Clear Law Institute

Tax Treatment of Gift Cards and Certificate Sales

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TAX TREATMENT OF GIFT CARDS & CERTIFICATE SALES

Stephen B. Jordan
Clear Law Institute

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Tax Treatment of Gift Cards & Certificate Sales

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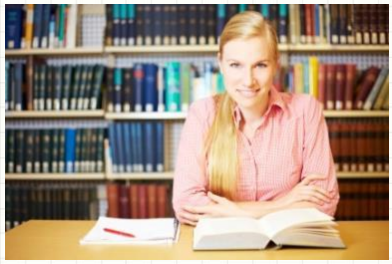

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Agenda
Tax Treatment of Gift Cards & Certificate Sales

1. Gift Cards – Tips, Best Practices & Nexus
2. Deferred revenue
3. Income recognition - general rules; Guidance allowing income deferral for advance payments
4. Gift card statutes & legislation
5. Updated IRS guidance addressing gift cards
6. Ongoing gift card considerations
7. Application for accounting change

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Income recognition general rules

IRC §451 & Rev Reg §1-451-1 provide that under an accrual method of accounting, income is recognized when:

- "All Events" that fix the right to receive the income have occurred,
  - AND
- The amount may be determined with reasonable accuracy
- *Revenue Ruling 84-31* provides that "all events" occur on the earlier of three dates: the date on which the income is
  - a) earned,
  - b) due, or
  - c) received.

Income deferral guidance

- *Rev Proc 71-21, 1971-2, CB 501*
- *Rev Reg §1.451-1*
- *Rev Proc 2004-34, 2004-22, IRB 991*

Review Question #1

True or False - the sale of a **gift card** may be deferred from immediate income recognition under two exceptions*: Rev. Proc. 2004-34* (1-year deferral) and *Treas. Reg. §1.451-5* (2-year deferral) ?

A. True

B. False

Income recognition for advance payments

- When TP receives a payment, it is generally included in income under *§61* even if the goods & services are provided in a future year
- Advance payments are payments received in a current year for goods & services and therefore generally recognized in the year of receipt
- General rule for gift card income is that it should be recognized fully in the year of receipt
- However… gift card income may be deferred under, common income deferral guidance - *Rev Proc 2004-34 & Rev Reg 1.451-5*
- ***(TAM #107447-15),*** release date, March 04, 2016 - the IRS concludes that a taxpayer **can** defer for up to two years, the recognition of certain advance payment income from the sale of gift cards for goods or services.

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Accounting for gift cards

Starbucks sells more than 2 million gift cards on the Thursday before Christmas, which is a rate of more than 1,500 gift cards per minute… For entire year, $4B worth the Starbucks gift cards are sold

CEB Tower Group estimates that in excess of 160 billion dollars worth of gift cards will be sold in 2018. A lot of them will not be redeemed at all

Consumer Reports estimates say that 10% to 19% of gift cards don't get redeemed?

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Updated guidance on gift cards

New guidance:

- *Rev Proc 2004-34* – One-year deferral
- *Rev Proc 2011-17* – Gift cards issued as a refund (merchandise returned in-exchange)
- *Rev Proc 2011-18* – third-party redemption (modified *Rev-Proc 2004-34)*
- *Rev Proc 2013-29* – third-party redemption (modified *Rev Proc 2011-18)*

Ongoing issues to be considered:

- Form 3115 required to adopt or change gift card/gift certificate program?
  - DCN 30 – overall accrual-accounting method
  - DCN 83 - full-inclusion method
  - DCN 84 - deferral method for advance payments
  - DCN 153 - deferral method for Advance payments—change in AFS *(Rev. Proc. 2004-34)*
  - DCN 156 - Gift cards issued as a refund *(Rev. Proc. 2011-17)*
  - *Rev Reg §1.451-5,* Method change to a two-year deferral, requires "Advance Consent" procedures on 3115, using *Rev Proc 97-27*.

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Rev Proc 2013-29 "Unrelated Party"

•*Rev. Proc.* ***2013-29***[481.1] modified *Rev. Proc.* ***2011-18***, allowing TPs to defer recognizing gross income on advance payments received from **gift card** sales that are redeemable for goods or services by an unrelated entity. TPs with or without an AFS will recognize revenue (earn) to the extent the **gift card** is redeemed by the unrelated entity during the tax year.

- [481.1] *2013-33 I.R.B. 141.*

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Review Question #2

Which Rev. Proc. clarifies *Rev. Proc. 2011-18* when a taxpayer may defer recognizing, in gross income, certain advance payments received from the sale of gift cards that are redeemable for goods or services by an **unrelated party**?

A. *Rev. Proc. 2013-29* (third-party redemption)

B. *Rev Reg §1.451-5* (Method change to a two-year deferral, "advance consent", using *Rev Proc 97-27*)

C. *Rev. Proc. 2004-34* (Method change to a one-year deferral)

D. *Rev. Proc. 2011-17* (goods returned in-exchange)

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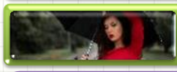
Gift Cards: Tips & Best Practices for Successful Management & Nexus

Tax treatment - A retailer issuing a **gift card** receives an "advance payment" in exchange for the obligation to provide goods or services at a future date.

Sale of a **gift card** may be deferred from immediate income recognition under two exceptions: *Treas. Reg. §1.451-5 and Rev. Proc. 2004-34.*

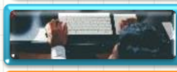


Rev. Proc. 2004-34 allows an accrual-basis TP to defer recognition of advance payments for goods, services, or a mix of both, but provides for **one-year deferral only.**

Treas. Reg. §1.451-5 applies to the sale of goods only, and allows an accrual-method TP to defer recognition of advance payments until the taxable year the payments are recognized as revenue for financial reporting purposes. This effectively grants a **two-year deferral.**

Rev. Proc. 2011-17 provides a safe harbor method of accounting for returned merchandise

Rev. Proc. 2011-18 modifies *Rev. Proc. 2004-34* to allow TPs to defer revenue from the sale of **gift cards** that are redeemable for goods or services of the TP or a third party.



•TPs currently deferring **gift card** sales under the two-year deferral of *Treas. Reg. §1.451-5* might consider filing an automatic consent **Form 3115** to change from the one-year deferral method afforded by *Rev. Proc. 2004-34.*

Beware of escheat - Retailers' short-term cash flows benefit greatly where **gift cards** are never redeemed. This **gift card** "breakage", i.e. unredeemed balances, may create legal reporting and remittance requirements for retailers under unclaimed property (escheat) laws

Nexus considerations - Gift cards can create state nexus — a physical or economic presence sufficient to establish jurisdiction to tax in the state. For example, if **gift cards** are issued pursuant to a license granted by the retailer, the retailer may be considered to have economic nexus in certain states where the **cards** are sold.

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Review Question #3

Which Rev. Proc. provides a "safe-harbor" method of accounting for gift cards issued as a refund to customers in "exchange for returned merchandise"?

A. *Rev. Proc. 2013-29* (third-party redemption)

B. *Rev. Proc. 2011-17* (goods returned in-exchange)

C. *Rev Reg §1.451-5* (Method change to a two-year deferral, , "advance consent", using *Rev Proc 97-27*)

D. *Rev. Proc. 2004-34* (Method change to a one-year deferral)

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Cap One Nexus Ruling Limits *Quill* Standard (March 2009)

- Supreme Judicial Court of Massachusetts ("SJC") has ruled that physical presence is not required in order for Massachusetts to impose its financial institutions excise tax ("FIET") on two affiliated out-of-state banks

Instead the Court ruled that substantial nexus for a tax other than a sales and use tax is established if the TP engages in significant, purposeful economic activity within the taxing state. *Capital One Bank & Capital One F.S.B. v. Commissioner of Revenue, 453 Mass. 1, 2009 Mass. LEXIS 5, decided January 8, 2009.*

The banks contested the assessments on the ground that they lacked sufficient **nexus** with Massachusetts under the Commerce Clause of the United States Constitution, *US Const., art. I, §8, cl. 3*, to allow the state to impose FIET on them.

In rejecting the banks' argument that physical presence is required for a state to impose a tax on income, the Massachusetts SJC relied on the decision of the West Virginia Supreme Judicial Court of Appeals in *Tax Commissioner of the State of West Virginia v. MBNA America Bank, N. A.*, 220 W. Va. *163, 640 S.E.2d 226 (2006), cert. denied,127 US S. Ct. 2997 (2007).*

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Cap One Nexus Ruling Limits *Quill* Standard (March 2009) (con't)

○One significant distinction between *Cap One* and *MBNA* can be found in the rationales for the decision. The West Virginia Supreme Court of Appeals found that there was substantial nexus for West Virginia to impose its tax simply as a result of the significant amount of gross receipts MBNA received from the use of credit cards by West Virginia residents during the relevant tax years.

○While the Massachusetts SJC did note the significant volume of gross receipts received by the banks from the use of credit cards by Massachusetts residents, it did not limit its rationale to that fact. In addition, the Court noted the quality and quantity of other activities engaged in on behalf of the banks within the Commonwealth…

- The SJC addressed the "burden of proof" issue by applying the presumption that a tax is constitutionally valid, unless the party challenging it, establishes its invalidity "beyond a rational doubt." *Capital One*, *453 Mass. 1 at 14*.

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US Supreme Court declines to review court decision

Capital One Bank v. Commissioner of Revenue (June 22, 2009)

○US Supreme Court declines to review court decisions out of Massachusetts in *Capital One Bank v. Commissioner of Revenue* and *Geoffrey, Inc. v. Commissioner of Revenue*

In *Quill Corp. v. North Dakota* (1992), the US Supreme Court held that the Commerce Clause requires a physical presence in a state before the state may impose *sales or use tax* on an out-of-state business. States in recent years have increasingly sought to bypass the constraints of *Quill* by limiting the ruling to sales and use taxes and assessing *income taxes* on out-of-state businesses that have sales but no physical presence in the taxing state. Massachusetts is one such state.

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Supreme Court Hears landmark e-Commerce Sales Tax Case
South Dakota v. Wayfair (June 18, 2018)

○*South Dakota v. Wayfair* challenges a previous high court decision in *Quill Corp. v. North Dakota, 504 U.S. 298 (1992),* which in turn reaffirmed an earlier decision that a state could require only a business with a physical presence in the state to collect and remit sales tax. Businesses without that physical presence could not be required to collect or remit these taxes.

○Since that decision, the rise of ecommerce has led to an explosion in sales by online retailers, but lack of authority has led to the inability of states to collect sales tax on ecommerce sales, resulting in a profound effect on revenue, costing them $13.4 billion in revenue in 2017, according to the US Accounting Office.

- In constructing the law, South Dakota directly challenged the *Quill* decision, declaring an "urgent need for the Supreme Court of the United States to reconsider" the physical presence precedent. A court challenge by Wayfair, Inc. has now made its way to the Supreme Court, and arguments began on April 17, 2018,

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Review Question #4

Which recent US Supreme Court case ruled in favor of South Dakota, holding the physical presence rule in *Quill* to be "unsound and incorrect" with the realities of today's internet in mind, and determined individual States will no longer be bound by the concept of sales-tax nexus. Instead, states will be able to require any online seller making a sale in their state, to collect sales-tax.

A. *South Dakota v. Wayfair (2018)* (Physical presence standard overturned/Substantial nexus can be through "substantial virtual connection" - (26 years after *Quill*))

B. *Quill v. North Dakota (1992*) (Physical presence required in the state in order to impose sales tax for purchases by in-state customers/No substantial nexus under Commerce Clause)

C. *Capital One Bank & Capital One F.S.B. v. Commissioner of Revenue, 453 Mass. 1, 2009 Mass*

D. *Tax Commissioner of the State of West Virginia v. MBNA America Bank, N. A., 220 W. Va. 163, 640 S.E.2d 226 (2006), cert. denied,127 US S. Ct. 2997 (2007)*

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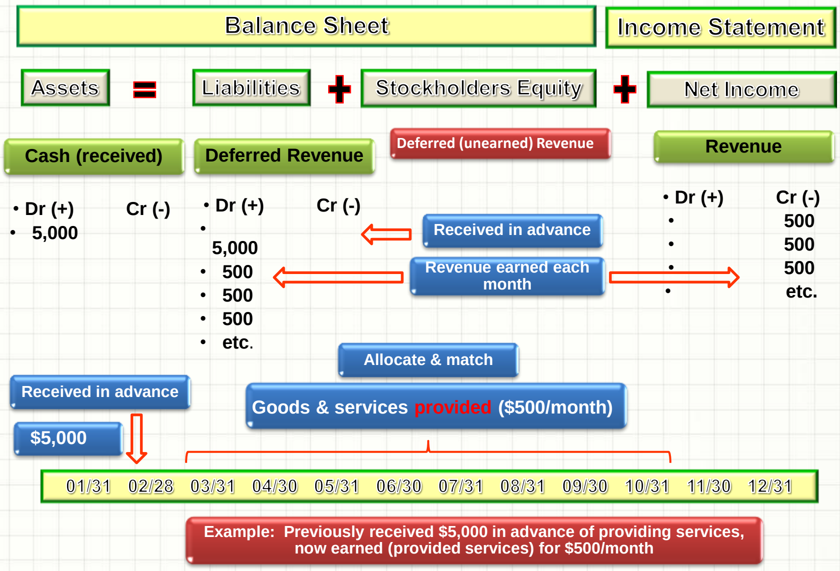
Deferred (Unearned) Revenue



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Review Question #5

Service Period Revenue Recognition Journal Entries: If payment is received in full (in-advance) before goods/service is rendered, which of the following journal entries, if any, are relevant?

A. Debit: Cash
Credit: Unearned Revenue (current liability).
(Receipt of Advance Payment)

B. Debit: Unearned Revenue (current liability),
Credit: Revenue.
(As Service is rendered)

C. Debit: Unearned Revenue (current liability),
Credit: Revenue.
(Repeat as service is rendered)

D. All of the above, in order

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IRS treatment of gift cards
Tax accounting implications

- IRS identifies treatment of gift card income as a significant compliance risk as part of its tiered examination initiative
- IRS issues Rev Proc's in response to rising gift card use, which is estimated to reach $160B in gift card sales by 2018
- TPs generally defer financial statement income recognition until card is redeemed
- IRS have several issues with TP's inappropriately deferring gift card income

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Gift of complexity?
Recognizing gift card revenue for tax purposes

Businesses often include gift card revenue in taxable income in the year the card is sold. Exceptions permit deferral of that revenue for one or even up to two years.

Treas. Reg. §1.145-5(c)	**Two-year deferral**
Rev. Proc. 2004-34	**One-year deferral**
Rev. Proc. 2011-17	**Safe Harbor for goods/merchandise returned "in-exchange"**
Rev. Proc. 2011-18	**•*Modifies Rev. Proc. 2004-34 for gift cards redeemed by third party* •Does NOT modify *§1.451-5* if issuing entity is NOT redeeming entity**
Rev Proc 2013-29	**Allows accrual TP to defer recognizing in gross income certain advance payments received from the sale of gift cards that are redeemable for goods or services by an unrelated entity, may defer recognition until the last day of the second tax year following the year of sale.**

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Review Question #6

Treas. Reg. §1-451-5(c) provides client may NOT defer advance payments for inventory goods beyond the end of the ___?___ taxable year following the year the client receives a substantial advance payment (e.g. gift card)?

A. 1st

B. Indefinitely

C. 5th

D. 2nd (hence, a two-year deferral)

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IRS Eases Rules for Deferring Income Recognition on Gift Card Sales *Rev Proc 2013-29*

An accrual method TP that receives an "advance payment" from the sale of gift cards may defer recognition of the payment in gross income until or to the extent the gift card is redeemed or, to the extent not redeemed, may defer recognition until the last day of the second tax year following the year of sale *Rev Proc 2013-29*

Rev. Proc. 2013-29 clarified the definition of "eligible gift card sales" provided in *Rev. Proc. 2011-18* by adding that if a gift card is redeemable by an entity whose financial results are not included in the TP's applicable financial statement (AFS) then the payment is treated as recognized by the TP in revenues of its applicable financial statement to the extent the gift card is redeemed by the entity during the tax year. The same rule applies for TPs without an AFS.

Gift Card Management Programs The popularity of gift card programs for retailers, restaurants and other hospitality businesses and their customers is readily apparent. "Breakage," that portion of gift card balances that are not redeemed for food, beverages or merchandise, can be an important short-term cash flow benefit for the card issuer.

- However, a number of states will treat that "breakage" as unclaimed property that must be paid over to a state after the expiration of a "dormancy period" (usually three or five years after the card was issued). As a result, some issuers of gift cards have used separate entities (subsidiary corporations or limited liability companies) to achieve intended unclaimed property compliance benefits.

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Rev Proc 2004-34 §5.03

Examples 23, 24 & 25

Example 23. R Corp operates department stores. U Corp, V Corp & W Corp are wholly owned domestic subsidiaries of R. X is a foreign controlled sub of R. Z is an unrelated entity. W administers a gift card program for the R consolidated group, X and Z.

Example 24. W is a Subchapter S-Corp that operates an affiliated restaurant corporation and manages other affiliated restaurants. These other restaurants are owned by other Subchapter S corporations, partnerships & limited liability companies. W has a partnership interest or an equity interest in some of the restaurants. W administers a gift card program for participating restaurants.

Example 25. X is a corporation that operates for the benefit of its franchisee members. X administers gift card program.

Review Question #7

Which Rev. Proc. provides for a one-year deferral of any amounts deferred for Applicable Financial Statement (AFS) purposes.

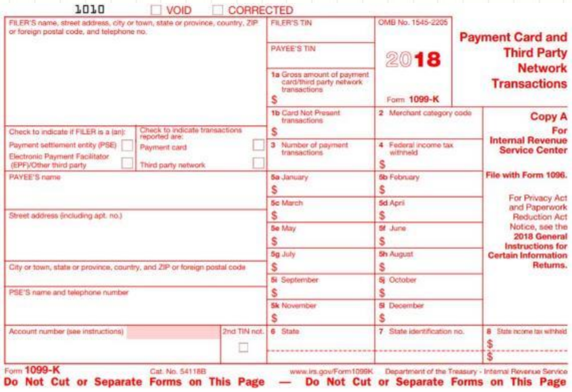
A. *Rev. Proc. 2013-29* (third-party redemption)

B. *Rev. Proc. 2011-17* (goods returned in-exchange)

C. *Rev Reg §1.451-5* (Method change to a two-year deferral, , "advance consent", using *Rev Proc 97-27*)

D. *Rev. Proc. 2004-34* (Method change to a one-year deferral)

§6050W reporting requirements:
Payment Settlement Entities (PSEs) (Form 1099-K)


1010 ☐ VOID ☐ CORRECTED

FILER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.

