Office of Chief Counsel
Internal Revenue Service
Memorandum

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subject: Co-operative Advertising and Section 199

You have requested that the National Office issue a Generic Legal Advice Memorandum addressing whether Co-operative Advertising Allowances (Allowances) that retailers of inventory (Retailers) receive from vendors of products (Vendors) for placement of advertisements of Vendors' products in Retailers' flyers may be treated as Domestic Production Gross Receipts (DPGR) for purposes of § 199 of the Internal Revenue Code (Code). This memorandum should not be used or cited as precedent.

Whether Allowances may be treated as DPGR depends on the facts and circumstances of each Co-operative Advertising Agreement (Agreement) between Retailers and Vendors. Specifically, whether Allowances are DPGR for federal income tax purposes depends on whether the Allowances are advertising income from Retailers' performance of advertising services for Vendors and whether the flyers qualify for the advertising income exception in § 1.199-(3)(i)(5)(ii) of the Income Tax Regulations (regulations).

FACTS

The facts below are based on the facts presented by CC:LBI in its Memorandum of March 12, 2013, requesting assistance from the National Office.

Vendors and Retailers commonly enter Co-operative Advertising Arrangements (Arrangements). Arrangements require Retailers to produce printed advertisements of Vendors' products and to distribute the printed advertisement flyers in Retailers' stores and through mail and in newspapers.[1] Retailers usually circulate flyers free of charge to retail customers.

Flyers increase foot traffic to Retailers' stores and may increase customer interest and demand for the advertised products offered at Retailers' internet websites. Vendor may be the manufacturer, supplier, wholesaler, or distributor of the product who directly or indirectly sells the product to Retailers at the wholesale level. In general, Retailers will include Vendors' products in Retailers' flyers pursuant to written or oral Agreements negotiated annually or on an ad hoc basis with Vendor.

We understand that the terms of Agreement between Retailers and Vendors may differ. However, Agreements often require Retailers to provide specific advertising services and may specify:

(1) the advertising media,
(2) the products that will be featured,
(3) the placement of the product in the flyer,
(4) the conditions for advertising specific products,
(5) the use of Vendor's name and logo,
(6) the size, length, and frequency of advertisement, and
(7) the substantiation and payment processes.

Retailers are responsible for all aspects of the production and distribution of the flyers. Retailers normally bear the entire up-front cost of the flyers. Under the terms of Agreements with Vendors, Retailers receive Allowances from Vendors for providing specific advertising services. Under the terms of some Agreements, the flyers must meet Vendors' specifications as a condition of Retailers receiving Allowances. Often Agreements provide that Allowances are calculated based on the volume of the advertised products that Retailers purchase from Vendors during a specified period.

[1] In this memorandum, Retailers' printed advertisements are referred to as "flyers." However, common synonyms include: inserts, circulars, catalogues, and tabs.

Typically Vendors make direct payments to Retailers of Allowances, or Vendors may reduce the amount owed by Retailers for prior purchases, or Vendors may issue a credit to Retailers for future purchases. Vendors may pay Allowances periodically (*e.g.,* as a Vendor's products are featured in the flyer) or at fixed intervals. Vendors may require Retailers to submit invoices, reimbursement substantiation claims, or proofs of performance of the advertising services required under Agreements before paying Allowances.

LAW AND ANALYSIS

Purchase Price Adjustments are not a Separate Item of Gross Income

Section 61 of the Code generally provides that gross income means all income from whatever source derived. The term "income" is broadly defined as "instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955).

As a general principle, taxpayers in the retail industry compute gross income from sales during a year by subtracting the cost of the goods sold (CGS) from gross sales receipts. *See* § 1.61-3(a) of the regulations.

Generally, when payments are made by Vendors to Retailers as an inducement to purchase merchandise, the payments do not constitute separate items of gross income but instead are an adjustment to the cost or price of the merchandise purchased (purchase price adjustment). In *Affiliated Foods, Inc., v. Commissioner*, 128 T.C. 62, 80 (2007), the Tax Court held that a "purchase price adjustment or a price rebate that a taxpayer receives for goods that it has purchased for resale is not, itself, an item of gross income but, instead, is treated as a reduction in the cost of the goods sold." A purchase price adjustment may still indirectly affect the amount of Retailer's gross income if it results in a reduction in CGS.

