



OFFICE OF  
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224  
December 29, 1998

CC:DOM:FS:IT&A  
TL-N-6594-98

UILC: 471.03-02; 61.00-00; 446.04-00  
Number: **199915011**  
Release Date: 4/16/1999

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Deborah A. Butler  
Assistant Chief Counsel CC:DOM:FS

SUBJECT:

This Field Service Advice responds to your memorandum dated September 29, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Taxpayer =  
1 Year 1 =  
First Tier Managers =  
Second-Tier Managers =

ISSUES:

1. Whether advertising and salary credits received by Taxpayer from various vendors are properly treated as "trade and other discounts" or whether such credits are properly treated as allowances for the provision of services.
2. Whether Taxpayer could change its method of treating the advertising and salary credits by using the automatic change procedures of Rev. Proc. 9449, 1994-2 C.B. 705 for Fiscal Year 1.

CONCLUSIONS:

1. The advertising and salary credits provided to Taxpayer are for the provision of services (cooperative advertising and extra marketing). Accordingly, the credits are treated as allowances and thus do not qualify as reduction in the cost of merchandise. Instead, the credits must be treated as accessions to wealth includible in income under I.R.C. § 61.
2. Even if the credits were properly treated as trade discounts, Taxpayer cannot avail itself of the automatic change provisions of Rev. Proc. 94-49. Because Taxpayer was on the simplified resale method for the years prior to and including Fiscal Year 1, it is prevented from adjusting “section 471 costs” by using the automatic provisions of the revenue procedure.

#### FACTS:

Taxpayer is a retailer . Taxpayer uses an accrual method of accounting. Taxpayer is on the retail LIFO method pursuant to Treas. Reg. § 1.471-8 and Treas. Reg. § 1.472-1(k). Taxpayer elected and used for years prior to and including Fiscal Year 1 the simplified resale method pursuant to Temp. Treas. Reg. § 1.263A-1T(d)(3) and Treas. Reg. § 1.263A-3(d).

Taxpayer receives various reimbursements or offsets (called credits) from certain vendors, with two credits at issue in this advice. One is an advertising credit provided to Taxpayer for what is commonly known as cooperative advertising. The other is a salary credit for Taxpayer’s sales staff. The credits are realized by Taxpayer through offsets to products purchased from the vendors offering the advertising and salary credits. The legal issue is whether such offsets can be treated as trade discounts under Treas. Reg. § 1.471-3(b) which reduce the cost of goods purchased or whether they should be treated as income under section 61.

Prior to Fiscal Year 1, Taxpayer treated the two types of credits as income and accounted for them for tax purposes by offsetting expense account items such as advertising and salary. This resulted in the equivalent of current income treatment. Taxpayer sought to change its method of accounting through an automatic change provision in Rev. Proc. 94-49, which applies to changes in accounting for section 263A costs, and filed a Form 3115 with its income tax return for Fiscal Year 1 as required by Rev. Proc. 94-49. The new method of accounting treats the credits as reductions in the purchase price of the goods.

Advertising credits are provided by a wide range of vendors. The advertising credits are negotiated between the Taxpayer's buyers and the vendor representatives. They are typically based on a percentage of purchases. They can also be a fixed amount for the year. The agreements between Taxpayer and the vendors are verbal contracts. The advertising credits are commonly referred to as cooperative advertising. Cooperative advertising is generally an arrangement by which a product is advertised with the names of both the vendor and the retailer. The arrangement usually requires advertising as well as other promotions. The cost of the promotion may be shared by the vendor and the retailer, or the vendor may pay all the costs.

The advertising credit is accounted for by the Taxpayer's buyer originating an invoice for an advertising credit. This invoice is used by Taxpayer to credit the vendor's invoice and therefore reduce the amount paid to the vendor. These credits are listed as an advertising reduction on Taxpayer's payment vouchers. A copy of the invoice for an advertising credit prepared by the Taxpayer is forwarded with the payment voucher to the vendor. The advertising credit invoice details the date, job number, type, size, and amount of the advertising. The advertising credits are booked to Taxpayer's general ledger. For book purposes, Taxpayer continues to record the credits as an offset to advertising costs, and has not changed its internal bookkeeping of the transaction.

Some vendors also provide salary credits in addition to advertising credits. The salary credits are negotiated by the First-Tier Managers. The salary credits often involve multiple-year agreements which are usually written contracts. The contracts typically offer a credit based on a percentage of the sales of the vendor's product, rather than purchases by Taxpayer. The contracts are typically entered into when a new store opens or a new line is introduced. These contracts offer a use of credit on payments vouchers, similar to the advertising credits. As part of the contract, certain marketing considerations, such as counter space, staffing, and pay incentives, are required of Taxpayer in order to qualify for the credit. Accordingly, the salary credit is provided to encourage more space and sales staff dedicated to promoting the vendor's product.