FILER'S TIN

PAYEE'S TIN

1a Gross amount of payment card/third party network transactions $

OMB No. 1545-2205

2018

Form 1099-K

Payment Card and Third Party Network Transactions

Check to indicate if FILER is a (an): Payment settlement entity (PSE) ☐ Electronic Payment Facilitator (EPF)/Other third party ☐

Check to indicate transactions reported are: Payment card ☐ Third party network ☐

1b Card Not Present transactions $

2 Merchant category code

3 Number of payment transactions

4 Federal income tax withheld $

Copy A For Internal Revenue Service Center

PAYEE'S name

5a January $ | 5b February $

Street address (including apt. no.)

5c March $ | 5d April $

5e May $ | 5f June $

5g July $ | 5h August $

City or town, state or province, country, and ZIP or foreign postal code

5i September $ | 5j October $

PSE'S name and telephone number

5k November $ | 5l December $

File with Form 1096.

For Privacy Act and Paperwork Reduction Act Notice, see the **2018 General Instructions for Certain Information Returns.**

Account number (see instructions) | 2nd TIN not. ☐ | 6 State | 7 State identification no. | 8 State income tax withheld $ $

Form **1099-K** Cat. No. 54118B www.irs.gov/Form1099K Department of the Treasury - Internal Revenue Service

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CARD Act of 2009 statutes & legislation

Credit **Card** Accountability Responsibility and Disclosure (**CARD**) Act

- **gift cards** cannot expire within **five years** from the date they were activated
- generally limits "inactivity fee" on **gift cards** except in certain circumstances, such as if there has been no transaction **for at least 12 months.**

Review Question #8

In 2009, Congress passed the Credit Card Accountability Responsibility and Disclosure (CARD) Act, which set consumer protections for gift cards based on many state laws. The law provides that gift cards cannot expire within ___?___ years from the date they were activated and generally limits inactivity fee on gift cards except in certain circumstances, such as if there has been no transaction for at least 12 months. The federal law creates a floor for regulation and leaves room for state regulation on redeeming gift cards for cash and unclaimed property provisions.

A. 3 years

B. 5 years

C. 1 year

D. 10 years

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Federal Gift Card Law: What is Required?

No Expiration Dates less than 5 years

Fees prohibited unless no activity for 12 months

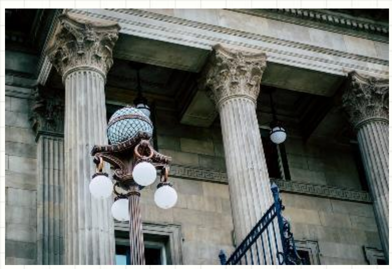
Expiration and fees require **clear and conspicuous disclosures**

Mandatory disclosures (toll-free number, URL, etc.)

The Fed punted on preemption: inconsistent state laws still apply and create risks of enforcement for issuers

Does not directly address escheatment, but prohibiting expiration before 5 years allows shorter state abandonment periods to apply to card balances

Breakage nationwide has reduced since 2010; overall redemption rates are higher *(CEB Towers Group 2014 Gift Card Executive Survey)*



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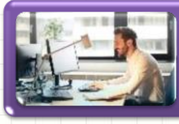
Rewards and airline miles

Citi sends out 1099s

"Rewards and airline miles that are provided in connection with a purchase on a credit card are routinely not subject to individual income tax reporting,"

"When a customer receives a gift for opening a bank account -- whether cash, a toaster or airline miles -- the value of that gift is generally treated as income and subject to tax reporting. This is separate and distinct from miles or points earned by our credit card customers for their purchases."



One of the customers who signed up reportedly got a 1099 notice showing $645 in "income" from the frequent flier miles. The customer claimed it was a surprise, but Citi's standard disclosure:

- WHEN FREQUENT FLIER MILES ARE PROVIDED AS A PREMIUM FOR OPENING A FINANCIAL ACCOUNT, IT CAN BE A TAXABLE SITUATION SUBJECT TO REPORTING UNDER CURRENT LAW

Unclaimed Property Escheatment Laws

All States have unclaimed property laws

If **the "owner"** of the property has not used the property for an "abandonment period", **the "holder"** of the property must pay the property to one of the States

Abandonment periods vary for types of property, and by State, but usually **three to five years**

The owner can reclaim the property from the State. Most States maintain databases online for the purpose

Which State gets the property?

- The US Supreme Court held in *Texas v. New Jersey et al 379 US 674 (1965):*
  - **The first priority State is the State of residence of the owner**, as shown on the holder's records
    - If there is no such record, or if the address is in a State which does not provide for the escheat of such property, **the second priority State is the State of incorporation of the holder**

Gift certificates - revenue recognition Example – spa package

William buys his spouse a $1,000 spa package gift certificate. It has a one-year expiration. She divorces William six months later and destroys the gift certificate.

At the end of the expiration period, despite the certificate's destruction, the spa has earned and can recognize the revenue.

In addition to gift certificates, retail stores have begun to offer a vast array of "reward programs."

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Financial Accounting Implications

Financial Accounting Implications

- When a company makes a gift card sale it receives cash and creates an unearned revenue liability.

Recognition

- Not all companies recognize gift card sales the same way
- it takes time and experience for companies to accurately establish "breakage" patterns
  - Home Depot example
- How to recognize "breakage"? the SEC has described 2 acceptable methods
  - specific identification
  - homogenous pool method
- Companies must worry about escheatment when accounting for "breakage"

•Disclosure

- When it comes to how and where to disclose information about gift cards there is no specific literature to guide companies
- Unredeemed gift cards constitute a liability

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New revenue recognition standard
5-Step Model (effective Jan 01, 2018) (FASB ASC 606, IFRS 15)

New revenue recognition standard has a five-step model on how you recognize revenue and <u>when control has transferred to the customer.</u>

- Core Principle
  - Recognize revenue to depict the transfer of goods or services to customers in an amount that reflects consideration to which the entity *expects to be entitled* in exchange for those goods or services

Step 1. Identify the contract with the customer

Step 2. Identify separate performance obligation. *So the goods or services to be delivered to a customer*

Step 3. Determine transaction price. *Which basically means how much you're going to get paid for the goods and services.*

Step 4. Allocate transaction price to performance obligations in the contract. *Total contract value between the goods and services that are be delivered.*

Step 5. Recognize revenue when each performance obligation satisfied. *You deliver the goods and services.*

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New revenue standard
Gift cards

Debit: Cash

Credit: ~~Sales Revenue~~

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New revenue standard

Gift cards

Dr: Cash 200

Cr: Deferred revenue 200

(Company sells gift card, w/ Estimated breakage of 10%)

Dr: Deferred revenue 200

Cr: Sales Revenue (earned) 200

(Customer Jane Doe redeems gift card)

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Review Question #9

True or False – a company should not record revenue at the time a gift card is sold… Instead, the payment received at the time a gift card is sold is recorded as a liability, because the company has an obligation to provide goods or services at a later date?

A. True

B. False

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New revenue standard

Gift cards

Dr: Cash 200

Cr: Deferred revenue 200

(Company sells gift card, w/ Estimated breakage of 10%)

Dr: Deferred revenue 168

Cr: Sales Revenue 168

(Customer redeems portion ($200 X 84%) of gift card)

Dr: Deferred revenue 17

Cr: Breakage Income 17

(Recognize Estimated breakage (($200 X 10%) X 84%) upon redeemed portion of gift card)

"Breakage"

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New revenue standard

Gift cards

- Determine whether the company expects to be entitled to the "breakage" amount
- Recognize "breakage" in proportion to customer redemptions
  - e.g. Recognize 50% of the total estimated "*breakage*" <u>upon redemption</u> of 50% of the customer rights

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Review Question #10

Under the new Revenue Recognition Standard, a company must determine whether it expects to be entitled to a "breakage" amount, and if so, it should recognize the "breakage" amount how?

A. Consider unredeemed gift cards as income, only when probability of redemption becomes "remote".

B. Recognize 'breakage" amount in proportion to customer redemption of gift cards.

C. Recognize only when the gift card expires

D. Recognize strategically, to put the company in the best possible light.

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New revenue standard

Gift cards

…the assessment of the estimated breakage should then be updated each reporting period

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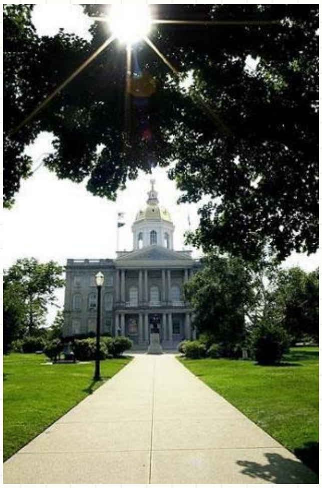
New revenue standard
Gift cards

…and any changes in estimated breakage should be accounted for by adjusting the contract liability to reflect the remaining rights expected to be redeemed

43 Tax Treatment of Gift Cards & Certificate Sales

New revenue standard
Gift cards

A company should not recognize any estimated breakage as revenue if unredeemed amounts must be remitted to a governmental entity in accordance with unclaimed property or state laws



44 Tax Treatment of Gift Cards & Certificate Sales

Gift cards

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 provided by the **gift card** subsidiary or other members of the affiliated group;

A franchise, 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 geographical 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.

Accounting for Customer Loyalty Programs

Regs. Sec. 1.451-4 provides a method of computing net income for TPs that issue or sell qualifying trading stamps or premium coupons that are redeemable by that TP for merchandise, cash, or other property

Because *Regs. §1.451-4* permits TPs to take into account the cost of future redemptions in the year the trading stamps or premium coupons are issued, applying the regulation may result in an accelerated recognition of redemption costs compared to what would otherwise be available under the general expense recognition rules of *§461.*

Non–trading stamp companies: TPs that issue trading stamps or coupons with sales (rather than sell the stamps or coupons as their primary product) may be able to use this method

Additional requirements: Regardless of whether a TP qualifies as a trading stamp company or non–trading stamp company, *Regs. §1.451-4* requires that trading stamps or premium coupons be redeemable in merchandise, cash, or other property.

In addition, *Regs. §1.451-4(d)* requires consistency with financial reporting

"All Events" Test Applied to Rewards Program
Giant Eagle v. Comm'r

•Two basic requirements of *Regs. §1.451-4* are that "premium coupons" must be issued "with sales" (assuming the TP is not a trading stamp company) and must be "redeemable" by the TP in merchandise, cash or other property. Retailer customer loyalty programs generally meet the regulation's "with sales" requirement because points are awarded to customers upon making a purchase and would seemingly meet the "redeemable" requirement to the extent the points are redeemable in cash, merchandise or other property.

Likewise, the IRS has addressed the regulation's "redeemable . . . in merchandise, cash or other property" requirement and concluded that, when additional consideration is required to redeem coupons (a "cents-off" coupon), a customer's right to redeem coupons is conditioned on a future purchase, making it more appropriate to match the coupon liability to that subsequent purchase (see *Rev. Rul. 78-212).*

in a decision issued on May 6, 2016, the Third Circuit *822 F.3d 666 (3rd Cir. 2016),* reversed the Tax Court *(Giant Eagle, Inc. v. Commissioner, T.C. Memo 2014-146).* In a divided opinion, the Third Circuit instead concluded that the grocery chain's liability becomes fixed immediately upon the customer's purchase of the groceries required to earn the points. At that time, the Third Circuit reasoned, the grocery chain enters into a unilateral contract requiring it to redeem the points upon demand, under the written terms of the program. The court appeared to give weight to the fact that the TP had not reserved the right to revoke any loyalty points already earned by customers, and had never done or considered doing so in the history of the program.

Quantifying the Deferral Method

For illustration purposes, assume company X, a home video rental retailer, defers $1 million of income from sale of **gift cards** under ***Rev. Proc. 2004-34***. The cash-tax benefit may be computed as follows:

$1,000,000	X 21%	= $210,000	X 1.91%	= $4,011
Gift Card Net Income	Fed Corp Tax Rate	Tax Liability	AFR Short Term Annual Rate Aug. 2019 @ 1.91% The IRS issues new figures monthly.	One Year Deferral Benefit

Review Question #11

The IRS forbids realizing Cost of Goods Sold before the gift card is redeemed because?

A. Unless Cost-of-Goods-Sold is accounted for in a different period.

B. It cannot be predicted what product will be purchased with the gift card.

C. Clients need make no additional disclosure because they are receiving income today (advance payment) for a transaction that can happen in the future.

D. In general, revenue is recorded when it is earned for financial accounting purposes, and when it is received for tax purposes.

49 Tax Treatment of Gift Cards & Certificate Sales

PRACTICAL APPLICATION

50 Tax Treatment of Gift Cards & Certificate Sales

One-year deferral exception
Two-year deferral exception

One-year deferral exception

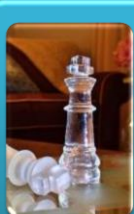
- A business may defer revenue from the sale of gift cards until the end of the year following the year in which the gift card was sold. This exception applies to almost any gift card regardless of the services or products for which it can be redeemed.
- Businesses make no additional disclosures about the cards on their tax returns, but they are required to properly adopt this method of accounting for tax purposes.
- A business that has not previously used this deferral but wants to start will need to file a Form 3115 with the IRS to change its accounting method.

Two-year deferral exception

- A TP may defer recognition of gift card revenue until the last day of the second taxable year following the year in which the gift card was sold if the card can be redeemed only for goods.
  - This restriction is onerous when a gift card can be redeemed for a combination of goods & services. Services that are considered integral to the sale of goods, like delivery and installation, may be viewed as part of the goods and will not disqualify the revenue from the two-year deferral.
- If the gift card can be redeemed for non-integral services, like third-party warranties or repair services, the revenue does not qualify for the two-year deferral.

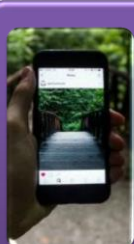
51 Tax Treatment of Gift Cards & Certificate Sales

Rev. Proc. 2004-34 §4.06
Automatic change *(Rev. Proc. 2009-39)*



Changes in accounting method to either the full inclusion method or the deferral method, with an applicable financial statement, are automatic changes. Under *Rev. Proc. 2004-34, § 4.06*, an "applicable financial statement" is one that is:

- (1) required to be filed with the SEC;
- (2) a certified audited financial statement accompanied by an independent CPA's report; or
- (3) a financial statement (other than a return) required to be provided to a Federal of state government of any Federal or state agency (other than the SEC or IRS).



TPs without an applicable financial statement would still be allowed an automatic change to the deferral method if they could determine how much of the advance payment was earned in the receipt year. If TPs cannot determine this, they can use statistics (if adequate data is available), using straight-line ratable basis over the life of the contract (however, they will still need to recognize all income by the end of the succeeding tax year), or any other method that clearly reflects income. Only income recognized over the straight-line method will be afforded treatment as an automatic accounting-method change.

52 Tax Treatment of Gift Cards & Certificate Sales

Rev. Proc 2017-30

IRC §481(a) adjustment

§ 481(a) adjustment. The corporation may have to make an **adjustment** under ***§ 481(a)*** of the IRC to prevent amounts of income or expense from being duplicated or omitted.

The *§**481(a)** **adjustment*** period is generally 1 year for a net negative **adjustment** and 4 years for a net positive **adjustment**. However, a corporation can elect to use a 1-year **adjustment** period if the net ***§481(a)*** **adjustment** for the **change** is less than $50,000. The corporation must complete the appropriate lines of Form 3115 to make the election.

53 Tax Treatment of Gift Cards & Certificate Sales

Review Question #12

A *§481(a)* adjustment requires a company to take into account those adjustments necessary to prevent amounts from being duplicated or omitted due to a Change-in-Accounting-Method. Recognition and timing of a positive *§481(a)* adjustment from an IRS exam change [adjustment in the earliest tax year under exam (1-year only adjustment period)], initiated by the IRS, and one voluntarily initiated by the client (4-year adjustment period, beginning with year of change), is?

A. May subject client and preparer to penalties is IRS finds client is using an impermissible accounting method. *Treas. Reg. §1-451-5(c)*

B. *§481(a)* adjustment is more favorable when Change-in-Accounting-Method requested is client initiated and is over 4-years beginning with year of change.

C. Time value of money

D. Doesn't matter if IRS contacts client for examination of the method client is currently using.

54 Tax Treatment of Gift Cards & Certificate Sales

Changing Accounting Methods

Form 3115 – *how it's done - overview*

- Use latest version of Form 3115 (December 2015)
- *Rev Proc's 2008-52, 2004-34, 2009-39, 2015-13, 2016-29, 2017-30*
- Accts Receivable 100,000
- Accts Payable (40,000)
- Net *§481(a)* Adjustment 60,000
- *§481(a)* $50,000 or less, or negative?
  - Add 100% in year of change
- else, bring *§481(a)* in ¼ per year, for next 4 years

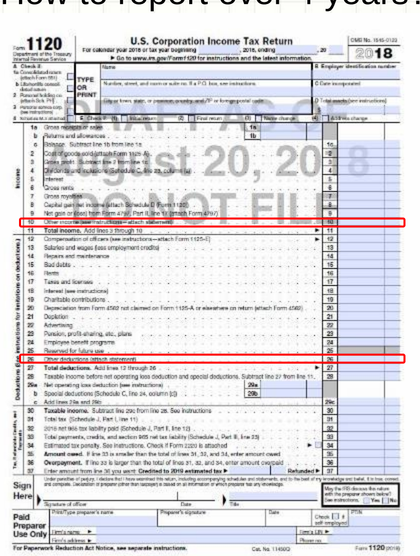
55 Tax Treatment of Gift Cards & Certificate Sales

Form 3115

§481(a) adjustment – How to report over 4 years?

Where the Form 3115 instructions say **line 10**: http://www.irs.gov/pub/irs-pdf/i1120.pdf page 9

- **Line 10. Other Income**
  - Any **net positive** *§481(a)* adjustment
- **Line 26. Other Deductions**
  - If the **net** *§481(a)* adjustment is **negative**


Form 1120
U.S. Corporation Income Tax Return
2018
DRAFT AS OF
August 20, 2018
DO NOT FILE

56 Tax Treatment of Gift Cards & Certificate Sales

Review Question #13

True or False –Any **net positive *§481*(*a*) adjustment** should be reported on Form 1120, Line 10. Other Income, or If the **net *§481*(*a*) adjustment** is **negative**, report it on Form 1120, Line 26 - Other Deductions?

A. True

B. False

57 Tax Treatment of Gift Cards & Certificate Sales

Change in Accounting Method
Form 3115

Automatic change request procedures

- No fee
- No acknowledgement

Returns under audit

- New rules in *Rev Proc 2015-13*

Procedural rules

- The latest list of automatic changes and specific instructions are in *Rev Proc 2017-30*

All increases added together (spread over 4 years)

All decreases added together (deduct in current year)

58 Tax Treatment of Gift Cards & Certificate Sales

Form 3115 - Covington, KY automatic changes
When & where to file

The **original** Form 3115 should be filed with the income tax return

A **duplicate** copy of the signed Form 3115 (automatic consent accounting method change) should be sent to:

Internal Revenue Service
201 West Rivercenter Blvd
PIN Team Mail Stop 97
Covington, KY 41011-1424

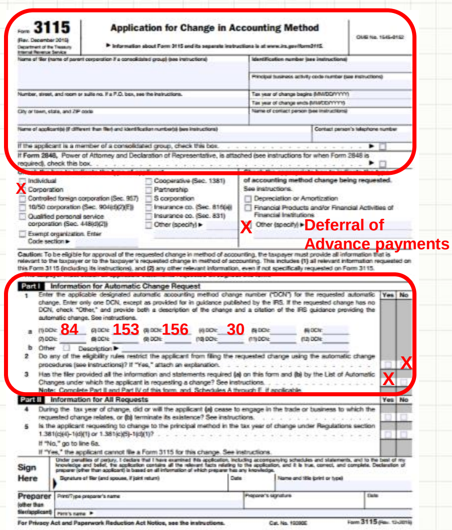
•"Advance consent" changes, continue to be filed with:

•IRS National Office
•1111 Constitution Ave, NW
•Washington, D.C. 20224

Completing Form 3115
Part I – Information for automatic change request

Most information on Form 3115, Page 1 is found on the TP's income tax return

Form 3115, Part I is for Automatic Changes, where the TP lists the DCN, which can be found in the instructions



Review Question #14

Taxpayers with eligible gift card sales who are currently deferring gift card sales using the 2-year deferral, may wish to consider which "automatic" consent DCN number on Form 3115, to change to one-year deferral method and secure Prior-Year audit protection and a 4-year spread of any positive §481 adjustment?

A. DCN #84 (deferral method for advance payments)

B. No DCN #, So as to reduce the chance of audit, even if it is not true?

C. DCN #156 (Gift cards issued as a refund)

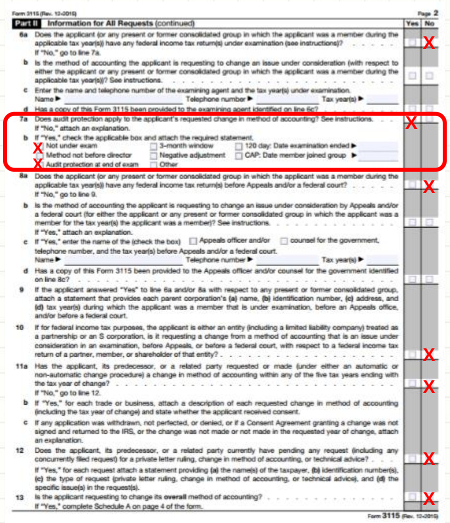
D. DCN #153 (retrospective accounting change in accordance with applicant's AFS.)

61 Tax Treatment of Gift Cards & Certificate Sales

Form 3115

Part II – Information for all requests

Form 3115, Part II information is required for all accounting methods. My defaults are checked "No" for 6a, 8A and 10, "Yes" for 7a, 17 and 18, "Not under exam" for 7b and the rest blank. However, each question should be reviewed thoroughly.



62 Tax Treatment of Gift Cards & Certificate Sales

Form 3115
Change in deferral method for advanced payments

Not all parts and schedules of Form 3115 are used and should be left blank.

Table A: Parts to Complete on Form 3115 for Accounting Method Changes

Information to be completed for automatic and non-automatic change requests

	Part I	Part II	Part III	Part IV
Automatic Change	X	X		X
Non-Automatic Change		X	X	X

Table B: Schedules to Complete on Form 3115 for Common Accounting Method Changes

Information to be completed for common method change requests

Common Method Changes	Schedule A		Schedule B	Schedule C		Schedule D			Schedule E
	Part I	Part II		Part I	Part II	Part I	Part II	Part III	
Accrual to Cash	X	X							
Cash to Accrual	X								
Capitalize to Expense									
Expense to Capitalize								X*	X*
Depreciation									X
Long-Term Contracts						X		X	
Inventory Valuation Change							X	X*	
LIFO Change–Including Pooling				X	X				
Change to Deferral Method for Advanced Payments			X						

X Must fully complete section

Section need not be completed

X* To be completed if applicable—See instructions regarding Schedules D and E, later

Source: Form 3115 instructions

Form 3115
Designated change numbers

List of DCNs

No.	Change
83	**Full inclusion method for certain advance payments (section 451)**—to the full inclusion method as described in section 5.01 of Rev. Proc. 2004-34, 2004-1 C.B. 991. The applicant must be using, or changing to, an overall accrual method of accounting. See section 15.07 of Rev. Proc. 2015-14.
84	**Deferral method for certain advance payments (section 451)**—to the deferral method as described in section 5.02 of Rev. Proc. 2004-34, 2004-1 C.B. 991 (except as provided in section 8.03 and 8.04(2) of Rev. Proc. 2004-34). The applicant must be using, or changing to, an overall accrual method of accounting. See section 15.07 of Rev. Proc. 2015-14.
153	**Advance payments—change in applicable financial statements (Rev. Proc. 2004-34)**—for an applicant using the deferral method for including advance payments in gross income in accordance with its applicable financial statement (AFS) to change its method **to** recognize advance payments in gross income under Rev. Proc. 2004-34 consistent with a changed manner for recognizing advance payments for its AFS. The requirement in section 6.03(3)(a) of Rev. Proc. 2015-13 to provide an additional copy of the application to the examining agent(s), appeals officer(s), and counsel to the government, if applicable, applies to this application. A statement in lieu of a Form 3115 is authorized for this change. See section 15.11 of Rev. Proc. 2015-14. **Note**. This change is implemented on a cut-off basis and does not receive audit protection.

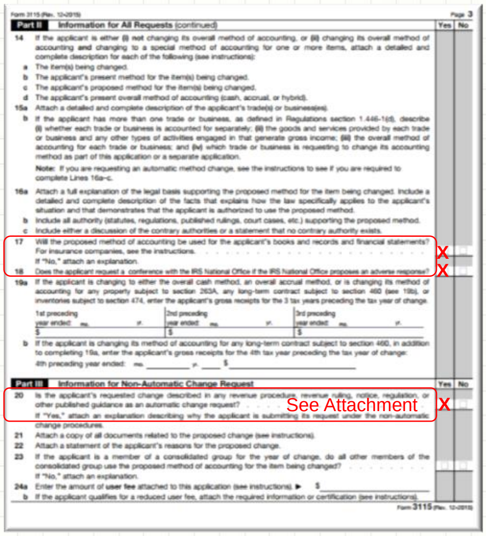
Source: Form 3115 instructions

www.ClearLawInstitute.com
(703) 372-0550

Form 3115
Part III

TOP TIP

- While Form 3115, corresponding instructions, related Rev Proc's and other rules are lengthy, Tax Preparers need only know a small portion for any given change.
- The key is to determine which sections are relevant.



Form 3115 (Rev. 12-2015) Page 3

Part II Information for All Requests (continued) | Yes | No

14 If the applicant is either (i) not changing its overall method of accounting, or (ii) changing its overall method of accounting and changing to a special method of accounting for one or more items, attach a detailed and complete description for each of the following (see instructions):
a The item(s) being changed.
b The applicant's present method for the item(s) being changed.
c The applicant's proposed method for the item(s) being changed.
d The applicant's present overall method of accounting (cash, accrual, or hybrid).
15a Attach a detailed and complete description of the applicant's trade(s) or business(es).
b If the applicant has more than one trade or business, as defined in Regulations section 1.446-1(d), describe (i) whether each trade or business is accounted for separately; (ii) the goods and services provided by each trade or business and any other types of activities engaged in that generate gross income; (iii) the overall method of accounting for each trade or business; and (iv) which trade or business is requesting to change its accounting method as part of this application or a separate application.
Note: If you are requesting an automatic method change, see the instructions to see if you are required to complete Lines 16a–c.
16a Attach a full explanation of the legal basis supporting the proposed method for the item being changed. Include a detailed and complete description of the facts that explains how the law specifically applies to the applicant's situation and that demonstrates that the applicant is authorized to use the proposed method.
b Include all authority (statutes, regulations, published rulings, court cases, etc.) supporting the proposed method.
c Include either a discussion of the contrary authorities or a statement that no contrary authority exists.
17 Will the proposed method of accounting be used for the applicant's books and records and financial statements? For insurance companies, see the instructions. X
If "No," attach an explanation.
18 Does the applicant request a conference with the IRS National Office if the IRS National Office proposes an adverse response? X
19a If the applicant is changing to either the overall cash method, an overall accrual method, or is changing its method of accounting for any property subject to section 263A, any long-term contract subject to section 460 (see 19b), or inventories subject to section 474, enter the applicant's gross receipts for the 3 tax years preceding the tax year of change.

1st preceding year ended: mo. yr.	2nd preceding year ended: mo. yr.	3rd preceding year ended: mo. yr.
$	$	$

b If the applicant is changing its method of accounting for any long-term contract subject to section 460, in addition to completing 19a, enter the applicant's gross receipts for the 4th tax year preceding the tax year of change:
4th preceding year ended: mo. ______ yr. ____ $ ______

Part III Information for Non-Automatic Change Request | Yes | No

20 Is the applicant's requested change described in any revenue procedure, revenue ruling, notice, regulation, or other published guidance as an automatic change request? See Attachment X
If "Yes," attach an explanation describing why the applicant is submitting its request under the non-automatic change procedures.
21 Attach a copy of all documents related to the proposed change (see instructions).
22 Attach a statement of the applicant's reasons for the proposed change.
23 If the applicant is a member of a consolidated group for the year of change, do all other members of the consolidated group use the proposed method of accounting for the item being changed?
If "No," attach an explanation.
24a Enter the amount of user fee attached to this application (see instructions). ▶ $
b If the applicant qualifies for a reduced user fee, attach the required information or certification (see instructions).

Form 3115 (Rev. 12-2015)

Attachment for Form 3115, Part III, Line 20

Attachment to Form 3115

- In addition to filing Form 3115, the TP may need to provide an attachment that lists additional detail.

Appendix 1

Sample Format for Form 3115 Attachments

Note: The following is a sample format of an attachment to Form 3115.

Attachment to Form 3115, Part III, Line 20

Name of Taxpayer
Identification Number
[redacted]

Item(s) being changed: **Gross income: revenue recognition**

Present method for item(s) being changed: **Gross income for the year received**

Proposed method for item(s) being changed: **Deferral of "Advance payments"**

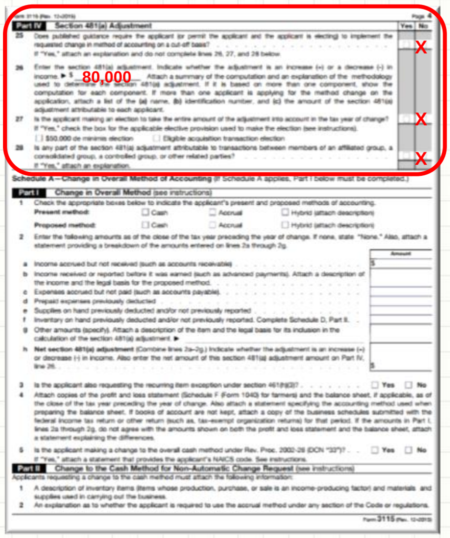
Regulation authorizing the proposed method: ***Treas. Reg. §1.145-5, Rev. Proc. 2013-29, Rev. Proc. 2011-18, Rev. Proc. 2011-17, Rev Proc 2004-34***

Present overall accounting method: **Accrual method**

Form 3115 - Part IV – *§481(a)* adjustment
Rev. Proc. 2018-31 - "Changes in the timing of recognition of income due to the New Standards" *(ASC 606)*

Form 3115, Part IV *§481(a)* adjustment

§481(a) provides that, where a TP's taxable income for a tax year is computed under a method of accounting different from that previously used, an adjustment will be made to prevent amounts from being duplicated or omitted solely by reason of the change in accounting method.



Page 4

Part IV Section 481(a) Adjustment | Yes | No

25 Does published guidance require the applicant (or permit the applicant and the applicant is electing) to implement the requested change in method of accounting on a cut-off basis? If "Yes," attach an explanation and do not complete lines 26, 27, and 28 below. X

26 Enter the section 481(a) adjustment. Indicate whether the adjustment is an increase (+) or a decrease (-) in income. ▶ $ 80,000 Attach a summary of the computation and an explanation of the methodology used to determine the section 481(a) adjustment. If it is based on more than one component, show the computation for each component. If more than one applicant is applying for the method change on the application, attach a list of the (a) name, (b) identification number, and (c) the amount of the section 481(a) adjustment attributable to each applicant.

27 Is the applicant making an election to take the entire amount of the adjustment into account in the tax year of change? If "Yes," check the box for the applicable elective provision used to make the election (see instructions). ☐ $50,000 de minimis election ☐ Eligible acquisition transaction election X

28 Is any part of the section 481(a) adjustment attributable to transactions between members of an affiliated group, a consolidated group, a controlled group, or other related parties? If "Yes," attach an explanation. X

Schedule A—Change in Overall Method of Accounting (If Schedule A applies, Part I below must be completed.)

Part I Change in Overall Method (see instructions)

1 Check the appropriate boxes below to indicate the applicant's present and proposed methods of accounting.
Present method: ☐ Cash ☐ Accrual ☐ Hybrid (attach description)
Proposed method: ☐ Cash ☐ Accrual ☐ Hybrid (attach description)

2 Enter the following amounts as of the close of the tax year preceding the year of change. If none, state "None." Also, attach a statement providing a breakdown of the amounts entered on lines 2a through 2g.

	Amount
a Income accrued but not received (such as accounts receivable)	$
b Income received or reported before it was earned (such as advanced payments). Attach a description of the income and the legal basis for the proposed method.	
c Expenses accrued but not paid (such as accounts payable).	
d Prepaid expenses previously deducted	
e Supplies on hand previously deducted and/or not previously reported	
f Inventory on hand previously deducted and/or not previously reported. Complete Schedule D, Part II.	
g Other amounts (specify). Attach a description of the item and the legal basis for its inclusion in the calculation of the section 481(a) adjustment. ▶	
h **Net section 481(a) adjustment** (Combine lines 2a–2g.) Indicate whether the adjustment is an increase (+) or decrease (-) in income. Also enter the net amount of this section 481(a) adjustment amount on Part IV, line 26.	$

3 Is the applicant also requesting the recurring item exception under section 461(h)(3)? ☐ Yes ☐ No

4 Attach copies of the profit and loss statement (Schedule F (Form 1040) for farmers) and the balance sheet, if applicable, as of the close of the tax year preceding the year of change. Also attach a statement specifying the accounting method used when preparing the balance sheet. If books of account are not kept, attach a copy of the business schedules submitted with the federal income tax return or other return (such as, tax-exempt organization returns) for that period. If the amounts in Part I, lines 2a through 2g, do not agree with the amounts shown on both the profit and loss statement and the balance sheet, attach a statement explaining the differences.

5 Is the applicant making a change to the overall cash method under Rev. Proc. 2002-28 (DCN "33")? ☐ Yes ☐ No
If "Yes," attach a statement that provides the applicant's NAICS code. See instructions.

Part II Change to the Cash Method for Non-Automatic Change Request (see instructions)

Applicants requesting a change to the cash method must attach the following information:

1 A description of inventory items (items whose production, purchase, or sale is an income-producing factor) and materials and supplies used in carrying out the business.

2 An explanation as to whether the applicant is required to use the accrual method under any section of the Code or regulations.

Form 3115 (Rev. 12-2015)

67 Tax Treatment of Gift Cards & Certificate Sales

Calculating the Election's Immediate Tax Effect

Exhibit 1: Effect of 2018 Advance payments ($100,000) on taxable income

Year	On Financial	Taxable Income No deferral	Taxable Income with deferral
2018	20,000	100,000	100,000
2019	20,000	-- --	80,000 (20,000)
2020	20,000	--	(20,000)
2021	20,000	--	(20,000)
2022	20,000	--	(20,000)
Total	100,000	100,000	100,000

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Doing Your Best Work

Figuring the Adjustment

Company Z, a calendar-year Corporation, has a net positive *§481(a)* adjustment of $320,000 at the end of 20X1. If Company Z initiates a change in its accounting method under *Rev Proc 97-27* for the 20X2 tax year, the company will recognize one-fourth of the *481(a)* adjustment in the four succeeding years, starting with 20X2. However, if Company Z is under examination for 20X1 and the IRS makes an accounting change adjustment, the entire *§481(a)* adjustment will be taxable in the year of examination.

YEAR	Taxable Income IRS initiates change	Company initiates change
20X1	$320,000	-0-
20X2	-0-	$80,000
20X3	-0-	$80,000
20X4	-0-	$80,000
20X5	-0-	$80,000
TOTALS	$320,000	$320,000

Under *Rev Proc 2015-13*, a TP under examination generally **may file** an automatic or nonautomatic **Form 3115**, but will not receive audit protection and will have only a two-year adjustment period for any positive *§481(a)* adjustment

69 Tax Treatment of Gift Cards & Certificate Sales

Types of Method Changes: Authority

Involuntary : On Exam or at Appeals

- *Rev Proc 2002-18*

Voluntary: "Non-automatic" Requires Commissioner's "Advance consent" (2-year deferral)

- *Rev. Proc. 97-27*

Voluntary: "Automatic change" approval by Commissioner (1-year deferral)

- *Rev. Proc. 2004-34 and 2008-52*, as updated by *Rev. Proc. 2009-39, Rev. Proc. 2011-14 and Rev. Proc. 2015-13*

70 Tax Treatment of Gift Cards & Certificate Sales

Review Question #15

Taxpayers without an applicable financial statement (AFS) who desire to change to a deferral method in which income is recognized based on a statistical basis or some other manner deemed appropriate, do not qualify for an automatic accounting change and must use ___?___ which governs advance consent changes (i.e., non-automatic changes) on Form 3115?

A. Rev. Proc 2002-18 (changes in method of accounting)

B. Rev. Proc 2008-52, as updated by *Rev. Proc 2009-39* and *Rev. Proc 2011-14, Rev. Proc. 2015-13* (automatic changes)

C. Treas. Reg. §1-451-5(c) (gift card advance payments)

D. Rev. Proc. 97-27 (Obtaining prior consent from Comm'r of IRS to change method of accounting)

Example - Electronic Store Inc.

In December 2018, a customer purchases a $200 gift card from Electronic Store, Inc. which sells, delivers & installs electronics. The customer did not redeem the gift card in 2018. The entire $200 of revenue can be deferred in 2018.

During 2019, the customer purchased $150 of electronics and $25 for delivery and installation. The $175 attributed to goods, delivery & installation must be recognized as revenue in 2019.

Because the TP sells goods and performs only services that are integral to the sale of the goods, the remaining $25 balance of the gift card can be deferred until the end of 2020, the second taxable year after the gift card was sold. Even if the remaining $25 balance wasn't redeemed by the customer until 2021, the $25 must still be recognized in 2020.

Example - Electronic Store Inc
Recent guidance

Things get more complicated for TPs that sell non-integral services. Fortunately, the IRS recently issued guidance clarifying how the rules operate for these TPs. The portion of gift card revenue that will be redeemed for goods and integral services will still qualify for the two-year deferral. Any remainder is eligible for only the one-year deferral.

The TP must estimate the portion of the gift card allocable to each category. This estimate may be done using any reasonable method but many TPs use a historical average based on previous gift card redemptions.

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Example - Electronic Store Inc

During December 2018, a customer purchases a $200 gift card from Electronic Store, Inc. which sells electronics, provides delivery & installation for those electronics, and provides repair services for any electronic item. The repair services are non-integral services. Historically, repair services accounted for 20% of total gift card usage. The gift card is not redeemed until 2021.

The $40 attributable to repair service can be deferred until 2019 (one-year) while the $160 attributable to goods and integral service can be deferred until 2020 (two-year).

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Rev Proc 2004-34
Clarification

In some cases, deferral of income for certain specific types of income is permitted without a written agreement. For example, a prepayment for a mailer or certificate that obliges a photographic processor to process film, prints or other photographic materials returned in the mailer or with the certificate may be included in income for the taxable year subsequent to the taxable year of receipt if the processor uses the deferral method of accounting and can determine the extent to which the advance payments are recognized in revenues (or earned) for the taxable year of receipt.[132]

Similarly, if a hair styling salon receives advance payments for redeemable gift cards that have an expiration date 12 months after the date of sale, the salon can use the deferral method for the advance payments if it can determine the extent to which advance payments are recognized in revenues (or earned) for the taxable year of receipt.[133]

- [132] *Rev. Proc.* ***2004-34****, 2004-22 I.R.B. 991, Ex. 6.*
- [133] *Rev. Proc.* ***2004-34****, 2004-22 I.R.B. 991, Ex. 8.*

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Rev Proc 2004-34
Example 7 – Hair styling salon

F, a hair styling studio, receives advance payments for gift cards that may later be redeemed for hair styling services or hair care products at the card's face value. The cards look like standard credit cards; each has a magnetic strip that identifies the available balance. They cannot be redeemed for cash and have no expiration date.

In its AFS, F recognizes advance payments for cards when redeemed. F does not determine the extent to which advance payments are recognized in revenue for the tax year of receipt and, thus, does not meet the requirements for deferral.

Further, F does not determine under an acceptable basis (e.g., statistical, straight-line or other method deemed appropriate) the extent to which payments are earned for the tax year of receipt.

Thus, F **may not** use the deferral method for these advance payments.

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Rev Proc 2004-34

Example 8 – Hair styling salon

The facts are the same as in Example 7, except

- (1) the gift cards have an expiration date 12 months from the date of the sale,
- (2) expired gift cards are not accepted and
- (3) F recognizes unredeemed gift cards in revenue in its applicable financial statement for the tax year in which the cards expire.

In Example 8, F can use the deferral method for the advance payments, because it can determine the extent to which such payments are recognizable in income for the receipt year and the subsequent year in which the cards expire.

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Review Question #16

R, a small restaurant, sells gift cards, with no expiration, no dormancy fees, not redeemable for cash. 85% redeemed in following year, and R recognizes advance payments for cards when redeemed. R **does not** have an AFS. Is R eligible to defer income up to 2-years on unredeemed dollars?

A. R is eligible to defer income up to 2-years on unredeemed dollars.

B. R should not recognize payments for cards when redeemed.

C. R **does not meet** requirements for deferral because it does not determine under an acceptable basis (e.g. statistical, straight-line or other method deemed appropriate) extent to which payments are earned for tax year of receipt, or subsequent year, as the cards do not expire, nor does R have an AFS. Thus, R may **not** use deferral method for these advance payments. R is required to include the entire amount in taxable income in the year of receipt. (*Rev. Proc. 2004-34* states if CL does not have an AFS, CL must recognize in the year of receipt, the amount of income <u>earned</u> during the year of receipt.)

D. is eligible to defer income up to 1-year on unredeemed dollars.

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Summary
Tax Treatment of Gift Cards & Certificate Sales

Sale of a **gift card** may be deferred from immediate income recognition under two exceptions*: Rev. Proc. 2004-34* and *Treas. Reg. §1.451-5*

Treas. Reg. § 1.451-5(c) provides that a TP generally may not defer advance payments for inventory goods beyond the end of the second taxable year following the year the TP receives a substantial advance payment such as a gift card sale (**hence, a two-year deferral**)

Credit **Card** Accountability Responsibility and Disclosure (**CARD**) Act states **gift cards** cannot expire within five years from the date they were activated?

- CARD Act generally limits "inactivity fee" on **gift cards** except in certain circumstances, such as if there has been no transaction for at least 12 months

Under the new Revenue Recognition rules a company should not record revenue at the time a gift card is sold… Instead, the payment received at the time a gift card is sold is recorded as a liability, because the company has an obligation to provide goods or services at a later date

Under the new Revenue Standard a company must determine whether it expects to be entitled to a "breakage" amount and then, if so, it should recognize the "breakage" amount in proportion to customer redemptions of the gift cards

- Track the appropriate data correctly for each gift card issued:
  - issue date, original amount, redemption date, redemption amount

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Summary (con't)
Tax Treatment of Gift Cards & Certificate Sales

Under deferral provisions, economic benefit for retailers with gift card sales is real and quantifiable. CLs who qualify, do benefit from liberalized income deferral rules. under either:

- *Rev. Proc. 2004-34 (1-year deferral) (using DCN#153 and DCN #156, "automatic-change" on 3115),*
- *Reg. §1.451-5 (2-year deferral) (requires "advance-consent" on 3115 using Rev Proc 97-27)*
- *Rev Proc 2011-17* ("Safe-harbor" for gift cards issued as a refund for returned merchandise) - "matching" Income & Expenses

Any **net positive** ***§481****(a)* **adjustment** should be reported on Form 1120, Line 10. Other Income, or If the **net** ***§481****(a)* **adjustment** is **negative**, report it on Form 1120, Line 26 - Other Deductions

IRS says here's what you do with that *481(a)* adjustment when you fill out the 3115. if it's a positive adjustment that's going to increase income, if it's 50,000 or less you're allowed to add it all in in the year of change, for example, 2019, or bring it in one-fourth a year, starting with a year of change e.g. 2019, 2020, 2021 & 2022

- Finally, if you have a negative adjustment, you're actually allowed to subtract the full amount of the negative adjustment in the year the change. so for example in 2019, the full amount in 2019

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Summary (con't)
Tax Treatment of Gift Cards & Certificate Sales

TPs with such "eligible gift card sales" who are currently deferring gift card sales under the two-year deferral of *Treas. Reg. § 1.451-5(c)* may wish to consider filing an automatic consent (automatic #84) Form 3115 to change to the one year deferral method afforded by *Rev. Proc. 2004-34* in order to secure prior-year audit protection and a four-year spread of any positive *§481(a)* adjustment?

•*Rev. Proc. 2018-31* entitled "Changes in the timing of recognition of income due to the New Standards" sets forth automatic change procedures for companies adopting FASB ASC 606.

- this automatic change is on a "cutoff basis" (i.e., No *§481(a) adjustment*)
- (DCN 231 on 3115)
- *IRS Notice 2018-35*, provides guidance on advance payments

QUESTIONS?

Rev. Proc. 2015-14 (Advance Payments)
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- Bentley University
- Bloomberg BNA Tax & Accounting, BNA.com/tax
- Crowell & Moring, David Ervin (202) 624-2622 dervin@crowell.com, Walter Nagel (202) 624-2570 wnagel@crowell.com
- Duff & Phelps, Robert Peters (312) 697-4924 robert.peters@duffandphelps.com

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- *Technical Advice Memorandum (TAM -107447-15)*, Rel. Date March 04, 2016 *(TAM 201610017)*
- Tax Foundation
- Thomson Reuters - Checkpoint
- *Treasury Regulations, Subchapter A, Sec. 1.451-5. (May 11, 2005)*

APPENDIX

Appendix 1 - What we can learn?

A TP generally must recognize advance payments (e.g., sale of a gift card) in taxable income in the year of receipt, because receipt satisfies the all events test *of Treas. Reg. § 1.451-1(a)*. Two exceptions to this general rule are provided by *Treas. Reg. § 1.451-5 and Rev. Proc. 2004-34: Treas. Reg. § 1.451-5* generally allows an accrual method TP to defer recognizing advance payments for goods as income until the taxable year the TP recognizes the advance payments in revenue under the TP's method of accounting for financial reporting purposes. However, the deferral of substantial advance payments for inventory goods is limited to the end of the second taxable year following the year the advance payment becomes substantial. In addition, *Treas. Reg. §1.451-5* applies only to "an agreement for the sale or other disposition in a future taxable year of goods held by the TP primarily for sale to customers in the ordinary course of his trade or business."

