American Bar Association Section of Taxation
Tax Accounting Committee
Washington, DC
May 6, 2011

Accounting for Vendor Allowances

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Overview

- Definition of vendor allowance
  - Payment or credit from seller to purchaser of inventory (retailer, wholesaler, manufacturer)
  - Could also apply to non-inventory purchases (e.g., services, lease), but inventory issues are not present
- Tax Accounting Issues
  - Character:
    - Gross income (§ 61), reimbursement of cost (e.g., advertising), or adjustment to cost of merchandise (§ 1.471-3—cost means "invoice price less trade or other discounts . . .")?
    - If the latter, how are the allowances assigned to inventory costs (allocation between COGS and ending inventory)?
  - Timing:
    - When are the allowances taken into account in accordance with the above?
    - Cash method vs. all-events test

Character: IRS Guidance

- Since 1976, IRS has generally treated pre-arranged vendor allowances based exclusively on purchases as an adjustment to cost
  - Rev. Rul. 76-96: Auto manufacturer rebates to retail customer
  - Rev. Rul. 84-41: Auto manufacturer rebates to dealer
  - Rev. Proc. 2007-53: Advance trade discounts
- Compare Coordinated Issues Paper/Tier III exam issue
  - Allowances in exchange for services, such as advertising, are not adjustments to the cost of merchandise acquired

Allocation Methods: In general

- Generally, two methods
  - Tracing of costs
    - Item-by-item
    - Averaging of all rebates for all or certain classes of purchases
  - Physical flow
    - Costs in inventory deemed to equate to physical items on hand without regard to inventory cost flow method (proposed regulations)

Tracing Allocation Method: Illustrated

- Taxpayer receives 10% rebate from $10 invoice price for each of the first 100 items purchased during year. 200 items purchased during year. $100 total rebates
  - If taxpayer uses FIFO, and inventory turns over 4 times
    - Ending inventory = $-0-
    - COGS = $100
  - If taxpayer uses LIFO, and has 20% increment
    - Earliest acquisitions method
      - Increment = 40 x $1 = $40
      - COGS = 60 x $1 = $60
    - Latest acquisitions method
      - Increment = $-0-
      - COGS = $ 100

Tracing Allocation Method: Illustrated

- Calendar-year taxpayer receives a $1 per unit volume rebate if purchases equal or exceed 120 units during 12-month period beginning July 1 ending June 30. Taxpayer purchases 10 units per month from January to December (each year).
  - If taxpayer uses FIFO, and inventory turns over 4 times per year
    - Ending inventory = $-0-
    - COGS $ = $120

Tracing Allocation Method: Illustrated

- If taxpayer uses LIFO (specific goods), and has 20% increment (each year)
  - Earliest acquisitions
    - Added to current-year increment = $24 (120 units x 20% = 24 units x $1/unit)
    - COGS = $96
  - Latest acquisitions
    - Added to prior-year increment = $24
    - COGS = $96

Allocation Methods: IRS Guidance

- Rev. Rul. 85-30
  - Excise tax refund to tire dealer
  - Specific tracing method applied
- Rev. Rul. 88-95
  - Suggests specific tracing method (but somewhat ambiguous)
- Rev. Rul. 2001-8
  - Increase or decrease in floor stocks excise tax
  - Specific tracing method applied
- CCA 200945034
  - Chargebacks for returned/defective merchandise based on fixed percentage of total purchases (regardless of facts) properly treated as adjustment to inventory cost
  - Allocation to all current purchases permitted

If Not Based Exclusively on Purchases: Other Guidance

- Rev. Rul. 88-95: Cotton equalization payments for cotton inventory
- Rev. Rul. 2005-28: Manufacturer Medicaid rebates to retailer

Treatment of Sales-Based Vendor Allowances

- TAM 200624066
  - Chargebacks based on discounted resale price are properly treated as an adjustment to inventory cost
  - Specific tracing method applied
- Retail Industry Director Directive (LMSB-04-0910-026, Sept. 24, 2010)
  - Directive on sales-based vendor allowances and margin protection payments under retail method
  - Current regulations § 1.471-8 permit allowances to be treated as a reduction in numerator of cost complement under retail inventory method

Prop. Reg. § 1.471-3(e): Sales-based Vendor Allowances

- Proposes to amend current regulations
  - As amended, a sales-based vendor allowance is an adjustment *only* to the cost of merchandise sold during the year
- Would prohibit use of specific tracing method
- Also proposes to amend Reg. §§ 1.263A-2 and -3 to provide (simplified production and resale methods) as follows:
  - Additional section 263A costs, section 471 costs incurred during year, and section 471 costs remaining on hand at year end do not include cost reductions described in Reg. § 1.471-3(e)
- Does not address application to retail method
  - Further guidance pending
- Proposed to be effective for tax years ending on or after publication of final regulations

Examples (Determination of Character and Allocation Method)

- *Example 1.* Taxpayer (per pre-existing agreement) is entitled to a 10% rebate from invoice price of all purchases during each 12-month period that corresponds to tax year if purchases exceed specified volume threshold during such period
- *Example 2.* Same as *Example 1*, except 12-month measurement period spans the end of the tax year and the threshold is satisfied after end of tax year

Examples (cont'd)

- *Example 3.* Same as *Example 1*, except that taxpayer also agrees that manufacturer is its exclusive supplier during the period
- *Example 4.* Same as *Example 1*, except that taxpayer also agrees to perform cooperative advertising services during the period. The value of the cooperative advertising is not separately stated, and taxpayer gets no rebate if it fails to reach the volume threshold

Examples (cont'd)

- *Example 5.* Same as *Example 1*, except that 10% rebate applies only to items that are sold for less than a specified amount (margin protection payments)
- *Example 6.* Same as *Example 1*, except that 10% rebate applies if **sales** exceed a specified volume during the period
- *Example 7.* Same as *Example 1,* except that there is no right to the rebate in the purchase agreement; to induce sales, manufacturer agrees to pay 10% rebate if sales volume exceeds a specified volume threshold during period