

**Office of Chief Counsel  
Internal Revenue Service  
Memorandum**

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POSTF-149051-10

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to: 8WFDB  
LB&I (Large Business & International)

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subject: Income recognition from sales of gift checks by a membership special entity (A)

This memorandum responds to your request for assistance. Although facts in this case are taken from years now closed in Examination, the issues and material facts are present in subsequent years. This opinion is intended to provide guidance with respect to these future years. This advice may not be used or cited as precedent.

**LEGEND**

8WFDB =

A, special entity, or the taxpayer =

B =

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C, parent of B =

D stores (Franchisees of B and stores operated by B) =

IDR## =

Month #, Year =

Month ##, Year =

The A versus B Litigation =

Hundreds =

Letter, Letter #Letter ##-##### =

(Letter)] =

Checking account #1#### =

General ledger account 2#### =

Redeemable \$XX Letter, Letter (Letter) =

E bank (an unrelated to taxpayer =

national chain of banks) =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Year 5 =

Year 6 =

Year 7 =

Year 8 =

Year 9 =

Year 10 =

Year 11 =

January 31, Year 10 =

January 31, Year 11 =

\$1##,###,###.00 =

\$1##,###,###.00 =

Minutes of the taxpayer Committee that took place on Month #, Year# =

Pay to the Order of any D (Franchisor or Franchisee) Restaurant =

Payable at E Bank, City, State, Zip Code =

SEE OTHER SIDE FOR DETAILS.

To D (B or B system)	=
This is a check issued by A. Please credit bearer \$X and present to any bank.	=
To Contacting Bank: Upon presentation, handle as a cash item payable at paying bank	=
This gift check is worth \$X and is redeemable toward the purchase of any product at most D restaurants in the United States. All taxes are payable by bearer.	=
State of G	=
Year 0	=
Year 0+6	=
X%	=
X+1%	=
F or Franchisee	=
Year 0 + 10	=
Year 0 + 10 Gift Certificate Program	=
\$1X,242,000	=
\$3X,651,000	=
\$0X,640,000	=
\$5X,533,000	=
\$1Y,550,335	=
\$2Y,582,520	=
\$0Y,361,445	=
\$4Y,494,300	=
Services	=
Program	=
Special entity or entities	=

## **ISSUES**

1. Are the proceeds that A receives from the sale of gift checks<sup>1</sup> gross income or nontaxable member contributions, deposits or funds held-in-trust?

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<sup>1</sup> For the years in question, the sales reportedly represent gift checks. Apparently, these have been issued as part of the Program documented in the Minutes of A's Committee that took place on Month #, Year. In Year 10, B launched its "Program". We have no documentation on the relationship of the Year 10 Program to the taxpayer's gift check program.

2. When must A include the proceeds it receives from the sale of gift checks in gross income?
3. Is it reasonable for the Service to determine that, in the absence of evidence to establish otherwise, gift checks provided by A to D stores for sale to customers have been sold to customers in the year that A receives funds from D stores?
4. When may A deduct amounts paid to D stores to redeem gift checks?

### **CONCLUSION:**

1. The proceeds that A receives from the sale of gift checks are gross income and are not nontaxable member contributions. The proceeds that A receives from its direct sale of gift checks to the public or a third party are not deposits or funds held in trust. However, the funds that A receives from D stores may be viewed as a deposit or an amount held in trust for the benefit of D stores up to the time D stores sell the gift checks to customers. At that time, the funds held by A may be viewed as proceeds from the sale of gift checks includable in A's gross income.
2. A must include the proceeds it receives in income when the gift checks are sold to the public, third parties, or customers of the D store.
3. It is reasonable for the Service to determine that, in the absence of evidence to establish otherwise, gift checks provided by A to D stores for sale to customers have been sold in the year that A receives funds from D stores.
4. The A may deduct amounts paid to D stores for redeemed gift checks when D stores redeem the gift checks. However, A may not deduct amounts paid that exceed amounts that it has previously included, or is currently including, in gross income for each batch of gift checks issued.

### **FACTS**

This opinion is based on facts determined for the taxpayer's taxable years ending January 31, Year 10 and January 31, Year 11. A is a State of G, Non-stock Corporation. A was formed in Year 0 as an unincorporated association by B (now a subsidiary of C) for the purpose of organizing a services program. A incorporated formally on Year 0+6. A uses the cash basis method of accounting for book purposes and the accrual method for tax purposes. A does not include gift check sales proceeds as income for book or tax purposes. Although A uses the term \_\_\_\_\_ to describe itself, and this opinion uses the name \_\_\_\_\_ for the taxpayer, A is a C corporation and is NOT \_\_\_\_\_ for federal income tax purposes.

A's members include B and its U.S. franchisees (there are hundreds of U.S. franchisees). A's governing body, known as the "Committee," is comprised of

members, of whom are franchisees who are elected by franchisees from regions throughout the U.S. One franchisee serves *ex officio* by reason of his position as , and four members are employees of B and are appointed by B. Each member has one vote. There has been litigation by A against B because of <sup>2</sup>.

A filed a Form 1120, "U.S. Corporate Income Tax Return," for both years . A's services budget is funded by contributions from its members. The contribution rate is voted upon and approved by the taxpayer's members and is based on a percentage of the members' gross sales. For purposes of calculating a member's contribution, a member's gross sales do not include any proceeds from the sale of gift checks. The A reports the members' contributions "Other Income," on its Form 1120 without including any of the gift check sale proceeds.

A sells gift checks, in preset denominations of \$X or \$XX, in different ways. First, A provides checks to D stores for sale to customers, and D stores pay A the face value of the gift checks. Second, A sells gift checks directly to scrip organizations at a 10% discount, which in turn, resell the gift checks. A recognizes the discount at the time of sale for both book and tax purposes. Finally, A sells gift checks through online sales. The link to online sales is located on the B website; however, A processes the orders and directly receives payment. The link on the B website is strictly a service provided for the benefit of . A maintains a small supply of gift checks on hand to fill orders from D stores, scrip organizations and online sales. A securely stores the unissued gift checks in a warehouse until it needs to replenish its supply.

The face of the gift checks is printed to read, in part, as follows:

**Pay to the Order of any D**

**Payable at E Bank, City, State, Zip Code  
SEE OTHER SIDE FOR DETAILS.**

The reverse of the gift checks is printed to read, in part, as follows:

**To D (B or B system) ...**

**This is a check issued by [... A ...]. Please credit bearer \$X and present to any bank.**

**To Contacting Bank: Upon presentation, handle as a cash item payable at paying bank.**

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<sup>2</sup> See The A versus B Litigation

**This gift check is worth \$X and is redeemable toward the purchase of any product at most D restaurants in the United States. All taxes are payable by bearer.**

The gift checks are similar to actual checks that circulate in the economy as negotiable instruments. The pre-numbered gift checks have separate checking account numbers based upon the face value of the gift check and, like an actual check, are processed through the Federal Reserve System. The gift checks are honored by E when presented for payment. The gift checks are not dated and have no expiration dates. A orders the gift checks in batches, and A opens a new checking account each time a batch of gift checks is produced. On average it takes about three (3) years to sell an entire batch of gift checks.

Because the gift checks are associated with a specific bank account through which they clear, A establishes a general ledger account for each batch of gift checks by denomination. For example, the batch of \$XX gift checks printed in year 8 has a general ledger account – Cash \$XX Letter, Letter #Letter ##-##### (Letter)] – to track the batch of the gift checks; A does not track the gift checks individually.<sup>3</sup> A does not have the ability to determine the breakdown of the gift checks based on the type of sale (D store, scrip organization or online).

To obtain gift checks, scrip organizations or D stores place orders with, and submit payment to . A will not deliver gift checks until it receives payment (for the face amount of the gift checks for gift checks provided to D stores). A initially deposits amounts that it receives into its general checking account. The entry to record the sale is a debit to the general checking account (Checking account #1####) and a credit to the corresponding gift check liability account that has been set up for the specific batch by denomination (i.e., general ledger account 2#### Redeemable \$XX Letter, Letter (Letter) Redeemable \$XX GC (T)).

At the end of each month, A transfers the amounts from the general checking account to a specific checking account. The entry to record this transfer is a credit to the general cash account Checking account #1#### and a debit to the specific cash account. When a gift check is redeemed by a customer for goods at a redeeming D store, the specific cash account is credited and a contra liability account, which was also set up on the books for each batch by denomination, is debited. The redeeming D store negotiates the gift check and receives payment from the checking account established for redemptions.

Disbursements from the checking account established for each batch of gift checks are solely for redemptions. Therefore, the balance in any gift check cash account represents the unredeemed gift checks by batch by denomination. Also, the net amount of the gift check liability account and the contra liability account equals the

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<sup>3</sup> Examination's Workpapers include information setting forth general ledger trial balance for checking accounts by batch.

amount of unredeemed gift checks. At the point redemptions slow to about \$10 a month, A recommends to the board to close the checking account and transfer the funds back into the general checking account to be used for services. If approved, A closes the checking account and transfers the funds to the general checking account. A usually closes a checking account eight (8) to ten (10) years from the date it sells the last check from a batch.

D stores are not required to participate in gift check sales. A common problem with gift check sales is that most of the activity occurs between October 1 and December 24 (70% to 80%) and unissued checks tend to “disappear” over time when stored at the restaurant. Stores have been instructed to accept any gift check, and E bank (an unrelated national chain of banks) has been instructed to process all checks, regardless of the age or the condition of the gift check. If a customer presents a gift check with a face amount of more than the purchase price of the store’s product, the store will pay the balance to the customer. For example, if a customer presents a \$XX gift check but only buys an item for \$1.50, the store will pay \$XX - \$1.50 in cash to the customer because the gift check is the equivalent of cash.

### A’s Books and Records

gift check sales for the fiscal years ending January 31 were as follows:

	Year 10	Year 11
D stores (Franchisee restaurants)	\$ 1X,242,000	\$ 1Y,550,335
Script Organizations	3X,651,000	2Y,582,520
Corporate Office Sales (includes sales on-line)	0X,640,000	0Y,361,445
Total sales	\$ <u>5X,533,000</u>	\$ <u>4Y, 494,300</u>

Assumed A journal entries are, as follows:

#### **1. Journal entries made at point of gift check sale:**

Account Type	Account Title	Account Title	Debit	Credit
Asset	Cash - General Checking		100,000	
Liability		Unredeemed Gift Checks		100,000
	- To record gift check sale -			

#### **2. Journal entries made at end of each month to transfer gift check sales to checking account established specific for batch and denomination of gift checks:**

Account Type	Account Title	Account Title	Debit	Credit
Asset	Cash – Bank Account # - \$XX Batch Identifier		100,000	

Asset		Cash—General Checking		100,000
	- To transfer gift check sales to checking account established specifically for batch and denomination of gift check -			

### 3. Journal entries made when gift check is redeemed:

Account Type	Account Title	Account Title	Debit	Credit
Contra Liability Account	Gift Checks redeemed		50,000	
Asset		Cash – Bank Account # - \$XX Batch Identifier		50,000
	- To record redemption -			

### 4. Journal entries made when redemptions become insignificant (usually 8 to 10 years):

Account Type	Account Title	Account Title	Debit	Credit
Asset	Cash - General Checking		5,000	
Asset		Cash – Bank Account # - \$XX Batch Identifier		5,000
Liability	Unredeemed Gift Checks		100,000	
Contra Liability Account		Gift Checks Redeemed		95,000
<b>Credit** Unknown</b>		<b>** Unknown account title</b>		5,000

**\*\* The actual account that gets credited at this point is unknown. However, the income for A's Form 1120, "U.S. Corporation Income Tax," return is based only on**

### D Store Books and Records

Although Examination has no definite information whether the following journal entries have been made by the D stores ( ), the following are the journal entries that should be recorded on the books of the D stores based on the gift check treatment that A has used. The **assumed** entries, amounts, and account titles are as follows:



**1. Journal entries made at point of gift check purchase:**

Account Type	Account Title	Account Title	Debit	Credit
Asset	Gift Checks – Available for Sale		100,000	
Asset		Cash		100,000
	- To record gift check purchase -			

**2. Journal entries made at point of gift check sales to public:**

Account Type	Account Title	Account Title	Debit	Credit
Asset	Cash		100,000	
Asset		Gift Checks – Available for Sale		100,000
	- To record gift check sale to the public -			

**3. Journal entries made when gift check is redeemed by customer:**

Account Type	Account Title	Account Title	Debit	Credit
Asset	Cash		50,000	
Sales		Sales		50,000
	- To record gift check redemption by a customer -			

**Further entries in A's Books and Records**

The taxpayer maintains sufficient books and records to be able to determine unredeemed gift checks by batch date.

## DISCUSSION, LAW AND ANALYSIS

**Issue 1: Are the proceeds that A receives from the sale of gift checks gross income or nontaxable member contributions, deposits or funds held-in-trust?**

**A. The non-taxable A members' contributions are separate and apart from A's taxable gift check sales proceeds.**

There is no logical or documented relationship between members' contributions and gift check sale proceeds. A's members make monthly contributions based on a contribution rate that is in effect at the time the payment is due. The rate may be X+1% or X% of "sales" per month. A reports amounts contributed by members "Other Income" of its Forms 1120. This line, reportedly, does not include

any of the gift check sale proceeds. For example, for the year ended January 31, Year 10, A reported members' contributions of \$1##,###,###.00; and, for the year ended January 31, Year 11, A reported members' contributions of \$1##,###,###.00.

A represents that it was formed solely for the not-for-profit purpose of conducting or promoting services that the D stores could not afford. The "Services Agreement" between A and the D stores specifies under Section 3 – Expenditures by

:

[A] agrees that it will operate solely for the not-for-profit purposes of conducting ... [services]... related to B and related products and that all amounts contributed to it by Franchisee will be expended solely for such purposes in connection with ..., "B and D products" and related products approved for sale at D outlets by Franchisor by the [various means of providing the services and an enumeration of services]. All contributions received by ...[A]... shall be received in trust and disbursed solely for the not-for-profit purposes set forth in its Certificates of Incorporation. No part of any contribution shall be returned to Franchisee.

Paragraph 2.4(b) of A's restated bylaws, dated Month ##, Year, states:

All contributions of members and other income shall be received by ,, A in trust and shall be disbursed and expended solely for the not-for-profit purposes set forth in the Certificate of Incorporation of ... A and no part thereof, either before or after the termination or dissolution of ...[A], shall inure to the benefit of any private member or individual.

The gift check sale proceeds do not meet the definition of contributions established by A's own documents. For example, A's by-laws and the Month #, Year board minutes make a distinction between the members' contributions and other income, which would include "the income (if any) derived from unredeemed Gift Certificates." The program was established at a later date and represents a source of "other income," and not members' contributions. The "Program" agreement between A and its members was approved in minutes dated Month #, Year, which established the "Program." The minutes, in part, state:

By motion duly made, seconded and then unanimously approved, it was resolved that a B's Program be established for the purpose of selling \$X and \$XX to Franchisees and to B customers nationally. Income (if any) derived from unredeemed will be used for the not-for-profit purposes of continuing to plan, administer, promote, and supervise a national ,,,[services],,, program on behalf of the franchisees and the franchisor of B and to do all things necessary to carry out these programs.

Based on A's response to IDR##, these minutes were never reduced to a written agreement between A and its members.

Although the stated purpose of A is a non-profit [special entity] for the members, A is still a corporation subject to the general rules of corporate income taxation. [redacted] are not exempt from federal income taxation, and, in general, are taxed in the same manner as other corporations. Subchapter T allows certain [redacted] that are "operating on a [redacted] basis" to exclude certain items from gross income through a series of special deductions in IRC §§ 1381-1388.<sup>4</sup> In effect, the

[redacted] may operate at cost and the "profits" belong to the members, and the patrons are taxed on distributions. The only [redacted] income that escapes taxation at the [redacted] level is patronage source income that flows through to the patrons.

To date, A reportedly has not distributed any [redacted] dividends to any member, despite having operated as a [special entity] for many years. A has not represented that the gift check sales are [redacted] income. But, assuming arguendo, that they were, A has not flowed through this income to patrons under Subchapter T or any other provision. Further, A did not flow through gift check sales income to A's members within the prescribed time limit under Subchapter T. See I.R.C. §§ 1381-1388 requirements to transfer the incidence of taxation to a [redacted]'s patrons.

The fact that A uses the gift check sale proceeds that exceed gift check redemptions for... purposes ... [that benefit its members]... does not transform the sales proceeds to members' contributions. The members did not sell the gift checks, did not include the proceeds in gross income, and did not contribute the gift check proceeds to A for ... [service]... purposes. Instead, A sold the gift checks, received the proceeds but failed to include the proceeds in gross income, and did not follow any of the Subchapter T provisions, and simply retained the untaxed unredeemed gift check sales proceeds, presumptively, for service purposes. The inherent abuse in taxpayer's method of accounting is clear: A does not simply defer the recognition of income from the gift check sales proceeds; but rather, income from unredeemed gift check sales proceeds completely escapes taxation.

**B. The proceeds that A receives from its direct sale of gift checks to the public or third parties are not deposits or funds held in trust. However, the funds that A receives from D stores may be viewed as a deposit or an amount held in trust for the benefit of D stores up to the time D stores sells the gift checks to customers. At that time, the funds held by A may be viewed as proceeds from the sale of gift checks includable in A's gross income.**

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<sup>4</sup> Farmers [redacted] that meet certain additional requirements may take advantage of further exclusions from gross income under I.R.C. §521. This section is inapplicable to this special entity.

IRC §61 defines gross income as all income from whatever source derived. Accordingly, any funds or other accessions to wealth received by a taxpayer are included in gross income, unless the taxpayer can demonstrate that a specific exclusion applies. Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 430 (1955). The taxpayer has not shown that any specific exclusion applies in this case, and we conclude that no exclusion applies.

North American Oil Consolidated v. Burnet, 286 U.S. 417 (1932), reflects the general rule that amounts received under a claim of right and without restriction as to its disposition constitute income in the year of receipt, even though the taxpayer might be required ultimately to restore an equivalent amount. In Johnson v. Commissioner, 108 T.C. 448, 470 (1997), aff'd 184 F.3d 786 (8<sup>th</sup> Cir. 1999), the court explained that not all refundable payments can be excluded from income and that a characteristic of a deposit is the lack of a binding agreement to apply the sum to the purchase of specific goods and services.

### **C. A's position**

A's position is that all amounts that it receives from gift check transactions are held in trust for the benefit of its members and do not constitute gross income. A asserts that it acts as an intermediary that only handles the administration of the gift checks; therefore, no amount is taxable income. In addition, A asserts that these funds are burdened with the obligation of use for [services] purposes. As stated in its returns, A considers the amounts it receives from its members to be:

[B]urdened with the obligation to expend such sums for ...[services]... purposes. Such payments, therefore, do not constitute gross income and the A is not subject to tax upon the excess of its receipts over its disbursements. Likewise, disbursements over receipts do not constitute a loss.

Thus, A asserts that it is not required to include proceeds from gift check transactions in income for both tax and book purposes. It would help to clarify whether the taxpayer deducts proceeds from gift checks that are spent on services.<sup>5</sup>

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<sup>5</sup> If relying on Seven-Up v. Commissioner, 14 T.C. 965 (1950), acq. 1950-2 C.B. 4, withdrawn and acq. 1974-2 C.B. 4, the taxpayer does not include gift checks proceeds in income, taxpayer should also not take a deduction for gift check proceeds spent on services. Ascertaining that the taxpayer does not do both (fail to recognize gift check income yet take a services expense deduction for gift check proceeds spent in services) may also be relevant to whether the taxpayer's treatment of gift check proceeds reflects a method of accounting. The fact that the taxpayer's exclusion of gift check proceeds from income is a permanent exclusion suggests that this is not a method of accounting. However, an argument can be made to the contrary. Therefore, if during your examination of the gift check issue in future cycles, you deem it appropriate or necessary to make adjustments for closed years, it will be necessary to address this complex issue. If this is the case, you will need to request further advice to addresses the question of whether the taxpayer's exclusion of gift check proceeds from income is a method of accounting. Any

Because its bylaws require that all “other income shall be received by A in trust and shall be disbursed and expended solely for the non-for-profit purposes,” i.e., for services program purposes, A argues that gift check proceeds cannot be taxed because they are required to be used for services. However, A does not distinguish between amounts received from gift checks that are never redeemed, which may be used for services, and amounts that are paid to the redeeming D stores, which are obviously not used for services.<sup>6</sup>

Citing the Program and Section 3 of the [Services] Agreement between A and D stores, A maintains that an amount received by a taxpayer is not an accession to wealth that must be included in gross income if the taxpayer never exercises dominion or control over the amount. A argues that gross income does not include amounts that a taxpayer receives acting in a fiduciary capacity or as a conduit for payment to another. A asserts that it does not handle the gift check program for its own benefit. Given A’s position that it acts as an intermediary that only handles the administration of the gift checks, any activity related to the gift checks is recorded directly on the balance sheet [Cash (segregated on the trial balance by allotment) and Unredeemed Gift Certificates accounts].