Rev. Proc. 2004-34 generally allows an accrual method TP to defer recognizing advance payments received for goods, services, or a mixture of both, as income until the taxable year the TP recognizes the advance payments in revenue under the TP's method of accounting for financial reporting purposes. However, the deferral is limited to the end of the next succeeding taxable year following the year the TP receives the payments. The manner in which retailers market, sell to customers, and redeem (i.e., accept as payment for goods or services) gift cards has evolved over time.

Appendix 2 - IRS Guidance Relating to the Tax Treatment of Gift Cards - accounting for gift cards

Rev Proc 2011-17

- Safe-harbor method accounting for gift cards issued to customers in exchange for returned merchandise

Rev Proc 2011-18

- Extends advance payment deferral method of accounting set out in *Rev Proc 2004-34*

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Appendix 3 - Before 2011

Before 2011, the IRS National Office had challenged and denied the deferral in certain instances. Specifically, if the **gift card** management companies were separate wholly owned subsidiaries that did not provide goods or services of their own, TP-specific guidance had taken the position that the regulations did not allow either the maximum two-year deferral under *Reg.* ***§1.451-5*** or the one-year deferral under ***Rev. Proc. 2004-34***.[481] These conclusions were based on the fact that neither of the deferral provisions applies where the group entity selling the **gift card** is not the same legal entity that will redeem the **gift card** with its own provision of goods and services. This approach to **gift card** subsidiaries reflected limited and restrictive applications of the regulations and ***Rev. Proc. 2004-34***, which is inconsistent with the intended scope of the deferral provisions.

- *[481] FAA 20093801F; 20082801F; TAM 200849015.*

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Appendix 4 – *IRC §451*

§451 requires accrual method TPs to include in gross income advanced payments received in the year of receipt, unless the income is properly accounted for as of a different period under the TP's accounting method. Exceptions allow for the deferral of "advance payments" for one or up to two years based on the TP's recognition of payments under its accounting method for financial reporting purposes. Specifically, ***Rev. Proc. 2004-34***[478] and *Reg.* §1.451-5 serve as exceptions to the general rule provided certain criteria are satisfied.

- 478 *2004-22 I.R.B. 991.*

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Appendix 5 - Advance Payments

Contextual Overview

Advance Payments Contextual Overview —The history of the treatment of advance payments received by accrual method TPs has reflected a gradual softening in the position of the IRS toward permitting a more favorable deferral opportunity for accrual method TPs. A common example of receiving such an advance payment exists in the context of the sale of **gift cards**, where the vendor receives an advance payment from the **card** purchaser for a specified amount of dollars/credit that may be applied towards future purchases. **Gift cards** with no expiration date may require a significantly different treatment from the sale of **cards** that expire in 12 months.[426]

- 426 See *Rev. Proc.* ***2011-18****, 2011-5 I.R.B. 443, modified and clarified by Rev. Proc.* ***2013-29****, 2013-33 I.R.B. 141,*

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Appendix 6 - Early IRS Guidance Regarding Advance Payments – *Rev. Proc 71-21*

While ***Rev. Proc. 71-21***[431] has been superseded,[432] it is addressed in detail herein for a number of reasons. First, it set the foundation for later guidance and accordingly, it is helpful to understand from a contextual perspective. Second, it may be of use for TPs with open years that relied upon this guidance in whole or in significant part. The general intent of ***Rev. Proc. 71-21*** was to allow accrual method TPs that received income in one tax year to defer recognition of a portion of such income for federal income tax purposes when the TP would be providing services (for which the original payment was received in the original tax year) in the succeeding tax year. ***Rev. Proc. 71-21***states in pertinent part:

- *431 1971-2 C.B. 549.*
- *432 See **Rev. Proc. 2004-34**, 2004-22 I.R.B. 991.[Footnote 433 reserved.]*

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Appendix 7 - Early IRS Guidance Regarding Advance Payments – *Rev. Proc 71-21* (con't)

The purpose of this Revenue Procedure is to implement an administrative decision, made by the Commissioner in the exercise of his discretion under ***§446*** of the Internal Revenue Code of 1954, *to allow accrual method TPs in certain specified and limited circumstances, to defer the inclusion in gross income for Federal income tax purposes of payments received (or amounts due and payable) in one taxable year for services to be performed by the end of the next succeeding taxable year.* Amounts due and payable are, for purposes of this Revenue Procedure, treated as payments received.[434] (emphasis added)

- *434 **Rev. Proc. 71-21**, §1.*

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Appendix 8 - Early IRS Guidance Regarding Advance Payments – *Rev. Proc 71-21* (con't)

The guidance further notes that TPs are not required to adopt the provisions and that so doing will be regarded by the IRS as an acceptable accounting method as long as it is applied consistently by the TP.[435] This procedure provided a safe harbor to those who chose to utilize it.

- [435] *Id., §3.14.*
- However, the revenue procedure was somewhat restrictive in that it only applied to agreements in which the TP would have agreed to perform all of the services under the contract (as it existed at the end of the year of the receipt of the advance payment) by the end of the succeeding tax year. Should those services not be performed in the succeeding tax year for any reason, they would still need to be recognized as income in the first succeeding tax year.[436]
  - [436] *Id., §3.02.*
- One of the inherent limitations of ***Rev. Proc. 71-21*** is the scope of transactions to which it applies. As it only applied on its face to services, many TPs felt they could not always rely on it to achieve income deferral for advance payments.

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Appendix 9 - *Rev. Proc. 2004-34*

Rev. Proc. 2004-34 allows accrual method TPs to defer income recognized from advance payment received for merchandise and services to the succeeding tax year if they do not recognize the advance payment as income for financial statement purposes in the year of receipt.

Reg. ***§1.451-5*** permits deferral of income recognition for advance payments received by an accrual method TP for goods held by the TP primarily for sale to customers until the tax year the payments are recognized as income for financial reporting purposes.[479] Under the regulations, if the TP has received "substantial advance payments" at least equal to the inventory costs of the goods and goods sufficient to satisfy the TP's contractual agreement are on hand or available through the TP's normal source of supply, then all advance payments received "by the last day of the second taxable year following the year in which such substantial advance payments are received, and not previously included in income in accordance with the TP's accrual method of accounting, must be included in income in such second taxable year."[480]

•Unlike ***Rev. Proc. 2004-34***, *Reg.* ***§1.451-5*** does not apply to advance payments for services on its face.

[479] *Reg.* ***§1.451-5(c)***.

[480] *Id.*

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Appendix 10 - *Rev. Proc. 2011-18*
Changes IRS Position

***Rev. Proc. 2011-18* Changes IRS Position** —

Rev. Proc. 2011-18 modifies and clarifies *Rev. Proc. 2004-34* to allow retailers to defer income recognition for tax purposes for advance payments received from sale of **gift cards** redeemable for goods or services of the retailer or a third party. It is effective for tax years ending on or after December 31, 2010.

However, it does not modify the *Reg.* *§1.451-5* deferral provision. In order to qualify for this provision:

(a) the TP must be principally liable to the customer (or **gift card** holder) for the value of the **card** until expiration or redemption;

(b) the **gift card** must be redeemable by the TP, or any other entity legally required to accept the **card** from the customer by way of payment for items enumerated in *Rev. Proc. 2004-34*.

The change of position under *Rev. Proc. 2011-18* can be attributed to a combination of factors, including the recognition of the merits of the TP's positions, evolving business patterns, administrative grace, and resolving controversy over a short-term timing item. In addition, TP optimism regarding favorable resolutions at the IRS Appeals Division level or potential inability of the IRS's position to withstand judicial scrutiny could have contributed to the change.

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Appendix 11 - *Rev. Proc. 2011-18*

Rev. Proc. 2011-18

(1) Background —

As most American consumers know, the use of **gift cards** offerings to induce spending has grown in popularity with retailers and various businesses, including brick-and-mortar video rental chains, online content distributors, motion picture theatres, and theme park operators. The prevalence of **gift cards** issuance is difficult to miss; they can be observed by the growing number of **gift card** malls and in-store kiosks that sell an assortment of **cards** from brand-name stores in various quantities and denominations. The proliferation of **gift card** use by companies is coupled with a growth in the manner in which the programs are structured. The IRS National Office provides the following examples of typical **gift card** structures that retailers may use to facilitate their respective programs:[477]

[477] Rev. Proc. 2011-18, 2011-5 I.R.B. 443, modified and clarified by Rev. Proc. 2013-29, 2013-33 I.R.B. 141.

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Appendix 12 - Virtual Currencies

- Cryptocurrency comes in many forms, "*receipt of something of value not backed by currency*":
  - Retail loyalty points
  - Air miles
  - Coupons
  - Game based virtual currency
  - Bitcoins
- Potential to be treated as "stored value card" or "electronic gift certificate" if:
  - Consideration is paid for "virtual" currency
  - Virtual currency is redeemable for cash or cash equivalent
  - Does not qualify under Federal Card Act as a Loyalty, Rewards Offering
- Growth out pacing use of gift cards or coupons.
  - In **2017**, the **estimated** value of the crypto-currency economy is something on the order of $162 Billion. *(Forbes)*
- Unclaimed property rules trail product and service offerings
- Legal ramifications exist, non-compliance with Federal card act and state unclaimed property provisions can result in significant liability, penalties, class action law suits and adverse publicity

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