

INTERNAL REVENUE SERVICE  
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE-MIS No.: TAM-128296-04/CC:ITA:B01

Director  
LMSB:NRC Houston

Taxpayer's Name:  
Taxpayer's Address:

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

LEGEND:

Taxpayer =  
Taxpayer Consolidated Group =

X =  
Y =  
Sub =

Products =  
Percent 1 =  
Percent 2 =

\$a =  
\$b =  
\$c =  
\$d =  
\$e =

Date =

This responds to your request for technical advice regarding Taxpayer, which claims a loss on sales of its accounts receivable (receivables) at a discount to its controlled, but not consolidated, subsidiary, Sub. A portion of the discount reflects the fact that Taxpayer sells most goods on a "sale or return" basis, under which a receivable is cancelled if a retailer returns an item. Although Sub bears the cost of cancellation of purchased receivables, without recourse against Taxpayer, Taxpayer retains the right to the returned goods.

#### ISSUES:

1. Whether the anti-avoidance rule in § 1.267(f)-1(h) of the Income Tax Regulations defers Taxpayer's loss.
2. Whether the anti-avoidance rule in § 1.1502-13(h) defers the loss.
3. Whether all or part of the loss is deferred because the sale is not a closed and completed transaction under §§ 165(a) and 1001 of the Internal Revenue Code.
4. Whether, in these circumstances, Taxpayer sells to Sub only some of the rights in the receivables, resulting in an allocation of basis that would reduce the amount of the loss on the sale under §§ 1011 and 165(b).

#### CONCLUSIONS:

1. The transaction falls within the "factoring exception" in § 1.267(f)-1(f), and the anti-avoidance rule in § 1.267(f)-1(h) does not apply.
2. The anti-avoidance rule set forth in § 1.1502-13(h) does not apply.
3. The sale of the receivables is a closed and completed transaction under §§ 165(a) and 1001 with respect to the rights that are transferred.
4. In these particular circumstances, Taxpayer sells to Sub only a portion of the rights in the receivables (primarily, the right to be paid in cash), while retaining others (primarily, the right to the return of goods if sales are cancelled). Therefore, it is appropriate and necessary to make an equitable allocation of basis based on the relative fair market value of the rights transferred and the rights retained, an allocation that would reduce the amount of loss on the sale of the receivables under § 165(b).

## FACTS:

Taxpayer files a consolidated return for federal income tax purposes as a member of the Taxpayer Consolidated Group; it uses an overall accrual method of accounting and a perpetual inventory method.

Taxpayer manufactures and sells Products and other merchandise to retailers, almost always on credit. For credit sales, Taxpayer conveys legal title to the goods to the retailers and creates an account receivable for the sale. Taxpayer's business is typical in the Products industry, in that Taxpayer produces and supplies its customers with inventory at the level necessary to ensure that there is a sufficient supply of Products and other items to meet retailer customer needs and expectations. Typically, unsold merchandise remains because of the way Taxpayer stocks its retailer customers.

Approximately % of Taxpayer's sales are Products. Generally, only Products (and most ) are sold on a sale-or-return basis. Products account for approximately % of returns. Under the sale-or-return contract between Taxpayer and the retailer, the retailer may return the goods within without cause, and upon their return, Taxpayer either refunds the purchase price or, in most cases, cancels (credits) the related receivable.

Taxpayer destroys nearly all returned Products, some of them on-site at the retailer, for two primary reasons. First, Taxpayer seeks to prevent the dilution of its market and reputation that would result from the bulk resale of Products (among other factors, resold Products might be damaged). Second, generally it is not economically feasible for Taxpayer to rework the Products for resale; typically, the cost to do so would exceed the cost to reproduce the Products. Of the returned goods that are not destroyed (mostly non-Products), approximately are returned to inventory and are donated to charity.

For financial accounting purposes, concurrent with the recording of sales revenue Taxpayer accrues offsets for estimated returns, bad debts, volume discounts, damaged merchandise, and other miscellaneous allowances. These accruals typically amount to approximately Percent 1 of the receivables generated.<sup>1</sup> Of this amount, estimated returns constitute approximately Percent 2, based on historical averages.

Taxpayer determined that setting up a factoring subsidiary would, among other business and tax benefits, achieve cost savings through consolidation of its collection operations and help Taxpayer obtain financing from external lenders through securitizing the receivables.