The basic salary credit is determined based on a percentage of sales of the vendor's product, which Taxpayer typically reports to the vendor on a monthly basis. Some salary credits, for Second-Tier Managers, however, are determined using projected sales and then are computed as a percentage of these employees' salaries. The salary credits are booked to Taxpayer's general ledger accounts. All sales staff, floor personnel, First-Tier and Second-Tier Managers are employees solely of Taxpayer, with Taxpayer responsible for all payroll and withholding issues.

For book purposes, Taxpayer continues to record the credits as an offset to salary costs, and has not changed its internal bookkeeping of the transaction.

## LAW AND ANALYSIS

### Issue 1

Section 61(a) provides generally, that gross income means all income from whatever source derived. The regulations under section 61 indicate that, unless excluded by law, gross income includes all income realized in any form.

Section 451 provides rules for determining the taxable year of inclusion for items of gross income. Treas. Reg. § 1.451-1(a) provides that under an accrual method of accounting, income is includible in gross income when all the events have occurred that fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Service position is that all the events that fix the right to receive income occur on the earliest of when 1) the required performance takes place, 2) payment is due, and 3) payment is made. Rev. Rul. 74-607, 1974-2 C.B. 149.

Treas. Reg. § 1.471-3(b) defines cost of merchandise for a retailer as the invoice price less trade or other discounts.<sup>1</sup>

At least indirectly, all allowances or credits are designed to increase sales of a vendor's product, which results in higher volume of purchases of that product by a retailer. Furthermore, the *effect* of an allowance or credit is that it reduces the cost of the merchandise acquired. This, Taxpayer suggests, is all that is required to have the credit qualify as a "trade or other discount" under Treas. Reg. § 1.471-3(b).

While not defined in the regulation, the Service defines trade discounts as reductions to the purchase price granted by a vendor, which vary depending upon volume or quantity purchases. Rev. Rul. 84-41, 1984-1 C.B. 130. If an allowance is contingent upon performance of services by the purchaser, the allowance is not a trade or other discount. Pittsburgh Milk Co. v. Commissioner, 26 T.C. 707, 717 (1956), acq., 1962-2 C.B. 5. Accordingly, a trade or other discount within the meaning of Treas. Reg. § 1.471-3(b) represents a reduction in purchase price as the result of the acquisition of the merchandise. Any reduction in purchase price representing compensation for services performed, or to be performed, or as a

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<sup>1</sup> Cash discounts approximating a reasonable interest rate also can reduce invoice price; otherwise, cash discounts are treated as income. Treas. Reg. § 1.471-3(b).

reimbursement of an expenditure is not a trade or other discount for purposes of Tres. Reg. § 1.471-3(b).

If an allowance is a trade discount, then it represents a reduction in purchase price and not an accession to wealth requiring inclusion as gross income under sections 61 and 451. Rev. Rul. 76-96, 1976-1 C.B. 23; Rev. Rul. 84-41; and Rev. Rul. 85-30, 1985-1 C.B. 30. Whether an allowance is a trade discount is a question of fact. Thomas Shoe Co. v. Commissioner, 1 B.T.A. 124,126 (1924), acq., IV-1 C.B. 3 (1925); Pittsburgh Milk, 26 T.C. at 717; Sun Microsystems, Inc. v. Commissioner, T.C. Memo 1993-467, 66 T.C.M. (CCH) 997, 1002.

### Cooperative Advertising

Cooperative advertising is offered by a vendor to encourage local advertising or store displays by the retailer of the vendor's product. In form, such credits appear to be for services provided, and not based on volume or quantity. Taxpayer calls it advertising on its own books and on the vouchers sent with payments to the vendors. In accounting for the advertising credit, Taxpayer creates an "advertising invoice" with detailed information concerning the type, date, and amount of the advertising.<sup>2</sup>

In substance, the advertising credits are a reimbursement of Taxpayer's cost which benefits both the vendor and Taxpayer. The vendors are getting a service, advertising, for which they are willing to pay. Taxpayer is performing a service for which it is compensated by property. Because it is providing a service, Taxpayer must recognize the credits/discounts as an accession to wealth requiring inclusion as gross income under sections 61 and 451. Pittsburgh Milk; Rev. Rul. 76-96; Rev. Rul. 84-41; and Rev. Rul. 85-30. The time of recognition is the year when the advertising services giving rise to the discounts are performed. Rev. Rul. 84-41.

