INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE-MIS No.: TAM-121007-08

Territory Manager (LMSB)

Taxpayer's Name:
Taxpayer's Address:
Taxpayer's Identification No
Years Involved:
Date of Conference:

LEGEND:

Taxpayer =
Parent =
Entity X =
State A =
State B =
c =
d =
e =
f =
Year 1 =
Year 2 =
Statute A =
Cite A =

Statute B =

ISSUES:

(1) Are amounts that Taxpayer receives as payments for sales of gift cards includible in Taxpayer's gross income?

(2) Are the amounts that Taxpayer receives as payments for sales of gift cards "advance payments" within the meaning of either § 1.451-5(a) of the Income Tax Regulations, or section 4.01 of Rev. Proc. 2004-34, 2004-22, I.R.B. 991?

(3) If an amount that Taxpayer receives as payment for a sale of a gift card must be included in gross income on receipt, may Taxpayer take an immediate deduction for the liability to pay the amount to a retailer?

CONCLUSIONS:

(1) The amounts that Taxpayer receives are includible in its gross income.

(2) The amounts that Taxpayer receives are not "advance payments" within the meaning of either § 1.451-5(a) or section 4.01 of Rev. Proc. 2004-34.

(3) Taxpayer may deduct the liability to make the payment to a retailer no earlier than the time at which all events have occurred that establish the fact of the liability; namely, no earlier than when the customer redeems the gift card at a retailer.

FACTS:

Taxpayer, a corporate subsidiary of Parent and an accrual method taxpayer, was formed to manage Parent's gift card program. Taxpayer oversees the entire gift card program for Parent's consolidated group, and all gift cards used in stores operated by Parent, certain related entities, and certain stores operated by an unrelated entity, Entity X, are issued and sold by Taxpayer. Gift cards sold by Taxpayer may be exchanged for goods, and a limited number of services integral to those goods, from retailers operated by other taxpayers within the consolidated group (the retailers), and from Entity X.

The gift card program agreement (the agreement) was entered into by Taxpayer and the various entities within the consolidated group that own and operate the retailers. The general terms of the agreement are as follows. Taxpayer is in the business of selling gift cards to the general public and of providing related gift card management

services to the consolidated group members. The retailers agree to sell, distribute, and reload Taxpayer's gift cards in their respective stores, and the retailers must remit all amounts paid to the retailers to Taxpayer. The retailers further agree to redeem the shopping cards in exchange for merchandise, products, goods or services in each of their respective stores, subject to the general gift card rules. After the cards are redeemed, Taxpayer pays the retailers amounts equal to the amounts of the redeemed gift cards. Taxpayer is responsible for all aspects of managing the gift card program, from purchase and design of the cards to tracking, sales, redemptions and all aspects of marketing of the cards. In return, Taxpayer receives a management fee from the retailers for managing the gift card program. Taxpayer is solely liable and obligated to the purchasers and holders of the gift cards; retailers have no liability to purchasers and holders of the gift cards except that retailers are liable to Taxpayer to accept the balance on a gift card as payment for goods and services. All payments under the gift card program are reflected by appropriate entries to intercompany accounts maintained and settled periodically. In a separate agreement between Taxpayer and Parent, Parent agreed to provide support services to Taxpayer in exchange for the use of Taxpayer funds free of interest. Parent has a standard license agreement that it enters into with unrelated licensees that wish to buy gift cards and make them available to their customers as a promotional incentive. The licensee must agree to be bound by the terms of the agreement and must buy the cards at face value.

Under the retailers' current business practices, gift card holders may receive cash refunds for card balances of $c or less. If a cardholder returns a purchase made with a gift card, the retailer will increase the balance on the cardholder's gift card by the amount of the return. If the return is less than $d, however, the retailer will refund cash to the cardholder. A card can be used by anyone in possession of the card.

LAW AND ANALYSIS:

ISSUE (1)

Section 61 of the Internal Revenue Code defines gross income as all income from whatever source derived. Gross income includes "instances of 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).

