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Internal Revenue Service
Memorandum

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to:

Revenue Agent
(LMSB, Natural Resources & Construction)
from: Industry Counsel, Food & Beverages
(LMSB, Retail, Food, Pharmaceuticals & Healthcare)

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subject: Recognition of Gift Card Sale Proceeds

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LEGEND

A:

B:

C:

D:

E:

$ *e:*

$ *f:*

Year 1:

Year 2:

g:

State Y:

ISSUES

Issue 1 (gross income): Does B, A's gift card managing subsidiary, have income from the sale of gift cards?

Issue 2 (timing of income recognition): When does B include proceeds from the sale of gift cards in its gross income?

Issue 3 (timing of deduction): When may B claim a tax deduction with respect to the gift cards that are redeemed at C stores (the retail stores)?

CONCLUSIONS

Issue 1 (gross income): B, A's gift card managing subsidiary, has income from the sale of the gift cards.

Issue 2 (timing of income recognition): B must include proceeds from the sale of gift cards in gross income when its right to receive the proceeds is fixed and the amount can be determined with reasonable accuracy. This will typically occur at the time that the gift card in question is purchased by a customer or reloaded by B or a C store. B can not defer the recognition of gift card income to a later year under the limited deferral provisions of § 1.451-5 of the Income Tax Regulations or Rev. Proc. 2004-34, 2004-1 C.B. 991.

Issue 3 (timing of deduction): B's liability is to provide gift card customers A branded products. This liability is satisfied by the C stores at B's direction when the C stores provide goods to gift card customers on B's behalf. B's liability is subject to the contingency that gift card customers must first redeem the gift cards. Therefore, B's liability is not fixed until redemption occurs. This is also when economic performance occurs, *i.e.*, when the C stores provide property to the gift card customers on B's behalf. Sections 1.461-4(d)(2) and 1.461-4(d)(6)(i).

FACTS

In Year 1, A formed B, a separate wholly-owned subsidiary, in State Y, for the purpose of managing A's trade name gift card sales. As reflected on its tax return, B's business is the sale of gift cards. Gift cards are sold at participating C stores. Some of the C stores are A-company owned, but most are independently owned. All C stores do business using A's trade name. A's trade name gift cards can be redeemed and reloaded at approximately *g* C stores. The banking relationship to process gift cards is set up with D, which also tracks gift card sales and redemptions. D is not related to A or B. A's trade name gift cards are non-refundable, do not expire, and no service fees are charged to the gift card purchaser. B does not include in gross income any proceeds from the sale of gift cards. B does not escheat any unredeemed gift card proceeds to any state.

A bears the entire cost of the gift card program. A believes it will sell more E and merchandise as a result of having a gift card program. B, a corporation that is legally separate from A, manages the gift card program.

The C stores do not directly profit when gift cards are sold. When a gift card is sold, the C store is contractually obligated to remit the proceeds to B. This is done by electronic transmission instantaneously with the purchase of the gift card. When a gift card is redeemed by a customer at a C store, B is contractually obligated to transfer the amount of the purchase to the C store where the merchandise is purchased. The C store reports income from the sale of goods upon redemption.[1]

LAW AND ANALYSIS

Issue 1 (gross income):

B, the gift card managing subsidiary, states that it is facilitating a gift card program on behalf of over *g* C stores and believes that it does not have gross income because it is not providing any goods or services for the cash that it collects. B relies on Commissioner v. Indianapolis Power & Light Co., 493 U.S. 203 (1990), and Westpac Pacific Food v. Commissioner, 451 F.3d 970 (9th Cir. 2006), for its position.

[1] It is our understanding that, for book purposes, when a gift card is sold to a customer the transaction is recorded as a non-revenue sale. The amount is reported in the category of non-merchandise sales. This sale is not credited to the C store's merchandise revenue account. Accordingly, it is not recognized as a merchandise revenue sale by the C store. This has the practical effect of not raising the C store's lease payments in situations where merchandise revenue is the basis used to determine the rent that the C store will pay. This could vary, according to the lease terms with independent parties, but the C store is being assured by A and/or B that this treatment will usually protect the C store from having to pay additional rent from gift card sales that it does not redeem. We assume that when a customer redeems a gift card, those sales are reported as merchandise sales of the C store that redeems the gift card in the amount redeemed.

