

TAX UPDATE

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Delayed Rebate—Tax Status of Accrued Rebates
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Tax Status of Rebate

Accountants run into issues of the proper timing of inclusion of income or a deduction for accounting purposes, and the somewhat different rules we run into for timing of inclusion of income or deductions for income tax purposes. This week the IRS issued a Chief Counsel Advice (ILM 200834019) that deals with the issue regarding proper timing of a deduction for rebate payments, analyzing the difference between the Supreme Court's rulings in the case of *United States v. Hughes Properties, Inc.*, 476 U.S. 593 (1986) (which the taxpayer in this case believed was applicable) and the case of *United States v. General Dynamics Corp.*, 481 U.S. 239 (1987) (the case the Chief Counsel would argue was actually the more applicable case in this fact pattern).

Year of Deduction

IRC Section 461 generally governs the year of deduction of an item, and it starts out in what sounds like a provision that will bring it into line with the proper accounting

treatment of an item. We find at §461(a) the following:

(a) General rule

The amount of any deduction or credit allowed by this subtitle shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

However, if you glance at §461 you'll find it goes on for a quite a few more subsections, which suggests (correctly) that the answer may not be quite as simple for accountants as the above provision suggests it would be.

Most important is the limitation found at §461(h) which introduces the conceptions of “economic performance” and the “all events test” in making this determination.

§461(h)(1) begins:

(1) In general

For purposes of this title, in determining whether an amount has been incurred with respect to any item during any taxable year, the all events test shall not be treated as met any earlier than when economic performance with respect to such item occurs.

At §461(h)(2) we find the rules for what is “economic performance”

(2) Time when economic performance occurs

Except as provided in regulations prescribed by the Secretary, the time when economic performance occurs shall be determined under the following principles:

(A) Services and property provided to the taxpayer

If the liability of the taxpayer arises out of--

(i) the providing of services to the taxpayer by another person, economic performance occurs as such person provides such services,

(ii) the providing of property to the taxpayer by another person, economic performance occurs as the person provides such property, or

(iii) the use of property by the taxpayer, economic performance occurs as the taxpayer uses such property.

(B) Services and property provided by the taxpayer

If the liability of the taxpayer requires the taxpayer to provide property or services, economic performance occurs as the taxpayer provides such property or services.

(C) Workers compensation and tort liabilities of the taxpayer

If the liability of the taxpayer requires a payment to another person and--

(i) arises under any workers compensation act, or

(ii) arises out of any tort,

economic performance occurs as the payments to such person are made. Subparagraphs (A) and (B) shall not apply to any liability described in the preceding sentence.

(D) Other items

In the case of any other liability of the taxpayer, economic performance occurs at the time determined under regulations prescribed by the Secretary.

Note that while the Code provides general principles, it also provides that the IRS may, by issuing regulations, modify those rules.

§461(h)(4) provides the definition of the “all events test”

(4) All events test

For purposes of this subsection, the all events test is met with respect to any item if all events have occurred which determine the fact of liability and the amount of such liability can be determined with reasonable accuracy.

Note that there are two key issues here—both that fact of the liability exists, and that we can determine that liability with reasonable accuracy. Or, looked at another way, if either of those factors are missing, the item will not be deductible for income tax purposes.

Note that for financial statement reporting purposes under *Statement of Financial Accounting Standards No. 5*, the key issue for recording a contingent liability boils down to the likelihood of the liability existing and that it can be computed, a lower trigger level than we find under the “all events/economic performance” standards noted above.

Of importance to the taxpayer involved in the ruling this week, Reg. §1.461-4(g)(3) gives us some specific guidance on when economic performance occurs for rebates a taxpayer

may owe:

(3) Rebates and refunds.

If the liability of a taxpayer is to pay a rebate, refund, or similar payment to another person (whether paid in property, money, or as a reduction in the price of goods or services to be provided in the future by the taxpayer), economic performance occurs as payment is made to the person to which the liability is owed. This paragraph (g)(3) applies to all rebates, refunds, and payments or transfers in the nature of a rebate or refund regardless of whether they are characterized as a deduction from gross income, an adjustment to gross receipts or total sales, or an adjustment or addition to cost of goods sold. In the case of a rebate or refund made as a reduction in the price of goods or services to be provided in the future by the taxpayer, "payment" is deemed to occur as the taxpayer would otherwise be required to recognize income resulting from a disposition at an unreduced price. See Example 2 of paragraph (g)(8) of this section. For purposes of determining whether the recurring item exception of section 1.461-5 applies, a liability that arises out of a tort, breach of contract, or violation of law is not considered a rebate or refund.

