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Date: July 28, 2014

TY:
LEGEND:

Taxpayer =
Industry =
Division =
Items =
Product =
$a =
$b =
Manufacturer =
Agreement =
Payment =
Date 1 =
Year 1 =

Dear :

This is in response to a letter sent by your representatives dated January 22, 2014, requesting a ruling that certain participation payments Division made are not required to be capitalized under § 263(a) of the Internal Revenue Code.

FACTS:

Taxpayer is the parent corporation of a multinational group that provides products and services to Industry. Division is a division of Taxpayer that is engaged in the design, manufacture, and service of Items and spare parts and components of Items.

Division enters into agreements with Product manufacturers pursuant to which Division agrees to design and manufacture Items for new Products. Under the terms of an Agreement, a Product manufacturer typically agrees to develop and manufacture the

new Product, to secure any required approval to market the Product, and to market the Product to customers, while Division typically agrees to design and develop the Items, to secure any required approval to market the Item, and to support the Product manufacturer's marketing and certification efforts. Both the Product manufacturer and Division commit to conduct their activities in accordance with a timeline that is agreed between the parties, and Division agrees to provide certain support and maintenance services to the Product manufacturer and any customers.

Pursuant to an agreement, a Product manufacturer generally agrees that Division will be the exclusive (or semi-exclusive) supplier of Items for the new Product, and Division looks to future sales of Product to recoup its investment. If a new Product is successful, such sales will occur in connection with both the initial sales of the Item to customers and any subsequent servicing and spare parts orders from those customers. If a Product is unsuccessful, however, Division may not receive any orders for its Items. Thus, the Product manufacturer does not guarantee that Division will receive any orders or compensation, but grants Division the exclusive (or semi-exclusive) right to supply Items for any orders that do materialize.

The amount that Division receives for the Items depends on the selling price of the Product to the customers and the volume of sales and is not specifically set by the agreement.

In exchange for the exclusivity rights granted by a Product manufacturer under an agreement, Division typically agrees to develop and manufacture Items at its own risk, as well as to provide other services enumerated in the agreement. For certain Products, Division also agrees to make a series of contributions or Payments to the Product manufacturer at various stages of the new Product's development.

On Date 1, Division entered into an Agreement with Manufacturer pursuant to which Division agreed to design, manufacture, certify, test, and supply Items for the Manufacturer. Under the terms of the Agreement, Manufacturer agreed that Division would be the exclusive supplier of Items for the new Product to be developed by Manufacturer. In exchange for these exclusivity rights, Division agreed to absorb all the non-recurring costs and expenses that it incurs in the performance of the Agreement, and to contribute $a to the Manufacturer's development and marketing costs. The Agreement provides that Division's contribution, or Payments, will be paid in various amounts according to a schedule of milestones. The first payment of $b was made in Year 1. No other payments have been made as of the date of this request.

The total amount of Division's contribution must be fully refunded if Manufacturer does not comply with its exclusivity obligations as set forth in the Agreement. Also, if Manufacturer cancels development of the Product before the canceled Product enters into production, Division's total contribution will be reduced.

The Agreement provides that "[Manufacturer] does not guarantee to [Division]: (i) any minimum amounts of [p]roducts to be purchased by [Manufacturer] under this Agreement . . . ; (ii) any minimum amount of money to be paid by [Manufacturer] pursuant to this Agreement; and/or (iii) any constant or fixed number of Purchase Orders to be placed by [Manufacturer] with [Division] in any given period of time; and/or (iv) the use of [p]roducts in any of its [c]ustomer's [product]." While Division provides enumerated support services and materials to Manufacturer and its customers from the outset of the development program, it generally does so at no cost to the customers or to Manufacturer. Further, Manufacturer has "no obligation or commitment whatsoever to (i) start the [program] on any specific date; (ii) comply with any specific time schedule for the performance or execution of the [p]rogram; or, (iii) having started the [p]rogram, to continue or complete it."

Under the terms of the Agreement, there is no guaranteed price for the Items that may be purchased. Rather, the price depends on what customers are willing to pay for Manufacturer's new Product, as the price of Division's Item is determined based on specified percentages of the price of each Product, subject to (1) a price floor that is adjusted annually based on the consumer price index, and (2) adjustments due to Division's failure to meet its performance guarantees. The specified percentages change based on the total number of Products sold by Manufacturer.