However, A’s direct sales of gift checks to online purchasers and scrip organizations are sales, and not deposits, in which the purchaser receives the right to receive goods and services. Further, for the direct sales, D stores do not advance any funds to the taxpayer, and A is not holding any of the proceeds from these sales as deposits or funds held-in-trust for the benefit of the D stores.

On the other hand, when A places gift checks with D stores to be sold by D stores to customers, the D store retains the ability to redeem the checks and recover the funds. These funds held by A may be viewed as deposit or an amount held in trust for the benefit of D stores. However, once a D store sells the gift check to a customer or other third-party,<sup>7</sup> the store has no right to recover the funds. Thus, if the value of the gift check funds held by A is viewed as a D store deposit, the funds are no longer a deposit when the D store sells the gift check to a customer.

**Taxpayer’s reliance on the Seven-Up, supra, case is misplaced.**

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such request with regard to taxpayer’s method of accounting will require referral to the national office, CC:ITA:7.

<sup>6</sup> We conclude that the redemption amounts represent cost of sales (for A’s previous gift check sales) that A may deduct when paid to the redeeming store, and the amounts received by the redeeming stores represent food sale revenue to the food establishment.

<sup>7</sup> It is important to note that the D stores may be reimbursed not only by selling the gift check, but also by using the gift checks as a means to pay employees, or for sale incentives, or otherwise. In all of these cases, the exchange is presumed to be an arms-length exchange for equal value.

Taxpayer relies solely on Seven-Up Co. v. Commissioner, 14 T.C. 965 (1950) acq. 1950-2 C.B. 4, withdrawn and acq 1974-2 C.B. 4, to support its position that gift check sales proceeds are not taxable income. In that case, the Tax Court determined that funds deposited with a soft drink company by its bottlers were not taxable income. In Seven-Up, the bottlers were given exclusive territories, and it was not feasible for any local bottler to conduct a national services campaign. Determining that a national advertising campaign would be beneficial, the bottlers decided to combine their funds for that purpose. The program was funded by contributions from the participating bottlers based on the volume of their beverage sales.

Because the advertising agency had no means to administer the bottlers' multiple contributions, the agency recommended that the bottlers make payments to the company. The agency and the company then entered into an agreement setting forth the arrangement. The company consistently represented that it was a trustee or custodian of the bottlers' funds in the discussions leading to the implementation of the fund and thereafter. Each time product was shipped to a bottler, the company sent a statement reflecting the bottler's required contribution to the advertising fund. In turn, the company paid the agency for advertising. The agency reported directly to the bottlers and provided the bottlers detailed information regarding the national advertising program. The company considered itself to be a nontaxable intermediary between the bottlers and the agency; therefore, the company did not report the bottlers' contributions to the fund as gross income or deduct the payments to the agency as business expenses.

The Service contended that the bottlers' contributions, reduced by the payments to the agency, were taxable income to the company. The Tax Court held that the amounts contributed by the bottlers constituted a trust fund for advertising purposes and that the company administered the fund as an agent for the bottlers. The court reasoned as follows: First, the members had contributed the funds to the cooperative for the specific purpose of paying for the advertising campaign; second, the company had a legal obligation to expend the funds for advertising and could not divert the funds for any other purpose; and, third, because of this obligation, the company derived no gain, profit, or benefit upon the receipt of the funds. Consequently, the Tax Court held that "... [P]etitioner did not receive the bottlers' contribution as its own property. They were burdened with the obligation to use them for national advertising. No gain or profit was realized on their receipt because of this offsetting obligation." See, Seven-Up, supra, 14 T.C. at 979.

