INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE-MIS No.: TAM-133566-05/CC:ITA:B06

Director
LMSB, Retailers, Food, Pharmaceuticals & Healthcare (LM:RFPH)

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

Taxpayer =

Products =

Marketing Agreement(s) =

Advertising Agreement(s) =

Rebate Agreement(s) =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Date 1 =

ISSUE:

Whether amounts received from vendors pursuant to Taxpayer's Marketing Agreement in Year 1 and Year 2 constituted discounts that may be treated as reductions to the cost of inventory under § 1.471-3(b) of the Income Tax Regulations.

CONCLUSION:

Amounts received from vendors pursuant to Taxpayer's Marketing Agreement in Year 1 and Year 2 constituted discounts that may be treated as reductions to the cost of inventory under § 1.471-3(b).

FACTS:

Taxpayer is a retailer of Products. Taxpayer uses an overall accrual method and accounts for inventories under the retail inventory method. Taxpayer was under examination in Year 1 and Year 2. Prior to Year 1, Taxpayer included *Rebates*[1] and *Allowances*[2] in income upon receipt. Taxpayer filed a Form 3115 effective for Year 1 seeking permission to change its methods of accounting with respect to *Rebates* and several other items pursuant to Rev. Proc. 97-27, 1997-1 C.B. 680. Since Year 1, when Taxpayer was granted permission to make the accounting method changes proposed in its Form 3115, Taxpayer has treated *Rebates* as reductions in the cost of merchandise purchased pursuant to § 1.471-3(b). Taxpayer has consistently treated *Allowances* received pursuant to its Advertising Agreements as reimbursements of (or reductions in) costs incurred to promote vendors' products.

For financial accounting purposes in Year 1 and Year 2, Taxpayer presented the *Rebates*, in part, as an offset to advertising expense up to the amount of that expense, and most of the *Rebates* in excess of advertising costs were taken into account in determining the cost of goods sold. Taxpayer adopted the position endorsed by the Financial Accounting Standards Board in Emerging Issue Task Force (EITF) No. 02-16 titled "Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor" in Year 3. EITF Issue No. 02-16 states that cash consideration received from a vendor is presumed to be a reduction of the cost of vendors' goods and should, therefore, be characterized as a reduction of cost of merchandise sold when recognized in the reseller's income statement. However, this presumption is overcome when the consideration is either a payment for assets or

[1] Amounts received from vendors pursuant to the Marketing Agreements (hereinafter *Rebates*).
[2] Amounts received from vendors pursuant to the Advertising Agreements (hereinafter *Allowances*).

services delivered to the vendor, in which case the cash consideration should be characterized as revenue (or other income, as appropriate) when recognized in the reseller's income statement, or a reimbursement of costs incurred by the reseller to sell vendors' products, in which case the cash consideration should be characterized as a reduction of that cost when recognized in the reseller's income statement.

Taxpayer regularly files financial statements, including annual reports, with the Securities and Exchange Commission. Taxpayer stated in Year 3 annual report that:

> [Taxpayer] currently receives . . . advertising co-op allowances for the promotion of vendors' products that are typically based on guaranteed minimum amounts with additional amounts being earned for attaining certain purchase levels. . . . [Taxpayer] received consideration in the form of advertising co-op allowances from [its] vendors pursuant to annual agreements, which are generally on a calendar year basis. . . . As permitted by EITF 02-16, [Taxpayer] elected to apply its provisions prospectively to all agreements entered into or modified after Date 1. Prior to the adoption of EITF 02-16 in Year 3, the entire amount of advertising co-op allowances received was offset against advertising expense and resulted in a reduction of Selling and Store Operating Expenses. In Year 1 and Year 2, advertising co-op allowances exceeded gross advertising expense . . . . These excess amounts were recorded as a reduction of Cost of Merchandise Sold in the accompanying Consolidated Statement of Earnings. In Year 4, pursuant to EITF 02-16, the majority of the advertising co-op allowances will be initially recorded as a reduction in Merchandise Inventories and a subsequent reduction in Cost of Merchandise Sold when the related product is sold. [Taxpayer] also receives certain advertising co-op allowances that will be recorded as an offset against advertising expense as they are reimbursements of specific, incremental and identifiable costs incurred to promote vendors' products.

