INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE-MIS No.: TAM-135171-11

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Years Involved:
Date of Conference:

LEGEND:

Taxpayer =
Subsidiary =
Business =
Products =

Business A =
Business B =
Program B1 =
Program B2 =
Year 1 =
b =
c =
d =
e =
f =
g =

h =
i =
j =
k =
l =

ISSUE:

Under the all events test of § 461 of the Internal Revenue Code, does an accrual method manufacturer's liability to pay certain trade promotion rebates to customers become fixed and determinable when customers purchase the goods, when customers purchase a minimum amount of the goods, or when customers submit the required claim forms for the rebates?

CONCLUSION:

Under the facts described below, Taxpayer's trade promotion liabilities become fixed and determinable when customers purchase the goods.

FACTS:

Taxpayer, an accrual method taxpayer, is a Business. Taxpayer and Subsidiary (also referred to as Taxpayer in this memorandum) sell Products. Taxpayer has two primary lines of business, Business A and Business B.

In Business A, Taxpayer sells products to operators and direct distributors. In its Business A sales agreements, customers agree to pay the list price of a product, and Taxpayer agrees to pay the customers trade promotion rebates based on the number of pounds or cases purchased, or based on a percentage of the list price. During Year 1, Taxpayer processed and accounted for over b individual trade promotion agreements with customers. Taxpayer uses a computer software system to track its trade promotions (the promotion tracking system).

While Taxpayer enters into many different agreements, the agreements have similar terms. In general, while some agreements provide for automatic payment of rebates, most customers must request in writing that Taxpayer pay the rebates. If the payments are automatic, Taxpayer generally has the right to reduce future payments if it is later determined a rebate was paid in error. A customer generally has one year from the date of an invoice to claim a trade promotion rebate. However, it is Taxpayer's practice to pay rebates to customers who submit claims past the one year deadline. Many of the Business A sales agreements state a minimum purchase amount.

The field and Taxpayer provided three sample Business A agreements. In the first agreement, Taxpayer's customer agreed to select Taxpayer as its supplier and to buy c

pounds of product from Taxpayer at “current pricing.” Taxpayer agreed to pay its customer a monthly automatic rebate of $d per pound of product that the customer purchased each month. Taxpayer also agreed to pay a quarterly marketing allowance of $e (not at issue in this case). The terms of the agreement pertaining to the marketing allowance, unlike the terms pertaining to the monthly rebate, specifically stated that the amount of the allowance was based on the customer’s purchase of f pounds of product. The agreement stated that “any significant change in the overall volume will effect the final [quarterly] payment positively or negatively based on the $g/lb. accrual rate.”

The second sample agreement for sales to another customer contained a table listing the names of five products with the price and the minimum pounds per year that the customer would order of each product. Separately, the agreement stated that Taxpayer “will pay an allowance of $h per pound on the purchases” of two of the listed products.

In the third sample agreement, Taxpayer agreed to pay the customer volume allowances for various products based on a per-case or per-pound rate. The provision addressing these allowances did not state a minimum purchase requirement, instead stating that the rates would remain in effect until renegotiated.

Taxpayer states that under its business practices, Taxpayer pays rebates to customers who do not meet the minimum purchase requirements stated in the agreements that are at issue here. According to Taxpayer, the minimum purchase amounts are the stated basis for the negotiated price and rebate amounts. If customers fail to purchase the minimum amounts, Taxpayer’s employees may renegotiate the amount of the rebates in future agreements with the customers, but Taxpayer’s employees nevertheless will approve payment of the rebates in accordance with the pricing agreement in effect.

In the case of its largest Business A customer, Taxpayer pays the rebate on a monthly basis based on estimated volumes. Taxpayer then trues up the rebate amount on a quarterly or yearly basis when the customer provides a written claim that identifies the claim amount, the rebate program, and the purchase dates. Thus, the interim payments are based on estimates of past activity, but still require the purchaser to provide the claim information at a later date. If the claim is not provided, Taxpayer has the right, per the agreement, to offset the unsupported rebate amount against any other amounts owed by Taxpayer to the customer.

In Taxpayer’s second line of business, the Business B sales business, Taxpayer sells products to wholesalers and retailers of Taxpayer’s Products. In its Business B sales agreements, Taxpayer enters into various types of trade promotion programs, including the two programs at issue here—Program B1 and Program B2.

Under Program B1, Taxpayer provides rebates to customers for every purchase of a particular product the customers make during a specific period of time. Program B1 typically is offered to smaller customers. Under the other program at issue here,

Program B2, Taxpayer offers its customers promotional funds to place new products on the shelf and/or place an existing product in a store for the first time.

Business A sales rebates, Program B1 sales rebates, and Program B2 payments are collectively referred to as trade promotion rebates in this memorandum.

