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TAX TREATMENT OF RETURNS OF MAGAZINES, PAPERBACKS, AND RECORDS

OCTOBER 5 (legislative day, SEPTEMBER 28), 1978.—Ordered to be printed

Mr. LONG, from the Committee on Finance, submitted the following

REPORT

[To accompany H.R. 3050]

The Committee on Finance, to which was referred the bill (H.R. 3050) to amend the Internal Revenue Code of 1954 to provide an exclusion from gross income with respect to magazines, paperbacks, and records returned after the close of the taxable year, having considered the same, reports favorably thereon with amendments, and an amendment to the title, and recommends that the bill as amended do pass.

39-010

I. SUMMARY

1. Returns of magazines, etc.

Under present law, sellers of merchandise who use an accrual method of accounting generally must include sales proceeds in income for the taxable year when all events have occurred which fix the right to receive the income and the amount can be determined with reasonable accuracy. The Internal Revenue Service has taken the position that accrual-basis publishers and distributors of magazines, paperbacks, or records must include the sales proceeds of these items in income when they are shipped to purchasers, and may reduce income for returns only in the year the items actually are returned unsold by the purchaser.

The bill permits an accrual-basis publisher or distributor of magazines, paperbacks, or records to elect to exclude from income amounts attributable to items returned within 2 months and 15 days (in the case of magazines) or 4 months and 15 days (in the case of paperbacks and records) after the close of the taxable year in which the sales of the items were made.

2. Redemption costs of discount coupons

Under Treasury regulations specifying the appropriate taxable year for inclusion of income items, accrual-basis issuers of premium coupons with sales may reduce gross receipts by the estimated cost of redeeming such coupons outstanding at the close of the taxable year (plus the cost of redeeming coupons during the taxable year that have not previously been taken into account). The term "premium coupons" is not defined in the regulation, and the courts have not directly addressed the question of what constitutes a premium coupon. The Internal Revenue Service has issued two revenue rulings that deny the applications of the regulation to two types of coupons which give consumers "cents off" or other discounts on the purchase price of specified merchandise.

The committee amendment provides a special accounting rule allowing certain issuers of qualified discount coupons to deduct for a taxable year the cost of redeeming qualified discount coupons which are (1) outstanding at the close of the taxable year and (2) redeemed within six months after the close of the taxable year, plus the cost (if not previously taken into account) of redeeming discount coupons received during the year. (This rule only applies to discount coupons and does not affect the tax treatment of premium coupons.) Also, the amendment allows taxpayers who, in prior years, have accounted for discount coupons under the existing premium coupon regulation to elect to treat their method of accounting as a proper method for those years.

3. Tire and tread rubber taxes

The committee amendment clarifies the treatment of credits or refunds of the manufacturers excise tax on new (or retreaded) tires where sales are later adjusted as the result of a warranty or guarantee.

The amendment also provides for credits or refunds of the manufacturers excise tax on tread rubber if tax-paid tread rubber is (1) wasted in the recapping or retreading process, (2) used in the recapping or retreading of tires the sales of which are later adjusted under a warranty or guarantee, or (3) used in the recapping or retreading of tires which are exported, sold to State or local governments, sold to nonprofit educational institutions, or sold as supplies for vessels or aircraft.

In addition, the amendment modifies the statute of limitations so that a credit or refund of the tread rubber or new tire tax can be obtained for a period of one year after the warranty or guarantee adjustment is made. Also, the amendment imposes a tax on tread rubber used in recapping or retreading certain tires abroad, if those tires then are imported into the United States.

4. Retirement bond interest rates

Under present law, the interest rate on an individual retirement bond or a retirement plan bond issued by the Treasury Department remains the same from the date of issuance until the bond is redeemed (generally when the owner retires, becomes disabled, or dies). The committee amendment authorizes the Treasury Department to make upward adjustments in the interest rate on outstanding retirement bonds, so that such a bond will earn interest at a rate consistent with the rate then established for new offerings of such retirement bonds.

5. Child care credit

Under present law, payments by a taxpayer to certain relatives for child care services qualify for the child care credit only if the relatives' services constitute "employment" as defined for purposes of social security taxes. Because of the operation of that definition, payments to grandparents to care for their grandchildren generally are not treated as qualifying for the credit.

The committee amendment repeals the requirement that qualifying child care services of relatives must constitute "employment" under the social security tax rules. Thus, otherwise qualifying payments to grandparents to care for their grandchildren will be eligible for the child care credit. Also, the amendment disallows the credit for amounts for child care services paid by the taxpayer to his or her child if the child performing such services is under age 19.

II. GENERAL STATEMENT

A. Tax Treatment of Returns of Magazines, Paperbacks, and Records (sec. 1 of the bill and new sec. 457 of the Code)

Present law

Generally, sellers of merchandise who use an accrual method of accounting must report sales proceeds as income for the taxable year when all events have occurred which fix the right to receive the income and the amount can be determined with reasonable accuracy (Treas. Regs. sec. 1.451–1(a)).

In some cases, the seller expects that accrued sales income will be reduced on account of events subsequent to the date of sale, such as returns of unsold merchandise for credit or refund pursuant to a pre-existing agreement or understanding between the seller and the purchaser. In these instances, the reduction in sales income generally must be recognized in the taxable year during which the subsequent event, such as the return of unsold merchandise, occurs, Deductions or exclusions based on estimates of future losses, expenses, or reductions in income ordinarily are not allowed for Federal income tax purposes.

Under these general tax accounting rules, the Internal Revenue Service has taken the position that accrual-basis publishers and distributors of magazines, paperbacks, or records must include the sales proceeds of these items in income when they are shipped to the purchaser, and may reduce income for returned items only in the taxable year the items actually are returned unsold by the purchaser.

Reasons for change

Publisher and distributors of magazines, paperbacks, and records often sell more copies of their merchandise than it is anticipated will be sold to consumers. This "overstocking" is part of a mass-marketing promotion technique, which relies in part on conspicuous display of the merchandise and ability of the retailer promptly to satisfy consumer demand. Publishers usually bear the cost of such mass-marketing promotion by agreeing to repurchase unsold copies of merchandise from distributors, who in turn agree to repurchase unsold copies from retailers. These unsold items are commonly called "returns".

The generally accepted method of accounting for returns in the publishing industry is to record sales at the time merchandise is shipped and to establish an offsetting reserve for estimated returns. The effect of this accounting treatment is to report sales net of estimated returns. Tax accounting rules, however, do not permit gross income to be reduced for returns until the returned items are received, which may not occur until a taxable year subsequent to that in which the sale was recorded.

The committee believes that the present method of tax accounting for returns of magazines, paperbacks, and records does not accurately measure income for Federal income tax purposes and that it adversely affects publishers and distributors of these items.

Explanation of provision

General

For taxpayers who account for sales of magazines, paperbacks, or records on an accrual method, the bill provides an election to exclude from gross income for a taxable year the income attributable to unsold merchandise returned within a certain time (the "merchandise return period") after the close of the taxable year (new sec. 457 of the Internal Revenue Code). In the case of magazines, the merchandise return period extends for 2 months and 15 days after the close of the taxable year. In the case of paperbacks and records, the merchandise return period extends for 4 months and 15 days after the close of the taxable year.[1]

Scope of election

The election applies only with respect to sales of magazines, paperbacks, and records. The term "magazine" includes other periodicals, but does not include newspapers. The term "paperback" means paperback books, which are characterized by a flexible outer cover to which the pages of the book are directly affixed. This method of binding distinguishes paperbacks from hardback books, which usually have stiff front and back covers enclosing pages which are bound to a separate spine. (If an item satisfies the definitions both of magazines and of paperbacks, it is to be treated as a paperback for purposes of the bill.) The term "record" means a disc, tape, or similar object on which musical, spoken, or other sounds are recorded; however, the election provided by the bill does not apply to blank records, tapes, etc., on which it is expected the purchaser will make his or her own recordings.

An election applies with respect to the trade or business in connection with which the magazines, paperbacks, or records are sold. If two or more such categories of merchandise are sold in connection with the same trade or business, each category is treated as a separate trade or business. For example, if a taxpayer sells both magazines and paperbacks in connection with a single trade or business, then solely for purposes of the merchandise-return election the sale of magazines will be considered one trade or business, and the sale of paperbacks will be considered a separate trade or business. With respect to any such separate trade or business, an election applies to all sales of merchandise items in that trade or business (e.g., to all sales of all magazines by an electing taxpayer who publishes several magazines within the same trade or business).

Requirements for application

The method of accounting provided for under the election differs from that used for financial reporting purposes, in that the amount of reduction in gross income pursuant to the election is limited by actual returns during the merchandise return period, while under financial accounting rules, the reduction may be based on an estimate of future returns. Accordingly, several requirements are established to define those returns which may be used to reduce gross income if a timely election is made.

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[1] Under regulations to be issued by the Treasury Department, an electing taxpayer may select a shorter merchandise return period than that otherwise applicable. Any change in the merchandise return period after its initial establishment will be treated as a change in method of accounting, subject to the rules applicable to such changes.

