Office of Chief Counsel
Internal Revenue Service
memorandum

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to: LMSB Group
Attention: Revenue Agent

from: Associate Area Counsel (LMSB) Area 3 - Nashville

subject:

Advisory Opinion

This responds to your request for advice regarding the issues further described below. This also follows several conversations between Revenue Agent , Team Manager and the undersigned. These issues have been reviewed by Associate Industry Counsel (Financial Products) and his industry reviewers within the context of this specific case. The Associate Industry Counsel agrees with the rationale and conclusions contained herein. The conclusions reached herein have also been discussed informally with the Office of the Associate Chief Counsel (Financial Institutions and Products).

ISSUES

1. Whether the taxpayer is entitled to exclude from income a "sales discount" on its consolidated Form 1120 for the taxable year ended in the amount of $ (an amount which represents the difference between the exercise price and the fair market value on the exercise date of warrants issued to and exercised by , an unrelated entity with which the taxpayer conducted business)?

2. If not, whether the taxpayer is entitled to deduct the amount of $ as an ordinary and necessary business expense under I.R.C. § 162?

CONCLUSIONS

1. The amount at issue does not constitute a "sales discount" and the taxpayer is thus not entitled to the claimed exclusion.

2. The claimed deduction does not constitute an ordinary and necessary expense under the provisions of I.R.C. § 162(a). We agree with the Examination Team that the amount at issue constitutes instead a capital expenditure which was incurred in connection with taxpayer's acquisition of a contract with and that the value thereof (as determined on the date the warrants were exercised) should be amortized over a period of ten years from the exercise date in accordance with the provisions of Treas. Reg. § 1.167(a)-14.

FACTS

The following facts have been provided by the Examination Team and with reference to various transactional documents supplied by the taxpayer. Only those facts necessary to permit discussion of the issue and resolution thereof are repeated herein. The reader's attention is directed to the attached Statement of Facts provided by Revenue Agent for a more complete discussion of the entities, the interrelationship between those parties, and the transactions involved.

(hereinafter referred to as "the taxpayer") is a publicly traded corporation that provides a wide spectrum of data products and support services to other businesses, both within the United States and abroad. The return at issue is a consolidated Form 1120 filed by the taxpayer for the period ended

based in , provides to a broad range of industries that about their customers.

In the early 1990's, allegedly in response to an extended downturn in business and on the recommendation of stock analysts, the taxpayer (most of whose business prior to that time was conducted on a project-by-project basis) sought to develop long-term "fixed revenue" relationships with its customers in an attempt to stabilize its income stream.

Prior to , operated its own

information data center near (the "Data Center"). Early in , the taxpayer, purportedly in accordance with the above-described pursuit of long-term "fixed revenue" relationships, approached , offering to operate the Data Center at a cost to of approximately 90% of the amount that it was costing to operate the center itself.

During spring and summer of , the taxpayer and conducted negotiations regarding this proposed contract for the operation of the Data Center. On the taxpayer and executed a document titled "Data Center Management Agreement". This agreement (hereinafter sometimes referred to as "the contract") vested the taxpayer with the authority to operate the Data Center. Certain tangible assets at the Data Center were also transferred by to the taxpayer as part of this agreement.

In accordance with the agreement, agreed to turn over the operation of the Data Center for an initial two and a half year term with the option to extend the agreement for an additional seven and a half years. The option rested solely in the hands of ; the taxpayer could not choose to exercise this option and had no contractual right to influence the exercise of the option by . In return, the taxpayer agreed to assume all existing equipment leases and to acquire from all of the assets at the Data Center for cash and shares of the taxpayer's common stock.[1]

Section of the Data Center Management Agreement sets forth the parties rights and obligations as of the closing date thereof. In accordance with the contract, the taxpayer agreed to acquire all of right, title and interest in the Data Center tangible property, assume all of obligations under their licenses of third party technology and to offer employment to all employees of who were currently working at the Data Center. In return, agreed to license to the taxpayer certain technology, to lease to the taxpayer the Data Center facilities, to assign to the taxpayer certain Data Center vender services agreements, and to grant the taxpayer access to data relating to the operation of the Data Center.

In accordance with the agreement, the taxpayer also agreed to (a) perform all of the duties and obligations of

[1] The warrants at issue were not part of this consideration, nor is this initial transfer of stock a subject of the inquiry discussed herein.

under the capital leases, the operating leases, the licenses to licensed third-party technology, and all of the other assigned and assumed agreements; (b) to save, defend, indemnify and hold harmless from and against any claims and any loss, liability, damages and expenses in connection with the taxpayer's assumption of duties and obligations; and (c) to pay or issue to the following:

(1) $ in cash payable in four installments,

(2) shares of common stock deliverable at closing, and

(3) to provide warrants to purchase an additional shares of common stock.