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<sup>1</sup> Other, "non-dilutional" credits, in the nature of promotional expenses, are not included in this amount.

Accordingly, on or around Date, Taxpayer formed X, a wholly owned subsidiary. Taxpayer contributed its customer-service department to X in exchange for X's stock. X then formed Y, a foreign corporation, by contributing \$a in exchange for % of Y's stock. Next, X and Y formed Sub, a domestic corporation. X contributed the customer-service department and \$b in exchange for stock constituting % of the value and % of the voting power in Sub. Y contributed \$a in exchange for the remaining % of the value and % of the voting power in Sub. As a result of these transactions, Sub was a member of the same controlled group as Taxpayer, but remained outside of Taxpayer Consolidated Group because it did not satisfy the "80% vote and value" test of § 1504(a)(2).

Finally, Taxpayer sold its receivables to Sub, at a discount of approximately Percent 1, in return for cash of \$c and an unsecured note for \$d. To arrive at the fair market value of the receivables, the invoiced amount of the receivables, \$e, was discounted to reflect the historical rate of returned merchandise, Percent 2, and the issuance of credit memos. Thereafter, Taxpayer entered into weekly sales of its receivables to Sub at a discount. The sale of the receivables to Sub is without recourse (meaning that Sub has no right to reimbursement from Taxpayer for receivables that are not collected in full). In addition, the agreement between Taxpayer and Sub provides that Sub has no rights in returned merchandise.<sup>2</sup> Taxpayer was able to securitize its receivables, using this structure to obtain outside financing.<sup>3</sup>

Prior to Date, for tax purposes, Taxpayer accrued the full sales price of goods sold to retailers, less cost of goods sold, as gross income in the year of the sale.<sup>4</sup> Taxpayer recognized adjustments for returns, bad debts, discounts, and similar allowances when they occurred. After establishing Sub in Date, Taxpayer continued to accrue the full sales price of goods sold to retailers, but also recognized losses under § 165 on the initial and ongoing factoring of the receivables to Sub of approximately Percent 1, approximately Percent 2 of which was attributable to estimated returns. On audit, the LMSB examination team (Examination) proposes to defer all or a portion of these losses.

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<sup>3</sup> We do not know the details of the borrowing transaction. If the separate sale and borrowing transactions were found to be parts of an overall integrated borrowing transaction under the step transaction doctrine, then the intermediate sale would not be respected and there would be no loss under § 165. This issue was not raised and is not addressed in this memorandum.

<sup>4</sup> Though the retailer's right of return exists, for tax purposes a sale-or-return transaction (unlike a consignment) is a completed transaction upon the transfer to the retailer. See n. 9 and related discussion below. Taxpayer is not covered by § 458, which permits certain taxpayers to treat actual returns as having occurred in the year of the original sale. Taxpayer did not mark its receivables to market under § 475 as in effect prior to the enactment of § 475(c)(4).

## LAW AND ANALYSIS:

Issue 1: Whether the anti-avoidance rule in § 1.267(f)-1(h) applies.

Section 267(a)(1) generally disallows a loss on certain sales or exchanges of property between related parties. Section 267(f)(2) generally requires corporations that are members of the same controlled group to defer losses on sales or exchanges between members until the property is transferred outside the controlled group and there would be loss recognition under consolidated return principles or until such other time as prescribed in regulations. For this purpose, a controlled group is defined by reference to § 1563(a), using 50 percent instead of 80 percent as the standard for control of both vote and value. § 267(f)(1).

The regulations promulgated under § 267(f) were revised in 1995 to harmonize with revisions to the intercompany transaction regulations of § 1.1502-13. See T.D. 8597, 1995-2 C.B. 147, 154-155. Thus, § 1.267(f)-1 uses the nomenclature and adopts many of the concepts underlying § 1.1502-13. Section 1.267(f)-1(a)(1) specifies that the purpose of the regulations under § 267(f) is to prevent members of a controlled group from taking into account a loss or deduction solely as the result of a transfer of property between a selling member (S) and a buying member (B). Section 1.267(f)-1(a)(2) provides that S's loss or deduction from an intercompany sale is taken into account under the timing principles of § 1.1502-13, treating the intercompany sale as an intercompany transaction.<sup>5</sup>