At the time a sale is recorded in the general ledger, the promotion tracking system interfaces with the general ledger to record any trade promotion rebate related to the sale. The trade promotion expense is recorded in the general ledger and an offsetting liability is established in the payable section of the balance sheet.

Customers typically request that Taxpayer pay trade promotion rebates that the customers have earned by submitting a formal invoice or other written request for payment, which Taxpayer may pay in cash or as a credit against future purchases. Written claims provided by customers are processed by Taxpayer's customer service center. For claims over the tolerance amount of $i, the customer service center compares the claim with the incentive information found in various trade promotion systems. If a variance exists, the customer service center will work with the customer and sales team to reach a resolution. If there are no variances, the customer service center will verify the accuracy of the claim and will either initiate cash payment to the customer or, in a majority of cases, authorize a credit to be used by the customer on a future purchase.

If the claim amount is at or under the tolerance amount of $i, the customer service center will not access the trade promotion system but rather will verify the accuracy of the claim and either issue a check or authorize a credit to be used against a future purchase. This under tolerance process is used for any request for payment that is $i or less, including payment of other amounts such as damaged good refunds, freight charges, etc. Taxpayer funds this account by accruing j% of each invoice to the account.

The accrual of the trade promotion incentives is adjusted through the use of a "utilization factor" at the end of each quarter to reflect the amount the taxpayer expects to pay. The utilization factor is based on payments made against historical accruals. The field and Taxpayer disagree over exactly how many of Taxpayer's customers either fail to claim the rebates or otherwise are denied payment by Taxpayer, but they agree that the range is between k% and l%.

LAW AND ANALYSIS:

Section 461(a) provides that the amount of any deduction or credit is 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 the 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.

The field and Taxpayer disagree, and have requested technical advice on, when the first two prongs of the all events test are met for Taxpayer's trade promotion rebate liabilities under the facts described above.[1] Taxpayer argues that the rebate liabilities are fixed and determinable when customers purchase goods from Taxpayer, because at that time Taxpayer is obligated to pay the rebates under its sales agreements with its customers and the amount of the rebates are determinable with reasonable accuracy. The field argues that the rebate liabilities are not fixed and determinable at the time customers purchase goods from Taxpayer.

First, the field argues that the liabilities are fixed and determinable only when customers submit claim forms and substantiation to Taxpayer to request payment of the rebates.

Where a taxpayer's liability is set forth in a written contract, the terms of that contract as interpreted under state law are relevant in determining when the taxpayer's liability is fixed for tax purposes. *See Decision, Inc. v. Commissioner*, 47 T.C. 58 (1966), *acq*. 1967-2 C.B. 2; Rev. Rul. 98-39, 1998-2 C.B. 198; Rev. Rul. 2007-3, 2007-1 C.B. 350. The establishment of the fact of a liability under the all events test is not delayed by an additional requirement in a contract that a claim or documentation be submitted to obtain payment, if such act is ministerial. *See* Rev. Rul. 98-39, *supra* (accrual method manufacturer's liability to pay a retailer for cooperative advertising services is incurred in the year the services are performed, not when the required claim form is submitted). However, in some cases, the requirement that a claim for payment be filed is a condition precedent that delays satisfaction of the all events test for § 461 purposes. In *United States v. General Dynamics Corp.*, 481 U.S. 239 (1987), the Court held that employees must file claims with the employer to establish the fact of the liability to reimburse employees for medical expenses under the all events test. The 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 mere technicality.

In the trade promotion rebate agreements between Taxpayer and its customers, Taxpayer's liability to pay the rebates arises when Taxpayer's customers purchase goods. The customers' submission of claim forms and substantiation that it has

[1] The field agrees that Taxpayer is entitled to use the recurring item exception of § 1.461-5 for the trade promotion rebate liabilities, which in general allows Taxpayer to treat the liabilities as incurred for a taxable year so long as the liabilities remain both fixed and determinable as of the end of the taxable year and economic performance occurs (*i.e.*, payment is made) within 8 ½ months after the close of the taxable year. *See* §§ 1.461-4(g)(3) and 1.461-5(b)(1).

purchased the goods is merely the mechanism by which the customers request payment of the rebates for the goods already purchased. Thus, the customers' submission of claim forms and proofs of performance is a ministerial act, much like the situation in Rev. Rul. 98-39, in which one business was required to submit an invoice to another business. These facts distinguish the trade promotion rebate agreements from *General Dynamics* and demonstrate that the customers' submission to Taxpayer of the claim form and proofs of performance is a mere technicality, not a condition precedent that is necessary to establish Taxpayer's liability for § 461 purposes. The fact that Taxpayer never pays between k% and l% of the rebates does not alter our conclusion that the submission of the claim forms under these facts is a ministerial act.

