Miller & Chevalier

Newly Proposed Regulations Would Affect All Taxpayers with Inventories

Tax Alert
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On December 16, 2010, the IRS and Treasury issued proposed regulations addressing sales-based royalties and sales-based rebates, allowances, and other types of price reductions. When final, the proposed regulations will impact virtually every taxpayer with inventories.

The proposed regulations generally favor taxpayers that pay sales-based royalties (by increasing cost of goods sold), but may negatively impact taxpayers that receive sales-based rebates, allowances, or other types of price reductions (by decreasing cost of goods sold).

The proposed regulations, if adopted without change, provide both pitfalls and possibilities to taxpayers. To understand the pitfalls and possibilities, taxpayers should review their current agreements, practices, and policies regarding both the costs of acquiring or producing inventories and the rebates, allowances, and other types of price reductions afforded purchases of their inventories.

The actual impact of the proposed regulations cannot be evaluated without such a review. At the same time, that review may provide opportunities for obtaining the benefits of the new regulations (where they otherwise will not apply), and avoiding the pitfalls (where they otherwise will apply).

While it might at first appear that the proposed regulations will apply whenever the amount or timing of a royalty, rebate, allowance, or other price reduction is based on sales, this is not the case. The key will be the rights and obligations of the parties under their agreements.

The proposed regulations also suggest the possibility that the IRS and Treasury will consider providing benefits to taxpayers in their treatment of other inventory costs now allocated between ending inventory and cost of goods sold, but that could be allocated entirely to cost of goods sold. Such costs might include environmental remediation costs attributable to inventory sold in prior years and certain pension costs attributable to production in prior years.

The proposed regulations do not address how taxpayers should effect changes to comply with them (e.g., with a section 481(a) adjustment or on a cutoff basis). In addition, the IRS has not indicated how it will treat royalties, rebates, allowances, and other types of price adjustments before the regulations become final.

If you have any questions regarding the forgoing, would like assistance in evaluating current agreements, practices, and policies, or would like to comment on the proposed regulations or on expanding the proposed benefits to other costs, please contact Steve, James, Patricia, or Dwight at the numbers or e-mail addresses shown below. We would be pleased to discuss this with you or others in the company, as appropriate.

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