OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
September 21, 2000

Number: **200101004**
Release Date: 1/5/2001
CC:ITA:1
TL-N-3702-00
UILC: 61.22-03

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL, NEW JERSEY
CC:NER:NJD:NEW
Attn: Patricia Y. Taylor

FROM: Associate Chief Counsel (Income Tax & Accounting)
CC:ITA

SUBJECT: Exclusion of Medicaid Rebates from Gross Income

This Field Service Advice responds to your request of June 22, 2000. 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.

**DISCLOSURE STATEMENT**

Field Service Advice is Chief Counsel Advice and is open to public inspection pursuant to the provisions of I.R.C. § 6110(i). The provisions of section 6110 require the Service to remove taxpayer identifying information and provide the taxpayer with notice of intention to disclose before it is made available for public inspection. Sec. 6110(c) and (i). Section 6110(i)(3)(B) also authorizes the Service to delete information from Field Service Advice that is protected from disclosure under 5 U.S.C. § 552 (b) and (c) before the document is provided to the taxpayer with notice of intention to disclose. Only the National Office function issuing the Field Service Advice is authorized to make such deletions and to make the redacted document available for public inspection. **Accordingly, the Examination, Appeals, or Counsel recipient of this document may not provide a copy of this unredacted document to the taxpayer or their representative.** The recipient of this document may share this unredacted document only with those persons whose official tax administration duties with respect to the case and the issues discussed in the document require inspection or disclosure of the Field Service Advice.

**ISSUE:**

Whether the amounts paid by pharmaceutical manufacturers as Medicaid Rebates may be excluded from amount realized on sale and hence from gross income as defined under section 61(a)(3).

**CONCLUSION:**

The amounts paid by pharmaceutical manufacturers as Medicaid Rebates may not be excluded from amount realized on sale or consequently from gross income as defined under section 61(a)(3).

**FACTS:**

In 1990, Congress established the Medicaid Rebate Program in an effort to reduce the costs of drugs for Medicaid recipients and to increase Medicaid recipients' access to drugs. The Rebate Program applies to drugs dispensed to Medicaid recipients on or after January 1, 1991. The program provides that a pharmaceutical manufacturer must enter into a rebate agreement in order for their drugs to be covered by Medicaid.

Generally, a pharmaceutical manufacturer sells its product to a wholesaler, who in turns sells the product to a retail pharmacy or pharmacy chain. A pharmacist then sells the product to an individual pursuant to a physician's prescription. If the customer is a Medicaid recipient, the pharmacist submits a claim to the appropriate State Medicaid agency for reimbursement of the cost of the product, plus a dispensing fee. If the State Medicaid agency approves the claim, it pays the pharmacist.

The State receives a portion of its expense, a "rebate" or more accurately a payment, from the pharmaceutical manufacturer. Each quarter annually, each drug manufacturer submits information to the Health Care Financing Administration (HCFA) on its average manufacturer price and its best price for covered outpatient drugs for that quarter. This information is submitted within 30 days of the end of the calendar quarter. The HCFA uses this information to compute the unit rebate amount. Within 45 days after the end of the calendar quarter, the HCFA submits the unit rebate amount to State Medicaid agencies. Upon receipt of this information, State Medicaid agencies submit the unit rebate amount and medicaid utilization data to manufacturers for payment of the rebate liability. The Medicaid utilization data is based on pharmacist's claims reimbursed during the quarter. The payment must be paid by the manufacturer within 30 days of the date of receipt of the States' utilization report.

The payment may be comprised of one or more of the following:

- base amount of between 12% and 15% of the average manufacturer price. The average manufacturer price is the price paid to the manufacturer for a drug by wholesalers for drugs distributed to the retail pharmacy class of trade.
- best price rebate component, if the manufacturer sells the product at a price which is lower than the price paid by a State Medicaid agency. If this occurs, the manufacturer must pay the difference between the best price and the average manufacturer price.
- increased payment, if the price of the drug product rises at a rate greater than the general inflation rate.

