Office of Chief Counsel
Internal Revenue Service
Memorandum

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to:

(Large & Mid-Size Business)

from: Thomas D. Moffitt
Branch Chief, Branch 2
(Income Tax & Accounting)

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subject:

This Chief Counsel Advice responds to your request for assistance dated February 7, 2008. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =

x percent =

Consumer Products =

ISSUE

Whether Taxpayer may treat its cash rebate liability as incurred on the date of the sale of the product to which the rebate relates by adopting the recurring item exception of § 461(h)(3) of the Internal Revenue Code.

CONCLUSION

The Taxpayer may not treat its cash rebate liability as incurred on the date of the sale of the product to which the liability relates by adopting the recurring item exception of § 461(h)(3) because that liability is not fixed until the customer later complies with the rebate requirements.

FACTS

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 Field has asked whether all the events have occurred that establish the fact of Taxpayer's liability for the cash rebates at the time of the issuance of the offers (at the time of the sale of a product) allowing Taxpayer to treat the liability as incurred in the year of issuance, as long as the rebates are paid within the period permitted under the recurring item exception of § 1.461-5 of the Income Tax Regulations.

LAW AND ANALYSIS

Section 461(a) provides that the amount of any deduction or credit must be taken for the taxable year that is the proper taxable year under the method of accounting used in computing taxable income.

Section 461(h) and § 1.461-1(a)(2)(i) provide that, under an accrual method of accounting, a liability is incurred, and is generally taken into account for federal income tax purposes, in the taxable 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 (collectively, the "all events test"). See also § 1.446-1(c)(1)(ii)(A). Section

461(h)(1) provides that the all events test is not met any earlier than when economic performance occurs.

Section 1.461-4(g)(3) provides that if the liability of the 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 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.

Section 1.461-5(b)(1) provides a recurring item exception to the general rule of economic performance. Under the recurring item exception, a liability is treated as incurred for a taxable year if: (i) at the end of the taxable year, all events have occurred that establish the fact of the liability and the amount can be determined with reasonable accuracy; (ii) economic performance occurs on or before the earlier of (a) the date that the taxpayer files a return (including extensions) for the taxable year, or (b) the 15th day of the 9th calendar month after the close of the taxable year; (iii) the liability is recurring in nature; and (iv) either the amount of the liability is not material or accrual of the liability in the taxable year results in better matching of the liability against the income to which it relates than would result from accrual of the liability in the taxable year in which economic performance occurs. Section 1.461-5(b)(5)(ii) provides that, in the case of a liability for rebates, the matching requirement of the recurring item exception is deemed satisfied.

Section 1.461-4(g)(1)(i) provides that for payment liabilities such as rebates, economic performance occurs when, and to the extent that, payment is made to the person to whom the liability is owed. If payment in connection with the liability is made first to any person other than the person to which the liability is owed, economic performance does not occur at that time. Rather, economic performance occurs as payments are made from the other person to the person to which the liability is owed, but only to the extent the taxpayer has transferred equal or greater amounts to the person other than the person to which the liability is owed.

Taxpayer's liability for rebates is not fixed in the taxable year the cash rebate offer is issued with the sale of a product

As expressed in Rev. Rul. 2007-3, 2007-4 I.R.B. 350 (Jan. 22, 2007), it is fundamental to the all events test that although expenses may be deductible before they become due and payable, liability must be firmly established. Rev. Rul. 2007-3, citing United States v. General Dynamics Corp., 481 U.S. 239 (1987). Generally, all events have occurred that establish the fact of the liability when (1) the event fixing the liability, whether that be the required performance or other event, occurs, or (2) payment is unconditionally due. Rev. Rul. 2007-3, citing Rev. Rul. 80-230, 1980-2 C.B. 169, and Rev. Rul. 79-410, 1979-2 C.B. 213. Taxpayer's liability to pay a rebate is not unconditionally due before a customer mails a properly completed rebate form with attachments. The mailing by a customer of a properly completed rebate form and attachments is the event which fixes the Taxpayer's rebate liability. Accordingly, all events have occurred that establish the

fact of Taxpayer's rebate liability when the customer mails the properly completed form and attachments.[1]

The touchstone cases addressing whether a liability is "fixed" are United States v. Hughes Properties, Inc., 476 U.S. 593 (1986) and United States v. General Dynamics Corp. The Supreme Court in Hughes Properties held that a Nevada casino operator could deduct the amount of money that it was required by a state statute to pay as a jackpot based upon on amounts gambled in progressive slot machines. The taxpayer was required to keep a cash reserve sufficient to pay the guaranteed jackpots when won. The Court reasoned that the state statute made the amount shown on the payout indicators incapable of being reduced. Accordingly, the Court held that the last event necessary to fix the casino's liability was the last play of the slot machine before the end of the casino's fiscal year.

The Supreme Court in General Dynamics held that the estimated liability represented by a self-insured medical plan reserve account did not satisfy the all events test because the last event necessary to fix that liability had not occurred by the end of the tax year. Even though the employees had received medical treatment and the amount of the employer's liability was determinable with reasonable accuracy, the employees had not filed claims for reimbursement. The Court held that, as a matter of law, General Dynamics' liability to reimburse its employees was conditioned on the employees submitting a properly documented claim. The filing of the claim was the last event necessary to create the liability and therefore absolutely fix the taxpayer's liability under the first prong of the all events test. General Dynamics, 481 U.S. at 244.

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.

Hughes Properties does not control the treatment of Taxpayer's cash rebates

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,

[1] Taxpayer's current treatment of its cash rebate offers, as a reserve under § 1.451-4, was deemed improper in a prior Chief Counsel Advice.

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.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

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Please call (202) 622-7900 if you have any further questions.

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