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Memorandum

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to: David W. Bulger
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from: Area Counsel, LMSB Area 2 (Heavy Manufacturing & Transportation)

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subject: Application of Rev. Rul. 2001-8 to Rebates

This Field Attorney Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =

ISSUE

Under the circumstances below, how does Taxpayer apply the principles of Rev. Rul. 2001-8 in determining the value of its LIFO inventory under the IPIC method for its taxable year ending June 30, 2002?

CONCLUSION

In computing the value of ending inventory for its taxable year ending June 30, 2002, Taxpayer must reduce the value of its opening inventory and correlatively reduce the value of prior year LIFO layers to account for rebates received during the year. Taxpayer must compute the value of the current year's inventory increment as the difference between its opening inventory, reduced by rebates received during the year with respect thereto, and ending inventory, without reduction for rebates. Taxpayer may not reduce the value of ending inventory for rebates because, as of year end, no rebates have been earned with respect to items remaining in ending inventory (the most recently purchased items).

BACKGROUND

A National Office Technical Advice Memorandum (TAM) relating to Taxpayer concluded that rebates are purchase price adjustments and that the inventory cost adjustment principles set forth in Rev. Rul. 2001-8, 2001-1 C.B. 726, are applicable in determining Taxpayer's inventory valuation. Questions have arisen as to precisely how Rev. Rul. 2001-8 applies to Taxpayer's determination of its inventory value under the Inventory Price Index Computation (IPIC) method set forth in Treas. Reg. § 1.472-8(e)(3). Although Taxpayer argues Rev. Rul. 2001-8 explicitly provides results that are consistent with the conclusions in the TAM, the fact is the TAM explicitly provides that it does not address this very issue (*i.e.*, how the rationale of Rev. Rul. 2001-8 applies).

FACTS

Taxpayer is a product wholesaler. In the ordinary course of its business, Taxpayer purchases products directly from manufacturers and sells the products to various retailers. A key aspect of the distribution and marketing of products is the rebate process. Under this process, price reductions are negotiated directly between the manufacturer and the retailer, and the wholesaler administers these contracts by charging back to the manufacturer the price reduction that is extended to the retailer (i.e., the wholesaler receives a rebate from the manufacturer).

Generally, Taxpayer enters into an agreement with manufacturers (the Taxpayer-mfg. agreement). Under the Taxpayer-mfg. agreement, products are sold to Taxpayer at the manufacturer's published wholesale price, or list price, in effect on the date of Taxpayer's order. The Taxpayer-mfg. agreement further provides that Taxpayer may generally return any products that are either outdated or within six months of the products' expiration date, for full credit. Additionally, if the manufacturer decreases its published list price after Taxpayer purchases the products, the manufacturer must pay Taxpayer the difference between the price charged to Taxpayer and the value of Taxpayer's inventory if valued at the new list price.

The Taxpayer-mfg. agreement also provides that Taxpayer will recognize and administer "supplier contracts." These supplier contracts establish the prices that a retailer would pay a manufacturer if the retailer purchased the products directly from the manufacturer. The Taxpayer-mfg. agreement also provides that Taxpayer's rebate policy will govern the administration of the rebates.[1] Rebates and promotional incentives are computed upon the manufacturer's list price without reduction for cash or off-invoice discounts.[2]

The rebate policy is explicitly incorporated into the Taxpayer-mfg. agreement and is an attachment thereto. The rebate policy provides that (1) Taxpayer will recognize and administer the supplier contracts, (2) amounts owed to Taxpayer will be computed based on average list price of the manufacturer's product on the date the product is sold to a retailer that has entered into a supplier contract with the manufacturer, and (3) amounts owed to Taxpayer for rebates will be paid within seven days of when Taxpayer submits a claim for a rebate. The Taxpayer-mfg. agreement also provides that if a retailer returns products to Taxpayer, Taxpayer does not need to repay the related rebate to a manufacturer unless the return is due to Taxpayer's error.

