Pharmaceuticals Should Reevaluate Accounting for Chargebacks under Final Regulations

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Pharmaceutical companies need to reevaluate the tax accounting method used for chargebacks under final regulations. The final regulations addressing changes in income recognition rules under Treas. Reg. sections 1.451-3 and 1.451-8 were published on January 6, 2021, and are effective for tax years beginning on or after January 1, 2021. Companies deducting the chargebacks accrual at the time of initial sale must consider whether it is required to change their method of accounting.

In certain situations, there may be an ability to distinguish the regulations from certain fact patterns. This article does not discuss these situations in detail.

This article is not meant to provide a detailed analysis of the final regulations, but instead discuss the implications on tax accounting methods used for chargebacks, a common accrued liability for companies in the pharmaceuticals industry. Also discussed is how to mitigate an unfavorable adjustment by factoring.

The tax accounting treatment for chargebacks is a long-standing source of significant controversy between taxpayers and the Internal Revenue Service ("IRS"). Many taxpayers in the pharmaceutical industry with chargebacks accrual deduct the accrual for federal income tax purposes at the time of an initial sale of product to a wholesaler, while the IRS's position is the deduction should not occur until the product is resold by the wholesaler. In summary, the final regulations which are mandatory for tax years beginning after December 31, 2020, as did the proposed regulations issued in 2019, are consistent with the IRS's position and therefore create the need for pharmaceutical companies to evaluate the accounting method used for chargebacks.

Actions

There are several considerations for taxpayers in the pharmaceutical industry to evaluate as it relates to chargebacks:

- Companies whose current method of accounting is to deduct the chargebacks accrual at the time of initial sale generally must change their method of accounting by filing Form 3115, *Application for Change in Accounting Method*. The change is automatic and must be made on the first tax return filed for tax years beginning on or after January 1, 2021.
- The chargebacks accrual may be very significant, so companies that need to file accounting method changes should understand the magnitude of the unfavorable adjustment for tax quarterly estimated payments.
- Companies should determine the appropriate period to reflect the tax accounting method change in financial statements.
- There are other peripheral implications to the final regulations and its impact on the proper tax accounting treatment for chargebacks, including state and local tax considerations.

What Remedial Step Can Be Taken to Mitigate the Impact to Affected Companies?

In certain situations, the effect of the unfavorable adjustment can be minimized by employing "factoring" for accounts receivable ("AR"), a form of alternative financing where the seller transfers title of its AR to a related party.