Section 1.267(f)-1(f) sets forth an exception to the general deferral rule of § 1.267(f)-1(a) in the case of certain sales of receivables to controlled group members (the "factoring exception"). Section 1.267(f)-1(f) provides that if S acquires a receivable from the sale of goods or services to a nonmember at a gain, and S sells the receivable at fair market value to B, any loss or deduction of S from its sale to B is not deferred to the extent the loss does not exceed S's income or gain from the sale to the nonmember that has been taken into account at the time the receivable is sold to B.<sup>6</sup>

Thus, to qualify under the factoring exception, the following requirements must be met: (1) S must acquire the receivable from a sale to a nonmember at a gain; (2) S and B must be members of the same controlled group (but not the same consolidated group)<sup>7</sup>;

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<sup>5</sup> Section 1.267(f)-1(b)(1) defines an intercompany sale as a sale, exchange, or other transfer of property between members of a controlled group, if it would be an intercompany transaction under the principles of § 1.1502-13. Section 1.1502-13(b)(1)(i) defines an intercompany transaction as a transaction between corporations that are members of the same consolidated group immediately after the transaction.

<sup>6</sup> The factoring exception was added by T.D. 7991, 49 FR 46992 (November 30, 1984). The preamble to T.D. 7991 states that the factoring exception was added in response to language in the Conference Committee Report for the Tax Reform Act of 1984, H.R. Rep. No. 98-861, 98<sup>th</sup> Cong. 2d Sess. 1033 (1984).

<sup>7</sup> The regulations promulgated under § 267(f) specify that they apply in addition to other applicable law, including the intercompany transaction regulations of § 1.1502-13. See § 1.267(f)-1(a)(3). Example 7(c) of § 1.267(f)-1(j) illustrates that when S and B are members of a consolidated group, a loss recognized by S on the sale of a receivable to B is subject to deferral under § 1.1502-13(c); the example concludes that S takes into account its

(3) S's sale of the receivable to B must be for fair market value; and (4) S's loss that is permitted to be taken into account cannot exceed the gain recognized on the underlying sale.

In this case, Taxpayer's sale of the receivables to Sub satisfies the literal requirements of the factoring exception. The first requirement is satisfied because Taxpayer acquired the receivables from sales to third parties on which gains were recognized. Taxpayer concedes that Taxpayer and Sub are members of the same controlled group, so the second requirement is met. Examination does not argue that the sales of the receivables were not for fair market value, so the third requirement is satisfied. With respect to the fourth requirement, based on the information provided, Taxpayer does not appear to have recognized loss on the sale of the receivables in excess of the gain recognized on the underlying sales to third parties.

Examination does not challenge the taxpayer's stated purpose for factoring the receivables. Instead, Examination argues that an adjustment is necessary under the anti-avoidance rule of § 1.267(f)-1(h) because Sub's ownership structure serves no purpose other than to place Sub literally outside the P consolidated group, thereby permitting Taxpayer to qualify under the factoring exception.

Section 1.267(f)-1(h) provides that if a transaction is engaged in or structured with a principal purpose to avoid the purposes of § 1.267(f)-1 (including, for example, by avoiding treatment as an intercompany sale or by distorting the timing of losses or deductions), adjustments must be made to carry out the purposes of § 1.267(f)-1. The parenthetical in § 1.267(f)-1(h) suggests two examples of bad purposes that might lead to application of the anti-avoidance rule.

In this case, it is undisputed that Taxpayer and Sub are members of the same controlled group. Therefore, it follows that Taxpayer's sale of the receivables to Sub constitutes an intercompany sale within the meaning of § 1.267(f)-1(b)(1). Thus, the taxpayer cannot be viewed as having engaged in or structured the transaction with a principal purpose to avoid treatment as an intercompany sale for purposes of § 1.267(f)-1(b)(1).

It also does not appear that the taxpayer is improperly distorting the timing of losses or deductions by the use of this structure. As discussed earlier, the sale of the receivables satisfies the requirements of § 1.267(f)-1(f), which represents an exception to the general deferral rule of § 1.267(f)-1(a). Moreover, Examination does not challenge the taxpayer's business purpose for factoring the receivables. In addition, the limited information provided (including the fact that Sub on its formation received a customer - service department that included personnel to service the receivables) tends to support the substance of the sale.

