

Memorandum

To : Mr. David J. Gau
Executive Director (MIC 73)

Date: May 3, 2016

From : Susanne Buehler, Deputy Director
Business Tax and Fee Department (MIC 43)



Subject : **Board Meeting May 24-26, 2016**
Item N: Administrative Agenda
Proposed Revisions to Audit Manual (AM)
Chapter 4, General Audit Procedures and Chapter 9, Grocers

I am requesting approval to forward the attached revisions to the Board Proceedings Division to be placed as a consent item on the Administrative Agenda at the May 2016 meeting. The proposed revisions incorporate current policies and procedures as follows:

- Chapter 4, adds section 0437.25, *Rebates and Incentives*
- Chapter 9, revises section 0906.40, *Purchase Discounts and Allowances*

The revisions have been reviewed and approved by Business Tax and Fee Department and Field Operations Department management, provided to Board Members, and posted on the Board's website at <http://www.boe.ca.gov/sutax/pmr.htm> to solicit comments from interested parties. No comments were received from Board Members or other interested parties.

If you have any questions, please let me know or contact Ms. Lynn Whitaker at (916) 324-8483.

SB:ljm

Attachment

STATE BOARD OF EQUALIZATION

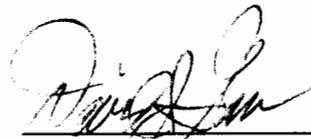


BOARD APPROVED

At the May 25, 2016 Board Meeting

Joann Richmond
Joann Richmond, Chief
Board Proceedings Division

Approved:



Mr. David J. Gau
Executive Director

cc: (all with attachment)
Mr. Wayne Mashihara (MIC 47)
Chief, Tax Policy Division (MIC 92)
Mr. Richard Parrott (MIC 88)
Mr. Kevin Hanks (MIC 49)
Mr. John Thiella (MIC 73)
Mr. Marc Alviso (MIC 73)
Mr. Chris Lee (MIC 73)
Ms. Leila Hellmuth (MIC 43)
Ms. Lynn Whitaker (MIC 50)

REBATES AND INCENTIVES

0437.25

GENERAL

This section explains the application of tax to payments received by retailers from rebate, incentive, buy-down and other promotional programs (third-party rebates) offered by manufacturers, vendors, and other third parties to promote the sale of their products.

Retailers often engage in marketing and sales promotions in which they issue coupons or other indicia to their customers that entitle them to a reduction in their purchase amounts. Manufacturers, vendors and other third parties offer various programs that result in credits or payments made to retailers with respect to a retailer’s taxable sale of products to a customer. Regulation 1671.1, *Discounts, Coupons, Rebates, and Other Incentives*, addresses this topic, provides definitions for terms used and includes several examples of when rebates and incentives are and are not included in gross receipts.

If the records of a retailer who participates in rebate and incentive program are lacking or incomplete, the Internal Revenue Service Form 1099-Misc (1099) may be used to determine the taxable portion of the retailer’s income when the 1099 is issued by a third-party who entered into a rebate or incentive program with the retailer that required a specific price reduction. However, a 1099 does not always represent taxable rebate payments that satisfy the conditions of the regulation. The amounts could, in whole or part, represent payments for nontaxable display, advertising or other nontaxable promotional allowances, as well as rebate payments that satisfy one, but not all, of the conditions of the regulation. The 1099 may also contain specific coding that will assist in the determination of the portion of the 1099 income that is received under a rebate or incentive program requiring a price reduction, earned for providing display space or for advertising the third-party’s products.

TAXABLE GROSS RECEIPTS

Third-party rebates are included in taxable gross receipts or the sales price of the sale when **all** of the following conditions are satisfied:

- The retailer is required to reduce the selling price of certain products in order to receive the third-party rebate,
- The rebate payment is certain (not contingent on other factors), and
- The rebate is for a like amount that reimburses the retailer for the amount of the price reduction, on a transaction-by-transaction basis.

That is, the rebate payment received as part of a promotional program (e.g., buy-down program) must be traceable to a specific sale of a particular product and reimburse the retailer for the specified amount of the required reduction in selling price. A rebate payment is considered certain when fulfillment of the requirements of the contract between the retailer and the third party are within the control of the retailer at the time of the underlying retail sale (e.g., requiring the retailer to set up promotional signage in order to get the rebate).

There are also promotional programs and marketing strategies that do not require a reduction of the selling price of products by the retailer. Others that require a price reduction tie the rebate payments to the retailer's wholesale purchases and not their sales of the product at the reduced price. In any case in which the promotional price reduction is not required by a third-party or where the rebate revenue is not based on retail sales on a transaction-by-transaction basis, the revenue is not included in taxable gross receipts.