Some of the facts of the instant case are similar to the facts of Seven-Up. For example, in Seven-Up, the bottlers made payments based on the volume of their beverage sales to the company that were earmarked for national advertising. In the instant case, the members' contributions are also based on a percentage of sales and are used by A to pay for services. However, the critical facts are different. First, Seven-Up did not involve gift check sales. Second, Seven-Up did not involve money inflows that had not yet been taxed. Further, Seven-Up did not address the taxability of the

sale of soft drinks to the public, but addressed only the taxability of contributions of bottlers' funds earmarked for advertising. Therefore, Seven-Up does not support A's argument that the full amount of taxable gift check sale proceeds are transformed into nontaxable members' contributions, deposits, or funds held-in-trust, simply because any potential profit from the transaction could be spent on services for the benefit of the A members. In short, the holding of the Seven-Up case does not address the taxability of the sale of gift checks to the public.

The income in question is not members' contributions but rather gift check sale proceeds. The Service has not reclassified any members' contributions into taxable income.<sup>8</sup> In this case, the proceeds from the sale of gift checks derived from A's direct sales to the scrip organizations and public and from indirect sales through D stores.

percent of the Year 10 gift certificates and percent of the Year 11 gift certificates were sold directly to third parties who are not members of A.

A argues that Seven-Up holds that monies received with an obligation to expend for a specific purpose for the benefit of another are not the income to the recipient. A asserts that that this applies not only to the members' contributions, but also to gift check sales proceeds. The taxpayer's position ignores the fact that A is the entity that is selling gift checks, not the D stores. When D stores sell the gift checks to customers, D stores do not place the proceeds with the A as agent or trustee.

We conclude that taxpayer's position that the gift check sales are nontaxable and its reliance on Seven-Up case for this conclusion are in error. We agree with Examination's determination that proceeds from gift card sales are taxable gross income of A.

**Issue 2: A must include the proceeds it receives in income when the gift checks are sold to the public, third parties, or customers of D stores.**

IRC §451(a) sets forth the general rule that items of income must be recognized in the year of receipt "unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period." Treas. Reg. §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. Rev. Rul. 84-31, 1984-1 C.B. 127.

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<sup>8</sup> If the contributions to the taxpayer from previously taxed sales to the public were at issue, then Seven-Up, supra, would be on point, but only for those contributions. However, what is at issue in this case is the taxability of previously **untaxed** gift check sales proceeds to the public **and NOT member contributions that have been already taxed** to the A members.

In determining whether the right to receive has become fixed, consideration must be given to a number of factors. These include the substance of the transaction, the agreement of the parties, the time when services are rendered or property delivered, the existence of contingencies, or condition precedent or subsequent, and whether the liability is acknowledged or disputed.

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, *supra* the Court in James v. United States, 366 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....”

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 with prepaid income for services rather than goods. The cases established the principle that, except for certain limited exceptions, an accrual method taxpayer must include in income amounts received for services even though the income had not yet been earned. Citing the trilogy of Supreme Court opinions, Hagen Advertising Displays, Inc. v. Commissioner, *supra*, held that a taxpayer must include in income prepaid amounts for blanket orders for manufactured advertising signs in the year the taxpayer received payment.

In the instant case, direct sales by A to the public or other third parties are completed sales of gift checks when A transfers the gift checks to the public or other third party. Thus, A must include amounts from the sale of the gift checks in income upon the earlier of when A transfers the gift checks or when A receives payment, whichever is first. Treas. Reg. §1.451-1(a).

Indirect sales of gift cards through D stores are initially nontaxable exchanges of a cash equivalent for cash between A and D stores because the gift checks are negotiable instruments that are payable to the order of any franchisor or franchisee restaurant.<sup>9</sup> The sale of the gift checks occurs when D stores sell the gift checks to a customer or other third-party. Thus, for indirect sales, A must include amounts from the

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<sup>9</sup> We emphasize, however, that an argument for immediate taxability could be made based on whether the parties to the transaction, the A and the franchisees, understand the transaction to be a completed sale of gift checks between the parties, rather than deposits. In the instant case, the known facts, *i.e.*, the freely negotiable nature of the gift checks, in this particular gift check program, support the conclusions reached in this opinion.



sale of the gift checks in income when D stores sell the gift checks to a customer or other third-party. That is when A becomes entitled to the funds, and when any prepaid funds held by A are no longer held in trust or as deposits and therefore are income to A, as discussed above. Treas. Reg. §1.451-1(a).