Legal obligation.—The taxpayer must be under a legal obligation (as determined by applicable State law), at the time of sale, to adjust the sales price of the magazine, paperback, or record on account of the purchaser's failure to resell it. Cash refunds, credits to the account of the purchaser, and repurchases of the merchandise constitute adjustments of the sales price. However, a markdown of the sales price, such as a refund or credit to the account of the purchaser of only a portion of the sales price under an arrangement whereby the purchaser may continue to hold the merchandise for sale or other disposition (other than solely as scrap), does not constitute an adjustment to the sales price for this purposes.

Failure to resell.—The adjustment to the sales price must be on account of the purchaser's failure to resell the magazine, paperback, or record in its trade or business. Adjustments attributable to damage of the merchandise do not qualify as reductions in gross income pursuant to a merchandise-return election. However, items returned under an obligation to adjust the sales prices of unsold merchandise qualify regardless of the fact that the returned magazines, paperbacks, or records may be damaged.

Return of merchandise.—A reduction in gross income may be made under a merchandise-return election only with respect to merchandise which has been returned to the taxpayer by the close of the merchandise return period. This return requirement may be satisfied by physical return of the merchandise or by other means to be prescribed by regulations to be issued by the Treasury Department.

Rather than requiring return of the entire magazine for an adjustment to the sales price, some publishers and distributors require only that the cover be cut off and returned, and that the rest of the magazine be disposed of. In these instances, the regulations could provide that certification from the purchaser that such magazines have not been resold and will not be resold constitutes evidence in lieu of physical return. Any permitted certification or other evidence must be acceptable to the Treasury Department as satisfactory proof of the quantity and time of returns. Either the physically returned merchandise or the alllowable substituted evidence must be in the possession of the taxpayer at the close of the merchandise return period.

Amount to be excluded

The amount to be excluded from gross income on account of otherwise qualifying returns is limited to the lesser of (1) the amount covered by the acknowledged legal obligation with respect to such returns or (2) the amount of adjustment to the sales price agreed to by the taxpayer before the close of the merchandise return period. An agreement to adjust the sales price may be evidenced by the taxpayer's making an actual refund or credit to the account of the purchaser, or by the taxpayer's issuing a credit memorandum or other document stating such amount credited to the purchaser.

If the amount of legal obligation with respect to such returns is in dispute at the close of the merchandise return period, the amount in dispute cannot be excluded from gross income.

Method of making election

A merchandise-return election does not require consent of the Treasury Department, but must be made in such manner as the Department may prescribe by regulations. (The Treasury has assured the committee that regulations on the manner of making the election

will be issued within six months from the date of enactment of the bill.) The election for a particular taxable year must be made not later than the time prescribed by law for filing the return for such taxable year (including extensions thereof); the election cannot be made on an amended return filed after the due date (including extensions thereof) for filing the return for such taxable year. Once made, an election is binding for future years with respect to the particular trade or business to which the election applies (e.g., sales of magazines) unless the taxpayer secures consent of the Treasury Department to revoke it.

Election as method of accounting; transitional adjustments

The computation of income under the merchandise-return election constitutes a method of accounting.[2] In the absence of a specific statutory rule to the contrary, an adjustment to income attributable to a change in method of accounting (called the "transitional adjustment") is amortized over a set period of time prescribed by the Internal Revenue Service, usually 10 years (sec. 481(c)). However, the provision sets forth specific rules for the transitional adjustments arising out of merchandise-return elections.

In the case of an election to account for magazine returns under this provision, a special 5-year amortization of the transitional adjustment is provided in place of the normal 10-year spread. In the case of an election to account for paperback or record returns under this provision, the provision establishes a "suspense account" to hold the transitional adjustment. The operative effect of the suspense account (described in detail below) is to defer deduction of the transitional adjustment until the taxpayer is no longer engaged in the trade or business of selling the items which were the subject of an election.

To the extent that this provision sets forth special rules applicable to computation of income under a merchandise-return election (such as the transitional adjustment rules) which are inconsistent with the rules generally applicable to changes in method of accounting, the special rules of this provision override. For example, the provision authorizes an initial merchandise—return election to be made without consent of the Treasury Department, which also is inconsistent with the general rule on changes in method of accounting. However, other rules under present law relating to accounting changes would continue to apply, such as the requirement of recognizing the balance of a deferred adjustment if the taxpayer ceases to be engaged in the trade or business to which it relates.

Suspense account for paperbacks and records

A separate suspense account is to be established for each trade or business (or category which is treated as a trade or business under this provision with respect to which an election is made. As long as merchandise returns during the merchandise return period remain at or below the level of the initial opening balance in the account, taxable income under the merchandise-return method is the same as it would have been absent an election. However, an increase in returns over the initial opening balance is recognized one year earlier under the elected method.

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[2] Thus, a change to another method of reporting merchandise returns would be a change in method of accounting subject to the applicable rules governing accounting changes. As stated in note 1, *supra*, a change in the merchandise return period after its initial establishment also constitutes a change in method of accounting.

Initial opening balance.—To compute the initial opening balance of the suspense account for the first taxable year for which an election is effective, the taxpayer must determine the dollar amount of merchandise returns which would have been excluded from gross income for each of the three preceding taxable years had the election been in effect for those years. The initial opening balance of the account is the largest such dollar amount determined for any one of the three prior years. If that initial opening balance exceeds the actual returns during the merchandise return period of the year immediately preceding the year of election, such excess is included in income in the year of election. Section 481(b) does not apply to this increase in the suspense account.

For example, assume that a paperback distributor made a timely merchandise-return election effective for its taxable year ending December 31, 1977, and did not select a merchandise return period shorter than the statutory period. If the taxpayer's merchandise returns in the first 4 months and 15 days of 1975, 1976, and 1977 were $5, $8, and $6 respectively, then the initial opening balance in the suspense account on January 1, 1977 would be $8 (the largest dollar amount of merchandise returns in the pertinent years). Since the initial opening balance exceeds the actual returns in the first 4 months and 15 days of the taxable year for which the election is first effective ($6 in 1977), the excess of $2 is added to gross income for such taxable year (1977).

Annual adjustments.—Adjustments are made to the suspense account each year to account for fluctuations in returns. To compute the annual adjustment, the taxpayer must determine the amount to be excluded from gross income for the taxable year under the election. If this amount is less than the opening balance in the suspense account for the taxable year, the account is reduced by the difference. Conversely, if such amount is greater than the opening balance in the suspense account for the taxable year, the account is increased by the difference (but not to an amount in excess of the initial opening balance). Adjustments which reduce the suspense account reduce gross income for the taxable year; adjustments which increase the suspense account increase gross income for the taxable year.

Under the facts of the example used above, the opening balance for 1978 would be $5. This equals the $8 initial opening balance for 1977 reduced by $3, which is the excess of the initial opening balance ($8) over merchandise returns in the first 4 months and 15 days of 1978 ($5).

Assume that qualifying returns in the first 4 months and 15 days of 1978, 1979, and 1980 are $5, $7, and $10, respectively. The amount excludable from gross income under the election for 1978 is $7, i.e., the amount of qualifying returns in the first 4 months and 15 days of 1979. Since the excludable amount ($7) exceeds the opening balance for 1978 ($5), the account is increased by $2 to $7, and $2 is added to gross income for the year. Thus the net amount excludable from income in 1977 after these adjustments is $5—the $7 exclusion netted against the $2 addition to gross income.

The amount excludable under the election for 1979 is $10, which is $3 more than the $7 opening balance in the suspense account for 1979. However, the suspense account is increased only by $1 to $8, the initial opening balance (and ceiling on the suspense account).

The $1 also is added to gross income for the year. The net amount excludable from income in 1979 after all adjustments is $9.

Comprehensive illustration.—This example is set out more fully for the years 1977 through 1980 in the following table.

	Years Ending Dec. 31—					
	1975	1976	1977 [1]	1978	1979	1980
Facts:						
Actual returns in first 4 months and 15 days	$5	$8	$6	$5	$7	$10
Adjustment to suspense account:						
Opening balance			$8	$5	$7	$8
Addition to account [2]				2	1	
Reduction to account [3]			(3)			
Opening balance for next year			$5	$7	$8	$8
Amount excludable from income:						
Intial year adjustment			$(2)			
Amount excludable as actual returns in merchandise return period			5	$7	$10	
Adjustment for increase in suspense account				(2)	(1)	
Adjustment for decrease in suspense account			3			
Net amount excludable for the year			$6	$5	$9	

[1] Year of change.

[2] Applies when returns during the merchandise return period exceed the opening balance; the addition is not to cause the suspense account to exceed the intial opening balance.

[3] Applies when returns during the merchandise return period are less than the opening balance.

Nonrecognition transactions.—When a taxpayer who is required to maintain a suspense account under this election is a party to a transaction with respect to which there is nonrecognition of gain or loss to any party to the transaction by reason of subchapter C of the Code, the operation and continuation of the suspense account is to be determined in accordance with regulations to be prescribed by the Treasury Department.

Effective date

The election provided by the provision may be made with respect to taxable years beginning after December 31, 1976. The time for making the election for any taxable year beginning before the date of enactment of this bill does not expire before the date which is one year after the enactment date.

Revenue effect

It is estimated that the provision will reduce budget receipts by $22 million in fiscal year 1979, $11 million in fiscal year 1980, $11 million in fiscal year 1981, $12 million in fiscal year 1982, and $12 million in fiscal year 1983.

B. Tax Treatment of Redemptions of Discount Coupons (sec. 2 of the bill and new sec. 466 of the Code)

Present law

Under Treasury regulation (§ 1.451–4) specifying the appropriate taxable year for inclusion of income items, accrual-basis issuers of premium coupons with sales may reduce gross receipts by the estimated cost of redeeming such coupons outstanding at the close of the taxable year (plus the cost of redeeming coupons during the taxable year that have not previously been taken into account). The term "premium coupon" is not defined in the regulation, and the courts have not directly addressed the question of what constitutes a premium coupon.

The Internal Revenue Service has ruled that two types of "cents-off" or "discount" coupons do not qualify under the regulation for the estimated deduction.[1] The two types are called "media coupons" and "in pak/on pak coupons". Media coupons are issued gratuitously through the mail or by newspaper, etc., while in pak/on pak coupons are included with merchandise purchased by the consumer. Both types allow the consumer "cents off" (or other discount) on the purchase price of specified merchandise.

Another income tax regulation (§ 1.461–1(a)(2)) provides that an accrual-basis taxpayer may accrue and deduct an expense in the taxable year in which all the events have occurred that fix the fact of the liability and the amount can be determined with reasonable accuracy. This is called the "all events" test. Under this rule, an accrual method taxpayer generally can accrue and deduct the cost of redeeming discount coupons tendered for redemption by the close of the taxable year. Further, it could be argued that a deduction may be claimed under this rule when the coupon is tendered for redemption to a person authorized to redeem it from the consumer.

Reasons for change

For many years, trading stamps and premium coupons have been employed as a means of promoting the sale of many companies' products. However, in recent years an increasing number of companies have been using discount coupons to promote their merchandise [2]

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[1] Rev. Rul. 73–415, 1973–2 C.B. 154, and Rev. Rul. 78–212, I.R.B. 1978–23, p. 11.

[2] At ypical discount coupon promotion program would operate in the following manner. Assume that a manufacturer of cereal desires to promote a new brand of cereal beginning October 1 of the current year. During September, the manufacturer sells large quantities of the new cereal to retailers so that they will have sufficient inventory on hand during the promotion period. The manufacturer also arranges to have coupons, allowing 50 cents off on the purchase of a box of the new cereal, distributed by newspaper, by direct mail, and by inclusion in packages of other products sold by the manfacturer.

Before the end of December (the cloae of the manufacturer's taxable year), perhaps as much as 75 percent of the coupons that will ultimately be redeemed will be tendered to retailers by consumers. The manufacturer, however, may not receive these coupons from the retailers for several months. This time lag between receipt by the retailer and redemption by the manufacturer occurs because the coupons usually go through a redemption process that includes grouping, counting, and verification by both the retailer and an intermediary party called a "redemption agent."

The regulation presently governing the tax accounting treatment for trading stamps and premium coupons does not specifically address the method of accounting for discount coupons. It is argued by some that no real distinction can be drawn between premium coupons and discount coupons, and that the principles of the regulation apply equally to both types.

Industries that rely heavily on discount coupons for product promotion have testified before the committee that they consistently have been using the accounting treatment provided in the trading stamp and premium coupon regulation for discount coupons. Accordingly, the IRS rulings that deny to certain types of discount coupons the accounting treatment provided in the regulation for trading stamps and premium coupons have caused confusion and uncertainty in industries that rely heavily on discount coupon promotions.

The committee has concluded that it is appropriate to allow a limited deduction for discount coupons estimated to have been turned in by consumers by the close of the issuer's taxable year, but which have not been received by the issuer by that time. This treatment is essentially in accord with the rule that allows a deduction under the "all events" test of present law, if the amount of deduction can be determined with reasonable accuracy. The bill provides this "accuracy" and the certainty needed for administration by providing, generally, that a deduction will be allowed for coupons outstanding at the close of the taxable year that are received by the issuer within six months after the close of the taxable year.

Explanation of provision

General

For taxpayers who use an accrual method of accounting, the bill provides an election to deduct the cost of redeeming qualified discount coupons outstanding at the close of the taxable year and received by the taxpayer within the "redemption period," which generally is the six-month period following the close of the taxable year [3] (new sec. 466 of the Internal Revenue Code).

Coupons for which election may be made

The election applies only with respect to qualified discount coupons. The tax accounting treatment of trading stamps and premium coupons presently provided in income tax regulation § 1.451–4 is not changed by this provision, and the committee's approval of this provision does not imply that the tax accounting treatment accorded trading stamps and premium coupons under regulation § 1.451–4 is improper.

To the extent (if any) that regulation § 1.451–4 applies to qualified discount coupons, the provision supersedes the regulation and provides, for the future, the sole accrual accounting method of deducting the cost of redeeming qualified discount coupons outstanding at the

[3] An electing taxpayer may select a redemption period shorter than six months. Any change in the redemption period after its initial establishment is a change in method of accounting, subject to the rules applicable to such changes.

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 to be accorded the tax accounting treatment provided by the trading stamp and premium coupon regulation. The appropriate period for deducting the cost of redeeming such discount coupons would be determined generally under the normal tax accounting rules provided in section 461 of the Code and the regulations thereunder.

The determination of whether a coupon is a premium coupon or discount coupon is to be made by taking into account all the facts and circumstances involving its issuance and redemption. The method of issuance may be one of the facts and circumstances taken into account to determine whether a coupon is a discount coupon or premium coupon (but not to determine whether a discount coupon is a qualified discount coupon).

A premium coupon 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. 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 of his or her own choosing.[4]

A discount coupon, on the other hand, usually is designed to encourage the purchase of a specific product by allowing a discount on its purchase price. Discount coupons may be issued in a number of ways, including through newspapers or other printed media, by mail, and printed on or included in the package of another product. The discount may be stated in terms of a cash amount, a percentage of the purchase price, or as a "two for the price of one" coupon. Ordinarily, a discount coupon is individually redeemable, while the premium coupon is intended to be collected and redeemed in large numbers for a single product.

To qualify under the provision, a discount coupon must be (1) issued by the taxpayer, (2) redeemable by the taxpayer, and (3) allow a discount on the purchase price of merchandise of other tangible personal property. Coupons redeemable for a discount on the price of services or real property do not qualify under the provision. A 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. A coupon is not a qualified discount coupon if the face amount (including the effective discount of the coupon if it is a "two for the price of one" or "percentage off" coupon) is more than $5, or if it may be used in connection with other coupons to bring about a price reduction of more than $5 with respect to any item.

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[4] A well-known example of a premium coupon is the type of coupon issued with each pack of certain brands of cigarettes.

A coupon is not a qualified discount coupon if it is redeemed by the issuer directly from the person using the coupon to obtain a price discount.[5] For purposes of this rule, corporations which are members of the same controlled group of corporations (as defined in section 1563(a) of the Code) as the issuer are treated as the issuer. Thus, a coupon redeemed by a wholly owned subsidiary of the issuer is not a qualified discount coupon if it is redeemed directly by such sibsidiary from the user.

Method of making election and scope of election

A discount coupon election does not require consent of the Secretary of the Treasury, but must be made in such manner as the Secretary may prescribe by regulations. The election for a particular taxable year must be made not later than the time prescribed by law for filing the return for such taxable year (including extensions thereof); the election cannot be made on an amended return filed after the due date (including extensions thereof) for filing the return for such taxable year. Once made, an election is binding for future years with respect to the particular trade or business to which the election applies unless the taxpayer secures consent of the Secretary to revoke it.

The election is made with respect to the trade or business in connection with which the coupons are issued. An election applies to all qualified discount coupons issued by that trade or business.

Election as method of accounting

The computation of income under a discount coupon election constitutes a method of accounting. Thus, the election of this method or a change to another method of accounting for discount coupons will be a change in method of accounting subject to the applicable rules governing accounting changes. However, to the extent that this provision sets forth special rules that are inconsistent with the rules generally applicable to changes in method of accounting, the special rules of this provision are to take precedence.

Thus, although an election made under this provision constitutes a change in method of accounting, the special rules of the provision relating to the treatment of the adjustment to taxable income resulting from the election are to take precedence over the general rules. Generally, under these special rules, net decreases in taxable income are deferred from recognition by being placed in a suspense account, and net increases in taxable income are taken into income over a 10-year period. Section 481(b)(2), relating to the computation of tax if there is a substantial increase in taxable income because of an accounting method change, does not apply to an election under this provision.

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[5] The provision in intended to allow a deduction with respect to coupons turned in by the consumer before the close of the issuer's taxable year, but where, because of the time lag inherent in the chan of redemption, the coupons are not received by the issuer until some time after the close of its taxable year. If a coupon is redeemed directly by the issuer, no such time lag exists.

The committee believes that the method of accounting provided by this provision generally will clearly reflect income. However, if (for example) a taxpayer manipulates the issuance of coupons in such a manner that the rules set forth in this provision do not result in a clear reflection of income, it is anticipated that the Secretary, within his general authority under section 446 of the Code, may modify the method so that it does clearly reflect income.

Amount of deduction

Under the election, a taxpayer is allowed a deduction for the cost of redeeming qualified discount coupons outstanding at the close of the taxable year that are received within the "redemption period", which generally is the six-month period following the close of the taxable year. In addition, a deduction is allowed for the cost of redeeming qualified discount coupons received during the taxable year for which a deduction has not been allowed with respect to a redemption period of a previous year. Coupons received by an agent of the taxpayer (other than an agent who accepted the coupon from the person who used it to receive a price discount) before the close of the redemption period qualify as having been received by the taxpayer before the close of such period.

The cost of redeeming a coupon is the amount of discount stated on the coupon of, if less, the amount incurred by the taxpayer for paying the discount, plus an amount payable to the retailer (or other person redeeming the coupon from the person receiving the price discount) for services in redeeming the coupon. The amount payable to the retailer or other person for services in redeeming the coupon is allowed only if the amount payable is stated on the coupon. The amount incurred by the taxpayer in paying the discount does not include incidental costs such as a redemption center service fee.

Suspense account

In the absence of a specific statutory rule to the contrary, an adjustment to income attributable to a change in method of accounting (called the "transitional adjustment") is amortized over a set period of time prescribed by the Internal Revenue Service, usually 10 years (sec. 482(c)). Instead of using this general rule, the bill provides two special rules for the treatment of the transitional adjustment. If the adjustment is a net decrease in taxable income, it is to be placed in a suspense account. If it is a net increase in taxable income, it is to be taken into income ratably over a 10-year period beginning with the year or change.

The effect of the suspense account, which is described in detail below, is to defer the deduction of the transitional adjustment until the taxpayer is no longer engaged in the trade or business in connection with which the discount coupons are issued. A separate suspense account is to be established for each trade or business with respect to which an election is made.

Initial opening balance.—To compute the initial opening balance of the suspense account for the first taxable year for which an election

is effective, the taxpayer must determine the dollar amount of the deduction for discount coupons that would have been allowed with respect to coupons redeemed during the redemption period for each of the three preceding taxable years had the election been in effect for those years. The initial opening balance of the account is the largest such dollar amount determined for any one of the three prior years, reduced by the sum of the adjustment attributable to the change in method of accounting that increase income for the year of change. If, in computing the initial opening balance, the largest dollar amount of deduction that would have been allowed in any of the three prior years exceeds the actual cost of redeeming coupons received during the redemption period of the year immediately preceding the year of election, the excess is included in income in the year of election. Section 481(b) does not apply to this increase in the suspense account.

For example, assume that an issuer of qualified discount coupons makes a timely election under new section 466 for its taxable year ending December 31, 1979, and does not select a coupon redemption period shorter than the statutory period of 6 months. If the taxpayer's qualified coupon redemptions in the first 6 months of 1977, 1978, and 1979 were $7, $13, and $8, respectively (and the accounting change adjustments that increase income for 1979 are $2), then the initial opening balance in the suspense account on January 1, 1976 would be $11 (the largest dollar amount of qualified coupon redemptions in the pertinent years ($13), reduced by the sum of the accounting change adjustments that increase income in the year of change ($2)). Since the coupon redemptions taken into account in determining the initial opening balance ($13 in 1978) exceed the actual redemptions in the first 6 months of the taxable year for which the election is first effective ($8 in 1979), the excess of $5 is added to gross income for the year of election (1979).

Annual adjustments.—Adjustments are made to the suspense account each year to account for fluctuations in redemptions. To compute the annual adjustment, the taxpayer must determine the amount to be deducted under the election with respect to coupons received during the redemption period applicable to the taxable year under the election. If this amount is less than the opening balance in the suspense account for the taxable year, the account is reduced by the difference. Conversely, if such amount is greater than the opening balance in the suspense account for the taxable year, the account is increased by the difference (but not to an amount in excess of the initial opening balance). Adjustments that reduce the suspense account are a deduction for the taxable year; adjustments that increase the suspense account increase gross income for the taxable year.

To continue the example above, assume that coupon redemptions in the first 6 months of 1980, 1981, and 1982 are $7, $10, and $12, respectively. Given these facts, and applying the rules relating to annual adjustments to the suspense account described above, the annual adjustments to the account for 1979, 1980, and 1981 are a reduction of $4, increase of $3, and increase of $1, respectively. The computation of these adjustments, as well as the net effect of all these adjustments on income for each year are set out in the following table.

Illustration.—This table illustrates the establishment of the suspense account and its operation for the years 1979 through 1981.

	Years Ending Dec. 31—					
	1977	1978	1979 [1]	1980	1981	1982
Facts:						
Actual coupons redeemed in first six months	$7	$13	$8	$7	$10	$12
Accounting change adjustments that increase income in year of change			2			
Net adjustment decreasing income in year of change under sec. 481 (a)(2)			6			
Adjustment to suspense account:						
Opening balance [2]			11	7	10	11
Addition to account [3]				3	1	
Reduction to account [4]			(4)			
Opening balance for next year			7	10	11	11
Amount deductible:						
Initial year adjustment [5]			(5)			
Amount deductible as actual coupon redemptions during redemption period			7	10	12	
Adjustment for increase in suspense account				(3)	(1)	
Adjustment for decrease in suspense account			4			
Net amount deductible for the year for coupons redeemed during the redemption period			6	7	11	

[1] Year of change.

[2] The largest dollar amount of deduction that would have been allowed with respect to coupons redeemed within any redemption period of the three years immediately preceding the year of election ($13), reduced by the accounting change adjustments that increase income in the year of change ($2).

[3] Applies when coupons redeemed during the redemption period for the taxable year exceed the opening balance; the addition is not to cause the suspense account to exceed the initial opening balance.

[4] Applies when coupons redeemed during the redemption period for the taxable year are less than the opening balance.

[5] The initial year adjustment applies when the initial opening balance is computed with respect to actual coupon redemptions in the first six months of either of the two years preceding the year of change. If the adjustment applies, the amount of adjustment is the excess of the coupons redeemed in the first six months of the applicable year over the coupons redeemed in the first six months of the year of change.

Nonrecognition transactions.—If a taxpayer who is required to maintain a suspense account under this election is a party to a transaction with respect to which there is nonrecognition of gain or loss to any party to the transaction by reason of subchapter C of the Code, the operation and continuation of the suspense account is to be determined in accordance with regulations to be prescribed by the Secretary of the Treasury.

Effective date

The provision is effective for taxable years ending after December 31, 1978.

Special rules for certain prior years and certain taxpayers

Under the provision a taxpayer who meets certain conditions may make an election, the effect of which is to validate for that taxpayer certain tax accounting methods used to account for discount coupons in years prior to the effective date of this provision. To qualify for this "protective" election, a taxpayer must (1) elect the provisions of new Code section 466 for his first taxable year ending after December 31, 1978, and (2) for a continuous period of one or more prior taxable years (each of which ends before December 31, 1978) have used a method of accounting for discount coupons that was reasonably similar to the method provided in the trading stamp and premium coupon regulation ((§ 1.451–4 or its predecessors under the Internal Revenue Code of 1954)). If a reasonably similar method was used in two or more separate continous periods, the election may be made only with respect to one such period.

It is not necessary that the discount coupons covered by this protective election be qualified discount coupons under new Code section 466. Further, some costs of redemption that are not allowed under new Code section 466 are to be allowed under this election, such as service costs paid to a retailer or other persons where the amount of the cost is not stated on the coupon.

If a taxpayer makes a timely election under these rules to "protect" prior years, and, in addition, the method of accounting used in those years was used for all discount coupons issued by the taxpayer in those years, then the taxpayer need not establish the suspense account normally required by new Code section 466. Instead, the taxpayer will treat the election of the method under new Code section 466 as a change in method of accounting to which the normal rules for accounting for transitional adjustments apply.

This protective election may be made at any time before the expiration of the period for making the election under new Code section 466 for the taxpayer's first taxable year ending after December 31, 1978.

The committee recognizes that, due to the Internal Revenue Service interpretation of the trading stamp and premium coupon regulation, some taxpayers may have agreed in prior years to discontinue the use of the regulation to account for discount coupons. If those years are not closed under the statute of limitations, or by reason of a closing agreement with the Internal Revenue Service, the taxpayer may file a claim for refund based on the use of the "protected" method of

accounting (assuming he makes the protective election) if he used that method in his original return filed for that taxable year. This is not to be construed, however, to abrogate in any way the rules regarding the closing of taxable years due to the statute of limitations or a binding agreement between the Internal Revenue Service and the taxpayer.

Revenue effect

The provision is estimated to reduce budget receipts by $103 million in fiscal year 1980, and $10 million in each of fiscal years 1981, 1982, and 1983. The estimated reduction in budget receipts of $103 million in fiscal year 1980 includes almost $100 million attributable to years prior to 1980 on the assumption that the position of the IRS with regard to the proper method of accounting for discount coupons under present law (see footnote 1, *supra*) would be upheld by the courts.

C. Excise Tax on Tires and Tread Rubber (sec. 3 of the bill and secs. 4071, 6416, and 6511 of the Code)

1. New tires—credit or refund if tire sale is adjusted pursuant to warranty or guarantee (subsec. (d) of the provision and new sec. 6416(b)(2)(L) of the Code)

Present law

Present law (sec. 4071(a) of the Code) imposes a manufacturers excise tax of 10 cents per pound on new tires[1] of the type used on highway vehicles, and 5 cents per pound on new nonhighway tires.[2]

Since these taxes are imposed on the basis of weight, rather than on the basis of the price for which the tire is sold, changes in the sale price of the tire generally do not affect the amount of tax due on a manufacturer's sale. However, under present practice (Rev. Rul. 59-394, 1959-2 CB 280), if a tire manufacturer sells a customer a new replacement tire pursuant to a warranty or guarantee on the tire that is being replaced, the manufacturers excise tax on the replacement tire is reduced in proportion to the reduction in price of the replacement tire.

The tire industry's practice has been to apply this rule based on the proportionate reduction in the price to the ultimate consumer where the manufacturer's warranty or guarantee runs to the ultimate consumer. The Internal Revenue Service did not dispute this industry practice before the publication of Rev. Rul. 76-423, 1976-2 CB 345 In that ruling, the Service has taken the position that the tax should be reduced in proportion to the reduction in price from the manufactuer to its immediate vendee—usually, a wholesaler or a dealer. Since this price reduction often is proportionately less than the reduction given by the retail dealer to the ultimate consumer, the Service's position generally produces a smaller tax reduction (hence, a larger net tax) than that produced by the rule that focuses upon the adjustment in sale price to the ultimate consumer.

As originally announced, the 1976 ruling was to take effect with respect to this issue on April 1, 1977. This effective date has been twice postponed by the Service, most recently to April 1, 1978, in order to give the Congress an opportunity to consider whether legislative change is appropriate.

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[1] In the case of a retail outlet of the tire manufacturer, the tax (sec. 4071(a) (1) and (2)) applies on the delivery of the tire to the retail outlet (sec. 4071(b)). For purposes of sec. 4071, a lease (sec. 4217) or use (sec. 4218) by the manufacturer is treated as a sale.

As to domestically manufactured tires, the tax applies to new tires and also to tires that have been retreated "from bead to bead" (thereby making them new articles). As to imported tires, the tax applies whether or not the tire is new, if the tire had not been previously sold in the United States. Also, the tax applies to domestic tires retreaded bead to bead in a foreign country and then imported. This report uses the term "new tire" to mean all tires subject to tax under subsections (a)(1), (a)(2), or (b) of sec. 4071.

[2] The tax on new highway tires is scheduled under present law to be reduced to 5 cents per pound on October 1, 1979 (sec. 4071(d)); the tax on nonhighway tires is to remain at 5 cents per pound.

Revenue Ruling 76-423 also provides similar rules for the situation where the manufacturer's warranty or guarantee runs to the dealer but not to the ultimate consumer, and where the replacement tire is not from the same manufacturer as the original tire being returned under the warranty or guarantee. Finally, the ruling provides that, where the manufacturer initially sells tires to a dealer "under a price reduction arrangement in lieu of a warranty", no adjustment in excise tax is allowable.

Reasons for change

In the absence of specific statutory provisions, questions have arisen as to the proper method of computing the credit or refund of the manufacturers excise tax where tire warranty or guarantee adjustments have been made.

The committee has concluded that the rules in this area should be established more clearly and in accordance with specific statutory standards.

Explanation

Subsection (d) of the provision codifies the long-standing administrative practice under which a manufacturer is allowed an excise tax credit or a refund with respect to sales of tires for which a warranty or guarantee is given by the manufacturer to the ultimate consumer and an adjustment is made on a tire-by-tire basis. The provision also applies the same general principles to cases where such warranty or guarantee adjustments are made on an overall basis. In addition, the provision sets forth corresponding rules for situations where the manufacturer's warranty or guarantee runs only to its purchaser and not to the ultimate consumer.

Tire-by-tire—warranty to ultimate consumer

If the manufacturer's warranty or guarantee on account of a new tire runs expressly to the ultimate consumer and a warranty or guarantee adjustment is made, the amount of the tax overpayment (allowable as a credit or refund) is the amount that bears the same proportion to the total tax paid on the replacement tire, as the adjustment (determined by tread wear or otherwise) to the ultimate consumer in the price of the replacement tire bears to the unadjutsed total price (at the time of adjustment) at the ultimate consumer level of an equivalent replacement tire.[3]

Although the amount of the credit or refund is calculated with respect to the replacement tire, the overpayment is an overpayment of tax on the original tire.

Product pricing between the manufacturer and dealers (or others) generally is not to enter into calculation of the excise tax overpayments attributable to a warranty or guarantee adjustment where the warranty or guarantee runs to the ultimate consumer. However, in no event is the tax overpayment to be greater than the amount of the tax

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[3] Under the provision, the refund or credit is to be computed by reference to the price of the replacement tire rather than the original tire, because in the new-tire industry it is administratively easier to determine the replacement tire's price than it is to determine the original tire's price. It is expected that (absent changes in the rates of the tire taxes), in the aggregate, the refund or credits so determined will not differ substantially from what they would be if they were to be determined on the basis of the original tire's prices.

credit or refund paid (or agreed to be paid) by the manufacturer to (or passed on to) the ultimate vendor, unless the manufacturer obtains the ultimate vendor's written consent to the obtaining of the refund or credit (sec. 6416(a)(1)(C)).

This approach is to be used regardless of whether the ultimate consumer has returned the tire to the same retailer from which it was purchased (or whether the replacement tire is obtained from the same manufacturer as the tire being returned) if the adjustment is made pursuant to a warranty or guarantee and the original manufacturer causes the tax overpayment to be passed on to the ultimate vendor—the party (generally a retail dealer) who makes the adjustment to the ultimate consumer. This approach also is to apply regardless of whether the adjustment is made by an allowance against the price of a replacement tire or by a cash refund. In the case of a cash refund, the overpayment is to be determined by reference to the current price of and tax on a tire essentially equivalent to the tire returned under the warranty or guarantee—a deemed replacement tire.

Tire-by-tire—warranty to immediate vendee

If a manufacturer's express warranty or guarantee is extended only to an immediate vendee (such as a private brand distributor) other than an ultimate consumer, the excise tax adjustment rules are to be the same as the tire-by-tire adjustment rules described above except that the proportion is to be taken at the level of the manufacturer's adjustment to its immediate vendee (and not at the level of the dealer's adjustment to the ultimate consumer). This rule also codifies Rev. Rul. 59–394, above, and the administrative practice of the Internal Revenue Service in such cases, where the manufacturer typically may not control the distribution process of its immediate vendee.

No credit or refund is to be allowed in this situation until after the adjustment has been made to the ultimate consumer.[4] The Treasury Department is to provide by regulations for methods that ordinarily will be acceptable to the Service to prove that the adjustment has been made to the ultimate consumer, and also that the amount of the tax refund has been paid (or agreed to be paid) to the ultimate vendor. For example, the regulations might provide that the Service ordinarily would accept certificates from the manufacturer's immediate vendees that the adjustments have been made (or, in the case of the adjustment to the ultimate vendor, that the immediate vendee has agreed to make the adjustment or that the ultimate vendor has agreed to the credit or refund). The immediate vendee, in such a situation, must maintain sufficient records to support the certificates. However, if a warranty runs solely from the manufacturer to a private brand dealer (and not further to the final purchaser), and if the private brand dealer in turn supplies the final purchaser with a warranty as good as or better than that which runs from the manufacturer to the private brand dealer, then it would only have to be established that an adjustment in the tax was made between the manufacturer and the private brand dealer in order for the manufacturer to obtain a credit or refund of the excise tax.

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[4] If the immediate vendee discovers a defect in a tire and returns it, then the making of an adjustment to the immediate vendee satisfies the requirement that an adjustment must have been made to the ultimate consumer.

Overall—warranty to ultimate consumer

Under the provision, rules similar to those described above are to apply if the adjustments are made on an overall basis, rather than on a tire-by-tire basis. In such cases, the tax credit or refund is to be in proportion to an average amount per tire based upon an adjustment method which is in accordance with Treasury regulations, but only if that is consistent with the method used by the ultimate vendor (generally, the retail dealer) in making adjustments to the ultimate consumer. The Treasury Regulations are to provide that the overall method proposed to be used (e.g., a sampling method) must produce essentially the same result, with a high degree of probability, as the tire-by-tire method.

For example, if (1) the manufacturer, by a sampling technique, determines that some percentage of that manufacturer's tires sold by a certain retailer (or by retailers in a given area) is adjusted under warranties or guarantees, (2) the manufacturer thereupon refunds the percentage of the sales price charged by it for tires ultimately delivered to that retailer (or those retailers), (3) this refund system is consistent with the method used by that retailer (or those retailers) in making adjustments to ultimate consumers, (4) the manufacturer has the requisite certificates as to adjustments to ultimate consumers and ultimate vendors from the immediate vendee, which in turn maintains records supporting the certificates, and (5) the Service is satisfied that this system of determining amounts of price adjustments fairly reflects the adjustments made on account of warranties or guarantees and that this system is not an artificial pricing system designed to produce tax credits or refunds, then this system may be used in calculating the amount of tire excise taxes deemed to be over-payments on account of such adjustments.

In the case of an advance adjustment, the manufacturer is to receive an excise tax credit or refund only after the warranty or guarantee adjustment is made (or is deemed to have been made) to the ultimate consumer. The Treasury Department is to issue regulations determining the time when a warranty or guarantee adjustment is deemed to have been made to the ultimate consumer, where it is actually made by an advance adjustment.

Those regulations may provide, for example, that warranty or guarantee adjustments made with respect to a single shipment of tires are to be treated for these purposes as having been made to ultimate consumers ratably during the period (1) which begins when the first of these tires could be expected to have been delivered to an ultimate consumer and (2) which ends at the expiration of the last of the warranties or guarantees on these tires. Another alternative might be to determine, on a sampling basis, the average pattern of adjustments actually made to ultimate consumers and deem all such adjustments to have been made in accordance with that pattern.

Overall—warranty to immediate vendee

If adjustments are made on an overall basis (and not tire-by-tire) and the manufacturer's express warranty or guarantee is extended only to an immediate vendee (such as a private brand distributor) other than an ultimate consumer, the excise tax adjustment rules are to be the same as the overall adjustment rules described above, except that the adjustment method need not be the same as the method used

by the ultimate vendor (generally, the retail dealer) in making adjustments to the ultimate consumer. However, no credit or refund is to be allowed in this situation until after any required adjustment has been made (or deemed made) to the ultimate consumer (see footnote 4, *supra*).

Examples

Certain of the principles discussed above, as applied under the (provision), may be illustrated by the following examples:

(1) Assume that a tire is returned by the ultimate consumer because of road failure after being used only 40 percent of its guaranteed life and that under the guarantee (from the manufacturer to the ultimate consumer), the owner of the tire is entitled to a reduction in the price of a replacement tire by an amount equal to 60 percent of the unadjusted price of the replacement tire. At the time of the adjustment, the new tire retail price (including the amount passed on as excise tax) for an equivalent replacement tire is $30, and the dealer reduces the price of the replacement tire to the ultimate consumer by $18 (60 percent of $30). The unadjusted excise tax for equivalent replacement tire is $2.50 (determined by weight). Under the basic proportionality rule, the tentative overpayment is $1.50 (60 percent of $2.50).

Under its contract with the manufacturer, the dealer purchases an equivalent tire from the manufacturer. But for the warranty or guarantee arrangement, the manufacturer would have charged the dealer $15 (including the amount passed on as excise tax) for the equivalent tire; because of the arrangement, the price to the dealer is reduced to $12.50. Since the dealer in this case is the ultimate vendor and the price reduction to that ultimate vendor ($2.50) was more than the $1.50 available for credit or refund (based on the reduction to the ultimate consumer), the full $1.50 is to be allowable as a credit or refund of the new tire manufacturers excise tax.

(2) The facts are the same as in example (1), except that the dealer receives a credit of $2.50 on its open account with the manufacturer. As in example (1), the full $1.50 is to be allowable as a credit or a refund of the new tire manufacturers excise tax.

(3) The facts are the same as in example (1), except that the manufacturer's adjustment to the dealer (whether by way of price reduction on an equivalent tire or by way of credit on account) is only $1. Since the manufacturer has not allowed to the dealer the full amount of the excise tax credit treated as having been passed on to the ultimate consumer, these adjustments are to give rise to a credit or a refund to the manufacturer of $1 (and not $1.50).

(4) The facts are the same as in example (1), except that a cash refund is given. The dealer refunds $18 to the ultimate consumer for the failed tire (based upon the current price for an equivalent replacement tire of $30) and receives from the manufacturer an adjustment of at least $1.50. These adjustments are to give rise to a credit or refund to the manufacturer of $1.50.

(5) Assume that a tire manufacturer has entered into an agreement with a private brand distributor providing an express warranty only between the manufacturer and the private brand distributor. A tire is returned by the private brand distributor to the manufacturer after being used only 40 percent of its guaranteed life. Under the warranty,

the private brand distributor is entitled to buy an equivalent replacement tire at a price reduced by an amount equal to 60 percent of the unadjusted price of the replacement tire.

The unadjusted excise tax for the replacement tire is $2.50. At the time of adjustment, the new tire price (including the amount passed on as excise tax) for an equivalent replacement tire is $30 at retail and $21 to the private brand distributor. Upon returning the tire to the manufacturer, the private brand distributor purchases an equivalent tire for $8.40 (40 percent of the $21 regular price to the distributor). The proportionality rule described above is applied with respect to the price adjustment to the dealer. Since the price to the dealer in this case is reduced by 60 percent of what it would have been but for the warranty, $1.50 (60 percent of the $2.50 unadjusted excise tax) is available for credit or refund after an adjustment of at least $1.50 has been made to the ultimate consumer. However, if the private brand dealer to whom the manufacturer's warranty ran in turn had supplied the final purchaser with a warranty as good as or better than that which ran from the manufacturer to the private brand dealer, then it would only have to be established that an adjustment in the tax was made between the manufacturer and the private brand dealer in order for the manufacturer to obtain a credit or refund of the excise tax.

2. Tread rubber—credit or refund under certain circumstances subsecs. (a), (b), and (c) of the provision and sec. 6416(b)(2)(G) and new sec. 6416(b)(3)(D) of the Code)

Present law

Present law imposes a tax of 5 cents per pound on tread rubber used for recapping or retreading tires other than from bead-to-bead [5] (secs. 4071(a)(4) and 4072(b)) [6].

Tread rubber may be sold tax-free for use otherwise than in the recapping or retreading of tires of the type used on highway vehicles (sec. 4073(c)). Also, a credit or refund (without interest) of the tread rubber tax may be obtained if the tax-paid tread rubber is used or sold for use otherwise than in the recapping or retreading of tires of the type used on highway vehicles (sec. 6416(b)(2)(G)).

In the case of new tires, sales may be made tax-free (or a credit or refund obtained if tax has been paid) if the tire is exported, sold for use as supplies for vessels or aircraft engaged in foreign trade, sold to a State or local government for exclusive use by such an entity, or sold to a nonprofit educational organization for its exclusive use (secs. 4221(a) and 6416(b)). A credit or refund also is available if the sale of a new tire is adjusted later under a guarantee or warranty (as discussed above, under 1. New Tires—Credit or Refund If Tire Sale is Adjusted Pursuant to Warranty or Guarantee). However, if a retreaded tire is exported, etc., or the price is adjusted pursuant to a warranty or guarantee, no credit or refund is available as to the tread rubber tax.

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[5] The recapping or retreading of a tire from bead-to-bead is considered to be manufacturing subject to the manufacturers excise tax on new tires. Treas. Regs. sec. 48.4071-1(d).

[6] The tax on tread rubber is scheduled to expire on October 1, 1979 (sec. 4071(d)(3)).

Reasons for change

There are several instances under present law where a manufacturers excise tax is imposed on tread rubber when in a similar situation the manufacturers excise tax is not imposed (or a credit or refund of the tax is allowed) for the tax on new tires.

First, rubber wasted in manufacturing new tires is not subject to tax since the tax is imposed when the completed tire is sold and is imposed only upon the material actually in the completed tire. The tax on tread rubber, on the other hand, is imposed before the recapping or retreading of a used tire. Wastage of tread rubber in that process occurs after the tread rubber tax liability has been determined, and under present law no refund or credit is provided for any portion of the tax imposed on tread rubber which is so wasted.

Second, if the sale of a retreaded tire is adjusted by reason of a warranty or guarantee, no credit or refund of the tread rubber tax is provided.

Third, no credit or refund is available for the tread rubber tax when a recapped or retreaded tire is exported, sold to a State or local government, sold to a nonprofit educational organization, or used or sold for use as supplies for a vessel or aircraft. Neither is the credit or refund available if a retreaded tire is mounted on a new vehicle that then is disposed of in any of the above ways.

The committee has concluded that it is appropriate to make the application of the tread rubber tax more nearly equivalent to the application of the tire tax.

Explanation

Subsections (a), (6), and (c) of the provision make a credit or refund of the tread rubber tax available in various situations where a credit or refund would be available for new tires.

First, the credit or refund is to be available if rubber is destroyed, scrapped, wasted, or rendered useless in the recapping or retreading process.

Second, the credit or refund is to be available if the tread rubber is used in the recapping or retreading of a tire if the sales price of the tire later adjusted because of a warranty or guarantee. In this case, the credit or refund is to be in proportion to the adjustment in the sales price of the recapped or retreaded tire, rather than the replace. ment tire.

Third, the credit or refund is to be available to the manufacturer of the tread rubber for the tread rubber on a recapped or retreaded tire if the tire, before being used, is by any person (1) exported, (2) sold to a State or local government for the exclusive use of a State or local government, (3) sold to nonprofit educational organization for its exclusive use, or (4) used or sold for use as supplies for a vessel or aircraft.

Fourth, if a retreaded tire is sold by a second manufacturer on or in connection with another article manufactured by the second manufacturer, the bill provides that a credit or refund of the tread rubber tax is to be allowed to the further manufacturer if the article is exported or sold for any of the purposes described in the preceding paragraph. Also, a credit or refund on the tread rubber tax is to be available to the manufacturer of the recapped or retreaded tire if

that retreader sells the tire on or in connection with any other article manufactured by it, and that other article is exported or sold by any person for one of the purposes described in the preceding paragraph.

3. Statute of limitations (subsec. (e) of the provision and new sec. 6511(g) of the Code)

Present law

Under present law, the general time by which a claim for credit or refund of a tax must be filed is 3 years from the time the tax return was filed or, if later, 2 years from the time the tax was paid (sec. 6511).

Reasons for change

Since a tire warranty or guarnntee typically begins to run when the sale is made to the ultimate consumer (some time after the taxable sale by the tire manufacturer or tread rubber manufacturer) and since many warranties and guarantees extend for several years, there are cases when adjustments are made too late to claim a credit or refund within the present statutory period.

Explanation

Subsection (e) of the provision modifies the statute of limitations in cases where a claim for credit or refund of tire tax or tread rubber tax is filed as a result of a warranty or guarantee adjustment. In such a case, a claim for credit or refund may be filed at any time before the date which is one year after the date on which the adjustment is made, if otherwise the period for filing the claim would expire before that later date.

In other words, under the provision, the manufacturer is assured that it will have at least one year after the time the adjustment is made (or deemed made) to the ultimate consumer (see footnote 4, above) within which to file a claim for credit or refund of the relevant tax.

4. Imported recapped or retreated U.S. tires (subsec. (f) of the provision and new sec. 4071(f) of the Code)

Present law

The excise taxes on tires and tread rubber apply to imported articles as well as those produced or manufactured in the United States. However, if a used tire which has been sold when new in the United States is exported, is retreaded (other than from bead to bead) abroad, and is then shipped back into the United States, then there is neither a tax on the imported retreaded tire nor on the tread rubber used in the retreading, because the tread rubber is considered to have lost its identity and there had been a previous sale of the tire in the United States.

Reasons for change

It has been brought to the committee's attention that some dealers are shipping used tires to Canada or Mexico, having them retreaded in those countries, and importing them back into the United States. The avoidance of United States excise tax because of the foreign retreading gives the imported tires a competitive advantage over domestically retreaded tires.

The committee has concluded that the law should not continue to create a competitive advantage in this country for foreign-made goods over domestic goods.

Explanation

Under subsection (f) of the provision, used tires which are exported from the United States, recapped or retreaded abroad (other than from bead to bead), and then reimported into the United States are to be subject to the tax on tread rubber to the extent that tread rubber is incorporated into the tire. For this purpose, the amount of tread rubber to be taken into account is to be determined as of the completion of the recapping or retreading of the tire. The amount so determined is to be either the amount which is established as actually used in recapping or retreading the tire or an average amount which is generally used on comparables tires in the industry, as determined by the Treasury Department (sec. 4071(c)).

If a retreaded tire is reimported on a vehicle which is not itself subject to a manufacturers excise tax (e.g., a passenger car or a light-duty truck), then the importer of the vehicle is (under existing law, sec. 4071 (e)) treated as the importer of the tire. This provision carries the process a step further in that situation, and treats the importer of the vehicle as the importer of the tread rubber that is in the retreaded tire.

5. Effective date (subsec. (g) of the provision)

The amendments made by the provision are to take effect on the earlier of (1) April 1, 1978, or (2) the first day of the first calendar month which begins more than 10 days after the date of enactment. Thus, they apply where, on or after the effective date—

(a) adjustments are made (or deemed made) to ultimate consumers (see footnote 4, above) on account of warranties or guarantees;

(b) tread rubber is destroyed, scrapped, wasted, or rendered useless in the recapping or retreading process,

(c) recapped or retreaded tires (or the articles on or in connection with which they are sold) are exported, sold to a State or local government for the exclusive use of a State or local government, sold to a nonprofit educational organization for its exclusive use, or used or sold for use as supplies for vessels or aircraft; and

(d) tires retreaded abroad are imported into the United States.

The statute of limitations amendment is to apply on and after the effective date. In effect, it applies to adjustments made (or deemed made) on or after the date one year before the effective date. For example, assume that the effective date of the bill is April 1, 1978, that the tire tax was paid with respect to a tire on July 1, 1974, and that an adjustment was made pursuant to a warranty or guarantee to an ultimate consumer with respect to that tire on November 2, 1977. The effect of this provision in those circumstances is to allow the manufacturer to file a claim for credit or refund with respect to that adjustment on any date from April 1, 1978, through November 2, 1978.

6. Revenue effect

The provision is estimated to reduce budget receipts by less than $300,000 in fiscal year 1979 and by less than $200,000 per year thereafter. These revenues would otherwise go into the Highway Trust Fund (through September 30, 1979).

D. Interest Rate Adjustments on Retirement Savings Bonds (sec. 4 of the bill)

Present law

Under present law, a person eligible to establish an individual retirement account may purchase retirement bonds issued for this purpose by the Treasury Department. These bonds are not transferable and are subject to many of the restrictions that apply to individual retirement accounts. Retirement plan bonds are issued for H.R. 10 plans established by self-employed persons and for retirement and annuity plans established by employers for thier employees. The interest rate on any such retirement bond remains unchanged throughout its life.

By contrast, the interest rates on issued Series E savings bonds are increased whenever there is an increase in the interest rates on new issues of Series E bonds. This adjustment is made in recognition of the holder's ability to redeem the outstanding bond before maturity for the principal and accrued interest and to reinvest the proceeds in new Series E bonds issued with the higher interest rate.

Reasons for change

Present law creates an inequity in the treatment of holders of different types of U.S. bonds. The owner of a Series E bond obtains the benefit of any higher interest rate designated for later-issued Series E bonds. The owner of a retirement bond receives the same interest rate throughout the bond's life, even if later-issued retirement bonds carry a higher rate.

Absent any provision authorizing adjustments in the interest rate for outstanding U.S. retirement bonds, potential purchasers may be expected to turn to various retirement plan arrangements offered in the private sector. Any net reduction in Treasury Department sales of retirement bonds will increase the amount of money that must be raised by the Treasury Department in some other manner.

Accordingly, the provision permits the Treasury Department ot adjust upard the interest rate paid on outstanding bonds.

Explanation of provision

The provision permits the interest rate on U.S. retirement plan bonds (sec. 405(b)) and U.S. individual retirement bonds (sec. 409(a)) to be increased for any interest accrual period so that the investment yield for that accrual period on the bonds is consistent with the investment yield for that accrual period on new offerings of such retirement bonds.

Any increased interest rates, and the accrual periods to which these rates apply, are to be specified in regulations to be issued by the Treasury Department. Under the provision, these regulations, to be effective, must be approved by the President.

Effective date

The provision applies to interest accrual periods that begin after the date of the bill's enactment, with respect to bonds issued before, on, or after the date of enactment.

Revenue effect

It is estimated that this provision will not have any effect on budget receipts, but will result in increased budget outlays of $1 million per year.

E. Child Care Credit for Amounts Paid to Certain Relatives (sec. 5 of the bill and sec. 44A of the Code)

Present law

Present law provides a nonrefundable income tax credit equal to 20 percent of household and dependent care expenses incurred to care for a dependent child under the age of 15 or for an incapacitated dependent or spouse. The maximum tax credit for one year's qualifying expenses is $400 for one dependent and $800 for two or more dependents (sec. 44A of the Code).

The credit is allowed for amounts paid to a relative only if (1) neither the taxpayer nor the taxpayer's spouse is entitled to treat the relative as a dependent for whom a personal exemption deduction could be claimed, and (2) the services provided by the relative constitute "employment" as that term is defined for purposes of social security taxes (sec. 44A(f)(6)).

For social security tax purposes, child care or other domestic services performed in the taxpayer's home by the taxpayer's parent generally do not constitute "employment" (sec. 3121(b)(3)(B)). Also, services by the taxpayer's parent which are not performed in the course of the taxpayer's trade or business generally do not constitute employment, whether or not performed in the taxpayer's home. The Internal Revenue Service apparently takes the position that child care services performed in a grandparent's home are not performed in the course of the taxpayer's trade or business. Under this view, both child care services performed by a grandparent in the taxpayer's home and child care services performed by a grandparent in the grandparent's home generally would not constitute "employment," and hence payments for such services would not qualify as expenses eligible for the child care credit.

However, services performed by a grandparent in caring for a child (living in the taxpayer's home) who is either under 18 or is mentally or physically incapacitated may constitute "employment" if the taxpayer is a surviving spouse or is divorced and not remarried, or if the taxpayer has a mentally or physically incapacitated spouse who is unable to care for the child (sec. 3121(b)(3)(B)). In these circumstances payments for child care services performed by the child's grandparent may be eligible with respect to the child care credit.

Services performed for the taxpayer by other relatives (other than by the taxpayer's child if under age 21) may constitute "employment" under the social security tax definition if a bona fide employer-employee relationship exists. Therefore, payments to these relatives may qualify with respect to the child care credit if neither the taxpayer nor the taxpayer's spouse can claim a personal exemption deduction for the relative. Services performed by the taxpayer's child, if under age 21, do not constitute such "employment" (sec. 3121(b)(3)(A)) and hence cannot qualify with respect to the credit.

Reasons for change

The committee believes that child care services provided by a taxpayer's adult relatives, particularly a child's grandparent, should qualify with respect to the child care credit on the same basis as

services performed by persons not related to the taxpayer, because relatives generally provide better attention and because allowance of the credit, especially with respect to child care services performed by grandparents, will help to strengthen family ties.

Explanation of provision

The provision eliminates the requirement of present law that child care services performed by relatives must constitute "employment" within the meaning of the social security tax definition in order to qualify under the child care credit provisions.[1] As a result, otherwise qualifying amounts paid by a taxpayer for care of his or her child by a grandparent of the child would be eligible for the credit to the same extent as if paid to a person who is not related to the taxpayer.

The provision does not affect the rule of present law that disallows the child care credit for amounts paid to a relative (including amounts paid to a child or to a parent of the taxpayer) for whom the taxpayer or the taxpayer's spouse could claim the deduction for personal exemptions for dependents. It does not matter for this purpose whether the taxpayer or spouse in fact actually claims the dependency exemption deduction on a tax return; the credit is denied if either spouse could have claimed the deduction for the relative. As a result, no credit would be allowed for otherwise qualifying amounts paid by a taxpayer for child care services performed by a grandparent of the child if either the taxpayer or the taxpayer's spouse could, for the year in which such services are performed, claim a personal exemption deduction for the grandparent.

The bill provides that the credit is not to be allowed for amounts paid by the taxpayer to his or her child (including a stepchild) for child care services if the child being paid is under the age of 19 as of the close of the year in which the services are performed. The credit is not allowed for any such payments to the child under 19 whether or not either the taxpayer or the taxpayer's spouse could claim a personal exemption deduction for the child being paid for child care services. If the taxpayer's child is 19 or over by the end of the year, payments for child care services performed by the child qualify for the credit only if neither the taxpayer nor the taxpayer's spouse could claim a personal exemption deduction for the child performing the services.

The committee intends that amounts paid by a taxpayer to his or her spouse to care for the taxpayer's child (including a stepchild) do not qualify for the child care credit. Because parents have the duty of caring for their children, it would be inappropriate to permit the credit for payments between spouses for child care.

Effective date

The provision applies to taxable years beginning after December 31, 1977.

Revenue effect

The provision is estimated to result in a decrease in budget receipts of $39 million in fiscal year 1979, $35 million in fiscal year 1980, $37 million in fiscal year 1981, $37 million in fiscal year 1982, and $38 million in fiscal year 1983.

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[1] The provision does not make any change in the sec. 3121(b)(3) definition of "employment" for purposes of social security taxes.

III. COSTS OF CARRYING OUT THE BILL AND VOTE OF THE COMMITTEE IN REPORTING H.R. 3050, AS AMENDED

Revenue Cost

In compliance with section 252(a) of the Legislative Reorganization Act of 1970, the following statement is made relative to the costs incurred in carrying out H.R. 3050, as reported by the committee. The committee estimates that the provisions of this bill will have the following effects on budget receipts:

Section 1 (returns of magazines, etc.)—It is estimated that this provision will reduce budget receipts by $22 million in fiscal year 1979, $11 million in fiscal year 1980, $11 million in fiscal year 1981, $12 million in fiscal year 1982, and $12 million in fiscal year 1983.

Section 2 (redemption costs of discount coupons)—It is estimated that this provision will reduce budget receipts by $103 million in fiscal year 1980, and $10 million in each of fiscal years 1981, 1982, and 1983. The estimated reduction in budget receipts of $103 million in fiscal year 1980 includes almost $100 million attributable to years prior to 1980 on the assumption that the position of the IRS with regard to the proper method of accounting for discount coupons under present law would be upheld by the courts.

Section 3 (tire and tread rubber taxes)—It is estimated that this provision will reduce budget receipts by less than $300,000 in fiscal year 1979 and by less than $200,000 per year thereafter. These revenues would otherwise go into the Highway Trust Fund (through September 30, 1979).

Section 4 (retirement bond interest rates)—It is estimated that this provision will not have any effect on budget receipts, but will result in increased budget outlays of $1 million per year.

Section 5 (child care credit)—It is estimated that this provision will result in a decrease in budget receipts of $39 million in fiscal year 1979, $35 million in fiscal year 1980, $37 million in fiscal year 1981, $37 million in fiscal year 1982, and $38 million in fiscal year 1983.

The Treasury Department agrees with this statement.

Vote of the Committee

In compliance with section 133 of the Legislative Reorganization Act of 1946, the following statement is made relative to the vote by the committee on the motion to report the bill. H.R. 3050 was ordered reported by a voice vote.

IV. REGULATORY IMPACT OF THE BILL AS REPORTED AND OTHER MATTERS TO BE DISCUSSED UNDER SENATE RULES

Regulatory Impact

Pursuant to rule XXIX of the Standing Rules of the Senate, as amended by S. Res. 4 (February 4, 1977), the committee makes the following statement concerning the regulatory impact that might be incurred in carrying out the provisions of H.R. 3050 as reported by the committee.

A. *Numbers of individuals and businesses who would be regulated.*—The provisions of the bill, as amended, affect accrual-basis publishers and distributors of magazines, paperbacks, or records; accrual-basic taxpayers who issue and redeem discount coupons (such as "cents off" coupons); manufacturers of tires and tread rubber in certain circumstances (such as where sales are later adjusted as the result of a warranty or guarantee); purchasers of retirement bonds issued by the Treasury Department; and taxpayers who make payments to certain relatives for child care services.

B. *Economic impact of regulation on individuals, consumers, and businesses affected.*—The provisions of the bill, as amended, will provide more accurate income tax accounting rules for sales revenues received by accrual-basis publishers and distributors of magazines, records, or paperbacks, and by accrual-basis taxpayers who issue and redeem discount coupons; will clarify the treatment of credits or refunds of the manufacturers excise taxes on new or retreaded tires and on tread rubber in certain circumstances (such as where sales are later adjusted as the result of a warranty or guarantee); will authorize higher interest rates for holders of outstanding retirement bonds issued by the Treasury Department, to match the rates on new offerings of such bonds; and will make available the child care credit for payments to certain relatives, including grandparents.

C. *Impact on personal privacy.*—The bill makes no changes in those provisions of Federal law relating to the personal privacy of taxpayers.

D. *Determination of the amount of paperwork.*—The bill will involve little, if any, additional paperwork for taxpayers.

Consultation with Congressional Budget Office on Budget Estimates

In accordance with section 403 of the Budget Act, the committee advises that the Director of the Congressional Budget Office has examined the committee's budget estimates (as shown in part III of this report) and agrees with the methodology used and the resulting dollar estimates for those items.

New Budget Authority

In compliance with section 308(a)(1) of the Budget Act, the committee states that sections 1, 2, 3, and 5 of the bill involve no new budget authority, and that section 4 (interest rate adjustments on retirement savings bonds) will result in an increase in budget outlays of $1 million per year in fiscal years 1979, 1980, 1981, 1982, and 1983.

Tax Expenditures

In compliance with section 308(a)(2) of the Budget Act with respect to tax expenditures, and after consultation with the Director of the Congressional Budget Office, the committee makes the following statement. None of the provisions of the bill involve new tax expenditures. Sections 1, 2, and 3 of the bill do not involve increased tax expenditures. With respect to section 4 (interest rate adjustments on retirement savings bonds), a small increase in tax expenditures may occur as the tax deferral is increased on the accrued interest income earned by any higher yield on U.S. retirement bonds. With respect to section 5 (child care credit for amounts paid certain relatives), existing tax expenditures would increase by $39 million in fiscal year 1979, $35 million in fiscal year 1980, $37 million in fiscal year 1981, $37 million in fiscal year 1982, and $38 million in fiscal year 1983.

V. CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

In the opinion of the committee, it is necessary in order to expedite the business of the Senate, to dispense with the requirements of subsection 4 of rule XXIX of the Standing Rules of the Senate (relating to the showing of changes in existing law made by the bill, as reported).