Many pharmaceutical manufacturers consider the Medicaid Rebate a reduction from gross sales to arrive at net sales. They reduce sales, based on an estimate, at the time the product is sold to the wholesaler. It has been asserted that the Medicaid Rebate is a price discount or "price adjustment" which reduces gross receipts under the rationale of Pittsburgh Milk Co. v. Commissioner, 26 T.C. 707 (1956), nonacq. 1959-2 C.B. 8-9, nonacq. withdrawn and acq. 1962-2 C.B. 5-6, acq. withdrawn and nonacq. 1976-2 C.B. 3-4, and nonacq. withdrawn in part and acq. in part 1982-2 C.B. 2.

**LAW AND ANALYSIS:**

Section 61(a)(3) defines gross income generally as all income from whatever source derived including gains from dealings in property. In a manufacturing or merchandising business, "gross income" means the total sales, less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources. Treas. Reg. § 1.61-3(a).

> If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent.

North American Oil Consolidated v. Burnet, 286 U.S. 417, 424 (1932). See Alexander Shokai, Inc. v. Commissioner, 34 F.3d 1480, 1485 (9th Cir. 1994), cert. denied, 514 U.S. 1062 (1995). Thus, clearly an item may be income even though it must returned some time in the future. See Johnson v. Commissioner, 108 T.C. 448, 470-71 (1997), aff'd in part, rev'd in part on other issues, 184 F. 3d 786 (8th Cir. 1999); Herbel v. Commissioner, 106 T.C. 392, 417 (1996), aff'd, 129 F.3d 788 (5th Cir. 1997). See also Alexander Shokai, 34 F.3d at 1485-86.

**Reliance upon Pittsburgh Milk**

The pharmaceutical manufacturers rely upon Pittsburgh Milk, where a rebate paid by a seller to a purchaser of a product was excluded from gross income. The taxpayer in Pittsburgh Milk was a milk producer subject to a state law that mandated minimum prices for milk. The taxpayer could effectively lower its price for milk below the legal minimum only by secretly and unlawfully rebating an agreed upon part of the price to certain purchasers. The issue in case was whether the rebates could be excluded from the amount realized on the sale, since the amount could not be deducted as against public policy.

The Tax Court reasoned that, under the Sixteenth Amendment and the Code, tax is imposed on income and not every conceivable receipt. For income derived from the sale of property this means the amount realized and no more. Further, the tax should be imposed on the true nature of the transaction.

The Court found that the milk was in fact not sold at the list prices fixed by the regulators but rather for net prices which resulted from the rebates. The list prices were only the starting point in agreed upon formulas for arriving at a net price. The court concluded the seller did not receive the rebate under any claim of right, but merely as a deposit which was to be returned in all events. As a result, the rebates could be excluded from the amount realized on the sale.

The Court also provided the following language describing the limits of its holding:

> It does not follow, of course, that all allowances, discounts, and rebates made by a seller of property constitute adjustments to the selling price. Terminology, alone, is not controlling; and each type of transaction must be analyzed with respect to its own facts and surrounding circumstances. Such examination may reveal that a particular allowance has been given for a separate consideration–as in the case of rebates made in consideration of additional purchases of specified quantity over a specified subsequent period; or as in the case of allowances made in consideration of prepayment of an account receivable, so as to be in effect a payment of interest. The test to be applied, as in the interpretation of most business transactions, is: What did the parties really intend, and for what purpose or consideration was the allowance actually made? Where, as here, the intention and purpose of the allowance was to provide a formula for adjusting a specified gross price to an agreed net

> price, and where the making of such adjustment was not contingent upon any subsequent performance or consideration from the purchaser, then, regardless of the time or manner of the adjustment, the net selling price agreed upon must be given recognition for income tax purposes.

Pittsburgh Milk, 26 T.C. at 716-17.

The holding of Pittsburgh Milk has been followed in a number of cases involving facts similar to it. See, e.g., Dixie Dairies Corp. v. Commissioner, 74 T.C. 476 (1980), acq. 1982-2 C.B. 1; Haas Brothers, Inc. v. Commissioner, 73 T.C. 1217 (1980), acq. 1982-2 C.B. 1; Max Sobel Wholesale Liquors v. Commissioner, 69 T.C. 477 (1977), aff'd 630 F.2d 670 (9th Cir. 1980), acq. 1982-2 C.B. 2; Atzinger-Whitehouse Dairy, Inc. v. Commissioner, 36 T.C. 173, 181 (1961), acq. 1961-2 C.B. 3, acq. withdrawn and nonacq. 1976-2 C.B. 3-4, and nonacq. withdrawn in part and acq. in part 1982-2 C.B. 1; Harmony Dairy v. Commissioner, T.C. Memo. 1960-109. It has been distinguished in other cases discussed below. The Tax Court has also held that Pittsburgh Milk does not create an exclusive test for determining the existence of a sales discount or allowance. Sun Microsystems, Inc. v. Commissioner, T.C. Memo. 1993-467.

The Service position on Pittsburgh Milk is embodied in Rev. Rul. 82-149, 1982-2 C.B. 56, which holds that rebates of a purchase price that are illegal payments within the meaning of section 162(c)(2) may be subtracted from gross sales to determine gross income when made by the seller directly to the purchaser.

**Pittsburgh Milk and its progeny not applicable**

**Transactions involving more than the seller and the purchaser**

The present case is distinguishable from the position taken in Rev. Rul. 82-149 and from Pittsburgh Milk, itself, in that the payment here is not made to the purchaser. Instead, the product is sold by the manufacturer to a wholesaler for a set price and the payment is subsequently made to a third party. There is no rebate paid to the purchaser on this price and the price by the purchaser, i.e., the distributor, is never in fact changed. The manufacturer has instead received the full amount paid to it by the purchaser under a claim of right.

Pittsburgh Milk has not been applied to transactions involving payments by or to parties other than the buyer or seller. This principle was explicitly recognized in Alex v. Commissioner, 70 T.C. 322 (1978), aff'd 628 F.2d 1222 (9th Cir. 1980), where insurance agent was not permitted to exclude from his commission income amounts he had paid to or on behalf of clients to purchase insurance. The taxpayer, a life insurance agent, realized that by selling a large amount of insurance he could receive more in commissions, office allowances, and bonuses than the premiums due from the insured in the first year. To build his volume, he sold insurance by reimbursing some clients' premiums and by paying other clients' premiums himself.

In rejecting the taxpayer's ability to exclude payments at issue, the Tax Court noted that almost all of the cases allowing the exclusion of a rebated purchase price involved arrangements made directly between seller and buyer. 70 T.C. at 325. The only exception was Schiffman v. Commissioner, 47 T.C. 537 (1967), acq. 1967-2 C.B. 3, and acq. withdrawn and nonacq. 1977-2 C.B. 2, which involved facts very much like Alex. The Court in Alex decided to overrule Schiffman, stating -

> After careful consideration, we now think that any claim of exclusion from gross income, based upon an adjustment to the purchase price resulting from a discount or rebate, should at most be available only to the buyer or the seller....In short, since petitioner cannot be considered as the seller, there is no selling price to which any adjustment as to him might be applied....

Alex, 70 T.C. at 326 (footnote omitted).

In affirming, the Ninth Circuit agreed, stating that -

> the Tax Court below correctly held that [the Pittsburgh Milk] theory applies only in the two-cornered situation where a seller effects a price adjustment by making a payment to its customer....But here the situation is three-cornered, and no price was adjusted by the seller.

Alex, 628 F.2d at 1224. See Wentz v. Commissioner, 105 T.C. 1, 10 (1995).