Some promotional programs (e.g. graduated rebate agreements) may require the retailer to sell a certain quantity of product at a specified reduced price for a set period to receive a wholesale price reduction or, in some cases, reimbursement for all, or a portion of the reduced selling price. Multiple thresholds, with an increase in rebate revenue for each threshold exceeded, may exist. This means the total rebate payment the retailer receives is not certain at the time of the retail sale. When the receipt of rebate payments or a portion of them are contingent and uncertain at the time of the retail sale of the specified products, the portion that is contingent and uncertain is not subject to tax. Regulation 1671.1, subdivision (d)(2)(D) provides an example of this situation.

Advertising and Display Allowances

Additional income received by retailers for the display or advertising of the third-party products is not included in taxable gross receipts. Display payments are earned by providing the display or shelf space, not by making retail sales of taxable products on a transaction-by-transaction basis. Advertising allowances, which are a reimbursement for a retailer's advertisement of particular products, are not included in gross receipts.

Third-Parties

A third-party is defined in Regulation 1671.1, subdivision (c)(1)(C) as a person other than the retailer or their customer, such as a manufacturer or retailer's vendor. Therefore, rebate revenues received by the retailer from a retailer's vendor are subject to tax in the same manner as rebate revenues received from manufacturers and other parties that do not sell the promotional products directly to the retailers.

Rebuttable Presumption

Although it is generally understood that all gross receipts are subject to tax unless the contrary is established, Regulation 1671.1 subdivision (c)(3)(A), provides a rebuttable presumption that consideration received by a retailer from a third-party related to promotions for sales of specified products is subject to tax, until the contrary is established. This subdivision provides a non-exhaustive list of examples that illustrate how this presumption can be rebutted.

Subdivision (c)(3)(A) provides specific regulatory support to include rebate revenue in taxable gross receipts when the retailer does not provide the necessary records and documentation to establish otherwise. This does not mean, however, that the retailer should not be given the opportunity to establish that such revenue may represent a purchase discount, advertising allowance, or some other nontaxable allowance. The presumption does not relieve staff of its responsibility to ensure that the retailer is aware of the type of documentation that will generally rebut the presumption or providing support in obtaining such documentation when requested.

The burden of establishing the taxable nature of rebate payments is on the retailer. However, this should not be interpreted as relieving staff of their auditing responsibility. At times, it may be easier for the auditor to verify the taxable nature of the rebates or have access to resources a retailer may not have to make the determination. The rebuttable presumption should not deter audit staff from providing support when requested or warranted.

Disclosure to Customers

Regulation 1671.1 subdivision (c)(3)(A) provides specific regulatory support for the inclusion of rebate revenue in taxable gross receipts when the retailer does not provide the necessary records and documentation to establish otherwise. Subdivision (c)(3)(B) states that when a retailer collects sales tax reimbursement (or use tax when applicable) from its customer, the retailer must disclose to the customer the amount upon which tax is collected, including the amount of any taxable discounts, rebates, or incentives offered or paid to the retailer by third parties. The regulation discusses the ways a retailer may satisfy its disclosure requirement. Staff should verify that the amount of any taxable rebates upon which a retailer is collecting tax is disclosed to customers. If not, the retailer should be informed of the requirement. It is recommended that auditors note in the audit working papers that these disclosure requirements were discussed with the retailer.

PURCHASE DISCOUNTS AND ALLOWANCES

0906.40

The following discounts constitute a reduction in the cost of merchandise for purchase-ratio purposes:

- Cash discounts.
- Volume rebates or quantity discounts.
- Promotional allowances.

If discounts of this type are significant, exempt food and taxable grocery costs should be reduced as appropriate when the purchase-ratio method is used. Since these discounts can apply to exempt food, taxable grocery, and nongrocery taxable items, a segregation test of the discounts may have to be made. These discounts are defined as:

“Cash discount” means a reduction from invoice price allowed the grocer for prompt payment.

“Volume rebate or quantity discount” means an allowance or reduction of the price for volume purchases based on the number of units purchased or sold. Such rebates or discounts normally are obtained without any specific contractual obligation upon the part of the grocer to advertise or otherwise promote sales of the products purchased. The term does not include patronage dividends distributed to members by nonprofit cooperatives pursuant to Section 12805 of the Corporations Code, or rebates which constitute a distribution of profits to members or stockholders.

“Promotional allowance” means an allowance in the nature of a reduction of the price to the grocer, based on the number of units sold or purchased during a promotional period. The allowance is directly related to units sold or purchased although some additional promotional expense may be incurred by the grocer. Normally, the grocer would feature the product in his/her advertising, although he/she may or may not be contractually obligated to do so. The retail price of the product may or may not be lowered during a promotional period. The term does not include display or other merchandising plan allowances or payments which are based on agreements to provide shelf space for a price not related to volume of purchases, or cooperative advertising allowances which are based on a national line rate for advertising and are not directly related to volume of purchases and sales. Cooperative advertising allowances are intended to reimburse a grocer for a portion of his/her advertising costs for a particular product or products.

[For information on payments received by retailers from rebates and other incentives see AM section 0437.25, *Rebates and Incentives*.](#)