Accordingly, the transaction falls within the factoring exception in § 1.267(f)-1(f), and an adjustment under § 1.267(f)-1(h) is not warranted in this case.

Issue 2. Whether the anti-avoidance rule in § 1.1502-13(h) applies.

Examination argues in the alternative that if the § 1.267(f)-1(h) anti-avoidance rule does not apply, then the § 1.1502-13(h) anti-avoidance rule should apply in this case because the taxpayer has structured the sale of the receivables so as to avoid the deferral regime of § 1.1502-13.

Section 1.1502-13(h)(1) provides that if a transaction is engaged in or structured with a principal purpose to avoid the purposes of § 1.1502-13 (including, for example, by avoiding treatment as an intercompany transaction), adjustments must be made to carry out the purposes of this section. The regulations define an intercompany transaction as a transaction between corporations that are members of the same consolidated group immediately after the transaction. § 1.1502-13(b)(1)(i).

In discussing the anti-avoidance rule of § 1.1502-13(h), the preamble to the final intercompany transaction regulations states that “transactions that take place indirectly between members but which are not intercompany transactions ... will be analyzed to determine whether they are substantially similar” to intercompany transactions, in which case the anti-avoidance rule might be applicable. See T.D. 8597, 1995-2 C.B. 147, 154. Example 5 of § 1.1502-13(h)(2) involves S’s sale of a factory to a nonmember, followed by S’s long-term leaseback of the factory pursuant to a plan to take into account unrealized gain while continuing to operate the factory. The example concludes that the transaction is not subject to an adjustment under § 1.1502-13(h)(1).

In this case, although Taxpayer and Sub are members of the same controlled group, at no time are they both members of the same consolidated group. Because Taxpayer’s sale of the receivables to Sub is not the sort of transaction that the anti-avoidance rule of § 1.1502-13(h) was intended to reach, an adjustment is not warranted.<sup>8</sup>

Issue 3. Whether the receivables sale is a closed and completed transaction under § 165(a).

Section 165(a) of the Code allows a deduction for any loss sustained during the taxable year and not compensated for by insurance or otherwise. The loss must be: (a) a bona fide loss; (b) evidenced by a closed and completed transaction; (c) fixed by identifiable events; and (d) with certain exceptions, sustained in the year claimed. § 1.165-1(b), (d). Ordinarily, a loss is not sustained if the taxpayer has a reasonable prospect of recovery. § 1.165-1(d)(2).

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<sup>8</sup> The conclusions under Issues 1 and 2 assume that Sub was not in fact part of the Taxpayer Consolidated Group. This issue was not raised and is not addressed in this memorandum.

Section 1001 provides that gain from the sale of property is the excess of the amount realized from the sale over the adjusted basis of the property and that loss is the excess of the adjusted basis of the property over the amount realized. For federal income tax purposes, a sale occurs when the benefits and burdens of ownership have passed to the purchaser. See Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1237-38 (1981).

Under the "all events" test in §§ 1.446-1(c)(1)(ii) and 1.451-1(a), accrual-basis taxpayers are required to recognize income for federal income tax purposes when all the events have occurred which fix the right to receive the income and the amount of the income can be determined with reasonable accuracy. Similarly, § 461(h) and § 1.461-1(a)(2)(i) provide that, under an accrual method of accounting, a liability is generally taken into account for federal income tax purposes in the tax year in which (1) all the events have occurred that establish the fact of the liability, (2) the amount of the liability can be determined with reasonable accuracy, and (3) economic performance has occurred with respect to the liability.

In the present case, upon the sale of the receivables, all rights arising from the contracts between Taxpayer and the retailers (with the exception of the contingent right to returned goods) pass permanently to Sub. Sub benefits if collections on a receivable exceed its cost, and Sub bears the burden if collections are less than its cost. The fact that certain contingent rights are retained by Taxpayer does not prevent there being a completed sale of the rights that *are* transferred. We conclude that the sale of the receivable is a closed and completed transaction under §§ 1001 and 165—with respect to the rights that are transferred to Sub.

Examination makes several related arguments supporting the position that there has been no sustained loss. Generally, Examination maintains that to the extent goods are returned there is no *bona fide* economic loss in this situation because the determination of losses calls for a practical, not a legal test, see Lucas v. American Code Co., 280 U.S. 445, 449 (1930), and, as a practical matter, the return of an item will restore Taxpayer to the *status quo ante*, reversing any transitory loss it suffered on the sale of the receivable. Arguably, it is premature for Taxpayer to recognize *any* loss on its receivables sales until it is determined whether or not the corresponding merchandise will be returned. But at least, Examination argues, the loss should be deferred to the extent of estimated returns—since, as a practical matter, Taxpayer knew from the outset that approximately Percent 2 of Products would be returned.

In this connection, Examination cites Glenn v. Louisville Trust Co., 124 F. 2d 418 (6th Cir. 1942). In that case a taxpayer incurred a loss in 1930 from its agent's unauthorized investments in a company, Banco, but recouped part of the loss in 1933 through a settlement in an action against the agent. The Commissioner allowed the loss for 1930 and treated the recovery as income for 1933. The Court determined that the loss was sustained in 1933:

Whether we say that the original investment by the [agent] and the recovery against it are but related phases of a single transaction ... or whether we say that [the principal] never owned Banco shares since his agent or trustee was never authorized to purchase them on his behalf and he had the right to claim from it a return of his money and securities, the result is the same.

124 F.2d at 420. See also Hearst Corp. v. United States, 13 Cl. Ct 178 (1987) (no loss when TV station switched network affiliation); Fender v. United States, 577 F.2d 934 (5th Cir. 1978) (no loss on sale of bonds with plan to repurchase); Shoenberg v. Commissioner, 77 F.2d 446 (8th Cir. 1935) (no loss on sale of stock with plan to repurchase substantially identical stock); Rev. Rul. 2000-12, 2000-1 C.B. 744, Situation 1 (no loss on planned sale of Note 1 offset by unrealized gain on Note 2).

An alternative version of Examination's argument is that, in substance, only those receivables for goods that are eventually resold to customers by the retailer are actually transferred to Sub; one can view the receivables that are "satisfied" by return of the goods as never having been sold to Sub. Thus, the argument runs, we must wait until the items are resold, returned, or destroyed to determine which corresponding receivables have been sold to Sub and which have not.

The difficulty with Examination's arguments, in our view, is that they are incompatible with the federal income tax treatment of the original sale-or-return transaction. As noted before, when an item is sold on a sale-or-return basis, it is settled that there is a closed transaction at that point, despite the fact that there is a quantifiable probability that the item will be returned and the sale cancelled.<sup>9</sup> For financial accounting purposes, sellers are generally required to reflect the probability of returns, through the use of a reserve or otherwise. For tax purposes, however, a seller generally can neither reduce income nor accrue an offsetting reserve deduction to reflect estimated returns.<sup>10</sup> The seller's liability to return the purchase price or cancel a receivable is not fixed unless and until an item is returned. The contingency that the sale might be cancelled is treated for tax purposes as a condition subsequent, to be taken into account if and when it occurs.

Although the authorities cited in the preceding paragraph involved sales at a gain, we see no reason for sales at a loss to be treated differently. Examination's arguments in favor of treating Taxpayer's sale of the receivables at a loss as an open transaction could also be made with respect to Taxpayer's original sales of goods at a gain. When Taxpayer sells goods and receives cash—or, more often, an obligation in the form of a receivable—the cash is subject to refund, or the receivable subject to cancellation, if the item is returned. Moreover, as a practical matter Taxpayer knows with reasonable

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<sup>9</sup> See Challenge Publications, Inc. v. Commissioner, 845 F.2d 1541 (9th Cir. 1988); Record Wide Distributors v. Commissioner, 682 F.2d 204, 206 (8th Cir. 1982); Ertegun v. Commissioner, 531 F.2d 1156 (2d Cir. 1976); J.J. Little & Ives Co. v. Commissioner, T.C. Memo. 1966-68; Rev. Rul. 71-451, 1971-2 C.B. 217.

<sup>10</sup> For the tax treatment of situations in which the buyer disputes liability, see Rev. Rul. 2003-10, 2003-3 I.R.B. 288.

certainty that approximately Percent 2 of those sales will in fact be cancelled.<sup>11</sup> Based on these facts, several arguments for deferring realization and recognition on a sale-or-return transaction could be made: that Taxpayer's right to the sales proceeds is not fixed under §§ 451 and 1001 until it is certain that an item will not be returned; that, in substance, those items that are returned by the retailer were never really sold; that there is a "plan" to reacquire a portion of the sold property; or that the sales are not *bona fide* economic gains and losses because the seller may be returned to the *status quo* when items are returned. However, it is clear that these arguments are not sustainable: under settled law, the possibility, even the probability, of a return is treated as a condition subsequent, not a condition precedent, to the realization and recognition of gain or loss on the original sale.

In the present case, we are not dealing with the sale of the original items at a gain, but rather with the sale of the corresponding receivables at a loss. It would be inconsistent, however, to treat the sale of the original items as a closed transaction, subject to a condition subsequent, while treating the receivables sale as an open transaction, subject to a condition precedent, when the contingency—the possibility of returns—is the same for both transactions. In both the original sale of the goods and the subsequent sale of the receivables, there has been a change in the seller's economic position—economically, sellers prefer completed sales to cancelled sales and do not regard the possibility of returns as a wash. In both cases, recognition of gain—or loss—is appropriate.

Accordingly, based on the information submitted, we conclude that Taxpayer's sale of the receivables is a closed and completed transaction under § 165—with respect to the rights that are transferred. The next section considers the *amount* of that loss, in view of the fact that in this particular case not all rights arising from Taxpayer's sales contracts with retailers are transferred to Sub.

Issue 4. Whether the receivables sale is a partial sale requiring an allocation of basis and a reduction in the amount of the loss under § 165(b).

Section 165(b) provides that the basis for determining the amount of the deduction for any loss is the adjusted basis provided in § 1011 for determining the loss from the sale or other disposition of property. Section 1011(a) provides that adjusted basis is the basis generally determined under § 1012, adjusted as provided in § 1016. Under § 1012, the basis of property is generally its cost.

Taxpayer's sale-or-return agreements with retailers establish certain mutual rights and obligations. Taxpayer, in return for the transfer of goods to the retailer, receives consideration in the form of cash—or, for a credit sale, an obligation from the retailer to pay the purchase price. In addition, if the retailer cancels the sale, the retailer is entitled

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<sup>11</sup> Similarly, it knows that a certain percentage of receivables will not be collected, in whole or in part, because of credit risk, subsequent discounts, etc.

to a refund or the cancellation of its obligation to pay, and Taxpayer is entitled to the return of the goods, or their destruction if Taxpayer chooses.

As a result of the sale of goods to a retailer on credit, Taxpayer acquires a receivable with a basis in its hands. In the present case, however, Examination asserts that when Taxpayer sells its receivables to Sub, it does not transfer all its rights under its agreements with the retailers. Rather, Taxpayer transfers the right to be paid in cash, if the retailer does not cancel the sale, but retains the right to the return of the sold goods, if the retailer does cancel. Accordingly, Examination argues, it is necessary to allocate Taxpayer's overall basis in its rights under the retail sale-or-return agreement between the rights transferred and the rights retained. We agree.

When part of a larger property is sold, the cost or other basis of the entire property must be equitably apportioned among the several parts, and the gain or loss sustained on the part of the entire property sold is the difference between the selling price and the cost or other basis allocated to that part. See § 1.61-6(a). An equitable allocation is one that is based upon the relative fair market values of the portion sold and the portion retained. Fairfield Plaza, Inc. v. Commissioner, 39 TC 706, 712 (1963), acq., 1963-2 C.B. 3.

This principle applies to the present situation. If, for example, Taxpayer transferred the right to be paid in cash to Sub, as it does, and the right to any returned items to another party, presumably an allocation of basis would be appropriate; there is no reason to treat the situation differently because Taxpayer itself retains the right to returned items.