Furthermore, the Service views cooperative advertising as the performance of services by a retailer for a manufacturer (or other vendor), with income and expense accrued in the year the advertising is placed. Rev. Rul. 98-39, 1998-33 I.R.B. 4. Rev. Rul. 98-39 focused on the expense liability and the year of accrual for a manufacturer who provides reimbursements of cooperative advertising costs. But its conclusion, focusing on when the all events test is met for the liability to

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<sup>2</sup> The purchase order upon which the credit will be requested will be subsequent to the placement of the advertising. In theory, then, the advertisement will move vendor's products already in Taxpayer's inventory, with the discount applied to goods purchased to replace the depleted inventory.

reimburse the advertising costs, makes clear that the advertising is viewed as the performance of a service:

Under the all events test of § 461, an accrual method manufacturer's liability to pay a retailer *for cooperative advertising services* is incurred in Year 1, the year in which *the services* are performed, ..., and even though the retailer does not submit the required claim form until Year 2. (Emphasis added)

### Salary Credits

The salary credits are determined based on a percentage of sales of the vendor's product, although some salary credits are determined using projected sales and then are computed as a percentage of certain employees' salaries. Salary credits are used to provide bonuses or other financial rewards to Taxpayer's employees for selling the vendor's product. The salary credits are provided by a vendor to support a level of service in the specified departments which exceeds other departments in the store. In addition, the employees' pay in the specified department's is greater than that of other salespeople.

The vendors are making specific marketing demands as to product placement and the number and pay (through incentives) of the salespeople who promote such merchandise. Accordingly, in form and substance, Taxpayer is performing extra marketing services (in terms of space, staffing, and location) and in return receiving from the vendor a credit offsetting the extra cost of such services (fewer sales staff available in other departments, less counter space available). The salary credit is contingent upon the performance of those services and the resulting increase in sales. Because Taxpayer is performing an extraordinary service for the vendor, the credits do not qualify as "trade or other discounts" under Treas. Reg. § 1.471-3. Therefore, the credits must be accounted for as gross income.<sup>3</sup>

### Issue 2

Rev. Proc. 94-49 provides the exclusive procedure for taxpayers to obtain expeditious consent to change certain methods of accounting for costs subject to section 263A. A taxpayer complying with the revenue procedure is deemed to have

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<sup>3</sup> Because Fiscal Year 1 is the first year Taxpayer treated the advertising and salary credits as trade discounts, a section 481(a) adjustment is not necessary. A correction reversing Taxpayer's treatment of the credits as trade and other discounts with a corresponding inclusion of the amount of the credits as income (expense offsets) is sufficient.

obtained the consent of the Commissioner to change its method of accounting for the first taxable year beginning on or after January 1, 1994.

Section 3.02 of the revenue procedure limits the scope of the automatic changes in method of accounting that can be made under its provisions. The revenue procedure does not apply to a change in method of accounting for purposes of determining "section 471 costs" under one of the simplified methods. Taxpayer was on the simplified resale method during Fiscal Year 1, which is an example of a simplified method that requires a determination of "section 471 costs." Section 3.02, Rev. Proc. 94-49.

"Section 471 costs" are costs which were capitalized under a taxpayer's method of accounting immediately prior to the effective date of section 263A. Treas. Reg. § 1.263-1(d)(2). For a reseller, generally only costs of merchandise acquired and the costs of transportation were capitalized immediately prior to the section 263A rules. "Additional section 263A costs" are costs other than interest that were not capitalized under the taxpayer's method of accounting immediately prior to the effective date of section 263A but are now required to be capitalized. Treas. Reg. § 1.263-1(d)(3). For a reseller, these costs generally include purchasing, handling, storage, and general and administrative costs. See Treas. Reg. § 1.263A-3(c)(1).

Trade or other discounts are reductions in the costs of merchandise. Under Taxpayer's method of accounting for years prior to the enactment of section 263A, it capitalized the cost of merchandise. Therefore, under Taxpayer's method of accounting, the cost of merchandise is a "section 471 cost" under the regulations. Rev. Proc. 94-49 is applicable only for automatic changes to "additional section 263A costs" or for interest costs. It does not apply to changes in "section 471 costs" for taxpayers who are on a simplified method. See Section 3.02(1), Rev. Proc. 94-49.

Accordingly, even if the advertising and salary credits were deemed to be trade or other discounts, Taxpayer could not avail itself of the automatic change procedures of Rev. Proc. 94-49. Thus, Taxpayer has changed its method of accounting for the credits without the consent of the Commissioner. If the credits were deemed to be trade or other discounts, the change in treatment should have been requested for Fiscal Year 1 pursuant to Rev. Proc. 92-20, 1992-1 C.B. 685.

#### CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

There are some hazards that Taxpayer could convince a court that the advertising and salary allowances provided by vendors falls within the "other discounts" language of Treas. Reg. § 1.471-3(b). While the Service considers that only volume and quantity discounts qualify, an argument can be made that placing of the advertising and reimbursement of salary costs based on sales both yield greater

sales of the vendor's products, and thus both are based, at least indirectly, on quantity purchases. If this argument is accepted, the taxpayer's treatment as a reduction in purchasing price would be proper.

If the taxpayer's treatment as a reduction in purchasing price is accepted, there are some hazards that a court would find the language of Rev. Proc. 94-49 broad enough to permit an automatic change in the treatment of trade or other discounts.

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