

AN ALERT FROM THE BDO FEDERAL TAX PRACTICE

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SUBJECT

INCREASED TAX OPPORTUNITY TO DEFER SALES OF GIFT CARDS REDEEMABLE FOR GOODS AND SERVICES

SUMMARY

For taxpayers in the retail, service, and hospitality industries, the sale of gift cards has become a lucrative business practice. Some gift cards are redeemable only for merchandise, while other gift cards can be redeemed for either merchandise or services. In a gift card purchase transaction, a taxpayer receives an advance payment from the customer in exchange for a future obligation to provide goods, or a mix of goods and services, when the gift card is redeemed. The sale of a gift card is generally deferred from revenue recognition until the redemption of the gift card for financial reporting purposes. However, for federal income tax purposes, the deferral of gift card sales is limited to either a one-year deferral or a two-year deferral. Taxpayers receiving sales of gift cards that are redeemable for either goods or services may be under a mistaken assumption that they do not qualify for the two-year deferral method. Recently, the IRS National Office clarified in a technical advice memorandum (TAM 201610017) the availability of the two-year deferral method for such gift cards. Accordingly, taxpayers that are currently recognizing gift card sales upon receipt or on the one-year deferral method should review their accounting methods to determine whether an additional year of deferral is available for tax purposes.

DETAILS

Background

For tax purposes, amounts received by an accrual-method taxpayer for goods or services to be provided in the future must generally be included in gross income in the taxable year of receipt. However, deferral for gift card sales is permitted under one of two exceptions: section 1.451-5 of the Income Tax Regulations or Revenue Procedure 2004-34.

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Treas. Reg. § 1.451-5 generally allows accrual-method taxpayers a deferral for advance payments received for the sale of goods and provides that a taxpayer may defer recognition of the advance payment until the taxable year that the payments are recognized in revenues under the taxpayer's method of accounting for financial reporting purposes. However, Treas. Reg. § 1.451-5(c) provides that a taxpayer generally may not defer advance payments with respect to an agreement for the sale of inventoriable goods beyond the end of the second taxable year following the year the taxpayer receives a substantial advance payment such as a gift card sale (hence, a two-year deferral). The regulations provide that the term "agreement" includes a gift certificate as well as any agreement obligating a taxpayer to sell goods in a future tax year and which also contains an obligation to perform services that are to be performed as an integral part of such sales (this is referred to as "integral services"). Therefore, a taxpayer may use the two-year deferral method for sales of gift cards that are redeemable for goods or integral services.

Example 1 - Gift Card Redeemable for Goods and Integral Services: On December 2015, ABC, a calendar-year accrual-basis taxpayer that operates retail stores and an e-commerce website, sells a \$100 gift card that is redeemable for products available at its retail stores or website. The gift card is also redeemable for any additional fee charged by the taxpayer to provide an assortment of integral services including delivery, installation, and repair of such products. The gift card, which has no expiration date and can be tracked electronically, is fully redeemed in June 2018, at which time the \$100 revenue is recognized for financial reporting purposes. For federal income tax purposes, ABC may use the two-year deferral method of Treas. Reg. § 1.451-5(c) to defer the \$100 gift card sale no later than the end of the second taxable year following the year the advance payment is received. Thus, ABC recognizes the \$100 in gross income on the federal tax return for the taxable year ended December 31, 2017.

There are special rules with respect to gift cards that are redeemable for goods, integral services, and for services that are unrelated to the taxpayer's sale of goods. The regulations in Treas. Reg. § 1.451-5(a)(3) provides that if an agreement for the sale of goods in a future taxable year also obligates the taxpayer to perform services that are not to be performed as an integral part of the sale of goods (non-integral services), then the amount received will only be treated as an "advance payment" to the extent such amount is properly allocable to the obligation to sell goods. The portion of the amount not allocable to the sale of goods obligation will not be considered an advance payment to which Treas. Reg. § 1.451-5 applies. According to the IRS in TAM 201610017, the taxpayer aggregates all gift cards outstanding at the end of the tax year of the cards' sale into a single pool and allocates the pool between the portion reasonably expected to be redeemed for goods and the portion reasonably expected to be redeemed for non-integral services. The amount reasonably allocable to future sales of goods would be eligible for the two-year deferral period.

Example 2 - Gift Card Redeemable for Goods and Non-integral Services: On December 24, 2015, a calendar-year accrual-basis taxpayer that operates retail stores and an e-commerce website in direct competition with ABC, sells a \$100 gift card that is redeemable for products available at its retail stores or website. The gift card can also be redeemed for any additional fee charged by the taxpayer to provide an assortment of related integral services including delivery, installation, and repair of such products. Additionally, the gift card can be redeemed for the sale of automotive repair services that XYZ provides at its retail location and that are unrelated to XYZ's sale of goods. At the end of 2015, XYZ is able to aggregate all gift cards outstanding at year-end into a single pool and can allocate the pool between the portion reasonably expected to be redeemed for goods (90%) and the portion expected to be redeemed for non-integral services (10%).

The gift card, which has no expiration date and can be tracked electronically, is fully redeemed in December 2017, at which time the \$100 revenue is recognized for financial reporting purposes. For federal income tax purposes, ABC may use the two-year deferral method of Treas. Reg. § 1.451-5(c) to defer \$90 of the gift card sale no later than the end of the second taxable year following the year the advance payment is received. Thus, ABC recognizes the \$90 in gross income on the federal tax return for the taxable year ended December 31, 2017. However, the remaining \$10 is not allocable to the sale of goods obligation and is ineligible for the two-year deferral method.

If an allocable amount received for gift card sales is not an advance payment for purposes of Treas. Reg. § 1.451-5, the TAM states that such amounts must either be included in gross income in the taxable year of receipt or deferrable under Rev. Proc. 2004-34.

The second exception to recognizing advance payments in the year of receipt, Rev. Proc. 2004-34, is broader but provides a shorter deferral period. Under this revenue procedure, an accrual-basis taxpayer may defer all or part of certain advance payments for, among other things, services or the sale of goods not recognized under Treas. Reg. § 1.451 until the taxable year following the year in which payment is received. Under this deferral method, a taxpayer must include the advance payment in gross income for the taxable year of receipt to the extent recognized in revenues in its applicable financial statements for that taxable year, and include the remaining amount of the advance payment in gross income in the subsequent taxable year (hence, a one-year deferral). Regardless of which exception the taxpayer selects, the taxpayer cannot defer the gift card receipts for tax purposes beyond the year in which it takes them into account for financial reporting purposes.

Opportunity for Extended Deferral

Gift cards are generally redeemable for merchandise and the vast majority have no expiration dates. Increasingly, taxpayers in the retail sector, such as department stores, superstores, and membership-only warehouse clubs, sell gift cards that are redeemable for both merchandise and services. As previously discussed, the taxpayer may perform integral services that are integrally related to the sale of goods, such as the repair, installation, or delivery of such sales. In other cases, the taxpayer may provide non-integral services such as automotive repair, photography studio, or travel-related services. In the restaurant and hospitality industry, gift cards are often redeemable for services (for example, spa treatments, meals at a restaurant) and for merchandise sold at the location or online (for example, souvenirs or gift shops).

Many accrual-basis taxpayers that sell gift cards recognize such advance payments under the one-year deferral method prescribed by Rev. Proc. 2004-34. While this affords a limited deferral benefit for tax purposes, some taxpayers may incorrectly assume that sale of gift cards redeemable for both goods and services (whether integral or non-integral) are ineligible for the two-year deferral method. In our experience, taxpayers are under the mistaken assumption that Treas. Reg. § 1.451-5 applies only to advance payments for goods and therefore gift cards that are redeemable for goods and services may not be deferred beyond the one-year deferral method. For such taxpayers, it is advisable to review the current accounting practices and gift card usage. To the extent that the company's gift card usage experience indicates a substantial portion of gift cards being redeemed beyond the end of the tax year following the year of receipt, taxpayers may be entitled to, and benefit from, an additional year of deferral under Treas. Reg. § 1.451-5. In the case of gift cards redeemable for goods and non-integral services, taxpayers evaluating the two-year deferral method need to follow the Service's guidance in TAM 201610017 to estimate a reasonable allocation between the sale of goods and the sale of non-integral services.

At the present time, any change in method of accounting to the two-year deferral method must be made by filing a Form 3115, Application for Change in Accounting Method, with the IRS under the advance consent (non-automatic) procedures of Rev. Proc. 2015-13. A non-automatic Form 3115 must be filed with the IRS National Office on or before the last day of the year of change and an IRS user fee will apply. Upon receiving consent, the taxpayer takes the favorable section 481(a) adjustment benefit entirely in the year of change.

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