Moreover, an allocation of basis helps address a distortion of income that occurs under Taxpayer's approach, which effectively splits the two components of profit—amount realized, or gross revenue; and basis, or cost of goods sold—and often places the tax effect of a product return on those components in two separate tax periods. A case decided under § 458, Hachette USA, Inc. v. Commissioner, 105 T.C. 234 (1995), aff'd, 87 F.3d 43 (2d Cir. 1996), illustrates this point. Section 458 provides relief for taxpayers in certain industries by permitting them to treat specified returns that occur in the year after the original sale (Year 2) as having occurred in the year of the sale (Year 1). In Hachette, the taxpayer challenged the validity of § 1.458-1(g), a regulation that requires taxpayers who reflect a Year 2 return by reducing sales revenue in Year 1 to make corresponding negative adjustments to Year 1 cost-of-goods-sold (that is, as though the goods had been returned to inventory). Under the regulation, the overall Year 1 adjustment reverses the Year 1 profit on the original sale, not just the gross revenue on the original sale. The taxpayer's practice was to reflect the reduction in sales revenue in Year 1 but recognize the offsetting cost-of-goods-sold adjustment in Year 2. Upholding the regulation, the Tax Court found that it was supported by generally accepted accounting principles, which require that a reserve for estimated returns take into account "symmetrical reductions" in both sales revenue and cost-of-goods-sold. Similarly, the court felt, the regulation was consistent with the tax principle of clear reflection of income under §§ 446 and 471, because by splitting the components of

profit, the taxpayer's practice resulted in a mismatching of income and related expenses. See 105 T.C. at 246-48.

Taxpayer's position here potentially achieves a mismatch similar to the one addressed in Hachette, since the loss on the sale of the receivables to Sub reflects only the negative impact of estimated returns on gross revenue. No right to, or credit for, returned goods is transferred to Sub; therefore, the offsetting reduction in cost-of-goods-sold arising from the right to the corresponding returned goods is recognized by Taxpayer when goods are actually returned, often in Year 2. In other words, the Year 1 loss on the sale of the receivables reflects lost gross receipts, not lost profit—a result that distorts income under the reasoning in Hachette and is potentially more favorable than Taxpayer would receive even under § 458. In contrast, Examination's approach, by allocating basis to the right to returned goods retained by Taxpayer, helps address this timing mismatch.<sup>12</sup>

In response to Examination's position on this issue, Taxpayer makes several arguments.

First, Taxpayer asserts that the obligation to make a refund or cancel a receivable under a sale-or-return agreement is a liability, not a right, and thus cannot be an asset to which basis can be allocated. We agree that the possibility of retailer returns, coupled with the obligation to cancel the corresponding receivable, may be a net liability, to the extent that the liability to refund the purchase price exceeds the value of the returned item. However, it is a *net* liability. Under the sales agreement, Taxpayer's obligation to refund or cancel the purchase price is associated with a corresponding right to receive the returned item from the retailer. Once Taxpayer splits that bundle, and transfers to Sub only the contingent liability to cancel the receivable, what remains is a contingent right to returned merchandise, free of any obligation.

Taxpayer argues that if there is a right, it is only contingent, and not within the control of Taxpayer: only the retailer can cancel the sale. We agree. However, the issue here is not whether Taxpayer has a *fixed right*—for example, a right that it must accrue as income under the "all events test" in § 1.451-1(a). Rather, the issue is whether Taxpayer has an *asset*, and many valuable assets are contingent.<sup>13</sup>

Taxpayer argues that the right to returned goods is not an asset because most of the returned items are destroyed. This confuses two issues: whether there is an asset, and, if so, whether that asset has value. Valuation is discussed briefly below. We note that

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<sup>12</sup> In our view, the potential for distortion under Taxpayer's approach exists regardless of the fact that Taxpayer may choose to destroy most Products in Year 2 rather than return them to inventory. This factor is discussed briefly below in the context of valuation.

<sup>13</sup> For example, the rights represented by a legal claim may be contingent, in the sense that—depending in whole or in part on events and contingencies outside a taxpayer's control—the claim may vary in value or even become worthless. Nevertheless, the claim may be a valuable asset to which basis would be allocated in appropriate situations.

even Taxpayer concedes that some of the returned items have value, since it has claimed a charitable contribution deduction for donating them to charity, and Taxpayer has not explained why the right to acquire valuable items for no consideration, even if contingent, is not an asset.

Taxpayer cites to the Uniform Commercial Code (the UCC) for the proposition that an "account receivable," even under a sale-or-return agreement, is defined as a right to receive a cash payment, not to receive cash or goods. Taxpayer also cites case law under the UCC to the effect that under a sale-or-return contract neither the seller of goods nor the assignee of the receivables for those goods has any rights in the sold items in the buyer's hands. Therefore, the argument runs, Taxpayer's retention of the right to returned goods was not a "splitting" of its rights in the receivables that would require basis allocation.

