

**Office of Chief Counsel
Internal Revenue Service
memorandum**

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subject: Tax treatment of hybrid coupons

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUES

Whether "hybrid" coupons (coupons that may be redeemed for products or used as a discount on a purchase of a product – depending on the customer's preferences upon redemption) are premium coupons¹ under section 1.451-4 of the Internal Revenue Regulations.

CONCLUSIONS

Section 1.451-4 of the Internal Revenue Regulations is reserved solely for trading stamps and premium coupons. Hybrid coupons that may be redeemed for a product or used as a discount on a purchase of a product are not premium coupons under section 1.451-4 of the Internal Revenue Regulations.

FACTS

An accrual method taxpayer has a points-based loyalty rewards program designed to enhance its sales. Membership is free of charge and no purchase is necessary to join.

¹ Although the requested advice focuses on the treatment of premium coupons, and not trading stamps, the conclusions set forth herein apply equally to trading stamps.

Under the rewards program, members earn points in connection with the purchase of qualifying products and services at the time the purchase occurs. Qualifying purchases include the purchase of products or services from retail stores or online portals. Gift cards, shipping charges, discounts from vendor coupons, and taxes and fees are not qualifying purchases.

Members earn 1 point for every \$1 spent on qualifying purchases. Each point has a value of one cent but points cannot be redeemed for cash. Points expire five years after the date earned. Members accumulate points which may be redeemed towards the purchase of products. If sufficient points are redeemed, the purchased product is free to the redeeming member. If insufficient points are presented at redemption, the purchase price is reduced according to the number of points redeemed and the member pays the reduced price. Thus, members can redeem the points for discounts on future purchases or receive free merchandise for redeemed points.

Under its current method of accounting taxpayer deducts the cost of points in the year a point is redeemed by its members. Taxpayer proposes to subtract from gross receipts for sales in the taxable year in which points are issued, an amount equal to: (i) the cost to the taxpayer of merchandise, cash, and other property used for redemptions in the taxable year; (ii) plus or minus the net addition/subtraction for the provision for future redemptions during the taxable year. That is, taxpayer proposes to apply section 1.451-4 of the Internal Revenue Regulations to the costs of redeeming the reward points.

LAW AND ANALYSIS

Section 1.451-4(a)(1) of the Internal Revenue Regulations provides that if an accrual method taxpayer issues premium coupons with sales and such coupons are redeemable by such taxpayer in merchandise, cash, or other property, the taxpayer should, in computing the income from such sales, subtract from gross receipts with respect to sales with which coupons are issued an amount equal to (i) the cost to the taxpayer of merchandise, cash and other property, used for redemptions in the taxable year, plus (ii) the net addition to the provision for future redemptions during the taxable year (or less the net subtraction from the provision for future redemptions during the taxable year).

Section 1.451-4 is an exception to the "all-events" test under section 461(h)(4), which generally requires that before a liability can be taken into account all events must have occurred which determine the fact of liability, the amount of such liability must be determinable with reasonable accuracy, and economic performance must have occurred with respect to such liability.

In Rev. Rul. 78-212, 1978-1 C.B. 139, the Service ruled that section 1.451-4 did not apply to discount coupon expenses because the right of redemption must be

unconditional. That is, the coupons must be redeemable without additional consideration from the consumer. The Service indicated that the intent of section 1.451-4 is to match, in the same taxable year, revenues with the expenses incurred in producing those revenues. Implicit to the matching concept is that the issuance of a coupon with the sale of a product creates an incidental obligation in an accrual method taxpayer that requires the taxpayer to incur additional expenses at some future time. This additional expense of premium coupon redemption is properly matched with the revenue derived from the sale of the product with which the coupon was issued. This is not the case with a discount coupon.

Internal Revenue Code section 466 (1978)² permitted an acceleration of the deduction for qualified discount coupons redeemed within six months of the close of the year. Under section 466, Congress defined a qualified discount coupon as a discount coupon which (i) was issued by the taxpayer, (ii) is redeemable by the taxpayer, and (iii) allows a discount on the purchase price of merchandise or other tangible personal property.

Congress subsequently repealed section 466, which was intended to be the sole relief for qualified discount coupons (discount coupons that were not qualified were not afforded any relief). As discussed below, at the time of enactment of section 466, Congress did not intend that taxpayers should seek relief for discount coupons under the section 1.451-4 trading stamp regulation.

Under section 1.466-1(a) (1979), the method of accounting under section 466 excluded trading stamps and premium coupons: "The method of accounting in section 466 is applicable only to the taxpayer's redemption of qualified discount coupons. Section 466 does not apply to trading stamps or premium coupons, which are subject to the method of accounting in § 1.451-4, or to discount coupons that are not qualified discount coupons."