As established in case law, the test for whether a payment, credit, allowance or rebate is a purchase price adjustment is what the parties intend and for what purpose the payment, credit, allowance, or rebate was paid. If the purpose was to adjust the price of the item between the parties, then the consideration given, regardless of the time or manner of the adjustment, is a purchase price adjustment and is not a separate item of gross income. The seminal case addressing purchase price adjustments is *Pittsburgh Milk v. Commissioner,* 26 T.C. 707(1956), *nonacq.* 1959-2 C.B. 8-9, *nonacq. withdrawn and acq.* 1962-2 C.B. 5-6, *acq. withdrawn and nonacq.* 1976-2 C.B. 3-4, and *nonacq. withdrawn in part and acq. in part* 1982-2 C.B. 2. There the Tax Court concluded that allowances that a milk producer paid to buyers lowered the sales price of the milk for income tax purposes. The court held that only the net price was includable in the seller's gross income, even though the discounts were illegal. The court stated:

> It does not follow, of course, that all allowances, discounts, and rebates made by a seller of property constitute adjustments to the selling prices. Terminology, alone, is not controlling; and each type of transaction must be analyzed with respect to its own facts and surrounding circumstances. Such examination may reveal that a particular allowance has been given for a separate consideration -- as in the case of rebates made in consideration of additional purchases of specified quantity over a specified subsequent period; or as in the case of allowances made in consideration of prepayment of an account receivable, so as to be in effect a payment of interest. The test to be applied, as in the interpretation of most business transactions, is: What did the parties really intend, and for what purpose or consideration was the allowance actually made? Where, as here, the intention and purpose of the allowance was to provide a formula for adjusting a specified gross price to an agreed net price, and where the making of such adjustment was not contingent upon any subsequent performance or consideration from the purchaser, then, regardless of the time or manner of the adjustment, the net selling price agreed upon must be given recognition for income tax purposes. 26 T.C. at 716-717.

The Internal Revenue Service has issued administrative guidance concluding that payments received that constitute adjustments to the purchase price are not includible in gross sales. *See, e.g.,* Rev. Rul. 84-41, 1984-1 C.B. 130 (manufacturer's rebate received by an automobile dealer represents a trade discount and should be treated as a reduction in the cost of the automobile purchased, and not as an item of gross income).

Timing of Income

The Internal Revenue Service has issued administrative guidance addressing the timing of payments of a co-operative advertising allowance by a taxpayer using the accrual method of accounting. *See* Rev. Rul. 98-39, 1998-2 C.B. 198. The ruling notes that the agreement under consideration required the provision of advertising services. The ruling concludes that the performance of the cooperative advertising services is the event that establishes the Vendor’s liability under the all events test under § 461 of the Code and fixes the Retailer’s right to income under § 451.

Section 471

Section 471 of the Code provides that whenever in the opinion of the Secretary the use of inventories is necessary in order to determine the income of any taxpayer, inventories shall be taken by such taxpayer 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 the income.

For a retailer, § 1.471-3(b) of the regulations defines cost for merchandise purchased since the beginning of the taxable year as the invoice price less trade or other discounts. Trade discounts, which may vary depending upon volume, quantity

purchases, or other factors established by the vendor, are properly treated as adjustments to the purchase price of goods acquired from a vendor. *See* Rev. Rul. 84-41.

As noted above, in *Pittsburgh Milk*, the Tax Court 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. However, if an allowance is contingent upon performance of services by the purchaser, the allowance is not a trade or other discount. *Pittsburgh Milk*, 26 T.C. at 717. Accordingly, any payment, reduction in any amount owed to a vendor by a retailer for prior purchases, or credit issued by a vendor to a retailer for future purchases that represents compensation for services performed, or to be performed, would be a separate item of gross income under § 61 of the Code and not a trade or other discount for purposes of § 1.471-3(b) of the regulations that reduces the cost of merchandise purchases.

Section 199

Section 199(a)(1) of the Code allows a deduction equal to 9 percent (3 percent in the case of taxable years beginning in 2005 or 2006, and 6 percent in the case of taxable years beginning in 2007, 2008, or 2009) of the lesser of (A) the qualified production activities income (QPAI) of the taxpayer for the taxable year, or (B) taxable income (determined without regard to § 199) for the taxable year.

Section 199(c)(1) of the Code defines QPAI for any taxable year as an amount equal to the excess (if any) of (A) the taxpayer's DPGR for such taxable year, over (B) the sum of (i) the CGS that are allocable to such receipts; and (ii) other expenses, losses, or deductions (other than the deduction under § 199) that are properly allocable to such receipts.

Section 199(c)(4)(A)(i)(I) of the Code defines DPGR to mean the taxpayer's gross receipts that are derived from any lease, rental, license, sale, exchange, or other disposition of qualifying production property (which includes tangible personal property) that was manufactured, produced, grown, or extracted (MPGE) by the taxpayer in whole or in significant part within the United States.

Sections 1.199-3(c) and 1.199-4(b)(1) of the regulations require taxpayers to determine gross receipts and CGS using the same method of accounting that taxpayers use for federal income tax purposes for the taxable year.

Section 1.199-3(i)(5)(i) of the regulations provides that, except as provided in § 1.199-3(i)(5)(ii), gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of qualifying production property, a qualified film, or utilities do not include advertising income and product-placement income.

Gross receipts from advertising are generally non-DPGR under § 1.199-3(i)(5)(i) of the regulations because the receipts are derived from providing a service. Section 1.199-3(i)(5)(ii), however, provides an exception allowing advertising related gross receipts to qualify as DPGR in cases of certain tangible personal property.

Section 1.199-3(i)(5)(ii) of the regulations provides that a taxpayer's gross receipts that are derived from the disposition of newspapers, magazines, telephone directories, periodicals, and other similar printed publications that are MPGE in whole or in significant part within the United States include the advertising income from advertisements placed in those media, but only if the gross receipts, if any, derived from the disposition of the newspapers, magazines, telephone directories, or periodicals are (or would be) DPGR.

Tax Treatment of Allowances

The proper federal income tax treatment of Allowances depends on the facts and circumstances of each case, including the language of Agreements between Vendors and Retailers. If the purpose and intent of the Allowance is to compensate the Retailer for advertising services, then the Allowance is a separate item of gross income for purpose of § 61. If the Allowance is a separate item of gross income under § 61, the Allowance may be included in DPGR under § 199 of the Code if the flyers fit within the advertising exception in §1.199-3(i)(5)(ii) of the regulations. However, if the purpose and intent of the Allowance is to reach an agreed upon price for the Retailer's products and is not compensation for services, then the Allowance is a purchase price adjustment and is not a separate item of gross income for purposes of § 61 and, as such, may not be included in DPGR under § 199.

The following examples illustrate the proper treatment of Allowances for federal income tax purposes under stated facts based on the contracts provided. In each example the Vendor does not include the Allowance in income for financial reporting purposes, but rather reduces its CGS by the Allowance. However, financial reporting is not controlling for federal income tax purposes.

Example 1: Retailer A and Vendor A enter into Agreement A. Under Agreement A, Retailer A is required to perform advertising services for Vendor A. Specifically, Retailer A will receive an Allowance for including specifically described advertisements of Vendor A's products (the advertised products) in Retailer A's weekly flyer. Retailer A is required to comply with Vendor A's advertising policies and procedures in order to receive the Allowance. The amount of the Allowance is calculated based on a percentage of Retailer A's purchase costs of the advertised products during a stated period. The Allowance is a reasonable amount in relation to the advertising services Vendor A performs. Under these facts and circumstances, even though the amount of the Allowance is calculated by reference to the cost of advertised products purchased by Retailer A, the purpose and intent of the Allowance is to compensate Retailer A for providing advertising services for Vendor A, and, therefore, the Allowance is treated as

a separate item of gross income under § 61 of the Code for the performance of advertising services.

Assume that in Year 1 Vendor A makes a payment of a $5 Allowance to Retailer A under Agreement A. Before receipt of the $5 Allowance, Retailer A's Gross Receipts from the sale of the advertised products is $100, its cost for the products sold is $20, and its total cost to produce and distribute the flyer is $25.
Under these facts, for federal income tax purposes, the $5 Allowance is treated as a separate item of gross income under § 61 of the Code for the performance of advertising services. Retailer A's gross income from placement of Vendor A's products in Retailer A's flyers is $5. Retailer A's gross income from the sale of the advertised products is $80 ($100 gross receipts - $20 CGS). Retailer A's taxable income, before application of § 199, is $60 ($80 gross income from sales of the advertised products + $5 advertising service income - $25 deductible expense).

Because the Allowance is a separate item of gross income for purposes of § 61, it must be characterized for purposes of § 199. For purposes of § 199, the $5 Allowance is advertising income from Retailer A's performance of advertising services. Gross receipts from advertising are generally non-DPGR under § 1.199-3(i)(5)(i) of the regulations because the receipts are derived from providing a service. Section 1.199-3(i)(5)(ii), however, provides an exception allowing gross receipts derived from advertising to qualify as DPGR in cases of certain tangible personal property. Under these facts, the flyers are "other similar publications" under § 1.199-3(i)(5)(ii), and thus, Retailer A's gross receipts derived from placing Vendor A's advertisements in the flyers qualify as DPGR if Retailer A meets all other applicable requirements of § 199. Therefore, assuming Retailer A meets all other applicable requirements of § 199, the $5 Allowance is included in DPGR under § 199.

Example 2: Retailer B and Vendor B enter into Agreement B. Under Agreement B, Retailer B is required to perform advertising services for Vendor B. Specifically, Retailer B will receive a flat rate Allowance for including specifically described advertisements of Vendor B's products (the advertised products) in Retailer B's weekly flyer. Retailer B is required to comply with Vendor B's advertising policies and procedures in order to receive the Allowance. The Allowance is not calculated based on Retailer B's purchase costs of the advertised products, and Retailer B is not required to purchase any of the advertised products. The Allowance is a reasonable amount in relation to the advertising services Vendor B performs. Under these facts and circumstances, the purpose and intent of the Allowance is to compensate Retailer B for providing advertising services for Vendor B, and, therefore, the Allowance is treated as a separate item of gross income under § 61 of the Code for the performance of advertising services.

Assume that in Year 1 Vendor B makes a payment of a $5 Allowance to Retailer B under Agreement B. Before receipt of the $5 Allowance, Retailer B's Gross Receipts

from the sale of the advertised products is $100, its cost for the products sold is $20, and its total cost to produce and distribute the flyer is $25.
Under these facts, for federal income tax purposes, the $5 Allowance is a separate item of gross income under § 61 of the Code for the performance of advertising services. Retailer B's gross income from placement of Vendor B's products in Retailer B's flyers is $5. Retailer B's gross income from the sale of the advertised products is $80 ($100 gross receipts - $20 CGS). Retailer B's taxable income, before the application of § 199, is $60 ($80 gross income from sales of the advertised products + $5 advertising service income - $25 deductible expense).

Because the Allowance is a separate item of gross income for purposes of § 61, it must be characterized for purposes of § 199. For purposes of § 199, the $5 Allowance is advertising income from Retailer B's performance of advertising services. Gross receipts from advertising are generally non-DPGR under § 1.199-3(i)(5)(i) of the regulations because the receipts are derived from providing a service. Section 1.199-3(i)(5)(ii), however, provides an exception allowing gross receipts derived from advertising to qualify as DPGR in cases of certain tangible personal property. Under these facts, the flyers are "other similar publications" under § 1.199-3(i)(5)(ii), and thus, Retailer B's gross receipts derived from placing Vendor B's advertisements in the flyers qualify as DPGR if Retailer B meets all other applicable requirements of § 199. Therefore, assuming Retailer B meets all other applicable requirements of § 199, the $5 Allowance is included in DPGR under § 199.

Example 3. Retailer C and Vendor C enter into Marketing Agreement C. Retailer C is not required to perform any specific services for the benefit of Vendor C, and Vendor C does not expect Retailer C to perform any specific services. Under the terms of Marketing Agreement C, Retailer C will receive an Allowance based on a percentage of the purchase costs of Vendor C's products. Under Agreement C, the purpose and intent of the Allowance is to reduce the cost of the products Retailer C purchases from Vendor C.

Assume that in Year 1 Vendor C makes a payment of $5 to Retailer C under Marketing Agreement C. Before receipt of the $5 Allowance, Retailer C's cost for the products it purchases from Vendor C is $20.

Under these facts and circumstances, for federal income tax purposes, the $5 Allowance is a purchase price adjustment that reduces the cost of the products Retailer C purchases and is not a separate item of gross income under § 61 of the Code. Retailer C's net cost for the products it purchases is $15. Because the $5 Allowance is not a separate item of gross income for purposes of § 61 of the Code, it is not included in DPGR under § 199.

Please call J. Peter Baumgarten at (202) 622-4920 if you have any questions on § 61, John R. Faron at (202) 622-4930 for questions on § 471, and James A. Holmes at (202) 622-3040 for questions on § 199.