

**Office of Chief Counsel
Internal Revenue Service
Memorandum**

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to: Janice Traficanti
Internal Revenue Agent
(Large Business & International)

from: Associate Area Counsel (Chicago, Group 2)
(Large Business & International)

subject: Deduction for Chargeback Reimbursement Accrued Expense

This memorandum responds to your request for assistance. This advice may not be used or cited as precedent. This advice has been coordinated with National Office, Income Tax and Accounting, Branch 1.

LEGEND

Taxpayer =
a =

ISSUE

Whether the “all events” test is met when the wholesaler/distributor sells to end-user customers at prices below the acquisition cost such that the Taxpayer may deduct accrued expense for chargeback reimbursement as claimed on its Federal income tax return for the taxable year ended *** a?

CONCLUSION

It is our opinion that the “all events” test is met when the wholesaler/distributor sells to end-user customers at prices below the acquisition cost. It is also our view that the Taxpayer is entitled to use the recurring item exception under § 1.461-5(b)(1) of the Income Tax Regulations. Whether this results in a deduction for the amount claimed by

the Taxpayer on its Federal income tax return is subject to further examination, particularly of the Taxpayer's recorded payments of chargeback reimbursements.

FACTS

The Taxpayer, a pharmaceutical company, negotiates discounted prices with certain organizations that are administered by the wholesalers/distributors through a chargeback program. Under the program the discounts are initially absorbed by the wholesalers/distributors who must accept a selling price that is less than their cost for the pharmaceuticals. In turn, the Taxpayer is obligated to pay chargeback reimbursements to its wholesalers/distributors for sales to favored end-user customers at prices below the wholesaler/distributor's acquisition cost. To receive payment the wholesalers/distributors must submit a chargeback reimbursement request to the Taxpayer to claim the reimbursement pursuant to the Taxpayer's standard policy incorporated into its wholesaler/distributor agreements.

Prior to receipt of the chargeback reimbursement request, the Taxpayer is unable to determine the exact chargeback reimbursement amount. However, the Taxpayer deducts an estimate of the chargeback reimbursement liability based upon its historical pricing information and other data. The Taxpayer did not provide chargeback reimbursement requests submitted by the wholesalers/distributors to substantiate any portion of the claimed deduction for chargeback reimbursement expense for the taxable year ended *** a. We assume that information regarding the timing of the payments of chargeback reimbursements has also not been provided.

LAW AND ANALYSIS

A liability is incurred and deductible when the "all events" test is met and economic performance has occurred. I.R.C. § 461(h); Treas. Reg. § 1.461-1(a)(2)(i). The "all events" test requires that (1) the liability is fixed and (2) the liability can be determined with reasonable accuracy. Generally, the fact of taxpayer's liability is established when (1) the event fixing liability, whether required performance or some other event occurs or (2) payment is unconditionally due. Rev. Rul. 2007-3, 2007-1 C.B. 350. The fixing event occurs when the wholesalers/distributors sell to end-user customers at prices below the acquisition cost. At this time the wholesaler/distributor's right to demand a chargeback reimbursement is unconditional. Whether the Taxpayer's data allows it to estimate the amount of its liability with reasonable accuracy must be determined on exam, however an estimate based on reliable inputs and reasonable methodology is generally acceptable. See Continental Tie & Lumber Co. v. United States, 286 U.S. 290 (1932).

The Taxpayer's contracts provide that a chargeback reimbursement will only be paid upon its receipt of a reimbursement request. In U.S. v. General Dynamics Corp., 481 U.S. 239 (1987), the Supreme Court held that the taxpayer could not claim a medical reimbursement expense deduction before the appropriate forms were submitted by the employees receiving the corresponding medical treatment, as submission of the claim

forms fixed the taxpayer's liability. Id. at 244. The Supreme Court noted that some covered employees fail to file claims with their employer for various reasons, such that an employee's receipt of covered medical services was not sufficient to fix the employer's liability. Thus, the filing of the claim was not a ministerial demand for payment; rather it represented a demand for indemnity from the employee who was otherwise free to pay for the medical services himself.

The Taxpayer's chargeback reimbursement expense deduction is distinguishable from General Dynamics Corporation's liability for employee medical expenses. Generally, if a requirement that documentation be submitted is ministerial, the requirement does not affect the determination of whether all events that fix the right to receive income or that establish the fact of liability have occurred. Rev. Rul. 2003-3; 2003-1 C.B. 252. In the present fact pattern, the fixing event is the below acquisition cost sale, which fixes the obligation of the Taxpayer to refund part of the purchase price to the wholesalers/distributors. The submission of a reimbursement form by the wholesalers/distributor appears to be a ministerial demand for payment and therefore a condition subsequent, the occurrence of which does not affect the Taxpayer's liability to reimburse the wholesalers/distributors, provided the below market sale occurs in the taxable year in question. See Rev. Rul. 98-39, 1998-2 C.B. 198.

Economic performance with respect to a liability to pay a rebate, refund or similar payment occurs as payment is made to the person to whom the liability is owed. Treas. Reg. § 1.461-4(g)(3). The Taxpayer has claimed a deduction for chargeback reimbursement expense that has not been paid to the wholesalers/distributors. However, so long as the chargeback reimbursement payments are made within the proscribed period under Treas. Reg. § 1.461-5(b)(1), then economic performance is deemed satisfied. Further, in the case of a liability for rebates, the matching requirement for the recurring item exception is deemed satisfied. See Treas. Reg. § 1.461-5(b)(5)(ii). In conjunction with the recurring item exception, it is our opinion that the Taxpayer can satisfy the economic performance requirement to the extent that the chargeback reimbursement payments are paid within the first 8½ months of the following taxable year. We see no reason to deny the Taxpayer use of the recurring item exception from the facts provided.

The Taxpayer relies upon The Pittsburgh Milk Co. v. Commissioner, 26 T.C. 707 (1956), to support its position that the chargeback reimbursement should be treated as a reduction in gross receipts based upon a purchase price adjustment. There is a reasonable basis for this assertion. See Rul. Rev. 2008-26, 2008-1 C.B. 985. However, the Taxpayer refers to the payments as refunds, and Treas. Reg. § 1.461-4(g)(3) applies to all rebates, refunds and payments or transfers in the nature of a rebate or refund regardless of whether characterized as a deduction from gross income, adjustment to gross receipts or total sales, or an adjustment or addition to cost of goods sold. Treas. Reg. § 1.61-3(a). Thus, whether the liability is treated as a reduction in gross receipts or a deduction does not affect our analysis of the timing of the liability. Therefore, we express no opinion on this issue.

For the reasons discussed above, it is our opinion that the fixed prong of the “all events” test is met when the wholesaler/distributor sells to end-user customers at prices below the acquisition cost. It is also our view that the Taxpayer is entitled to use the recurring item exception under § 1.461-5(b)(1) of the Income Tax Regulations.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call (312) 368-8387 if you have any further questions.

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