While Alex involved a payment to a purchaser from someone other than the seller; Mississippi Chemical Corp. v. Commissioner, 86 T.C. 627 (1986), applied the same limiting principle to a rebate paid by the seller to party other than the purchaser. Thus, Mississippi Chemical is like the present case.[1]

The taxpayer in Mississippi Chemical was a cooperative that sold fertilizer to shareholders and others based on patronage rights. Only a shareholder could receive patronage rights, but the rights could be assigned to nonshareholders. The taxpayer also paid patronage dividends which were based on the amount of fertilizer sold to a party; however, patronage dividends could only be paid to shareholders.

---

[1] See also United Draperies, Inc. v. Commissioner, 41 T.C. 457 (1964), aff'd 340 F.2d 936 (7th Cir. 1964), cert. denied, 382 U.S. 813 (1965), ((discussed below) disallowing an exclusion from income for payments made to a parties other than the purchaser); Rev. Rul. 76-96, 1976-1 C.B. 23, (implicitly holding that rebates paid by manufacturer to retail customers should be included in the income of the manufacturers.)

One of the taxpayer shareholders, Southern Nitrogen Supply Company (SNS), assigned its patronage rights to a third party, Pro Rico, but, under the agreement with Pro Rico, also retained its right to receive the patronage dividends attributable to the purchase. Pro Rico purchased the fertilizer and the taxpayer paid the attributable patronage dividend to SNS.

The taxpayer argued in Tax Court that the patronage dividend was excludible as a refund of the purchase price and relied upon Pittsburgh Milk and its progeny, i.e., Dixie Dairies; Haas Brothers; and Max Sobel. The Court rejected this reliance, stating -

> A common thread runs though each of these cases, viz, in each case there was an agreement between the taxpayer and its customers, entered into prior to the sale of the product, providing for the refund of some part of the purchase price. In this case, the common thread does not appear.

Mississippi Chemical, 86 T.C. at 640 (footnote omitted).[2] The Court further rejected the taxpayer's assertions that the assignment agreement between the SNS and Pro Rico, which the taxpayer possessed before the sale, created any prior agreement between the taxpayer and the purchaser, Pro Rico, regarding refund of the purchase price. Thus, the existence of a prior agreement to pay the third party does not necessary change the result.

It has been argued that the present transaction should be treated as if the manufacturers sold the drugs directly to the state agency at a reduced price, that is, as if the agency is the purchaser. A taxpayer must accept the tax consequences of its transaction as structured and may not enjoy the benefit of some other route that might have been taken. See Commissioner v. National Alfalfa Dyhydrating & Milling Co., 417 U.S. 134, 149 (1974); City of New York v. Commissioner, 103 T.C. 481, 493 (1994).

---

[2] Significantly, the omitted footnote cites to Eaton v. Commissioner, T.C. Memo. 1979-320, in which the Tax Court implicitly accepted the Commissioner's argument that payment must be made to the buyer, or his agent, to be adjustment to sales price.

**Transactions where the payment is contingent upon subsequent performance**

As indicated in the quote from Pittsburgh Milk, its holding would not apply where the payment is contingent upon subsequent performance or consideration. In the present case, after the initial sale by the drug manufacturer, the wholesaler and perhaps the chain store in turn sell the product to a direct retailer. Unless and until the retailer sells the product to a Medicaid recipient for a lower price, there is no obligation for the drug manufacturer to pay any payment. Even then, the retailer must put in a claim to the state agency, which in turn must put in a claim to the drug manufacturer, before the manufacturer is required to make the payment.

On similar facts, Ertegun v. Commissioner, 531 F.2d 1156 (2d Cir. 1976), refused to apply Pittsburgh Milk where a rebate was contingent upon the return of phonograph records. The Ertegun case involved the Atlantic Records Sales Company, Inc. (Atlantic), a wholesaler of records, which sold to approximately 60 distributors. Forty-one of the distributors had the right under the terms of sale to return unsold records to Atlantic after the end of each calendar quarter and thereby receive a credit towards their bills from Atlantic for the next quarter. The distributors who could return their records were guaranteed that Atlantic would accept unsold merchandise up to an amount equal to 10 percent of the distributors' purchases for the previous quarter. Sometimes the distributors were allowed to return more. The qualifying distributors routinely returned records up to the 10 percent limit and were permitted to purchase unsold records from other distributors to meet their limit.