We do not suggest that Taxpayer and Sub have any present rights in *unreturned* goods. The issue here is whether Taxpayer's contract with the retailer provides for rights in *returned* goods, if any, and the case law cited by Taxpayer does not persuade us that a right to returned goods would not ordinarily pass to a receivables purchaser under the UCC.<sup>14</sup> Taxpayer and Sub can, of course, vary what would otherwise occur under the UCC by agreement, specifying that rights to returned goods will not pass to Sub. Arguably, however, that constituted a severing of rights in an "account receivable" that would normally have passed to Sub under the UCC.

But more broadly, the issue here does not turn on definitions or labels derived from commercial law or the UCC. The issue is whether, in substance, Taxpayer transferred to Sub some rights arising from its contracts with retailers and kept others. A sample retailer agreement provided by Taxpayer states: "

. " This right to the merchandise was not transferred to Sub along with the obligation to provide credit for returns. Whether we say that the agreement between Taxpayer and Sub divided an "account receivable," as defined under the UCC, or simply that the agreement divided the bundle of rights established by Taxpayer's retailer agreements, regardless of labels, the result is the same: an allocation of basis is necessary in order to clearly reflect income.<sup>15</sup>

Assuming, as we conclude, that an allocation of basis is necessary, Examination and Taxpayer differ on how to determine the fair market value of the right that is retained by Taxpayer. The determination of fair market value is a highly factual issue that is not

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<sup>14</sup> Under the UCC, the purchaser of a receivable is treated as having a secured interest in any "proceeds" of the account, which would normally include returned goods. See, e.g., UCC § 9-306(1); General Motors v. Third National Bank, 812 S.W.2d 593 (Tenn. Ct. App. 1991).

<sup>15</sup> Taxpayer also questions how it would recover basis allocated to the right to returned goods. This issue was not raised in the request for advice and is beyond the scope of this memorandum; however, we note that any benefit or loss associated with the right to returned goods will be realized as and when the goods are either resold, returned, or destroyed.

appropriate for resolution in technical advice. However, certain observations can be made to provide guidance in making the determination. Generally, fair market value is defined as the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. See § 1.170A-1(c)(2). For a description of the three established valuation methods (replacement cost; comparable sales; and discounted income projections), as applied to inventory, see Rev. Proc. 2003-51, 2003-2 C.B. 121.<sup>16</sup>

Examination argues that the value of the right to returned goods must necessarily be equal to Percent 2 of the wholesale price of the goods, since that amount represents estimated returns, and the closest "comparable sale" for valuing returned goods is the original sale of the goods themselves. Examination also points out that Taxpayer used a value close to wholesale price in determining the charitable deduction it took for donating returned goods. Taxpayer, in contrast, argues that the value of the right is zero, since most of the goods are destroyed. Alternatively, Taxpayer argues that the value must be equal, at most, to the original cost basis of the goods, on the ground that this represents their replacement cost—the use of which, Taxpayer maintains, is mandated by the inventory regulations under § 471. See § 1.471-4(a).

We cannot conclude that any of these positions necessarily equate to the value of the right to returned Products or other returned items for present purposes. Examination's position overlooks certain factors—such as the fact that returned goods may not be in new condition. Moreover, on audit Examination has challenged the values Taxpayer used in valuing returned goods for charitable deduction purposes. On the other hand, Taxpayer's assertion that the value of the right is zero because most of the Products are destroyed is not persuasive. The right to control the disposition of property is an asset that could be of value to a willing third-party buyer, and Taxpayer itself acknowledges that it retains the right because it has value to Taxpayer in controlling its market. With respect to Taxpayer's alternative argument that an original cost value is mandated by the § 471 regulations, the issue is what a prospective hypothetical buyer would pay for the right—a factual question that is not governed by the inventory regulations.

Ultimately, the allocation of basis in this case should be resolved on the basis of the acknowledged willing-seller/willing-buyer standard for fair market value.

#### CAVEATS:

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

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<sup>16</sup> While it may be relevant, we do not suggest that Rev. Proc. 2003-51—which concerns the value of inventory, not the value of a right to returned goods, and which deals with a bulk purchase as part of a business—controls the valuation issue here.