Taxpayer used the term "advertising co-op allowances" in its Annual Report to refer to amounts paid collectively, *Allowances* and *Rebates* for our purposes, under both the Advertising Agreements and Marketing Agreements. Taxpayer historically treated the "advertising co-op allowances," or *Allowances* and *Rebates*, received pursuant to the Advertising Agreements and Marketing Agreements as offsets against advertising expense for financial accounting purposes. However, with the adoption of EITF Issue No. 02-16, Taxpayer began to record the *Rebates* received under the Marketing Agreements as reductions to the cost of goods sold while continuing to apply the

Allowances paid under the Advertising Agreements as offsets against advertising expense.

Taxpayer strives to acquire merchandise at the lowest possible cost. Taxpayer meets with its vendors on an annual basis to agree on the projected volumes of purchases anticipated over the next twelve months. Based on these projections, Taxpayer enters into both Rebate Agreements and Marketing Agreements with its vendors that reflect the negotiated terms of the *Discounts*[3] and *Rebates*.[4] The *Rebates* are linked to the dollar-volume of actual purchases and, in some cases, involve guaranteed minimums based on projected purchases.[5] On some occasions, Taxpayer may enter into an Advertising Agreement in which Taxpayer agrees to furnish advertising services for a particular vendor in exchange for *Allowances*. These arrangements are not based on purchase volumes and entail a commitment by Taxpayer to undertake specific activity to benefit the vendor.

The *Discounts*[6] and *Rebates* under Rebate Agreements and Marketing Agreements are computed as a designated percentage of purchases. In some of the Marketing Agreements, the *Rebates* may not be less than the designated percentage multiplied by Taxpayer's projected purchases for the year from the vendors paying the *Rebates*. The designated percentages and the projected purchases, while varying among vendors, are negotiated by Taxpayer to obtain the net lowest prices for purchases from its vendors taking into account base invoice prices, all other rebates, discounts offered by vendors, and the increasing economies of scale achieved by the vendors as Taxpayer's purchase levels increase. *Rebates* are recorded for accounting purposes as purchases are made. Substantially all of the *Rebates* are applied as a reduction of amounts due on vendor invoices. Occasionally, Taxpayer receives cash payments under the Marketing Agreements.[7]

According to Taxpayer, its use of multiple contractual mechanisms for getting to the lowest net cost occurs for historical business reasons. Many years before Year 1,

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[3] Amounts received from vendors pursuant to the Rebate Agreements (hereinafter *Discounts*).

[4] In Year 1 and Year 2, all but a few of the approximate vendors that provide *Rebates* to Taxpayer entered into both agreements.

[5] Usually, the purchase projections are reached. *Rebates* may be renegotiated (and often are) during the year by Taxpayer and its vendors if it appears purchase projections will not be attained depending on the factors that contributed to the failure to meet the purchase projections.

[6] The Examination Team has not challenged Taxpayer's treatment of the *Discounts* received under the Rebate Agreements. Accordingly, the remainder of the ruling will focus on the *Rebates* paid under the Marketing Agreements.

[7] We assume these cash payments are received from vendors subsequent to purchases and are not otherwise similar to the upfront cash payments addressed in Westpac Pac. Foods v. Commissioner, T.C. Memo 2001-175.

services were provided by Taxpayer under cooperative advertising programs.[8] Although this practice has been discontinued, the request for *Rebates* under the of an equitable contribution to vendee overhead supplanted it, and the Marketing Agreement in its current form is still used for this purpose. At issue in this request for technical advice is the effect of the following language contained in the form of the Marketing Agreement (hereinafter *Statement*)[9] on Taxpayer and its tax treatment for *Rebates* received pursuant to the Marketing Agreements:

Specifically, the Examination Team requested technical advice on whether the amounts received from vendors pursuant to Taxpayer's Marketing Agreement in Year 1 and Year 2 constituted income from providing services to vendors under § 61 of the Internal Revenue Code (Code) or discounts under § 1.471-3(b).