LAW AND ANALYSIS:

Taxpayer asks whether Payments made with respect to the Agreement constitute capital expenditures. Section 263(a) generally prohibits deductions for capital expenditures. Section 1.263(a)-4 of the Income Tax Regulations 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: (i) an amount paid to acquire an intangible, (ii) an amount paid to create an intangible, (iii) an amount paid to create or enhance a separate and distinct intangible asset, (iv) 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 (v) 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)(i) provides that the term separate and distinct intangible asset means a property interest of ascertainable and measurable value in money's worth that is subject to protection under applicable State, Federal or foreign law and the possession and control of which is intrinsically capable of being sold, transferred or pledged (ignoring any restrictions imposed on assignability) separate and apart from a trade or business. 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 that produces rights or benefits for the taxpayer are not treated as amounts that create or facilitate a separate and distinct intangible asset.

The Payments made under the Agreement 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) because the benefit the Taxpayer receives is not capable of being sold, and would not have value if separated from the Taxpayer's manufacturing business. As a result, the Payments are not required to be capitalized under § 1.263(a)-4(b)(1)(iii). Further, the Payments do not result in a "future benefit" identified in published guidance. Accordingly, § 1.263(a)-4(b)(1)(iv) does not apply in this case.

However, the 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. Sections 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. The Payments that Division made or will make in this case are to support Manufacturer's effort to develop and market Product under an agreement that grants Division status as its exclusive or semi-exclusive supplier of Items for a specific Product. Division did not acquire or purchase an intangible from Manufacturer under the Agreement. As a result, the Payments that Division made or will make pursuant to the Agreement 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)(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. However, § 1.263(a)-4(b)(3)(ii) provides a cross-reference to §§ 1.263(a)-4(d)(2), (6), and (7), which state that amounts paid to create or terminate certain types of agreements must be capitalized. 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) generally provides that a taxpayer must capitalize amounts paid to another party to create, originate, enter into, renew or renegotiate with that party certain financial interests. Among the financial interests described in § 1.263(a)-4(d)(2)(i) are forward contracts and options. 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 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 section 1.263(a)-4(d)(2)(i)(C)(7); 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 Estate of Franklin v. Commissioner, 544 F.2d 1045 (9th Cir. 1976).

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).

Under the Agreement, the Manufacturer is not required to purchase any specific number of Items from Division during the term of the Agreements, and the price of the any particular Item is not fixed at the time the Agreement was executed. Rather, the price of the Item is determined by at the time of the sale based on a percentage of the Product's price, subject to a floor price adjusted for Index [CPI] and any applicable adjustments due to the price customers are willing to pay for a particular Product, adjusted for Division's failure to meet performance obligations. Further, Division does not have the right to provide any Items to Manufacturer as Manufacturer may place no orders. Division provides support services and materials, but it does so at no cost to

Manufacturer. Under these circumstances, the Agreement does not constitute a forward contract or option because the price, quantity, and date of purchase of the Items to be ordered are not specified. Accordingly, the Payments made pursuant to the Agreement 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 include: (A) An agreement providing the taxpayer the right to use tangible or intangible property or the right to be compensated for the use of tangible or intangible property; (B) An agreement providing the taxpayer the right to provide or to receive services (or the right to be compensated for services regardless of whether the taxpayer provides such services).

Taxpayer's Agreement provides it with an exclusive or semi-exclusive right to provide tangible property and is not covered by § 1.263(a)-4(d)(6).

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 Division's participation payments.

As a result, the Payments Division made or will make pursuant to the Agreement in this case do not constitute amounts paid to create an intangible within the meaning of § 1.263(a)-4(b)(1)(ii).

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)(i) 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. The term "transaction" means all of the factual elements comprising an acquisition or creation of an intangible and includes a series of steps carried out as part of a single plan. Section 1.263(a)-4(e)(3).

Although the payments the Taxpayer makes under the Agreement are part of a business strategy intended to result in sales of Items, the payments are not part of a plan to create or acquire any identifiable intangible described in § 1.263(a)-4(b). Thus,

Division's Payments are not described in § 1.263(a)-4(b)(1)(v) and do not constitute amounts paid to facilitate the acquisition or creation of an intangible.

RULING:

Payments which Division made or will make in connection with the Agreement are not required to be capitalized under § 263(a).

Except as expressly provided herein, no opinion is expressed or implied concerning the federal income tax consequences of any aspect of any transaction or item discussed or referenced in this ruling. For example, we express no opinion on whether the Payments in this case are properly deductible under § 162 or subject to capitalization under § 263A.

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.

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.

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.

Sincerely,

Sean M. Dwyer
Assistant to the Branch Chief, Branch 3
(Income Tax & Accounting)