Gift Card Issuers will Benefit from Liberalized Income Deferral Rules

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Accrual method retailers that issue gift cards for merchandise returns or that sell gift cards redeemable for the merchandise or services of the retailer or a third party will benefit from new income deferral rules provided in Revenue Procedure 2011-17 and Revenue Procedure 2011-18. This Tax Alert is the third alert that Williams Mullen has prepared to address gift card tax issues for its clients in the retail industry. See past alerts on Structuring Retail Gift Card Subsidiaries & Retail Gift Cards and Store Credits.

Background

Retailers that sell gift cards receive and hold the proceeds from a gift card sale until the purchaser uses the gift card to purchase merchandise or services. Retailers often sell the gift cards of other participating retailers under gift card service agreements. If a customer redeems the gift card for merchandise or services from a participating retailer, the participating retailer accepts the gift card as payment for its goods or services, and the seller of the gift card reimburses the participating retailer for the sales price of the merchandise or services. The gift card seller is liable to the customer for the value of the gift card until the gift card expires, is redeemed with the seller, or is redeemed with another retailer under a gift card service agreement.

Some retailers use a gift card subsidiary in their gift card program. A retailer using a gift card subsidiary will sell the gift cards at retail stores or through a website but process the sale through and forward the proceeds to the gift card subsidiary. In effect, the gift card subsidiary is selling the gift cards at its parent's retail store or on its parent's website. When a customer redeems the gift card balance at the retailer, the gift card subsidiary forwards the redeemed amount to the retailer. The retailer may use the gift card subsidiary to manage its gift card program and to take advantage of favorable unclaimed property laws in the gift card subsidiary's state of organization.

Uncertainty Surrounded Multi-Entity Gift Card Programs

In tax parlance, a gift card is a form of *"advance payment"* by a customer who prepays the retailer for merchandise or services. Revenue Procedure 2004-34 allows accrual method taxpayers, including retailers, to defer income recognition from advance payments they receive for merchandise and services to the succeeding tax year if they do not recognize the advance payment as income in their financial statements (or, in certain cases, do not earn the advance payment) in the year of receipt. Treasury Regulation ?1.451-5 also permits deferral of income recognition for advance payments received by an accrual method taxpayer for "goods held by the taxpayer primarily for sale to customers." Unlike Revenue Procedure 2004-34, Treasury Regulation ?1.451-5 does not apply to advance payments for services.

The IRS contends that retailers can only defer income recognition from advance payments, including advance payments in respect of gift card sales, if the gift card issuer is the same entity that holds the merchandise for sale to customers. The IRS has taken inconsistent positions on deferral of income recognition from advance payments received by a wholly-owned gift card subsidiary that issues its parent's gift cards. In Legal Advice Issued by Field Attorneys 20082801F, the IRS concluded that deferral of income recognition from the advance payments was not available because the customers redeemed the gift cards for the retailer's merchandise and not the gift card subsidiary's merchandise. Two years later, the IRS came to the opposite conclusion in Legal Advice Issued by Field Attorneys 20100901F, also addressing a retailer that used a gift card subsidiary.

Retailers that sold gift cards for other related or unrelated retailers under gift card service agreements were also uncertain whether they could defer income recognition from the advance payments.

IRS Extends Deferral to Multi-Entity Gift Card Programs

In Revenue Procedure 2011-18, the IRS modifies Revenue Procedure 2004-34 (and, presumably, modifies its other earlier guidance) to allow retailers to defer income recognition from advance payments received from the sale of gift cards redeemable for the merchandise or services of the retailer or a *third party*. The IRS provides the following examples of typical gift card programs that retailers operate under service agreements with other participating retailers:

- Members of an affiliated group of corporations may establish a gift card subsidiary to sell gift cards that may be redeemed for goods or services of the members;
- A franchisor, purchasing cooperative, not-for-profit membership organization, or franchisee may sell gift cards that may be redeemed for goods or services provided by independently-owned franchisees or members;
- A restaurant management company may sell gift cards that may be redeemed by participating restaurants in different geographic locations or with different trade names; or
- A retailer may issue a gift card that may be redeemed for merchandise at the retailer's stores, retail stores operated by a related party, or retail stores operated by unrelated parties.

Revenue Procedure 2011-18 provides clarity for retailers that sell gift cards redeemable for other related or unrelated retailers' merchandise and services by broadening Revenue Procedure 2004-34 to permit deferral of income from advance payments in respect of *"eligible gift card sales."* Retailers should be able to defer income recognition of their gift card sales proceeds if (i) they otherwise satisfy the requirements of Revenue Procedure 2004-34, and (ii) their gift card sales are eligible gift card sales. An eligible gift card sale is the sale of a gift card where:

- The retailer is primarily liable to the customer (or holder of the gift card) for the value of the card until redemption or expiration; and
- The gift card is redeemable at the retailer or at any other entity that is legally obligated to the retailer to accept the gift card from a customer as payment for merchandise or services.

Audit Protection

Revenue Procedure 2011-18 is effective for taxable years ending on or after December 31, 2010, but the IRS provides retailers with audit protection for years ending before December 31, 2010. During an audit, the IRS will not raise the issue of whether deferral under Revenue Procedure 2004-34 can apply to gift card sales that are "eligible gift card sales" under Revenue Procedure 2011-18. The audit protection extends to appeals and controversies before the U.S. Tax Court.

IRS Extends Deferral to Gift Cards Issued for Exchanged Goods

An accrual method retailer is allowed to reduce its gross receipts immediately by the amount of any refund paid in cash or refunded to a customer's credit card, in part because economic performance is deemed to be complete. The retailer is put in the same tax position it would be in if it had never made the sale when it makes a cash refund or refunds the customer's credit card. Prior to Revenue Procedure 2011-17, retailers that made refunds with gift cards were not allowed to reduce gross receipts by the amount of the refund because economic performance was deemed to be incomplete until the customer redeemed the gift card.

Retailers within the scope of Revenue Procedure 2011-17 will be allowed to treat gift cards issued for refunds as the payment of a cash refund followed by the customer's cash purchase of a gift card. The retailers will then be able to apply Revenue Procedure 2004-34 (as modified by Revenue Procedure 2011-18) or Treasury Regulation ?1.451-5 to achieve income deferral in respect of the deemed gift card sale.

Revenue Procedure 2011-17 is effective for taxable years ending on or after December 31, 2010. For taxable years ending before December 31, 2010, retailers that treat refunds made with gift cards consistent with Revenue Procedure 2011-17 will receive audit protection similar to that granted by the IRS under Revenue Procedure 2011-18.

Change in Method of Accounting

A change in a retailer's treatment of gift cards to the methods under Revenue Procedure 2011-17 or Revenue Procedure 2004-34 (as modified by Revenue Procedure 2011-18) is a change in method of accounting that requires the IRS's consent. Revenue Procedure 2011-17 and Revenue Procedure 2011-18 allow retailers to change their method of accounting by following the automatic consent procedures in Revenue Procedure 2008-52.

Income Tax Planning and Compliance

Williams Mullen suggests that retailers comprehensively examine their income tax reporting of gift card sales to determine if income deferral is available to them under Revenue Procedure 2011-17 and Revenue Procedure 2004-34 (as modified by Revenue Procedure 2011-18). Retailers that decide to seek income deferral under the recent IRS guidance must comply with the change in method of accounting rules.

If you have any questions, please contact a member of our Tax Law Practice Group or Retail Industry Group.

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