However, there is an exception to economic performance (but not all events) allowed under §461(h) for "recurring items" if the taxpayer so elects. That provision provides:

(3) Exception for certain recurring items

(A) In general

Notwithstanding paragraph (1) an item shall be treated as incurred during any taxable year if--

(i) the all events test with respect to such item is met during such taxable year (determined without regard to paragraph (1)),

(ii) economic performance with respect to such item occurs within the shorter of--

(I) a reasonable period after the close of such taxable year, or

(II) 8-1/2 months after the close of such taxable year,

(iii) such item is recurring in nature and the taxpayer consistently treats items of such kind as incurred in the taxable year in which the requirements of clause (i) are met, and

(iv) either--

(I) such item is not a material item, or

(II) the accrual of such item in the taxable year in which the requirements of clause (i) are met results in a more proper match against income than accruing such item in the taxable year in which economic performance occurs.

(B) Financial statements considered under subparagraph (A)(iv)

In making a determination under subparagraph (A)(iv), the treatment of such item on financial statements shall be taken into account.

(C) Paragraph not to apply to workers compensation and tort liabilities

This paragraph shall not apply to any item described in subparagraph (C) of paragraph (2).

A few key factors to note in the above provision:

- Note that the 8 ½ limit serves as an absolute cap on the time period involved, but the period may be shorter if that is the “reasonable” period
- The item either must be immaterial *or* it must be an item that is required to be recognized (and is recognized) on the financial statements of the entity for proper matching *and*
- Most importantly, the enterprise must consistently treat this item under the recurring item exception—so that means this method must be elected for the first year to which it would apply. (See Reg. §1.461-5(d)(1))

Since this is an exception to the economic performance requirement, it is potentially applicable in the case of a rebate payment. Thus, if a taxpayer pays rebates and has properly elected the recurring item exception, the question boils down to whether the “all events” test has been met—and that is the key issue for this ruling.

Ruling Facts

The CCA sets out the following fact pattern for the taxpayer in today's ruling:

Taxpayer is a retailer of consumer products. Taxpayer uses an accrual method of accounting. Taxpayer has a cash rebate program which involves the issuance of cash

rebate offers in conjunction with the sale of a product. The taxpayer contracts with a third-party administrator to process the rebates. Under the cash rebate program, the customer pays full price for the product at checkout, but receives a rebate offer for a stated amount. To comply with the rebate offer the customer must: fill out the rebate form provided when the merchandise is purchased; cutout and attach a copy of the UPC code from the merchandise; attach a copy of the sales receipt; and send these items by mail to a third-party administrator within 30 days of the date of purchase. If the customer timely submits a properly completed form requesting a rebate, and otherwise complies with the terms of the rebate offer, the third-party administrator will issue the customer a check in the amount of the rebate offer after at least 30 days have passed from the date of purchase to insure the customer has not returned the merchandise. This check is often issued several months after a rebate request is properly submitted.

Based on experience, Taxpayer estimates that it pays or redeems only x percent of the total rebate offers.

The above facts would justify (and in fact require) the taxpayer to accrue that expected liability for financial accounting purposes. But our question becomes whether the all events test has been met.

The second prong of the test, that the liability can be reasonably estimated, seems to be met by these facts. The taxpayer likely has a significant base of historical data that would support their expected level of redemption of the rebates. But given the facts, is the fact of the liability fixed?

Hughes Case

The taxpayer believed that the Supreme Court's 7-2 ruling in favor of the taxpayer in the case of *United States v. Hughes Properties*, 476 U.S. 593 was sufficient support of their deduction in their facts. In *Hughes* the taxpayer operated a casino and had progressive slot machines. Such machines were subject to regulation by the Nevada Gaming Commission which required that such progressive payouts had to actually be eventually paid out. While the casino was not required to specifically limit its use of the funds for each machine, the Supreme Court noted

The Commission does not regulate respondent's use of the funds thus collected, but since 1977, it has required that a casino maintain a cash reserve sufficient to provide payment of the guaranteed amounts on all its progressive machines available to the public.

The IRS complained that there couldn't be a liability fixed at this point because although we might know the amount of the liability, we didn't know who was to receive the payout. The Supreme Court disagreed that this was fatal, holding:

The Government misstates the need for identification of the winning player. That is, or should be, a matter of no relevance for the casino operator. The obligation is there, and whether it turns out that the winner is one patron or another makes no conceivable difference as to basic liability.

In our case, the taxpayer argues that while they might not know the person they would pay rebates to, they could very reasonably estimate the amount they would pay.

