

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

Number: **200638015**

Release Date: 9/22/2006

Index Number: 451.13-04, 461.01-00

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
CC:ITA:B02
PLR-116490-06

Date:
June 21, 2006

Legend:

Taxpayer =
Subsidiary 1 =
Subsidiary 2 =
Seller =

Distributor =

Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Amount A =

Dear :

This is in response to a letter dated Date 1, that was submitted by the authorized representative of the Taxpayer. In that letter, a ruling was requested that the Seller is adopting a permissible method of accounting if the Seller (1) includes a certain prepayment for goods in the Seller's income in the taxable year in which the prepayment is received by the Seller, and (2) reduces the Seller's income by the amount of the cost of goods sold attributable to those goods in the taxable year in which the goods are delivered to the Distributor.

Taxpayer, a U.S. corporation, owns all of the stock of two U.S. corporations, Subsidiary 1 and Subsidiary 2. Taxpayer, Subsidiary 1, and Subsidiary 2 are members

of the same consolidated group. Subsidiary 1 owns all of the stock of Seller, a foreign corporation. Subsidiary 2 owns all of the stock of Distributor, also a foreign corporation.

The Distributor regularly purchases inventory (the products) manufactured by the Seller. The Seller has not previously received any prepayments for the sale of goods. As of Date 2, the Seller and the Distributor plan to enter into an amendment to their preexisting distribution agreement dated Date 3. In general, the Seller will agree to supply the products to the Distributor in certain amounts for each calendar quarter (the supply commitment), and the Distributor will agree to purchase the products from the Seller in the amount of the supply commitment for each calendar quarter.

On or about Date 2, the Distributor will pay the Seller approximately Amount A (the prepayment) in consideration for the Seller's supply commitment. The Seller will be entitled to any interest earned on the prepayment once paid by the Distributor, and the Seller may use the prepayment for any purpose without restriction. The exact amount of the prepayment will be determined immediately before the date of the prepayment based on several factors, including currency exchange rates and the time value of money. Beginning on Date 4, the Seller will begin applying the portion of the prepayment allocable to the calendar quarter as payment for the Distributor's purchases of the products during the calendar quarter. The agreement between the Seller and Distributor makes further specifications regarding the utilization of the prepayment with regard to purchases in amounts that are lesser or greater than the supply commitment.

The amendment will continue in effect until the earlier of the full utilization of the prepayment or Date 5.

The Seller may terminate the agreement, effective immediately, in the event that (1) the Distributor (a) goes out of business, (b) becomes insolvent, (c) is adjudged bankrupt, or (d) makes a general assignment for the benefit of creditors; (2) a receiver is appointed with respect to all or substantially all of the Distributor's property; or (3) any substantial change in the ownership of the Distributor occurs as a result of any sale, transfer, or relinquishment. The Seller also may terminate the agreement by giving 60 days prior written notice of termination in the event of a breach of the agreement (as amended) by the Distributor; provided that the Distributor may remedy such breach within the 60 day notice period, in which event such notice will be considered withdrawn and of no further effect. If, pursuant to the provisions discussed in this paragraph, the Seller terminates the Agreement prior to the earlier of the full utilization of the supply commitment or Date 5, the Seller will repay the Distributor an appropriate portion of the prepayment.

If, prior to the earlier of the full utilization of the prepayment or Date 5, the Seller unreasonably and on a continuing basis fails to supply the Products to the Distributor following the Distributor's placement of orders in accordance with the terms of the agreement (as amended), the Distributor may terminate the agreement by giving 60

days prior written notice of termination. If the Distributor terminates the agreement pursuant to this rule, the Seller will repay the Distributor the remaining portion of the prepayment.

Treas. Reg. § 1.451-1(a) provides that, under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. See also Treas. Reg. § 1.446-1(c)(1)(ii)(A). All the events that fix the right to receive income occur when (1) the required performance takes place, (2) payment is due, or (3) payment is received, whichever happens earliest. See Schlude v. Commissioner, 372 U.S. 128, 133 (1963); Rev. Rul. 84-31, 1984-1 C.B. 127.

Treas. Reg. § 1.451-5(b)(1) provides that an accrual method taxpayer may include advance payments for the sale of goods in income in the taxable year of receipt. Similarly, section 5.01 of Rev. Proc. 2004-34, 2004-1 C.B. 991, provides that “A taxpayer within the scope of this revenue procedure that includes the full amount of advance payments in gross income for federal income tax purposes in the taxable year of receipt is using a proper method of accounting under § 1.451-1, regardless of whether the taxpayer recognizes the full amount of advance payments in revenues for that taxable year for financial reporting purposes and regardless of whether the taxpayer earns the full amount of advance payments in that taxable year.”

Based upon the representations made by the Taxpayer, we conclude that the prepayment in this case is an advance payment for goods with respect to which inclusion in the year of receipt is a permissible method of accounting.

Treas. Reg. § 1.461-1(a)(2)(i) provides that under an accrual method of accounting, a liability is incurred and generally taken into account for Federal income tax purposes in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. See also Treas. Reg. § 1.446-1(c)(1)(ii)(A). The term “liability” includes costs taken into account in computing cost of goods sold. Treas. Reg. §§ 1.461-1(a)(2)(i) and 1.446-1(c)(1)(ii)(B).

Section 461(h)(2)(B) of the Internal Revenue Code provides that with respect to liabilities that require the taxpayer to provide property or services, economic performance occurs as the taxpayer provides such property or services.

Based upon the representations made by the Taxpayer, we conclude that the Seller’s reduction of income by the amount of the cost of goods sold attributable to the products in the taxable year in which the products are delivered to the Distributor is a permissible method of accounting.

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, including whether the taxpayer is allowed a deduction under section 965 of the Internal Revenue Code. 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.

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, copies of this letter are being sent to your authorized representatives.

Sincerely,

Thomas D. Moffitt
Branch Chief, Branch 2
(Income Tax & Accounting)

cc: