v. Commissioner, 544 F.2d 1045 (9th Cir. 1976); U.S. Freight Co. v. U.S., 422 F.2d 887, 894 (Ct. Cl. 1970). Section 1.263(a)-4(d)(2)(i)(C)(7).

An amount paid to another party is not paid to create, originate, enter into, renew or renegotiate a financial interest with that party if the payment: (1) is made with the mere hope or expectation of developing or maintaining a business relationship with that party and (2) is not contingent on the origination, renewal, or renegotiation of a financial interest with that party. Section 1.263(a)-4(d)(2)(ii).

In the case of Category One and Category Two supply agreements, Taxpayer is obligated to provide customers with their requested amount of product at all times during the term of the supply agreement. However, customers are not required to purchase any specific amount of product during the term of the supply agreements, and the price of the product is not fixed at the time customers execute the supply agreements. Rather, the price of the product is determined when customers submit a purchase order to Taxpayer requesting an amount of a particular product. Further, the activation of the supply agreements is contingent upon customers' requests for the product, which may never occur, and, therefore, Taxpayer does not have the right to provide any product to customers. Under these circumstances, neither Category One nor Category Two supply agreements constitute forward contracts or options. Accordingly, these amounts are not paid to create an intangible described in § 1.263(a)-4(d)(2).

2. Section 1.263(a)-4(d)(6)

Section 1.263(a)-4(d)(6) provides that a taxpayer must capitalize amounts paid to another party to create, originate, enter into, renew or renegotiate with that party certain enumerated agreements or covenants. These agreements includes an agreement providing the taxpayer: (1) the right to provide or to receive services or (2) the right to be compensated for services regardless of whether the taxpayer provides such services. Section 1.263(a)-4(d)(6)(i)(B). However, an agreement does not provide the taxpayer a

right to provide services if the agreement merely provides that the taxpayer will stand ready to provide services if requested, but places no obligation on another person to request or pay for the taxpayer's services. Section 1.263(a)-4(d)(6)(iv). The amounts Taxpayer may recover from its customer for investment in machinery and equipment under a Category Two supply agreement do not relate to a right to provide or receive services or the right to be compensated for services. Accordingly, the incentive payment made by Taxpayer under Category One and Category Two agreements do not provide it with either (1) the right to provide or to receive services or (2) the right to be compensated for services regardless of whether the taxpayer provides such services. Those payments are not otherwise described in § 1.263(a)-4(d)(6). As a result, the incentive payments made by Taxpayer in this case do not constitute amounts paid to creat an intangible within the meaning of § 1.263(a)-4(b)(1)(ii). In contrast, in the case of Category Three supply agreements, customers are obligated to purchase a minimum amount of product, and, therefore, incentive payments made with respect to Category Three supply agreements are described in § 1.263(a)-4(d)(6) with the result that they are described in § 1.263(a)-4(b)(1)(ii) and are required to be capitalized under § 263(a). See § 1.263(a)-4(b)(1).

3. Section 1.263(a)-4(d)(7)

Section 1.263(a)-4(d)(7) provides that a taxpayer must capitalize certain contract termination payments. This provision does not apply to Taxpayer’s incentive payments.

C. Amount paid to facilitate acquisition or creation of an intangible

Section 1.263(a)-4(b)(1)(v) provides that, in general, a taxpayer must capitalize amounts paid to facilitate the acquisition or creation of an intangible described in paragraph (b)(1)(i), (ii), (iii) or (iv). Section 1.263(a)-4(e)(1) provides that, in general, an amount is paid to facilitate the acquisition or creation of an intangible (the transaction) if the amount is paid in the process of investigating or otherwise pursuing the transaction. Whether an amount is paid in the process of investigating or otherwise pursuing the transaction is determined based on all the facts and circumstances. The incentive payments made by Taxpayer in this case are paid only upon execution of the supply agreements and, therefore, are not paid in the process of investigating or otherwise pursuing the transaction. As a result, Taxpayer’s incentive payments are not described in § 1.263(a)-4(b)(v).

CONCLUSIONS

(1) Incentive payments made by the Taxpayer relating to Category One supply agreements are not capital expenditures that are required to be capitalized under § 263(a).

(2) Incentive payments made by the Taxpayer relating to Category Two supply agreements are not capital expenditures that are required to be capitalized under § 263(a).

(3) Incentive payments made by the Taxpayer relating to Category Three supply agreements are capital expenditures that must be capitalized pursuant to § 263(a).

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. For example, we express no opinion on whether the incentive payments in this case are properly deductible under § 162.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

Sincerely,

JOHN P. MORIARTY
Chief, Branch 1
Office of Chief Counsel
(Income Tax & Accounting)

cc: