PUBLICATION

IRS (Again) Eases Rules for Deferring Income Recognition on Gift Card Sales

August 27, 2013

An accrual method taxpayer 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. With the issuance of Revenue Procedure 2013-29 on July 24, that is effective retroactively to taxable years ending on or after December 31, 2010, the IRS continues to liberalize its approach to gift card management programs.

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 also 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. For example, an affiliated group of corporations would establish a gift card subsidiary corporation or limited liability company to issue gift cards that would be redeemed for goods or services provided by other members of the group. Other examples include a franchisor selling gift cards that may be redeemed for goods or services provided by a franchisee, or a restaurant management company selling gift cards that may be redeemed by participating restaurants.

While these gift card management programs may have achieved some or all of the state unclaimed property compliance objectives that were intended, the income tax consequences and income recognition from gift card sales has been an audit focus of the IRS for several years. Various IRS audit initiatives, as well as IRS field and legal advice, cast doubt on the effectiveness of certain gift card management programs, implemented for unclaimed property compliance and other purposes, to achieve the desired deferral of income recognition for federal (and state) income tax purposes. We first covered gift card management in our December 3, 2009 "Spotlight on Unclaimed Property: Gift Card Management - When Income Tax and State Unclaimed Property Laws Converge." In general, up until at least 2011, the IRS was disallowing deferral of income recognition when the entity selling or issuing the gift card was not also the seller of the goods or services purchased by a customer redeeming the gift card.

IRS Liberalization

Beginning with Revenue Procedure 2011-18, issued on January 6, 2011, the IRS began permitting deferral of income recognition for a variety of increasingly common gift card management programs. As long as all other "advance payment" deferral of income requirements were satisfied, a taxpayer that sells gift cards redeemable through other entities (that may or may not be related to that taxpayer) would be treated the same as a taxpayer that sells gift cards redeemable only by that taxpayer. A problem existed, however, with this IRS guidance – if a gift card was redeemed by an unrelated entity whose financial statement revenues were not consolidated with the gift card issuer's revenues, the liberalized guidance technically did not apply. For example, a retailer may sell gift cards for other unrelated retailers, online stores, restaurants and other providers of goods and services.

With Revenue Procedure 2013-29, the ability of the gift card seller to benefit from income deferral is now clarified. According to the Revenue Procedure, an "eligible gift card sale" (i.e., eligible for deferral of income recognition as an advance payment) is the sale of a gift card if:

1. the gift card seller is primarily liable to the owner or buyer of the gift card until redemption or expiration, and
2. the gift card is redeemable by the gift card seller *or by any other entity that is legally obligated to the gift card seller* to accept the gift card from a customer as payment for goods or services.

In addition, Revenue Procedure 2013-29 also updates the "audit protection" provided by Revenue Procedure 2011-18, so that the IRS will not raise upon examination the issue of whether advance payment deferral applies to an "eligible gift card sale" for taxable years ending before December 31, 2010 to the extent provided by Revenue Procedure 2011-18.

If you would like to discuss the matters discussed in this alert, as well as state unclaimed property treatment of unredeemed gift card balances, please contact one of the attorneys in the Firm's Tax Department.