The agreement provided that the warrants could be exercised at varying prices depending on the date of exercise. The warrants limited ability to exercise its right to obtain common stock; not more than shares of common stock could be purchased before (1) delivered to its election to extend the alliance into the extended term, or (2) elected to discontinue the relationship on account of a material default by .

As mentioned previously, the initial term of the Data Center Management Agreement was two and a half years. In return for the services performed by the taxpayer during the initial term, agreed to pay the taxpayer a "Data Center Management Fee" in the amount of $ in monthly installments. These fees were subject to adjustment depending upon the actual cost incurred by the taxpayer to operate the Data Center. The fee was to be increased by a percentage of the amount by which any actual costs to operate the Data Center during the calendar year exceeded or was less than

At the end of the initial two and a half year term, , at its sole option, obtained the right to do any of the following:

(1) could exercise its right of disentanglement (i.e., to end all contractual relationships with the taxpayer);

(2) could elect to continue the agreement in full and extend the relationship with the taxpayer, in which case, was required to grant to the taxpayer the responsibility to manage the Data Center and to provide the other services provided for seven and one

half years from the last day of the initial term, or

(3) could exercise a right of "partial disentanglement" for the extended term.

In accordance with the above-referenced contract, also granted to the option to purchase shares of common stock. This agreement, which was included in the Data Center Management Agreement, provided that could not acquire more than shares of the common stock unless or until delivered to the taxpayer a notice of its election to extend (either fully or partially) the relationship with the taxpayer past the initial term.

Pursuant to the terms of the warrants themselves, could exercise its right to purchase additional shares of the taxpayer's common stock at varying prices, depending upon (1) the date of exercise, (2) whether elected to extend the agreement beyond the initial two and a half year term, and (3) percentage of ownership of the outstanding shares of the taxpayer's stock at the time of exercise. With respect to the varying exercise prices, could purchase the additional stock at $ per share if, and to the extent, it exercised its right to purchase such shares, on or before the end of business on the fifth anniversary of the closing date of the Data Center Management Contract. The exercise price increased on a yearly basis if elected prior to end of business on the sixth, seventh and the eighth anniversary of the closing date.

ability to purchase additional stock of the taxpayer was further limited by the percentage of outstanding stock owned by it prior to exercise. In particular, was prohibited from acquiring common stock that would result in ownership of more than 10% of the then outstanding shares of the taxpayer's common stock.

At the expiration of the first two and a half years of the agreement, extended the agreement for the remaining seven and a half year period. Consequently, on , advised of its intent to exercise its right to purchase additional common stock of the taxpayer pursuant to the terms of the warrants.

ANALYSIS

Under certain circumstances, the value of stock warrants granted in connection with the sale of goods or services may represent a sales discount or allowance incurred by the grantee. *See*, Sun Microsystems, Inc. v. Commissioner, T.C. Memo. 1993-467, 66 T.C.M. [CCH] 997 *and* Convergent Technologies, Inc. v. Commissioner, T.C. Memo. 1995-320, 70 T.C.M. [CCH] 87. If so, those amounts are excluded from gross sales in determining income. The taxpayer in the instant case contends that the facts surrounding the issuance of the warrants to is analogous to the facts involved in the above-referenced Tax Court cases and thus concludes that exclusion of the amount at issue should be allowed, either under the rationale of those two cases or as an ordinary and necessary deduction under I.R.C. § 162. The Examination Team, on the other hand, points to relevant factual distinctions in contending that the warrants at issue do not constitute a sales discount or allowance and thus cannot be excluded from gross income. Moreover, the Team contends that the amount at issue does not qualify for a deduction under section 162. We agree with the Examination Team on both counts.

Both Sun Microsystems and Convergent Technologies involved situations where stock warrants were offered to customers as an incentive to purchase the respective taxpayer's product. In both situations, the customers sold the warrants to a third party shortly after they became subject to exercise and the customer never became a shareholder in the taxpayer. Further, in each of those cases, there existed a direct connection between the warrants and the purchase price of the product. In order to qualify for the warrants, the customer had to purchase a significant amount of the taxpayer's product (which the Court found as a fact they would not have done absent issuance of the warrants) and the actual terms of the warrant agreements varied according to the amount of product purchased. Therefore, the taxpayer's value was not enhanced by the issuance of the warrants and the warrants lowered the overall cost of the product to the purchaser. Finally, each respective Court found that, since the purchase agreements and the warrants were contained in two separate written agreements, the warrants did not constitute additional consideration for the purchase of the products.

Initially, we note that the instant case differs from both Sun Microsystems and Convergent Technologies in that the warrants at issue in the instant case were issued in connection primarily with the "sale" of services, rather than tangible goods. While services sold do not contain a traditional "cost of goods sold" component as do tangible goods, it would still be appropriate to exclude a true discount from the gross sales price reported on the tax return of the service provider. *See, e.g.*, Max Sobel Wholesale Liquors v. Commissioner, 69 T.C. 477 (1977), *aff'd* 630 F. 2d 670 (9^{th} Cir. 1980), *acq*. 1982-2 C.B. 2 and Rev. Rul. 82-149, 1982-2 C.B. 56. Thus, this distinction is of no consequence to our conclusion.