General Dynamics Case

However, it turns out that a year later the Supreme Court had cause to revisit the issue, and that case is the one the IRS believes is more applicable to the matter at hand, *United States v. General Dynamics Corp*, 481 US 239. In that case, in which the Supreme Court ruled in favor of the government by a 6-3 majority, the question involved a taxpayer's deduction for unpaid claims under its self-insured medical reimbursement plan. In this case the employees had a right to have their covered expenses paid by General Dynamics, but there would often be a delay between the time the expense was incurred and when the employee would file a claim. The key issue here was whether General Dynamics could recognize the liability for expenses the employees had incurred at the time they were incurred, but for which a claim was not yet filed by the year end which it covered with a reserve for unfiled claims.

The court majority distinguished this case from *Hughes*, holding that the fact that the employees had not yet filed their claim meant that, in fact, the liability was not yet fixed since that filing was a necessary requirement for the employer to have to pay the expense. The majority held:

We disagree with the legal conclusion of the courts below that the last event necessary to fix the taxpayer's liability was the receipt of medical care by covered individuals. A person covered by a plan could only obtain payment for medical services by filling out and submitting a health expense benefits claim form. Employees were informed that submission of satisfactory proof of the charges claimed would be necessary to obtain payment under the plans. General Dynamics was thus liable to pay for covered medical services ONLY if properly documented claims forms were filed. Some covered individuals, through oversight, procrastination, confusion over the coverage provided, or fear of disclosure to the employer of the extent or nature of the services received, might not file claims for reimbursement to which they are plainly entitled. Such filing is not a mere technicality. It is crucial to the establishment of liability on the part of the taxpayer.

The majority distinguished the case from *Hughes*, holding that

Nor does the failure to file a claim represent the type of "extremely remote and speculative possibility" that we held in *Hughes*, 476 U.S., at ___, did not render an

otherwise fixed liability contingent. Cf. *Lucas v. North Texas Lumber Co.*, 281 U.S. 11, 13 (1930) (where executory contract of sale was created in 1916 but papers necessary to effect transfer were not prepared until 1917, unconditional liability for the purchase price was not created in 1916 and the gain from the sale was therefore not realized until 1917). Mere receipt of services for which, in some instances, claims will not be submitted does not, in our judgment, constitute the last link in the chain of events creating liability for purposes of the "all events" test.

In a dissenting opinion, Justice O'Connor issued a complaint that will find a sympathetic ear among accountants:

The holding of the Court today unnecessarily burdens taxpayers by further expanding the difference between tax and business accounting methods without a compelling reason to do so. Obviously, tax accounting principles must often differ from those of business accounting. The goal of business accounting "is to provide useful and pertinent information to management, shareholders, and creditors," while the responsibility of the Internal Revenue Service is to protect the public fisc. *United States v. Hughes Properties, Inc.*, 476 U.S., at _____. Therefore, while prudent businesses will accrue expenses that are merely reasonably foreseeable, for tax purposes the liability must be fixed. But Congress has expressly permitted taxpayers to use the accrual method of accounting, and from its inception in *United States v. Anderson*, supra, the all-events test has been a practical adjustment of the competing interests in permitting accrual accounting and protecting the public fisc. Unfortunately, the Court today ignores the pragmatic roots of the all events test and instead applies it in an essentially mechanistic and wholly unrealistic manner. Because the liability in this case was fixed with no less certainty than the range of expenses both routinely accrued by accrual method taxpayers and approved as deductible for tax purposes by this Court and other courts in a variety of circumstances, I respectfully dissent.

Our Facts

In this case, the Chief Counsel's office believes the fact that customers must submit their rebate forms is virtually identical to the filing of claims in *General Dynamics* with the same required results. The CCA notes:

Taxpayer's rebate program liability is more like the employer's liability for employee medical expenses in *General Dynamics* than it is like the casino's jackpot liability in *Hughes Properties*. The casino's liability in *Hughes Properties* was fixed by a state law requiring the taxpayer to set aside a cash reserve to cover its liability. No such facts are present in this case. Without a state law requiring the set-aside of funds as in *Hughes Properties*, Taxpayer's liability is not fixed. See *Chrysler Corporation v. Commissioner*, 436 F.3d 644 (6th Cir. 2006), aff'g T.C. Memo. 2000-283. There is no material

distinction between this case and *General Dynamics*.

Specifically the CCA holds:

Taxpayer may not treat the liability as incurred when the rebate offer is issued with the sale of the product by using the recurring item exception. The liability does not meet the requirements of the recurring item exception at that point because the liability is not fixed. Similar to *General Dynamics*, the filing of a claim in this case is necessary to fix Taxpayer's liability. On the other hand, we see no factual basis upon which to argue that after the mailing of a properly completed rebate offer by a customer, the processing and issuing of a rebate is anything other than a ministerial act. Therefore, the last event fixing Taxpayer's liability for cash rebates occurs when the customer mails a properly completed rebate form with the required attachments.

So, as noted, the triggering event for recognizing the expense for tax purposes is the actual mailing of the rebate form by the individual customer.