Second, the field argues that the minimum purchase amounts stated in the agreements are conditions precedent that cause the rebate liabilities to be fixed and determinable only when the minimum purchase amounts have been met, and/or when Taxpayer's employees have approved the payment of the rebates for customers who have failed to make the minimum number of purchases. The field argues that the minimum purchase amounts are *per se* conditions precedent, and that Taxpayer's business practice in applying the agreements is never relevant in interpreting the meaning of the agreements.

Taxpayers generally may not disregard the terms of their own contracts for tax purposes. Under the *Danielson* rule, "[a] party can challenge the tax consequences of his agreement as construed by the Commissioner only by adducing proof which in an action between the parties to the agreement would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc." *Commissioner v. Danielson*, 378 F.2d 771, 775 (3rd Cir. 1967)." Several courts, including the Tax Court, have declined to adopt the *Danielson* rule, instead applying the strong proof rule, under which a taxpayer must present more than a preponderance of the evidence that the terms of the written instrument do not reflect the actual intentions of the contracting parties. *Elrod v. Commissioner*, 87 T.C. 1046, 1066 (1986).

However, neither the Danielson rule nor the strong proof rule applies if the agreement in question is ambiguous, in which case extrinsic evidence may be used in interpreting the agreement. *Id.* If the terms of an agreement are ambiguous, weight may be given to business practices in interpreting the agreement. "Generally speaking, the practical interpretation of a contract by the parties to it for any considerable period of time before it comes to be the subject of controversy is deemed of great, if not controlling, influence." *Old Colony Trust Co. v. City of Omaha*, 230 U.S. 100, 118 (1913); *see Diehl v. Commissioner*, 1 T.C. 139, 144, (1942), *affd*. 142 F.2d 449 (6th Cir. 1944) (citing *Insurance Co. v. Dutcher*, 95 U.S. 269 (1877)).

We disagree with the field's conclusions regarding the effect of the minimum purchase amounts in the agreements. First, while we are unable to interpret each of the b

agreements between Taxpayer and its customers in a technical advice memorandum, we conclude that the in the three sample agreements, the effect of the minimum purchase amounts on the amount of the trade promotion rebates is ambiguous. In these agreements, it is not clear that the trade promotion rebates were conditioned on the customer ordering a minimum amount of goods. Because the agreements are ambiguous, the *Danielson* rule does not apply and Taxpayer's business practices may be examined in interpreting the meaning of the agreement. *See Elrod v. Commissioner*, *supra; Diehl v. Commissioner*, *supra; Badcock v. Commissioner*, 491 F.2d 1226 (5th Cir. 1974). We further conclude that Taxpayer's description of its business practice of paying the rebates to customers who do not meet the minimum purchase requirements is consistent with the language in the agreements.

Finally, the field argues that the amounts of Taxpayer's rebate liabilities are not determinable with reasonable accuracy when customers purchase goods from Taxpayer. We disagree. The amount of a liability is determinable with reasonable accuracy when the basis for calculation of liability is known or knowable at end of the tax year. *Continental Tie and Lumber Corp. v. United States*, 286 U.S. 290, 297-298 (1932); Rev. Rul. 81-176, 1981-2 C.B. 112. In this case, all the information necessary to calculate the amount of the rebate liabilities is available to Taxpayer when customers purchase goods from Taxpayer.

The last events necessary to establish the fact of Taxpayer's rebate liabilities occur when customers purchase goods from Taxpayer under the agreements that require Taxpayer to pay trade promotion rebates for the purchases. The minimum purchase amounts in the agreements do not affect when the all events test is met under these facts because, consistent with the provisions in the sample agreements, Taxpayer approves payment of the rebates regardless of the amount of goods that its customers purchase. The amount of Taxpayer's rebate liabilities also is determinable with reasonable accuracy at the time of the purchases because Taxpayer has all the information necessary to calculate the rebate liabilities at that time. Therefore, the rebate liabilities become fixed and determinable with reasonable accuracy in the taxable year in which the customers purchase goods from Taxpayer.

CAVEATS:

This memorandum addresses only the technical issues raised by the field and Taxpayer. Specifically, this memorandum addresses whether the amount of the rebate liabilities is determinable with reasonable accuracy based on the information that is known to Taxpayer at a certain time. It does not address the accuracy of Taxpayer's estimate of the amount of the liabilities, or Taxpayer's estimate of when and in what amount the liabilities are paid for purposes of the economic performance rules. For example, this memorandum does not address whether Taxpayer's calculation of the "utilization factor" is accurate and/or takes into account the best information available to

Taxpayer. While the field asserts that Taxpayer's estimates are not accurate, this is a highly factual issue that is not appropriate for resolution in technical advice.

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