

Part I

Section 61.--Gross Income Defined

26 CFR 1.61-3: Gross income derived from business
(Also § 162; 1.162-1.)

Rev. Rul. 2005-28

ISSUE

Are Medicaid Rebates incurred by a pharmaceutical manufacturer purchase price adjustments that are subtracted from gross receipts in determining gross income, or ordinary and necessary business expenses that are deductible from gross income under § 162 of the Internal Revenue Code?

FACTS

M, who uses an accrual method of accounting and files returns on a calendar year basis, manufactures and sells prescription drugs. In 1992, *M* entered into a “Rebate Agreement” with the Department of Health and Human Services (HHS) pursuant to the Medicaid Rebate Program established by the Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388 (1990) (the Act).

The Medicaid Rebate Program is designed to reduce the cost of drugs paid for by the Medicaid Program and to increase Medicaid beneficiaries’ access to prescription

drugs. Under the Act, pharmaceutical manufacturers must sign a “Rebate Agreement” with HHS (who acts on behalf of each State Medicaid Agency) to gain access to the Medicaid-funded segment of the pharmaceutical market.

The Rebate Agreements require pharmaceutical manufacturers to pay Medicaid Rebates directly to each State Medicaid Agency. A Medicaid Rebate is a portion of the price paid by State Medicaid Agencies to retailers for covered outpatient drugs dispensed to Medicaid beneficiaries. The amount of the Medicaid Rebate is designed to ensure that the Medicaid Program is charged no more for covered outpatient drugs than any other purchaser. See H.R. Rep. No. 101-881 at 96 (1990).

In 2005, the following events occur: (1) *M* sells *Product D*, a prescription drug, to *W*, a wholesaler; (2) *W* sells *Product D* to *R*, a retail pharmacy; (3) *R* dispenses *Product D* to individual *A*, a Medicaid beneficiary, and then files a reimbursement claim with *S*, a State Medicaid Agency; (4) *S* approves the claim and then reimburses *R* for the cost of *Product D* plus a dispensing fee; and (5) *M* pays a Medicaid Rebate to *S* pursuant to the Rebate Agreement.

LAW AND ANALYSIS

Section 61(a) provides that, except as otherwise provided, gross income means all income from whatever source derived. Section 1.61-3(a) of the Income Tax Regulations provides that in a manufacturing, merchandising, or mining business, "gross income" means the total sales, less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources.

Section 162 allows as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Section 1.162-1(a) provides, in part, that business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business.

In *Pittsburgh Milk Co. 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, the Tax Court addressed whether allowances, discounts, or rebates paid by a milk producer to certain purchasers of its milk, in willful violation of state law, are adjustments to the purchase price of the milk resulting in a reduced sales price, or ordinary and necessary business expenses under § 162 (in which case no deduction would be allowed under the rules of § 162(c)). The court reasoned that for income derived from the sale of property, in determining gain, the amount realized must be based on the actual price or consideration for which the property was sold and not on some greater price for which it possibly should have been, but was not, sold. The court focused on the facts and circumstances of the transaction, what the parties intended, and the purpose or consideration for which the allowance was made. The court found that the allowances 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 actually sold. Thus, under *Pittsburgh Milk*, where a payment is made from a seller to a purchaser, and the purpose

and intent of the parties is to reach an agreed upon net selling price, the payment is properly viewed as an adjustment to the purchase price that reduces gross sales.

In contrast, in *United Draperies, Inc. v. Commissioner*, 41 T.C. 457 (1964), *aff'd*, 340 F.2d 936 (7th Cir.), *cert. denied*, 382 U.S. 813 (1965), the Tax Court held that a drapery manufacturer could not exclude from income kickbacks paid to employees of the companies that purchased the taxpayer's draperies. The court noted that the kickbacks were made to employees of its customers and were "independent of its agreement with its purchasers fixing the selling price of the products sold," and that "[t]hese amounts were paid for a consideration separate from the selling price of its products, namely these employees sending the business of their employers to petitioner" *United Draperies* at 465.

Rev. Rul. 76-96, 1976-1 C.B. 23, addresses the tax treatment of rebates paid by an automobile manufacturer to retail customers. The manufacturer offered rebates of a set amount to retail customers who independently negotiated at arm's length with one of the manufacturer's dealers to arrive at a purchase price for a new car. The ruling holds that the rebates reduce the purchase price of the cars and are not includible in the retail customer's gross income. The ruling further holds that the manufacturer may deduct the rebates as ordinary and necessary business expenses under § 162.

The Medicaid Rebate is paid by *M* to *S* pursuant to the terms of the rebate agreement. Under the purpose and intent test of *Pittsburgh Milk*, the Medicaid Rebate is made with the purpose and intent of reaching an agreed upon net selling price, and is negotiated and agreed to before the sale to *W* takes place.

HOLDING

Medicaid Rebates incurred by a pharmaceutical manufacturer are purchase price adjustments that are subtracted from gross receipts in determining gross income.

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 76-96 is suspended in part. Whether a rebate of the type described in Rev. Rul. 76-96 is an ordinary and necessary business expense or, alternatively, is a reduction of gross receipts in determining gross income, is an issue under reconsideration. Accordingly, the conclusion of Rev. Rul. 76-96 that rebates made by the manufacturer are ordinary and necessary business expenses deductible under § 162 is suspended pending the Service's reconsideration of the issue and publication of subsequent guidance. Therefore, the Service will not apply, and taxpayers may not rely on, this conclusion while it is being reconsidered.

DRAFTING INFORMATION

The principal author of this revenue ruling is Susie K. Bird of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, contact Ms. Bird on (202) 622-4950 (not a toll-free call).