Section § 61 of the Internal Revenue Code defines gross income as all income from whatever source derived. Gross income includes all "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." See Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955).

A deposit, however, is not includible in gross income when received as evidenced in Indianapolis Power. In that case, the Supreme Court considered whether deposits received by Indianapolis Power & Light Company (IPL), an electric utility company, should be treated as taxable advance payments or nontaxable deposits. IPL required customers with suspect credit to make deposits to insure prompt payment of future utility bills. The customer was entitled to a refund of the deposit after making timely payments for several months or satisfying a credit test. The customer could choose to receive the refund by cash or check or to apply the refund against future bills. The deposits were commingled with other receipts and at all times were subject to IPL's unfettered use and control. The Service argued the deposits were advance payments immediately includable in income; IPL argued they were analogous to loans and as such not taxable.

In its analysis, the Supreme Court noted that the distinction between advance payments and deposits was one of degree rather than kind. While both bestow economic benefits to the recipient, economic benefits qualify as income only if they are undeniable accessions to wealth, clearly realized, and over which the taxpayer has complete dominion. The key to determining whether a taxpayer enjoys "complete dominion" over a given sum is whether the taxpayer has some guarantee that it will be allowed to keep the money. The proper focus is on the rights and obligations of the parties at the time the payment was made. With respect to distinguishing between taxable advance payments and nontaxable deposits, the Supreme Court further explained:

> An advance payment, like the deposits at issue here, concededly protects the seller against the risk that it would be unable to collect money owed it after it has furnished goods or services. But an advance payment does much more: it protects against the risk that the purchaser will back out of the deal before the seller performs. From the moment an advance payment is made, the seller is assured that, so long as it fulfills its contractual obligation, the money is its to keep. See Indianapolis Power at 210.

In Johnson v. Commissioner, 108 T.C. 448 (1997), aff'd 184 F.3d 786 (8th Cir. 1999), the Tax Court explained the application and limits of Indianapolis Power as follows:

> Indianapolis Power and Light did not purport to overrule [prior authority] and establish refundability as the exclusive criterion for distinguishing taxable sales income from nontaxable deposits in all cases. Continental Ill. Corp. v. Commissioner, 998 F.2d 513 (7th Cir. 1993), aff'g on this issue T.C. Memo. 1989-636. What distinguished the nontaxable deposits in the Indianapolis Power and Light line of cases from taxable income was not

> their refundability per se; ultimately the classification of these amounts as nontaxable deposits turned on the fact that the taxpayer's right to retain them was contingent upon the customer's future decision to purchase services and have deposits applied to the bill. See Johnson v. Commissioner at 471.

B's reliance on Indianapolis Power is misplaced. Unlike the facts in Indianapolis Power, B, the gift card managing subsidiary, has not shown that it is subject to an obligation to refund gift card amounts to either the store or the gift card purchaser.[2] Accordingly, the money transferred to B is not a deposit.

In Westpac, the U.S. Court of Appeals for the Ninth Circuit reversed the U.S. Tax Court and determined that upfront cash payments received by an accrual method grocery partnership were "advance trade discounts" and were akin to security deposits or loans/liabilities rather than "accession to wealth" or income. The "advance trade discounts" were received in consideration for a commitment to make future volume purchases. The taxpayer had to fulfill a volume purchase obligation before it could keep the "advance trade discount" payments (a condition precedent). If the purchase obligation was not met, the taxpayer had an obligation to repay a prorata portion of the "advance trade discounts".

B's reliance on the rationale in Westpac is unpersuasive. In Westpac, the taxpayer could not keep the money if it did not purchase the predetermined volume. The taxpayer had to fulfill this contingency before it could keep the money (a condition precedent). In the instant case, B will keep the proceeds from the gift card purchase unless, and until, the consumer redeems the gift card (a condition subsequent). Additionally, the Service has not acquiesced to the Westpac decision, which is a 9th Circuit case. Taxpayer is located in State Y, in a different circuit, and Westpac, is not the law outside the 9th Circuit.

North American Oil Consolidated v. Burnet, 286 U.S. 417 (1932), is instructive and reflects the general rule that amounts received under a claim of right and without restriction as to their disposition constitute income in the year of receipt, even though the taxpayer might be required ultimately to restore an equivalent amount. Citing North American Oil, the Court in James v. U.S., 336 U.S. 213, 219 (1961) stated "[w]hen a taxpayer acquires earnings, lawfully or unlawfully without the consensual recognition, express or implied, of an obligation to repay and without restriction as to their disposition, he has received income…."

In the instant case, although the amounts received by the taxpayer are subject to the possibility of return present at the time of the receipt, viz., the possibility of redemption, these receipts are in no sense placed out of the control of the taxpayer. They are not in escrow or other special account outside the taxpayer's control. As shown in North American Oil, the fact that B may have to transfer funds to a C store upon redemption of

[2] However, even if the gift card proceeds were refundable in the instant case, the proceeds may still be income. "Not all refundable payments can be excluded from income." See Johnson at 470.

a gift card does not mean B does not have income upon receipt. Cash is sent back to the C stores if, and when, the gift cards are redeemed. Whether and to what extent B will transfer funds is subject to the contingency that the consumer will redeem the card and in what amount. As a matter of practical experience in the industry, we believe that B can not show that all the gift cards its sells will be redeemed, in full, and with any certainty as to when any portion of the redemption will occur.

In conclusion, B can not escape taxation with respect to gift card proceeds. B has, in fact, received income, over which it exercises complete dominion and control, and over which it holds under a claim of right unless, and until, it has to transfer a portion of the proceeds back to the C stores.

Issue 2 (timing of income):

Section 451(a) provides that the amount of any item of gross income is included in gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, the amount is to be properly accounted for as of a different period. Section 1.451-1(a) provides that, under an accrual method of accounting, income is includible in gross income when all the events have occurred that fix the right to receive the income and the amount can be determined with reasonable accuracy. All the events that fix the right to receive income generally occur when (1) the payment is earned through performance, (2) payment is due to the taxpayer, or (3) payment is received by the taxpayer, whichever happens earliest. See also Rev. Rul. 84-31, 1984-1 C.B. 127. Therefore, an advance payment of income generally is includible in gross income in the taxable year received.

These principles were made clear by a trilogy of Supreme Court opinions and a Sixth Circuit opinion, inter alia. See Schlude v. Commissioner, 372 U.S. 128 (1963); American Automobile Assn. v. United States, 367 U.S. 687 (1981); Automobile Club of Michigan v. Commissioner, 353 U.S 180 (1957); and Hagen Advertising Displays, Inc. v. Commissioner, 407 F.2d 1105 (6th Cir. 1969). The cited Supreme Court cases dealt specifically with prepaid income for services rather than goods (B sells the gift cards and provides the clearing house services associated with these sales). They established the principle that, except for certain limited exceptions, an accrual method taxpayer must include amounts received for services even though the income is not yet earned. Citing the trilogy of Supreme Court opinions above, the Hagen, supra, case held that prepaid receipts for blanket orders for manufactured advertising signs must be reported in income in the year received. Thus, advance payments for the sale of goods must be included when received unless an exception is available. Section 1.451-5(b)(1).

B does not qualify for the deferral available under § 1.451-5 because the amount received is not an “advance payment” under § 1.451-5(a)(1) since B will not be redeeming gift cards with its own goods held for sale. Rather, B will be transferring cash to the seller of the goods, the C store, when its liability to make such a transfer is fixed, *i.e.*, when a C store redeems the gift card through the sale of its own goods. B

does not qualify to use the Deferral Method under Rev. Proc. 2004-34, because B can not determine the extent to which the amounts received will be recognized as revenues in its applicable financial statements for the taxable year of receipt. See section 5.02 (1)(b)(i) of Rev. Proc. 2004-34.[3] If a C store sold gift cards on its own behalf, the C store would be the recipient of an advance payment for goods held for sale by the C store, and would presumably be able to qualify for the limited deferral regime of § 1.451-5.

Thus, for tax purposes, B must report gift card sale proceeds as gross income in the year when they are received by B or when B has the right to receive them, whichever occurs earliest. Tax accounting and financial accounting for advance payments are not the same. Although B defers the proceeds from unredeemed gift cards for financial accounting purposes, there is nothing in tax law to allow deferral. See Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 542 (1979). B has complete control over the money received from the purchaser of the gift cards. B does not refund gift cards and is entitled to keep the money from gift card sales until the cards are redeemed, and in some cases, the cards are never redeemed.

Issue 3 (timing of deduction):

Section 461(a) provides that the amount of any deduction or credit must be taken for the taxable year that is the proper taxable year under the method of accounting used in computing taxable income.

Section 1.461-1(a)(2)(i) provides that, under an accrual method of accounting, a liability is incurred, and is generally taken into account for federal income tax purposes, in the taxable year in which (1) all the events have occurred that establish the fact of the liability, (2) the amount of the liability can be determined with reasonable accuracy, and (3) economic performance has occurred with respect to the liability (the "all events test"). See also § 1.446-1(c)(1)(ii)(A).

Section 461(h)(1) provides that in determining whether an amount has been incurred with respect to any item during any taxable year, the all events test shall not be treated as met any earlier than when economic performance with respect to such item occurs. Section 461(h)(2)(A) provides that if the liability of the taxpayer arises out of the providing of services or property to the taxpayer by another person, economic performance occurs as such person provides such services or property. See also § 1.461-4(d)(2)(i). Section 1.461-4(d)(6)(i) provides that services or property provided to a taxpayer includes services or property provided to another person at the direction of the taxpayer.

Accrual basis taxpayers are not considered to have met the all-events test, for purposes

[3] However, a taxpayer that is unable to determine the extent to which a payment (such as a payment for contingent goods or services) is earned in the taxable year of receipt may determine that amount on a statistical basis if adequate data are available to the taxpayer. Section 5.03(b)(i) of Rev. Proc. 2004-34. At this time we do not believe adequate data would be available to B due to B's brief existence.

of being able to claim a tax deduction, until all events have occurred to fix the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has taken place. B's liability is to provide gift card customers A branded products. This liability is satisfied by the C stores at the direction of B when gift card customers redeem the cards at the C stores. B's liability is subject to the contingency that gift card customers must first redeem the gift cards. B does not have a liability to transfer any amount to a C store, until the gift card customer redeems the gift card. The liability will be fixed when redemption occurs. This means that B can only deduct the actual cash or credit outlays that B has a fixed liability to transfer to a C store for completed retail sales to gift card customers using the gift cards that B sold.

B's liability can not be considered incurred until the gift card is redeemed by the gift card customer. At this time B's liability is fixed, determinable, and the economic performance requirement is met. Before the gift cards are redeemed, all events have not occurred to establish the fact of the liability and estimates of the amount of the liability are subject to the vagaries inherent to gift card redemptions (*e.g.*, when, if, and in what amount the redemptions will occur). Therefore, B's tax deductions for gift card redemptions for the years at issue are the amounts actually redeemed during those years.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

This legal opinion benefited from the analysis and insight of the issue that was provided by Philip J. Hofmann, Technical Advisor (Food & Beverage) to Industry Counsel (Food & Beverage) Rogelio A. Villageliu, during the formulation of the opinion. Please call Mr. Villageliu at (312) 368-8740 or Mr. Hofmann at (316) 352-7434, if you have any further questions. Prior to its being issued this opinion was coordinated with the national office, Income Tax and Accounting.

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