IRS Issues Guidance for Retailers Regarding Permissible Methods of Accounting for Revenue Derived from the Sale of Gift Cards

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Executive Summary

The Internal Revenue Service ("IRS") recently issued guidance (the "Rev Procs") to retailers on methods of accounting for gift cards for U.S. federal income tax purposes. Revenue Procedure 2011-17[1] ("RP 2011-17") and Revenue Procedure 2011-18[2] ("RP 2011-18") liberalize for eligible retailers the existing IRS guidance on methods of accounting for gift cards contained in Revenue Procedure 2004-34[3] ("RP 2004-34").

Specifically, the Rev Procs modify prior guidance in the following ways:

- A safe harbor method of accounting is provided in RP 2011-17 for eligible taxpayers that issue gift cards to customers in exchange for returned merchandise, pursuant to which a taxpayer will be allowed to treat gift cards issued to customers for returned goods as the payment of a cash refund and sale of a gift card, resulting in more favorable treatment under current U.S. federal income tax law.
- The scope of an eligible taxpayer's ability to defer income resulting from advance payments on the sale of gift cards is expanded under RP 2011-18 to include income resulting from advance payments on the sale of gift cards that are redeemable for goods or services of a third party, as well as goods or services of a taxpayer.
- The definition of "financial statements" is expanded by RP 2011-18 to include the group's financial statements if the taxpayer is a member of a consolidated return group for U.S. federal corporate income tax return purposes for purposes of determining when an eligible retailer that uses the deferral method of accounting for gift cards described in RP 2004-34 is required to recognize an advance payment.

Additionally, the Rev Procs provide guidance as to which taxpayers are eligible for the benefits of these changes, and prescribe the procedures to be followed for retailers who choose to change their method of accounting to take advantage of the Rev Procs.

The Rev Procs are effective for taxable years ending on or after December 31, 2010, meaning that an eligible retailer who uses the calendar year as their taxable year would be able to take advantage of this guidance for the 2010 taxable year just concluded. Additionally, RP 2011-18 provides taxpayers with limited audit protection where a taxpayer employed RP 2011-18 for taxable years ending before December 31, 2010. A general summary of the most important aspects of the guidance in the Rev Procs follow.

RP 2011-17: Gift Cards Issued in Exchange for Returned Merchandise

Under current U.S. federal income tax law, if a retailer that is an accrual method taxpayer pays a cash refund for returned goods, the retailer has a refund liability that generally may be used to reduce the retailer's gross receipts.[4] If the customer were to immediately use the proceeds of such a cash refund to acquire a gift card, the retailer would be treated as receiving an advance payment from the sale of the gift card, and recognition of such advance payment for U.S. federal income tax purposes may be deferred to a limited extent (subject to the retailer employing a method of accounting that permits such deferral under either RP 2004-34 or the applicable Treasury regulations [5]). By contrast, if a retailer issues a gift card directly in exchange for returned goods, under applicable Treasury regulations the retailer generally does not have a fixed liability, because the regulations treat the refund as conditioned on the customer actually redeeming the gift card.[6]

RP 2011-17 notes that retailers have contended that issuing gift cards in exchange for returned merchandise should, for U.S. federal income tax purposes, be treated the same as issuing customers cash refunds, and that commentators in the retail industry have argued that issuing a gift card in exchange for returned goods is tantamount to making a cash refund that the customer immediately uses to purchase a gift card.

For eligible taxpayers, RP 2011-17 allows a safe harbor method of accounting that changes the result under current law. A taxpayer that is within the scope of RP 2011-17 will be allowed to treat issuing a gift card directly in exchange for returned goods as though a cash refund were issued to the customer, and the customer immediately used that cash to purchase the gift card, irrespective of whether it is the taxpayer's policy to provide a cash refund for returned goods. The effect of this is to produce the same refund liability benefit to a retailer as a cash refund would, and the same opportunity for deferral on gift cards issued in exchange for returned goods as on all other gift cards sold by a retailer.

The relief described in RP 2011-17 is available to a taxpayer that is engaged in the trade or business of selling goods at retail, uses an overall accrual method of accounting, and issues "gift cards" in exchange for returned goods. The term gift cards is defined for this purpose to include any evidence of a promise to provide a specific dollar amount of goods and/or services to a customer in a future sale, but does not include any evidence of such a promise that requires the customer to perform any act or service beyond presenting the card (such as purchasing additional goods or services).

RP 2011-17 provides that an eligible retailer who takes advantage of this relief has made a change in method of accounting; a discussion of the guidance in RP 2011-17 on this subject is under the heading “Changing Methods of Accounting Pursuant to the Rev Procs.”

RP 2011-18: Deferring Recognition of Advance Payments on Sales of Gift Cards Redeemable by Third Parties

RP 2011-18 expands the scope of advance payments on sales of gift cards that are eligible for deferral. Under U.S. federal income tax law, payment for a gift card is treated as a payment for goods or services to be provided in the future. While the general rule is that an accrual method taxpayer must include amounts received for goods or services to be provided in the future (*i.e.* “advance payments”) in gross income in the taxable year of receipt,[7] two exceptions are provided that permit the use of a deferral method of accounting for advance payments:

- The Treasury regulations permit a method of accounting that allows a limited deferral of advance payments received for the sale of goods in a future taxable year;[8] and
- RP 2004-34 permits a retailer that is an accrual method taxpayer to defer income recognition from the sale of gift cards redeemable for the retailer’s own goods or services until the next succeeding taxable year to the extent that the retailer also defers recognizing the payments as revenues in its applicable financial statement (the “Deferral Method”).