Taxpayer claims that its advertising and marketing expenditures are directed solely at maximizing value to Taxpayer and without regard to the *Rebates* paid by any vendor under the Marketing Agreement. There is no correlation between amounts paid by particular vendors and amounts expended by Taxpayer on advertising for the products of such vendors. The *Rebates* have been used without limitation by Taxpayer for any corporate purpose. Taxpayer is neither obligated nor expected to provide any services in exchange for the *Rebates*. The *Rebates* are not paid to reimburse Taxpayer for any expenses incurred or to be incurred. Taxpayer's vendors do not receive and are not entitled to receive reports on how the *Rebates* are used. Taxpayer does not use its own funds, including any funds from the *Rebates*, to provide vendor point-of-sale displays, other promotional materials customarily supplied by the vendors, or other promotional materials to meet vendor specifications.

There is no designation of funds for marketing of any products in the Marketing Agreements. As stated above, most of the *Rebates* are applied as a reduction of amounts due the vendor. Negotiations with vendors pertaining to the *Rebates* are not based on past or projected marketing and advertising spending. Information is not provided to vendors as to amounts spent on marketing and advertising either generally or for any particular vendor. *Rebates* are paid under Marketing Agreements by some vendors of commodity products that are never advertised by Taxpayer and for others that are rarely advertised. Certain media advertising purchased by Taxpayer involves

[8] A cooperative advertising program is generally an arrangement by which a product is advertised with the names of both the vendor and the retailer. While programs can vary, an arrangement usually requires advertising as well as other promotions. The cost of the promotion may be shared by the vendor and the retailer, or the vendor may pay all the costs.

[9] The *Statement* is also contained in Taxpayer's Advertising Agreements.

advertising directed to no specific product.

In addition to advertising, Taxpayer incurs other expenses that also promote store traffic and build awareness. These expenditures include such items as the costs of displaying signs on the outside of the building, the wages paid to store personnel who answer customer questions, the costs of ensuring that the products that the customers want and need are on the store shelves, the costs of training employees to provide good customer service, rental expense and the costs of capital for store financing, utility expenses for stores, and the costs of management and administrative personnel that direct, administer, and account for all of these expenditures.

Taxpayer stated in its submission related to the ruling request that it will voluntarily clarify the *Statement* in its Marketing Agreement for prospective use with all vendors (hereinafter *Prospective Clarifications*) to read:

LAW AND ANALYSIS:

Section 61(a) provides generally, that gross income means all income from whatever source derived, including compensation for services. See also § 1.61-1(a).

Section 451 provides the general rule that the amount of any item of gross income shall be included in gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

Section 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. Therefore, under such a method of accounting if, in the case of compensation for services, no determination can be made as to the right to such compensation or the amount thereof until the services are completed, the amount of compensation is ordinarily income for the taxable year in which the determination can be made.

Section 471 provides that whenever in the opinion of the Secretary the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

Section 1.471-1 provides that in order to reflect taxable income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor.

Section 1.471-2(c) states that the bases of valuation of inventories most commonly used by business concerns and which meet the requirements of § 471 are (1) cost and (2) cost or market, whichever is lower.

Section 1.471-3(b) defines cost in the case of merchandise purchased since the beginning of the taxable year as the invoice price less trade or other discounts, except strictly cash discounts approximating a fair interest rate, which may be deducted or not at the option of the taxpayer, provided a consistent course is followed. To this net invoice price should be added transportation or other necessary charges incurred in acquiring possession of the goods.