Determination of whether the warrants at issue constitute a sales discount or allowance is fact intensive, requiring close consideration of the specific facts involved and the relationship of the parties to the transaction in the context of that transaction.

While the transactions at issue in the instant case bear a surface relationship to the transactions involved in both Sun Microsystems and Convergent Technologies, the true nature and effect of those transactions differs such that a different conclusion is warranted. Specifically, we have identified at least three aspects of this case which differ materially and substantially from the facts of each of those cases. Close analysis of the facts of the instant transaction in accordance with these cases leads to our conclusion that the issuance of the warrants at issue clearly does not constitute a sales discount and/or an allowance and that the value of the warrants may thus not be excluded from gross sales price.

The first and most important material difference between the issuance of the warrants in the instant case and those in Sun Microsystems and Convergent Technologies is that actually exercised the warrants and became a shareholder of the taxpayer. This situation, which differs markedly from the situation involved in the two previously cited cases (where the customer simply sold the warrants and took the cash) indicates that was interested in obtaining and retaining a capital interest in the taxpayer rather than in simply securing a "discount" for the services purchased. This intent by the warrant holder to acquire and retain ownership in the taxpayer is of "critical" importance to this determination. Convergent Technologies, 70 T.C.M. at 93.

The second material difference is that issuance of the warrants here at issue was not tied to the purchase of a specific quantity of goods or services or otherwise directly connected to a specific net or gross profit to be realized by the taxpayer. Moreover, the price reflected in the contract was in no way tied to the issuance of or exercise of the warrants. While was granted additional warrants if it extended the period of the original contract, no such extension was required with respect to the first shares. As noted above, did in fact become a shareholder of the taxpayer in accordance with the warrant during the first term of the contract and was already a shareholder at the time the "conditional warrants" came into effect. This provides a clear indication that did not consider exercise of these additional warrants as some sort of a discount; rather, they saw this as an opportunity to increase their equity interest in the taxpayer, with whom (by extending the initial term of the agreement) they continued to do business.

Finally, in the instant case, there is no indication that either party to the transaction at issue viewed the warrants as a mechanism to lower the overall cost of the contract to   Rather, all objective facts indicate that   saw this as an opportunity not only to conduct business with the taxpayer, but also as an opportunity to acquire equity in the taxpayer, which was involved in a business activity that complemented and benefitted . The fact that the two parties agreed to share technology as they progressed in this venture provides clear evidence that the parties intended that their relationship would lead to joint ownership rather than involve a simple discount relating to a single contract.

After close analysis of the facts of this case, we conclude that issuance of the warrants at issue does not constitute a discount or allowance related to the contract to operate the Service Center and that the value of the warrants thus may not be excluded by the taxpayer from the contract price (i.e. the "sales price" of the services rendered) under the rationale of <u>Sun Microsystems</u> and/or <u>Convergent Technologies</u>. We also conclude, for the reasons briefly discussed below, that the value of the warrants does not constitute an ordinary and necessary expense, deductible under I.R.C. § 162.

I.R.C. § 162 provides a deduction for ordinary and necessary expenditures incurred in carrying on a trade or business. In order to qualify as a deduction under section 162, an expenditure must be (1) paid or incurred in connection with carrying on the business of the taxpayer, (2) "ordinary and necessary", and (3) not capital in nature. As noted previously, the taxpayer is engaged in the trade or business of providing data products and support services to other businesses. It is not in the trade or business of selling equity interests for profit. Thus, any "expenditure" relating to the issuance of the stock warrants (i.e. the "value" of the warrants for which the taxpayer seeks a deduction/exclusion from income) quite clearly do not qualify as deductible under section 162.

As discussed above, we conclude that no deduction or exclusion from income is warranted with respect to the "value" of the warrants. Rather, we believe that issuance of the warrants should be viewed as a capital expenditure which is related to the acquisition of the contract to provide services to . These warrants are treated as options under I.R.C. § 1234, which provides that tax treatment of the warrant be determined as of the date that the warrant is exercised. I.R.C. § 1234 (a)(1). We agree with the Examination Team, for the reasons set forth in the attached Statement of Facts, that the value of the warrants, as determined on the applicable exercise date(s), is subject to amortization over a period of ten years.

The issues and conclusions discussed in this memorandum have been reviewed and approved by the Area Counsel (Financial Products) .

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney-client privilege. If disclosure becomes necessary, please contact this office for our views.

Please feel free to contact the undersigned at (615) 250-5598 if you have any questions on the above or if you desire any further assistance regarding this case in general.

ASSOCIATE AREA COUNSEL (LMSB)
AREA 3

By:____________________________

Senior Attorney (LMSB)

Attachment:
Statement of Facts