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IRS UPDATE: New Rules on the Treatment of Marketer Image Cash

With its recent issuance of Revenue Procedure 2007-53, the IRS has weighed in among conflicting court opinions as to how marketers should account for image enhancement cash for tax purposes: based on its July 2007 revenue procedure, they may not owe tax on the entire upfront amount paid by refiners as marketer image cash, provided certain conditions are met.

Generally speaking, when marketers receive image cash (or similar advance trade discounts), the receipts may be treated as either income or a loan for tax purposes. Historically, the IRS has been inclined to treat the entire amount as income in the year received (to be offset by depreciation on any assets purchased with these funds), while marketers have argued that the cash is really a loan, to be repaid over time. (Treating this money as a loan not only defers income tax, but has the added benefit of allowing marketers to avoid tax completely if the loan is repaid because a marketer fails to meet refiner volume or other conditional requirements.)

The United States Court of Appeals for the Ninth Circuit seemingly resolved this issue in favor of the marketers in *Westpac Pacific Food v. C.I.R.*, 451 F.3d 970 (9th Cir. 2006). The *Westpac* court determined that advance trade discounts paid by a wholesaler to resellers are <u>not</u> gross income for tax purposes. In *Westpac*, the taxpayer received trade discounts up front, but the discounts were conditioned on the taxpayer purchasing a minimum quantity.

If minimums were not met, the taxpayer was obligated to repay the funds advanced on a pro rata basis.

A conflicting decision was issued the next year, however, by the United States Court of Appeals for the Third Circuit. In *Karns Prime & Fancy Food, Ltd. v. C.I.R.*, 494 F.3d 404 (3d Cir. 2007), the court decided, under slightly different circumstances, that funds provided to a marketer by its supplier in exchange for a promissory note and supply agreement were taxable income. In reaching its decision, the court emphasized that the taxpayer had control over whether it could keep the advance trade discount.

Just three days after the *Karns* decision, the Internal Revenue Service weighed in on the issue by publishing its revenue procedure, which applies to accrual-basis taxpayers who use an inventory method of accounting and receive advance trade discounts.

The procedure states that the IRS will follow *Westpac* in general (in which the court did <u>not</u> treat advance trade discounts as income), and further states that the IRS will allow taxpayers to account for advance trade discounts under the "Advance Trade Discount Method" detailed in the procedure.

Essentially, under the Advance Trade Discount Method, an advance trade discount or other similar payment is not recognized as gross income when received, provided certain conditions are met. Also, the revenue procedure establishes a method by which a taxpayer can obtain the automatic consent of the Commissioner to change to the Advance Trade Discount Method. Rev. Proc. 2007-53.

The benefit of this method is that, for taxpayers who qualify, trade discounts will not be considered income for tax purposes when received. Instead, these discounts will be considered income in the tax year in which the payment is reflected in the company's financial statements.

A payment received by a taxpayer may properly be classified as an advance trade discount (allowing a taxpayer to use the Advance Trade Discount Method of accounting) if:

1. the payment is received from a seller of merchandise in exchange for a commitment to purchase a minimum amount of merchandise from the seller within a period that does not exceed five years from the date of the agreement;

2. except as provided in the revenue procedure, the payment is intended to be a discount to the price of the merchandise to be purchased;

3. the taxpayer is obligated, either in writing or because of industry custom, to repay an allocable portion, or all, of the payment if the underlying purchase commitment is not met; and

4. the taxpayer does not treat the payment as a payment for services in its financial statements.

Rev. Proc. 2007-53.

Amounts allocable to exclusive supplier agreements will be treated as advance trade discounts if the taxpayer is obligated to repay a portion of these amounts if the underlying purchase commitment is not met. The five year limitation, however, remains a substantial obstacle.

Given the conflict among the court decisions, there is now speculation that the IRS may revoke the taxpayer-friendly elements of its revenue procedure. This is unlikely, however, given that the facts of *Karns* would not have allowed the taxpayer to use the Advance Trade Method in any event. This is so because the supply agreement at issue exceeded the five-year maximum established by the procedure as a condition to the allowance of advance trade discount tax treatment.

As of now, the IRS has specifically authorized taxpayers to adopt the Advance Trade Discount Method of accounting, provided certain conditions are met, in order to defer (or possibly avoid) recognition of income associated with trade discounts such as marketer image cash.

As an extra safeguard, every transaction of this type should be carefully documented to ensure that the transaction has the characteristics of a typical loan transaction (i.e., reflects an unconditional obligation to repay the money), and marketer image payment transactions should be separate from supply agreements.

Alternately, taxpayers may seek to avoid this controversy entirely by characterizing trade discounts as purchase price adjustments, rather than seeking to classify these payments as loans versus income.

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