**Issue 3: It is reasonable for the Service to determine that, in the absence of evidence to establish otherwise, gift checks provided by A to D stores for sale to customers have been sold the year the that A receives funds from D stores.**

It is reasonable to assume that D stores are unlikely to be advancing or depositing money to be held-in-trust in exchange for gift checks that exceed the amount of gift checks that the D stores may sell. D stores do not want to keep excessive gift checks on hand because they may be stolen, damaged, or lost. Just-in-Time-Inventory or a close approximation thereto, makes business sense because the gift checks are not interest-bearing instruments. It is an accepted business principle that an entity wants to manage its cash and cash equivalents in a profitable manner by investing all non-essential cash and cash equivalents.

It is also reasonable to conclude that a D store will determine its inventory not less often than once a year, for purposes of determining its annual income and, in all likelihood more frequently (to aid the taking of annual inventory through interim inventories or for financial statement preparation, interim or annual). In addition, as the taxpayer is an association of the member franchisor and the franchisees and as the taxpayer makes the gift check program available to participating members, it is reasonable to conclude that the taxpayer should be able to require its gift check participating members to provide information on the number of unsold gift checks on hand.

An important factor to be considered is how often any one D store orders checks. It is reasonable to conclude that, when a store places a new order for gift checks, it is because it has sold all or almost all of its previously purchased gift checks to customers. The ordering party may always provide documentary evidence to the contrary. Therefore, it is reasonable for the Service to require A to establish by persuasive documentary evidence, including a reasonable estimate, the amount of gift check bank account proceeds that represent unsold gift checks. In the absence of such evidence, we conclude that it would be reasonable for the Service to determine that funds advanced by D stores that remain in taxpayer's gift check bank accounts after a reasonable amount of time (e.g., for        days or more) represent gift check sales proceeds from sales by D stores to customers. There is no magical number; the figure        days is just one possible reasonable figure. What this reasonable amount of time is would depend on the specific facts and circumstances. Each examiner or reviewer may consider what a particular store's gift check inventory policy is and how often a store orders, or reorders, gift checks.

**Issue 4: A may deduct amounts paid to D stores to redeem gift checks when D stores redeem the gift checks.**

The next issue is whether taxpayer may deduct its liability for gift check redemptions when it includes gift check proceeds in income. I.R.C. §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.

Treas. Reg. §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 Treas. Reg. §1.446-1(c)(1)(ii)(A).

A taxpayer may not deduct a liability that is contingent, nor may a taxpayer deduct an estimate of an anticipated expense, no matter how statistically certain, if it is based on events that have not occurred by the close of the taxable year. United States v. General Dynamics, 481 U.S. 239, 243 (1987); Brown v. Helvering, 291 U.S. 193, 201 (1934).

In the instant case, until a customer returns to a D store to redeem a gift check, A faces only a contingent liability to pay the redeeming D store. Thus, the return of the customer and redemption by the D store of the gift check is a condition precedent to establish the taxpayer's liability. A may deduct the liability to make the payment to D stores no earlier than the time at which all events have occurred that establish the fact of the liability; namely, no earlier than when customers return to the D stores to redeem the gift checks. At that time, A's liability will be fixed and determinable. Before the customers return to the D stores to redeem checks, 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 check redemptions (e.g., if, and when, and in what amounts, will the redemptions occur).

**Other considerations**

Finally, A maintains that there are costs directly attributable to the sale of gift checks, mainly printing, storage, and bank fees that would exceed the gift check sales proceeds. The taxpayer may always claim any legitimate ordinary and necessary business expenses under I.R.C. §162 and any other applicable provision. Assuming A is correct, the fact that its expenses may exceed its income and result in a loss activity, does not mean that the income is excludable in the first instance.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[REDACTED]

[REDACTED]

[REDACTED]

**CONCLUSION:**

It follows that A has to recognize the gift check sales proceeds as taxable income (gross sales net of redemptions and other substantiated gift check sale costs).

Prior to being issued this case has been coordinated with, and reviewed by the National Office. If you have any questions, please call Industry Counsel (Food, Beverages, and Cooperatives) Rogelio A. Villageliu, at (312) 368-8728.

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