The IRS acknowledges in RP 2011-18 that the manner in which retailers market, sell to customers, and redeem gift cards has evolved over time. In response to these changes, RP 2011-18 expands the definition of an "advance payment" that is eligible for the Deferral Method to include payments for an "eligible gift card sale," which is the sale of a gift card (or gift certificate) if (1) the taxpayer is primarily liable to the customer (or holder of the gift card) for the value of the card until redemption or expiration and (2) the gift card is redeemable by the taxpayer or by any other entity that is legally obligated to the taxpayer to accept the gift card from a customer for items otherwise eligible for the Deferral Method.

However, the relief described in RP 2011-18 is not available to taxpayers who employ the limited deferral method of accounting for gift cards described in the Treasury regulations, since the relevant regulation applies only to an agreement for the sale or other disposition in a future taxable year of goods held by the taxpayer, and goods provided by retailers other than the taxpayer issuing a gift card are not “held by the taxpayer” for this purpose.[9]

RP 2011-18 also provides an expanded definition of “financial statements” for purposes of the Deferral Method that works an important change on the timing of recognition of a deferred advance payment under the Deferral Method. A retailer employing the Deferral Method is required to recognize a deferred advance payment on the earlier of (i) the end of the succeeding taxable year after the advance payment is received or (ii) when the payment is included on the “financial statements” of the taxpayer. Under RP 2011-18 the definition of “financial statements” is expanded for purposes of the Deferral Method to include the group's financial statements if the taxpayer is a member of a consolidated return group for U.S. federal corporate income tax return purposes. This will have the effect of increasing the situations in which a taxpayer will be required to recognize an advance payment before the end of the deferral period.

RP 2011-18 includes an example that illustrates how the change in the definition of “financial statements” affects the application of the Deferral Method, and also includes two additional examples that illustrate situations where a taxpayer is eligible to use the Deferral Method as a result of the expanded definition of an “advanced payment.”

RP 2011-18 also provides that the IRS will not examine, for taxable years ending before December 31, 2010, whether the Deferral Method can apply to eligible gift card sales (as newly defined in RP 2011-18), and will not further pursue the issue in cases currently pending before the Tax Court.

Changes in Methods of Accounting Pursuant to the Rev Procs

A retailer that chooses to take advantage of either or both of the Rev Procs will be treated as making a change in method of accounting for U.S. federal income tax purposes, and as such the consent of the IRS is required.[10] The Rev Procs provide that a taxpayer generally may obtain automatic consent by following the automatic consent procedures provided for in existing guidance on this subject.[11] However, if a taxpayer wishes to make a change in method of accounting for purposes of RP 2011-18, and the taxpayer does not have an “applicable financial statement” for purposes of the Deferral Method, the taxpayer may be required to apply for advance consent.[12] Additionally, if a taxpayer wishes to change to a proper method of accounting under the Treasury regulations (as opposed to a method described in RP 2004-34) and to the method provided for in RP 2011-17, advance consent procedures must also be followed.

The Rev Procs also contain provisions for taxpayers who have consent requests pending with the IRS to convert those requests into automatic consents; where applicable, these provisions will generally make it easier for taxpayers to take advantage of the guidance in the Rev Procs.

If you would like to discuss the application of the Rev Procs to your company's particular situation, or have questions about changes to methods of accounting generally, please contact one of the Proskauer lawyers listed on this Alert, or the Proskauer lawyer that you normally consult with on these matters.

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[1] Rev. Proc. 2011-17, 2011-5 I.R.B.

[2] Rev. Proc. 2011-18, 2011-5 I.R.B.

[3] Rev. Proc. 2004-34, 2004-22 I.R.B. 991.

[4] Treas. Reg. Section 1.461-1(a)(2)(i) generally provides that, under an accrual method of accounting, a liability is incurred, and generally is taken into account for federal income tax purposes, in the taxable year in which all events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred. Treas. Reg. Section 1.446-1(g)(3) provides that economic performance occurs for a refund liability when the refund is paid (whether paid in property, money, or a reduction in the price of goods or services to be provided in the future).

[5] Treas. Reg. Section 1.451-5.

[6] Treas. Reg. Section 1.461-1(a)(2)(i).

[7] Section 451 of the Internal Revenue Code of 1986, as amended (the “Code”) (unless otherwise stated all references to Section hereafter are to the Code); *Schlude v. Commissioner*, 372 U.S. 128 (1963).

[8] *See* Treas. Reg. Section 1.451-5. The method of accounting described in this regulation is by its terms limited to advance payments for goods held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business.

[9] Treas. Reg. Section 1.451-5(a)(1)(i).

[10] RP 2011-17, Section 5.01; RP 2011-18, Section 6.01.

[11] Rev. Proc. 2008-52, 2008-2 I.R.B. 587, as modified, amplified and clarified by Rev. Proc. 2009-39, 2009-38 I.R.B. 371, or its successor.

[12] The procedures for securing advance consent are set forth in Rev. Proc. 97-27, 1997-1 I.R.B. 680 (May 8, 1997).

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