INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

February 15, 2006

Third Party Communication: None
Date of Communication: Not Applicable

Index (UIL) No.: 471.03-02, 472.01-01, 263A.03-01
CASE-MIS No.: TAM-148648-05
Number: **200624066**
Release Date: 6/16/2006
Director
LMSB:RFPH:DFO:EAST

Taxpayer's Name:
Taxpayer's Address:

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

LEGEND:

Taxpayer =
Product =
Retailer =
Percentage 1 =
Percentage 2 =

ISSUE(S)[1]:

1. Are received by Taxpayer purchase price adjustments?

2. If are purchase price adjustments, are products sold with

(products) the same items for purposes of the dollar-value last-in, first-out (LIFO) inventory method as physically identical products held in inventory without a (non- products)?

[1] The Examination Division statement of issues raises several additional issues. We believe that our conclusions regarding the above stated issues also address these additional issues. Accordingly, the additional issues that have been raised by the Examination Division's are not separately addressed.

3. If the are purchase price adjustments, do the principles of Revenue Ruling 2001-8 allow Taxpayer to reduce its LIFO inventory value to account for the ?

CONCLUSION(S):

1. The received by Taxpayer are purchase price adjustments.

2. For purposes of the dollar-value LIFO method, products are the same items as physically identical non- products.

3. The principles of Revenue Ruling 2001-8 allow Taxpayer to reduce its LIFO inventory value to account for the .

FACTS:

Taxpayer is a large 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 system. Under this system, 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 or from the manufacturer).

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 The further provides that Taxpayer may generally return any products that are either outdated or within six months of the products' expiration date, for full credit.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

The also provides that Taxpayer will recognize and administer These establish the prices that a retailer would pay a manufacturer if the retailer purchased the products directly from the manufacturer. The also provides that Taxpayer's "Standard Policy on will govern the administration of the .[2] , rebates, and promotional incentives are computed upon the manufacturer's WAC without reduction for cash or off-invoice discounts.[3]

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

Taxpayer also frequently enters into agreements with its customers called

The 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 WAC on the date Taxpayer invoices the retailer, adjusted to reflect any applicable contract pricing. Added to the WAC is an amount negotiated between Taxpayer and the retailer. This agreement also provides that if a 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 (the , the

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and) taken together provide a process that Taxpayer follows when it sells products that are subject to . Under this process, when a retailer places an order, Taxpayer ships the products to the retailer,

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[2] Wholesalers and suppliers adopted the system, at least in part, to prevent or discourage arbitrage by wholesalers. The system 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 . 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 system, by class of trade.

[3] In addition to , manufacturers provide discounts though other means. For example, manufacturers often pay rebates based on volume of purchases and timing of payments.

bills the retailer at the contract price and files with the manufacturer a claim for the difference between the contract price and the WAC on the date of the sale. Generally, this all occurs electronically.

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

LAW AND ANALYSIS:

1. Are received by Taxpayer purchase price adjustments?

Section 61(a)(3) defines gross income generally as all income from whatever source derived including gains from dealings in property. In a manufacturing or merchandising business, "gross income" means the total sales, less the cost of goods sold, plus any income from investments and from incidental or outside operation or sources. See § 1.61-3(a). A taxpayer determines its cost of goods sold amount by subtracting the inventory it has on hand at the end of the year from the sum of the inventory it had on hand at the beginning of the year and the cost of its purchases. See Rotolo v. Commissioner, 88 T.C. 1500, 1514-1515 (1987). The Code further requires a taxpayer to keep its inventories 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 income. See § 471. The regulations underlying § 471 provide general rules for the valuation of inventories at cost. See §§ 1.471-2 and 1.471-3. In particular, § 1.471-3(b) defines cost as 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. Section 263A requires resellers of property to include in inventory the direct costs and a proper share of the indirect costs of such property.

In the present case, Taxpayer asserts that the it receives from manufacturers are in the nature of purchase price adjustments and, therefore, not includable in its gross income. In support of its position, Taxpayer cites numerous cases including Federal Bulk Carriers, Inc. v. Commissioner, 66 T.C. 283 (1976); Pittsburgh Milk v. Commissioner, 26 T.C. 707 (1956); Foretravel, Inc. v. Commissioner, T.C. Memo. 1995-494; Sun Microsystems, Inc. v. Commissioner, T.C. Memo. 1993-467, and Freedom Newspapers, Inc. v. Commissioner, T.C. Memo. 1977-429. Taxpayer argues that each of these cases demonstrates that if, prior to the time a taxpayer acquires property, the taxpayer enters into an agreement that provides some sort of inducement to buy the property, the inducement should be regarded as a purchase price adjustment that is excluded from gross income. The Examination Division contends that are consideration for administering the program on behalf of a manufacturer and is, therefore, consideration for a transaction that is separate from the purchase of the underlying products. Accordingly, the Examination Division contends that the are sales receipts and, therefore, income for purposes of § 61.

The Tax Court has consistently held that a purchase price adjustment or a price rebate that is received by a taxpayer with respect to purchased merchandise is not included in gross income, but instead is treated as a reduction to the cost of the purchased merchandise. See Dixie Dairies Corp. v. Commissioner, 74 T.C. 476 (1980); Haas Brothers, Inc. v. Commissioner, 73 T.C. 1217 (1977); Max Sobel Wholesale Liquors v. Commissioner, 69 T.C. 477 (1977), affd. 630 F.2d 670 (9th Cir. 1980); Pittsburgh Milk Co. v. Commissioner, supra; Sun Microsystems, Inc. & Consolidated Subsidiaries v. Commissioner, supra; Foretravel, Inc. v. Commissioner, supra.

In Pittsburgh Milk Co. v. Commissioner, supra, the Tax Court addressed whether a rebate paid by a milk producer to certain purchasers of its milk, in violation of state law, were adjustments to the sales price of the milk or ordinary and necessary business expenses under § 162. If the court held that the rebates were expenses under § 162, no deduction would have been allowed under § 162(c). In Pittsburgh Milk, the Tax Court opined that when determining gain from the sale of property, the amount realized must be based on the actual price or consideration for which the property was sold. In so opining, the court examined the facts and circumstances of the transaction, what the parties intended, and the purpose for which the rebate was paid. The Tax Court further held that the rebates were part of the sales transaction and concluded that gross income must be computed with respect to the agreed net prices for which the milk was sold. Accordingly, the court in Pittsburgh Milk held that when a payment is made from a seller to a purchaser, and the purpose and the intent of the payment is to reach an agreed upon net selling price, the payment is properly viewed as an adjustment to the sales price.

Revenue Ruling 2005-28, 2005-19 I.R.B. 997, holds that Medicaid Rebates paid by a drug manufacturer to a State Medicaid agency are purchase price adjustments. The ruling holds that the Medicaid Rebates are purchase price adjustments because the payments are made with the purpose and intent of reaching an agreed upon net selling price, and the agreements providing for such payments are negotiated and agreed to before the sale from the manufacturer to the wholesaler takes place.

In this case, we conclude that the chargebacks are purchase price adjustments because the payments are made with the purpose and intent of reaching an agreed upon net selling price. Moreover, the series of agreements between the manufacturer and Taxpayer, and between Taxpayer and retailers, are negotiated and agreed to before the sale from the manufacturer to Taxpayer takes place.

2. If are purchase price adjustments, are products sold with (products) the same items for purposes of the dollar-value last-in, first-out (LIFO) inventory method as physically identical products held in inventory without a (non- products)?

The Examination Division contends that products and non- products are separate "items" for purposes of LIFO, even though the products are physically identical. The Examination Division contends that separate item treatment is required because of the differing cost structures of products and non- products. According to the Examination Division, Taxpayer's treatment of products and non- products as the same item distorts the index and inventory value under the dollar-value LIFO method because Taxpayer incorrectly determines current year cost of the non- products actually held at the end of the year based, in part, on the lower cost of the less expensive products that were sold throughout the year.

The definition or scope of an "item" is a critical element of the dollar-value LIFO method. The dollar-value method tracks changes in the dollar value of a taxpayer's inventory by grouping its inventory into "pools." Furthermore, the dollar-value LIFO method provides taxpayers with four methods to determine the base-year cost and LIFO value of an inventory pool: the double-extension method, the index method, the link-chain method, and the inventory price index computation (IPIC) method. Under all of these methods, a taxpayer first determines the current-year cost of its ending inventory by ascertaining the quantity of each "item" in its ending inventory and extending those "items" at their current year cost. Then all of these methods require a taxpayer to value its ending and beginning inventories at base-year cost and compare them to determine whether the base-year cost of the ending inventory has increased or decreased. Finally, under each of these methods any resulting increment stated at base-year cost is then valued at current year cost using a price index based on the ratio of base-year cost to current-year cost. The price index is essentially the weighted average inflation rate of the various items in the pool.

Unfortunately, neither the Code, nor the regulations provide a definition of the term "item." However, several courts have addressed the issue. See Kohler Co. & Sub. v. United States, 34 Ct. Cl. 379, affd. 124 F.3d 1451 (Fed. Cir. 1997); E.W. Richardson v. Commissioner, T.C. Memo. 1996-368[4]; Hamilton Indus. v. Commissioner,

[4] In E.W. Richardson v. Commissioner, T.C. Memo. 1996-368, the taxpayer was required to treat each vehicle in its new car and new truck LIFO pools that contained a different model code as a separate item.

97 T.C. 120 (1991); Amity Leather Products Co. v. Commissioner, 82 T.C. 726 (1984); Wendle Ford Sales, Inc. v. Commissioner, 72 T.C. 447 (1979). These courts have uniformly held that the proper scope or definition of an item depends on the specific facts and circumstances of the case. Furthermore, the Tax Court has emphasized that the facts and circumstances must be examined in light of the objectives of the dollar-value LIFO method. See Hamilton Indus. v. Commissioner, supra at 135-163; Amity Leather Products Co. v. Commissioner, supra at 733-734; Wendle Ford Sales, Inc. v. Commissioner, supra at 458-459.

A major objective of the LIFO inventory method (dollar-value LIFO or specific goods LIFO) is to eliminate the artificial profits that arise from inflation from the current-period income computation. Another major objective of the dollar-value method is to free taxpayers from the requirement of taking into account minor technological changes in a product. See Wendle Ford Sales, Inc. v. Commissioner, supra. The definition or scope of an item necessarily impacts both of these objectives.

To isolate and accurately measure inflation, a taxpayer's definition of an item must provide that similar goods are grouped together and dissimilar goods are separated. See Amity Leather Products Co. v. Commissioner, supra. When the scope of an item is drawn narrowly, the cost increases attributable to inflation are properly isolated from any cost increases that are attributable to differences in physical and/or cost characteristics of dissimilar items. However, if a taxpayer were to define an item too narrowly minor technological changes to a product would require the taxpayer to treat the product as a new item. In contrast, when dissimilar goods are included in the same item category, the cost increases attributable to factors other than inflation will be treated as inflation and included as part of the current period's cost of goods sold.

In Wendle Ford Sales, Inc. v. Commissioner, supra, the Tax Court held that vehicles equipped with solid-state ignitions and catalytic converters and vehicles without solid-state ignitions and catalytic converters were not different items. The court reasoned that to hold otherwise would undermine the rationale of the dollar-value LIFO method. Under the dollar-value LIFO method, the quantity of goods contained in beginning and ending inventories is expressed, not in physical units, but instead in terms of dollars. Because the dollar-value LIFO method measures quantities in terms of equivalent dollars, rather than in terms of physical units, the method affords a practicable means of applying the LIFO principle to inventories that contain a wide variety of items by eliminating the need to match specific goods in opening and closing inventories. By instead focusing on the total dollars invested in inventory, the dollar-value LIFO method necessarily ignores minor differences in the design of a product from year to year. The court in Wendle Ford also found that the cost of a catalytic converter and solid-state ignition together represented only an insignificant percentage of the total cost of the parts of an unassembled vehicle. Accordingly, the court held that 1974 Fords and 1975 Fords did not have sufficiently different cost structures so as treat them as separate items for purposes of the taxpayer's dollar-value LIFO inventory method.

Subsequently, in Amity Leather Products Co. v. Commissioner, supra, the Tax Court held that physically identical wallets manufactured in Puerto Rico and the U.S. were separate items. In so doing, the court found that the separate item treatment was necessary because the substitution of less expensive wallets manufactured in Puerto Rico for more expensive domestically manufactured wallets would result in the inflation that related to the cost of producing wallets domestically being partially offset by the lower cost of the wallets made in Puerto Rico. Similarly, in cases involving bargain purchases of inventory, courts have held that creating a new item is sometimes required to ensure that a taxpayer's LIFO inventory method clearly reflects income. In Hamilton Industries, Inc. v. Commissioner, the taxpayer purchased inventory consisting of office furniture at a bargain purchase price as part of its acquisition of another business. In that case, the court held that the taxpayer was required to treat the bargain purchased inventory and the subsequently purchased raw materials and produced inventory as separate items. See Hamilton Industries, Inc. v. Commissioner, supra. However, in Hamilton Industries the Tax Court noted that not every bargain purchase of inventory requires the creation of new items. Instead, the court recognized that occasional purchases concluded on advantageous terms are to be expected. Accordingly, the court viewed an isolated bargain purchase in the course of an ongoing business differently from the case where a taxpayer attempts to value its entire base year inventory at bargain cost. See Hamilton Industries, Inc. v. Commissioner, supra at 139, n. 6. In Hamilton Industries and other cases involving bargain purchases, the bargain purchased products were significantly less expensive than the physically identical goods that were manufactured by the taxpayer. For example, see Hamilton Industries, Inc. v. Commissioner, supra, and Kohler Co. & Sub. v. United States, supra.