Rev. Rul. 84-41, 1984-1 C.B. 130, states that discounts represent adjustments to the purchase price granted by a vendor, which may vary depending upon volume, quantity purchases, or other factors established by the vendor.

In Pittsburgh Milk Co. v. Commissioner, 26 T.C. 707 (1956), *nonacq*., 1959-2 C.B. 8, *nonacq*. *withdrawn* and *acq*., 1962-2 C.B. 5, *acq*. *withdrawn* and *nonacq*., 1976-2 C.B. 3, *nonacq*. *withdrawn in part* and *acq*. *in part*, 1982-2 C.B. 2, the Court stated:

> It does not follow, of course, that all allowances, discounts, and rebates made by a seller of property constitute adjustments to the selling prices. Terminology, alone, is not controlling; and each type of transaction must be analyzed with respect to its own facts and surrounding circumstances. Such examination may reveal that a particular allowance has been given for a separate consideration -- as in the case of rebates made in consideration of additional purchases of specified quantity over a specified subsequent period; or as in the case of allowances made in consideration of prepayment of an account receivable, so as to be in effect a payment of interest. The test to be applied, as in the interpretation of most business transactions, is: What did the

> parties really intend, and for what purpose or consideration was the allowance actually made?

Section 9.05 of the Appendix of Rev. Proc. 2002-9, 2002-1 C.B. 327, provides guidance for taxpayers seeking to obtain automatic consent to change their methods of accounting with respect to certain trade discounts. Section 9.05 describes the circumstances in which taxpayers may obtain automatic consent to treat qualifying volume-related trade discounts as reductions in the cost of merchandise purchased at the time the discount is recognized in accordance with § 1.471-3(b). The revenue procedure defines a "qualifying volume-related trade discount" as a discount satisfying the following criteria:

1) the taxpayer receives or earns the discount solely as the result of the purchase of the merchandise to which the discount relates;

2) the taxpayer is neither obligated nor expected to perform or provide any services in exchange for the discount; and

3) the discount is not a reimbursement of any expenditure incurred or to be incurred by the taxpayer.

We have been asked to rule on whether the amounts received from vendors pursuant to Taxpayer's Marketing Agreement in Year 1 and Year 2 constituted income from providing services to vendors under § 61 of the Internal Revenue Code (Code) or discounts under § 1.471-3(b).

Initially, we note that the advertising arrangement posited by the Examination Team under the Marketing Agreement is clearly not a classic cooperative advertising agreement. Under a typical cooperative advertising program, retailers provided advertising services while vendors compensated the retailers in the form of rebates or allowances for the advertising services performed under the terms of the advertising agreements. See Rev. Rul. 98-39; TAM 9343006; TAM 9416004; TAM 9143083; FSA 199915011. In each of these cases, the participating retailers were required to perform specific activities within identifiable guidelines under the various advertising programs available through the vendors. However, in this case, there was no similar arrangement between Taxpayer and its vendors under the Marketing Agreement.[10] The only language on the one-page form, apart from its caption, Marketing Agreement, that could be construed as requiring advertising services is the *Statement*, and the broad and general nature of these two sentences contained on Taxpayer's form is quite dissimilar from the specific requirements usually mandated by vendor-initiated cooperative advertising arrangements. Taxpayer's *Statement* follows.

[10] Taxpayer uses its form, the Advertising Agreement, with vendors when it agrees to undertake specific and identifiable promotional activities for *Allowances* received from vendors. Taxpayer treats the *Allowances* as reimbursements for specific, incremental and identifiable costs incurred to promote vendors' products.