On its tax return, Atlantic reduced its income for the last quarter of the taxable year for the amount of the anticipated discount for the last quarter, which was attributable to records that had not yet been returned. The Service disallowed this exclusion. The taxpayers argued that the amount of the discount could be excluded under Pittsburgh Milk. However, both the Tax Court, T.C. Memo. 1957-27, and Second Circuit determined otherwise, because the return of the records was required before the discount was paid. Even though the distributors almost always returned the records, the reduced price was not automatic as it had been in Pittsburgh Milk.

In both Ertegun and the present case, a submission is necessary before the payment or discount arises. The present case is even more contingent because there is no potential liability until some sale is made to a Medicaid recipient and the number of those sales is not known at the time of the sale of the drugs by the manufacturer. In contrast in Ertegun, the distributors routinely met their 10 percent limit even if it involved buying records from others.

**Transactions where there is no mechanism for computing the payment**

Transactions where the rebate is contingent on subsequent performance should be distinguished from cases where the amount of the discount is not known at the time of the sale, but a method of calculation has been provided. See Convergent Technologies, Inc. v. Commissioner, T.C. Memo. 1995-320; Sun Microsystems, Inc. v. Commissioner, T.C. Memo. 1993-467. These two cases both involved sellers granting stock warrants to purchasers of their products. The Service argued that there was no agreed upon net price since the value of the warrants was speculative. However, the court in both cases found that a specified dollar amount at the inception of a purchase arrangement is not necessary. Instead, it is enough that a mechanism for determining the price is established in the arrangement. Compare Foretravel, Inc. v. Commissioner, T.C. Memo. 1995-494, where the Tax Court allowed the taxpayer under very special facts to exclude rebates from income even though there was no mechanism for determining the price at the time of the sale.

Because the number of sales to Medicare recipients is not known and the formula for determining the payments can vary, we do not think that a qualifying mechanism exists for determining the amount of the payments at the time of the sale by the manufacturer.

**Transactions where the payment is paid as consideration for something else**

The Second Circuit in the Ertegun case (discussed above) also noted that the return of the records was valuable to Atlantic because it allowed Atlantic to reduce the royalty payments it was required to make to its recording artists. 531 F.2d at 1160. Similarly, the language quoted from Pittsburgh Milk indicates that a allowances provided for separate consideration are not excludible. In the present case, the pharmaceutical manufacturers are making the payments, because it is the only way their drugs can be sold to Medicaid patients. Thus, the payments are paid to reach an additional market for the manufacturers' drugs.

In this sense the present case is like United Draperies, where the Tax Court refused to allow the taxpayer to excluded from income amounts paid to the employees of companies that purchased its merchandise. The taxpayer in United Draperies was engaged in the manufacture and sale of draperies for mobile homes. In prior years, its business had not focused on mobile homes. However, certain individuals who held important positions with companies that built mobile homes directed business for draperies to the taxpayer. The taxpayer paid the individuals commissions on the sales and excluded these amounts from its income.

The Tax Court rejected the taxpayer's reliance on Pittsburgh Milk to justify the exclusions stating -

> In the instant case, petitioner's agreement to pay rebates was made with employees of its customers and was independent of its agreement with its purchasers fixing the selling price of the products sold. The fact that the amounts it agreed to pay these employees was measured by a fixed percentage of its collections from their employers is immaterial. These amounts were paid for a consideration separate from the selling price of its products, namely these employees sending the business of their employers to the petitioner, and the amounts received from these employers in consideration for its products sold is properly includable in petitioner's gross income.

United Draperies, 41 T.C. at 465.

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

HEATHER C. MALOY

By: ______________________________
GERALD M. HORAN
Senior Technician Reviewer
Branch One
Income Tax & Accounting