Taxpayer also frequently enters into agreements with its customers (Taxpayer-retailer agreements). These agreements provide that Taxpayer is the retailer's primary wholesale provider of products. Under the agreement, the retailer pays Taxpayer on a "cost plus" basis. For this purpose, cost is defined as the manufacturer's list price on the date Taxpayer invoices the retailer, adjusted to reflect any applicable contract pricing. Added to the list price is an amount negotiated between Taxpayer and the retailer. This agreement also provides that if a rebate request from Taxpayer to the product's manufacturer is disallowed by the manufacturer, the applicable charge will be billed back to the retailer. Taxpayer retains the right to refuse orders or to cease its supply relationship with a retailer for non-payment or based on credit considerations.

These series of agreements taken together provide a rebate process that Taxpayer follows when it sells products that are subject to rebates. Under this process, when a retailer places an order, Taxpayer ships the products to the retailer, bills the retailer at the contract price and files with the manufacturer a claim for the difference between the contract price and the list price on the date of the sale. Generally, this all occurs electronically.

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[1] Wholesalers and suppliers adopted the rebate process, at least in part, to prevent or discourage arbitrage by wholesalers. The process prevents such arbitrage by requiring the wholesaler to prove to a manufacturer that it has sold the products to a contract retailer prior to being entitled to the rebate. This mechanism allows manufacturers to distribute products through wholesalers while still being able to target pricing to particular classes of customers. This pricing mechanism was challenged in antitrust litigation and the courts seem to permit the mechanism to the extent the resulting price discrimination differentiates buyers based on, but not among, classes of trade. Consequently, manufacturers that employ this pricing mechanism stratify their customers by class and price their products, via the rebate process, by class of trade.

[2] In addition to the type of rebate at issue herein, manufacturers provide discounts though other means. For example, manufacturers often pay rebates based on volume of purchases and timing of payments.

For tax accounting purposes, Taxpayer treats rebates as a reduction to the cost of its inventory. Therefore, the portion of the rebates that Taxpayer attributes to goods in ending inventory are treated as ending inventory cost reductions.

Taxpayer is not entitled to a rebate from its suppliers until it sells an item to a “contract customer”. Taxpayer’s inventory physically moves on a first-in, first-out (FIFO) basis. Taxpayer has elected the last-in, first-out (LIFO) cost flow assumption for computing the value of its ending inventory for federal income tax purposes, using IPIC and determining its current-year cost based on its most recent purchases.

LAW AND ANALYSIS

Rev. Rul. 2001-8 dealt with floor stocks, i.e., payments made or received with respect to items physically held in inventory on the “floor stocks date”. Rev. Rul. 2001-8 provides the following (in pertinent part):

> Consistent with the requirements of §§ 1.471-3 and 1.263A-1, payments made or received with respect to floor stocks must be accounted for as adjustments to the cost of the goods physically held on the floor stocks date to which the payments relate. "Cost" for this purpose means invoice price or production cost. The resultant effect on either gross income or inventory depends on the extent to which the cost of the goods physically held on the floor stocks date remains in ending inventory. Whether the cost of the goods physically held on the floor stocks date remains in ending inventory is determined by applying the taxpayer's inventory cost flow assumption (e.g., LIFO, first-in, first-out (FIFO), or a specific-goods method) to identify the particular costs that are deemed to be contained in ending inventory. See Rev. Rul. 85-30; Rev. Rul. 88-95.

Rev. Rul. 2001-8 goes on to explain –

> For taxpayers using a LIFO inventory method, payments made or received with respect to floor stocks affect ending inventory only when one or more LIFO cost increments that remain in ending inventory, as computed under § 472 (b) and § 1.472-1, include the cost of the goods physically held on the floor stocks date. For taxpayers using a FIFO inventory method, payments made or received with respect to floor stocks generally are included in cost of goods sold and not ending inventory because the goods physically held on the floor stocks date to which the payments

relate usually do not remain in FIFO inventory at the end of the year.

There are factual differences between the situation in Rev. Rul. 2001-8 and Taxpayer's situation. Rev. Rul. 2001-8 neither dealt with a regularly occurring post-purchase price adjustment nor with post purchase-price reductions earned subsequent to the taxable year at issue. Taxpayer argues the Exam Team's position renders the longstanding contested issues a nullity. Although, this position does indeed result in the same ending inventory values, the reason this occurs is because the post-purchase price reductions have not been accrued for the goods physically on hand at taxable year end. Accordingly, Taxpayer's contention that the Exam Team has not provided supporting legal theory for its position is without merit. The Exam Team's position is based on sound principles underlying the accrual method of accounting. Moreover, although Rev. Rul. 2001-8 provides guidance with respect to the revaluation of prior-year layers, it does not address the valuation of the current-year layer where, as here, the post-purchase price adjustment is made after the end of the year at issue.

