CALIFORNIA FRANCHISE TAX BOARD

Legal Ruling No. 269

September 17, 1964

METHOD TO DETERMINE TAXABLE INCOME OF TRADING STAMP COMPANY

Syllabus:

X was organized in 1956 and commenced doing business in that year. It entered into contracts with retail merchants to sell them trading stamps to be issued by the merchants with sales to customers, and agrees to redeem the stamps for merchandise. Stamps are sold to the merchants at a price that the company anticipates will cover the cost of merchandise and the expenses of operation at little or no profit. Stamps are redeemed at stores maintained in various locations where the stamps are in use.

The taxpayer files its franchise tax returns on a fiscal year. It has been computing income as stamps are redeemed, not as stamps are sold, using an estimate that 95 percent of the stamps issued will be redeemed. Thus, as stamps are redeemed 100/95ths of the amount redeemed are included in income for the period. The cost of merchandise distributed in redemption and all expenses are deducted for the period. The amount of unredeemed stamps is set up in a liability account.

What method should be used to determine the taxable income of a trading stamp company?

There appears to be little legal authority which treats directly with the problem of the determination of the net income of trading stamp companies. The existing authorities generally deal with the situation of a taxpayer which distributes its own stamps or coupons with sales of its product and itself redeems the stamps or coupons.

In the latter situation, regulation (Reg. 17562(a)[17571d] of the 1954 Personal Income Tax Law, which is the same as the Federal regulation) provides that the taxpayer "should in computing the income from such sales subtract only the amount which will be required for the redemption of such part of the total issue of trading stamps or premium coupons issued during the taxable year as will eventually be presented for redemption." Instances of the application of the identical Federal regulation are found in U. S. v. Morrison Stores (1938), 99 Fed. 2d 77; Creamette Co. (1938), 37 BTA 216; Brown & Williamson Tobacco Corp. (1951), 16 T.C. 432; The Grolier Society Inc. (1953), 12 T.C.M. 1039. The rule is clear with respect to taxpayers who issue stamps with sales and redeem their own trading stamps that the total sales price is included in the period the stamps are issued and that there should be subtracted in the same period the amount which will be required to redeem those stamps issued during the period that will eventually be presented for redemption.

Although the regulation by its express terms is applicable to taxpayers which issue their own trading stamps, is there any grounds upon which to hold that the rule is not equally applicable to the taxpayer whose operations consist solely of providing stamps and redeeming them for merchandise for other merchants who distribute them with sales? There does not appear to be any fundamental difference in the two situations that would support different treatment. In both cases, as far as the issuing company is concerned, the stamps are sold in one period and redeemed in a subsequent period, and the process of determining income should be the same.

In the case of a trading stamp company, the business from which its net income is derived is a bifurcated operation; the sale of trading stamps to the merchants who distribute them and the subsequent redemption of the stamps in exchange for merchandise. There is little question but that income from the sale of stamps is includible in the period in which the stamps are sold. The sale of the stamps to the merchant is a closed transaction between those parties so that income is realized at that time. However, it does not follow that the entire receipts constitute gross income. The basis of the regulation pertaining to the issuance of trading stamps would seem to be that the total amounts received upon the sale of stamps do not constitute gross income but are, rather, gross receipts from which the cost of goods sold must be subtracted to determine gross income. (See, Reiling, Tax Accounting for Repricing and Other Reserves, 31 Taxes 990, 991.) Of course, the rule is well settled that amounts received as a return of capital or investment are not income (Doyle v. Mitchell Bros. Co., 247 U.S. 179), and this includes inventory. If determining income from the sale of trading stamps does not require recognition of the factor that an allowance must be made for the cost of goods to be exchange[d] in redemption, then the regulation provides an inexplicable departure from the well settled rule prohibiting the deduction from current income of a reserve for estimated future expenses. (Mertens, Sec. 12.22 et seq.)

In summary, it is concluded that gross receipts from the sale of stamps are includible by the company in the period in which the stamps are sold, on the basis either that the sale is a completed transaction in the period or that income is includible under the claim of right doctrine. And it is further concluded that there should be subtracted from gross receipts the amount required for the redemption of stamps sold during the period, for the reason that the instant situation is not fundamentally different from that covered by the regulation, and that in either case the gross receipts from the sale of stamps constitute in part the recovery of the cost of goods which must be allowed in computing gross income. Although it decided against the taxpayer because the regulation was not complied with, the court stated in U. S. v. Morrison Stores, supra, 80, that ". . . it seems apparent that some deduction should be made for the amount necessary to redeem the purchase slips . . ." In that case the taxpayer issuing the redeemable vouchers did its own redemption, but the statement would seem to be applicable to the instant type of taxpayer as well. Furthermore, the general principles approved herein are in accord with the method that has long been accepted by the taxing authorities as used by perhaps the leading trading stamp company in the country, The Sperry & Hutchinson Company.

The recent case of Automobile Club of New York, Inc. (1959), 32 T.C. 906, held that the excess of the proceeds from the sale of redeemable coupons over the redemptions of such coupons is taxable income for the year. The coupons were not redeemable in merchandise but could either be applied by members of the taxpayer to the payment of annual dues or be redeemed in case. The basis of the decision appears to be that no deduction is allowable for a contingent liability to refund income in the future. The taxpayer had reported no income from its coupon plan on the ground that all of the receipts were refundable. The trading stamp regulation and cases are not discussed. The prime issue in the case, however, is over the question of deferring prepaid membership dues.

The remaining problems relate to the manner of determining the amount to be subtracted in computing income from the sales of stamps. It is concluded, in accordance with the foregoing principles, that:

1. The amount should be based upon the quantity of stamps sold during the period.

2. The amount should cover only the cost of goods required to redeem the stamps that will eventually be presented for redemption.

3. The amount to be subtracted should be based on the "reasonable expectation" of the proportion of stamps issued in the year which will eventually be redeemed. Brown and Williamson Tobacco Corp., supra. The taxpayer must furnish the information necessary to support the amount. U. S. v. Morrison Stores, supra; The Grolier Society, Inc., supra. In the case of a beginning enterprise, there would appear to be no objection to using the experience of all years available at this time. The redemption figure of 95 percent contended for by the taxpayer based upon the experience of other taxpayers does not appear to be justified for the early years. It is recommended that we determine a proper allowance for redemption based on all of the evidence available including the actual experience of this taxpayer.

4. When a cash value is assigned to the stamps, the amount subtracted should be at least equal to the cash value of the stamps expected to be redeemed. However, in all likelihood, the cost of merchandise required for redemption will exceed the cash value of the stamps.