Under section 1.466-1(c)(2)(i) (1979), the term "discount coupons" was narrowly defined and specifically excluded trading stamps and premium coupons: "A discount coupon is a sales promotion device used to encourage the purchase of a specific product by allowing a purchaser of that product to receive a discount on its purchase price. The term 'discount coupon' does not include trading stamps or premium coupons, which are subject to the method of accounting in § 1.451-4. A discount coupon may or may not be issued as part of a prior purchase. A discount coupon normally entitles its holders to receive nothing more than a reduction in the sales price of one of the issuer's products. The discount may be stated in terms of a cash amount, a percentage or fraction of the purchase price, a 'two for the price of one' deal, or any other similar provision. A discount coupon need not be printed on paper in the form usually associated with coupons; it may be a token or other object so long as it functions as a coupon."

² Repealed by Tax Reform Act of 1986, P.L. 99-514, Title VIII, § 823(a), 100 Stat. 2373.

In discussing enactment of section 466, the Joint Committee on Taxation³ notes that Congress did not intend that section 466 and section 1.451-4 were to apply to the same types of coupons. That is, Congress intended that if section 466 applied then section 1.451-4 did not apply: "To the extent (if any) that regulation § 1.451-4 applies to qualified discount coupons, this provision of the Act supersedes the regulation and provides, as of the effective date of this provision, the sole accrual accounting method of deducting the cost of redeeming qualified discount coupons outstanding at the close of the taxable year. Also, discount coupons which are not 'qualified discount coupons' under the provision are not accorded the tax accounting treatment provided by the provision, nor are they accorded the tax accounting treatment provided by the trading stamp and premium coupon regulation."⁴ Thus, it was intended that section 1.451-4 would be limited to only trading stamps and premium coupons and that section 1.466-1 would be the sole relief for qualified discount coupons.

A premium coupon, the Joint Committee explained further, generally is issued in connection with the sale of some item and entitles the holder to tender it (or, more usually, a large number of such coupons) in exchange for a product, often selected from a catalog, of the consumer's choosing.⁵ These coupons are used to promote the sale of the product with which the coupon is issued by allowing the consumer to collect coupons in order to acquire a different product.⁶

At the time it was enacted, Congress was aware that taxpayers were applying section 1.451-4 to discount coupons and disfavored such treatment. Congress preferred that section 1.451-4 be applied solely to trading stamps and premium coupons. The subsequent repeal of section 466 does not alter the fact that Congress disfavored taxpayers applying section 1.451-4 to discount coupons. In fact, Congress understood that with the repeal of section 466, "only those costs of redeeming discount coupons received for redemption during the taxable year will be allowed as a deduction during that taxable year." H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. (1986), 1986-3 C.B. Vol. 4 at 321.

Historically, premium coupons are exchanged for a single product. If a customer does not have enough premium coupons to acquire a certain product, the customer must make additional purchases to collect more coupons until the customer can obtain the product. As noted by the Joint Committee, this ensures that the coupons are used to promote the sale of the product with which the coupon is issued.⁷ By their very nature, hybrid coupons promote not just the sales of the products with which the coupons are issued, but products bought in the future at a discount. Thus, by definition, hybrid coupons are not premium coupons.

³ Staff of the Joint Committee on Taxation, General Explanation of the Revenue Act of 1978, 95th Cong., 2d Sess. 244 (1978), discussing § 466 (later repealed by the Tax Reform Act of 1986).

⁴ Id.

⁵ Id.

⁶ Id.

⁷ Id.

Additionally, hybrid coupons can be viewed as discount coupons allowing a member to acquire enough coupons to receive a discount off the purchase of a product. After a member has acquired a sufficient number of hybrid coupons to receive a discount on the purchase of an item, the member may also continue accumulating coupons until the purchase price is reduced to zero. However, the fact that a discount coupon may be accumulated in sufficient quantities to result in a free product does not alter the nature of the coupon as a discount coupon. Thus, hybrid coupons are more properly characterized as discount coupons and are not premium coupons under section 1.451-4 because the nature of hybrid coupons, like discount coupons, is that of a price reduction. See *Giant Eagle v. Commissioner*, T.C. Memo. 2014-146, *rev'd on other grounds*, 822 F.3d 666 (3d Cir. 2016). Moreover, bifurcating hybrid coupons between premium coupon and discount coupon contradicts congressional intent that to the extent section 466 and section 1.451-4 apply, section 466 would supersede section 1.451-4 and section 466 would be the "sole" method of accounting for qualified discount coupons.

Accordingly, the taxpayer's points that may be redeemed for a product or used as a discount on a purchase of a product (depending in part on the customer's preferences upon redemption) are not premium coupons under section 1.451-4.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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