Although products and non- products have different costs, they do not have different cost structures. As is discussed above with regard to whether are purchase price adjustments, the series of agreements between the manufacturer and Taxpayer, and between Taxpayer and retailers, are negotiated and agreed to before the sale from the manufacturer to Taxpayer takes place. Accordingly, the costs of products and non- products are both determined in accordance with the same purchase agreements and are both initially purchased at the same price. Moreover, most, if not all, products purchased and sold by Taxpayer are eligible for .

We have also not been presented with any facts that would lead us to conclude that products and non- products should be treated as separate items for purposes of Taxpayer's dollar-value LIFO method under the bargain purchase line of cases. As discussed above, in the bargain purchase line of cases, the bargain purchased goods were significantly less expensive than the physically identical goods that were manufactured by the taxpayer. In the instant case, the Examination Division has represented that the as a percentage of AWP, ranges from less than percentage 1 to more than percentage 2. Although of percentage 2 appear to be significant enough to bring this case within in the ambit of the bargain purchase cases, the Examination Division has not presented us with any information to determine how much of Taxpayer's products are sold subject to a percentage 1 versus a percentage 2 . Moreover, products are more appropriately considered purchases concluded on advantageous terms in the ordinary course of business rather than bulk bargain purchases. Accordingly, taken as a whole, we cannot conclude that the bargain purchase line of cases is applicable in this case so that products and non- products should be treated as separate items for purposes of Taxpayer's LIFO inventory method.

3. If the are purchase price adjustments, does the rationale of Revenue Ruling 2001-8 allow Taxpayer to reduce its LIFO inventory value to account for the ?

Revenue Ruling 2001-8 provides guidance with regard to how floor stocks tax adjustments (increases and decreases) are to be reflected in a taxpayer's LIFO inventory when the adjustments arise in a year subsequent to when the inventory item was purchased. According to the revenue ruling, a floor stocks provision, which applies to a designated type of goods held in inventory (floor stocks) on a particular date (the floor stock date), is sometimes enacted in conjunction with a tax, change in tax rate, or subsidy that is imposed upon similar goods purchased or produced on or after that date. The purpose of the floor stocks provision is to ensure that all goods sold on or after the floor stocks date are subjected to the same total amount of tax or subsidy, regardless of whether the items sold were goods held as floor stocks on the floor stocks date or goods purchased or produced after that date. This equal treatment is achieved by imposing with respect to goods held on the floor stocks date an amount, to be either paid or received, that will serve to eliminate any differential in total tax or subsidy that would otherwise exist relative to the goods subsequently purchased or produced.

The revenue ruling holds that payments made or received with respect to floor stocks must be accounted for as adjustments to the invoice price or production cost of the goods physically held on the floor stocks date to which the payments relate, rather than as an adjustment to the tax basis (i.e., carrying value) of those goods. Under the revenue ruling, 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. Therefore, the revenue ruling provides that payments received that relate to goods the cost of which have been included in cost of goods sold in a previous year under the taxpayer's inventory cost flow assumption increase gross income. However, to the extent that the cost of the goods associated with the rebates remains in ending inventory under the taxpayer's inventory cost flow assumption, such rebates reduce ending inventory. For taxpayers using a LIFO inventory method, payments received with respect to goods 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 that are subject to the payment.

The Examination Division contends that the received by Taxpayer in this case are not like the governmental payments received in Revenue Ruling 2001-8. According to the Examination Division, the governmental payments described in the revenue ruling compensate the taxpayer for a diminution in the value of its inventory caused by the government's action. The Examination Division argues that the received by Taxpayer do not result in a diminution in value of its inventory, but instead creates an accretion of wealth. Accordingly, the Examination Division contends that Revenue Ruling 2001-8 is not applicable in this case.

Although we agree that the payments received in Revenue Ruling 2001-8 and prior similar rulings (Revenue Ruling 85-30 and Revenue Ruling 88-98) were governmental payments, we do not agree that Revenue Ruling 2001-8 is not applicable to . Revenue Ruling 2001-8 does not address whether an adjustment is a purchase price adjustment that reduces inventory costs, but only addresses the allocation of the purchase price adjustment with respect to a taxpayer's LIFO inventory when the purchase price adjustment arises in a year subsequent to when the inventory items was purchased. Although in this case are not governmental payments, we have concluded that are purchase price adjustments that reduce the cost of Taxpayer's inventory. Accordingly, the inventory cost adjustment principles of Revenue Ruling 2001-8 are applicable in this case. Neither the Examination Division nor Taxpayer requested us to opine on how such adjustment is to be computed under Revenue Ruling 2001-8. Accordingly, we will not address this issue.

CAVEAT(S):

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