Prior year LIFO layers

Rebates earned during the year, like payments received during the year in Rev. Proc. 2001-8, to the extent that they are attributable to opening inventory, reduce the value of opening inventory by reducing the value of the prior year's layers to which the payments are deemed to apply.

Current year increment

Under the Taxpayer's LIFO methodology, it computes its current-year cost for ending inventory by reference to the actual cost of its most recent purchases in accordance with Treas. Reg. § 1.472-8(e)(2)(ii)(a)[3]. Because Taxpayer's inventory physically moves on a FIFO basis, the most recent purchases are on hand at year end, i.e., they have not been sold. A rebate with respect to a unit is not earned until the unit is sold. Thus, no rebates have been earned with respect to Taxpayer's most recent purchases. At year end, there is no basis upon which Taxpayer may accrue the rebate adjustment to units on hand at year end. Accordingly, the cost of ending inventory for the current year cannot be reduced for rebates. The Exam Team is applying the conclusions and underlying rationale of the TAM – *i.e.,* the rebates are being treated as purchase price adjustments applying the principles set forth in Rev. Rul. 2001-8.

Under the dollar-value LIFO method, the existence and amount of any increment in inventory is determined based on the change in the amount of dollars of inventory on

[3] Although Treas. Reg. § 1.472-8(e)(2) is specifically applicable to the dollar-value LIFO, double extension method, the methods of determining current-year cost set forth therein are generally applicable to all LIFO methods.

hand, not on the physical quantity of goods on hand. Thus, the value of any increment will be the difference between the dollar value of the base costs of the opening and ending inventories. Because Taxpayer's inventory physically moves on a FIFO basis, by year end, the opening inventory will have been sold and the rebates thereon will have been earned. Thus, the cost of opening inventories should be reduced by rebates. For the reasons explained above, under the Taxpayer's LIFO methodology, the current-year cost of ending inventory is computed without any reduction for unearned rebates.

Accordingly the value of the current-year increment at base cost is the difference between the opening inventory at base cost, which is reduced for rebates, and ending inventory at base cost, which is not reduced for rebates.

Illustration of computation

The following example illustrates the computation:

Assumptions

Date	Cost	Excise Tax	Total Cost	Units	Cum. Index
12/31/1999	$0.226	$0.104	$0.330	10,000	1.10
01/01/2000	$0.226	$0.084*	$0.310	10,000	
12/31/2000	$0.236	$0.084	$0.320	11,000	1.12

* A rebate is received on 01/01/2000

The LIFO schedules are as follows:

	12/31/1999			1/1/2000			12/31/2000		
Year	Base Cost	Index	LIFO Cost	Base Cost	Index	LIFO Cost	Base Cost	Index	LIFO Cost
1995	900	1.000	900	900	1.000	900	900	1.000	900
1999	2,100	1.100	2,310	1,918	1.100	2,110	1,918	1.100	2,110
2000							325	1.120	364
Total	3,000		3,210	2,818		3,010	3,143		3,374

Computation of Base Cost

	12/31/1999	1/1/2000	12/31/2000
Cost per Item	0.330	0.310	0.320
Quantity	10,000	10,000	11,000
Total Current Cost	3,300	3,100	3,520
Current Year Index	1.100	1.100	1.120
Base Cost	3,000	2,818	3,143
Beginning of Year Base Cost	900	900	2,818

Increment at Base	2,100	1,918	325

In this example, the LIFO cost of the 1999 layer on 12/31/1999 is $2,310. When the rebate is received, the value of this layer is decreased to $2,110.

In the computation of the inventory value for the year ending 12/31/2000, the base cost is $3,143. The opening inventory at base cost after receipt of the rebate is $2,818. The difference is $325 which is the amount of the 2000 increment at base cost.

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