The Examination Team has argued that the *Statement* in the Marketing Agreements, on its own, is enough to establish that Taxpayer provided advertising services or was required to provide advertising services to its vendors in Year 1 and Year 2. We disagree. The *Statement* is extremely vague. It is doubtful that the *Statement* alone created a legal obligation to provide advertising or marketing services. In addition, Taxpayer's representations concerning the *Rebates* in its financial statements as well as its conduct with respect to the *Rebates* received under the Marketing Agreement are consistent with the conclusion that the *Statement* did not require Taxpayer to perform advertising or marketing services.[11] We do not believe that, absent other facts or circumstances, the vague language used in the *Statement* is sufficient to create a reasonable expectation that advertising, marketing, or any other services would be provided.[12]

Other than the *Statement*, additional facts have not been presented to show that Taxpayer's vendors were entitled to, expected, or received advertising services or other consideration, apart from purchasing their products, in exchange for the *Rebates* paid under the terms of the Marketing Agreements. For example, there is no evidence that vendors expected or received any documentation regarding advertising by Taxpayer with respect to the Marketing Agreements. No facts were advanced to demonstrate that any of Taxpayer's vendors ever sought to obtain marketing services or information related to marketing services pursuant to the terms of the Marketing Agreements. Moreover, further evidence was not submitted, beyond the *Statement*, to establish that Taxpayer was reimbursed for advertising services performed or to be performed under the Marketing Agreements. In fact, when Taxpayer did undertake an obligation to perform advertising services, it entered into an Advertising Agreement with its vendors for specific and identifiable marketing activities in exchange for *Allowances*, which it accounted for as reimbursements of specific, incremental and identifiable costs incurred to promote vendors' products. In this case, the facts indicate that advertising services or marketing expenditures were neither expected nor received and that the parties intended the *Rebates* to serve as volume discounts.

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[11] We are not suggesting that Taxpayer's adoption of EITF Issue No. 02-16 and subsequent treatment of the *Rebates* as discounts for financial accounting purposes is controlling for tax purposes. Nonetheless, Taxpayer's treatment of the *Rebates* as discounts for financial accounting purposes serves as additional evidence that Taxpayer did not believe it was expected to provide marketing services.

[12] If, for example, some vendors will not accept Taxpayer's *Prospective Clarifications* to the Marketing Agreement, then it will be apparent that those vendors do in fact expect some performance by Taxpayer in exchange for the *Rebates*. Similarly, Taxpayer's failure to adopt the *Prospective Clarifications* to the Marketing Agreement will indicate that vendors reacted unfavorably to the *Prospective Clarifications*.

The Examination Team has also suggested that Taxpayer's vendors require the *Statement* in the Marketing Agreement to comply with the Robinson-Patman Price Discrimination Act (Robinson-Patman), 15 U.S.C. § 13, regulated by the Federal Trade Commission (FTC). The Act requires that allowances or services be offered by sellers on proportionally equal terms to competing customers, except in instances in which a seller in good faith attempts to meet another seller's lower-priced offer. Among other things, the Act permits vendors to reimburse resellers for promotional services. The Examination Team has asserted that Taxpayer's vendors need the *Statement* as proof they are receiving promotional services from Taxpayer for purposes of the Robinson-Patman Act.

We agree that factual assertions made by Taxpayer to other regulatory agencies are relevant to the issue in this case. It does not appear, however, that Taxpayer has ever testified under oath or submitted statements under penalties of perjury to the FTC that it provided promotional services in exchange for the *Rebates* received under the Marketing Agreement. On the other hand, Taxpayer has represented in its Year 3 Annual Report, filed with the Securities and Exchange Commission, that the *Rebates* under the Marketing Agreements were not received in exchange for services. Likewise, in connection with this technical advice request, Taxpayer stated under penalties of perjury that the *Rebates* were not for the provision of services to its vendors. These assertions are consistent with the facts concerning Taxpayer's advertising and marketing activities presented in this case.

Based on the facts presented in this case, we conclude that the amounts received from vendors pursuant to Taxpayer's Marketing Agreement in Year 1 and Year 2 constituted discounts under § 1.471-3(b) that may be treated as reductions in the cost of merchandise sold.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the Taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.