Taxpayer asserts that, because of a customer's right to a refund in certain states, the payments for sales of gift cards are nontaxable deposits because the gift card holders may request and obtain a full cash refund at any time under the laws of State A and State B. In addition, the taxpayer asserts that the payments are deposits because of its business practice of issuing refunds of $c or less.

<u>Claim of Right Doctrine</u>

North American Oil Consolidated v. Burnet, 286 U.S. 417, 424 (1932), holds 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 later might be required to restore an equivalent amount. Citing *North American Oil*, the Court in *James v. U.S.*, 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…."

In the present case, after the cards are redeemed, either for goods, services, or refunds, Taxpayer must transfer amounts received for gift cards to the retailer in an amount equal to the redeemed amount. However, from the time of the receipt these payments are in Taxpayer's direct control. The payments are not in escrow or other special account outside Taxpayer's control. As in *North American Oil*, the fact that Taxpayer may have to transfer funds to a third party does not mean that Taxpayer does not have income upon receipt. Taxpayer will make reimbursements to a retailer if the gift cards are redeemed or amounts are refunded. Whether and to what extent the Taxpayer will transfer funds is subject to the contingency that the customer will redeem the card for goods or services or obtain a refund. There is no certainty at the time of Taxpayer's receipt of the payment for gift cards that the cards will be redeemed in full or in part and whether any refund will be issued.

Income v. Nontaxable Deposit

A deposit is not income when received because it is not an undeniable accession to wealth, clearly realized, over which the taxpayer has complete dominion. The leading case on this issue is *Commissioner v. Indianapolis Power & Light Company*, 493 U.S. 203 (1990). In that case, the Supreme Court considered whether amounts 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 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 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. *See Indianapolis Power* at 210. The proper focus is on the rights and

obligations of the parties at the time the payment was made. The Court noted that the deposits were acquired subject to an "express obligation to repay," either at the time the service was terminated or at the time a customer established good credit.

In *Johnson v. Commissioner*, 108 T.C. 448 (1997), *aff'd on this issue* 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.

In *Westpac Pacific Food v. Commissioner*, 451 F.3d 970 (9th Cir. 2006), rev'g. 82 T.C 175 (2001), the taxpayer received "advance trade discounts" 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 pro rata portion of the "advance trade discounts." Under those facts, the appellate court determined that upfront cash payments received were like security deposits or loans/liabilities rather than "accession to wealth" constituting income.

Taxpayer asserts that the payments received from gift card sales are deposits in states where a cardholder may request a cash refund. The field first asserts that the state law that Taxpayer cites does not require a retailer to issue a full cash refund of the gift card upon the cardholder's demand. The field also asserts that any portion that Taxpayer might be required to refund after the cardholder had spent some portion of the card on goods or services is not a deposit.

Taxpayer interprets State A and State B law to require that the cardholder may obtain a full cash refund at any time and represents that it has operated its program consistent with this interpretation. State A law prior to Year 1 allowed the gift card retailer the option of whether to issue a cash refund or to provide a new gift card for the value of the remainder on the original card. The customer could not independently demand a cash refund. The legislative history to the relevant statute, Statute A, clearly indicates that Statute A allowed the retailer, and not the customer, the option of whether or not to issue a cash refund. Cite A. After the amendment to Statute A in Year 2, gift card

retailers are required to issue a cash refund if there is less than $e remaining on the gift card. In State B, gift card retailers are required to provide a cash refund only after at least f% of the card's value has been redeemed. Statute B. Therefore, under both State A and State B law, a customer who buys a gift card cannot demand a full cash refund for the initial value of the card (unless it is a gift card for less than $e in State A for years beginning in Year 2). Thus, taxpayer's premise for characterizing the payments as deposits is misplaced.

Focusing on the nature of the rights and obligations of the parties in the present case, Taxpayer has "complete dominion" over the payments and the payments for the sale of cards are not deposits. At the time a customer buys the card, the customer acquires the right to use the card as a vehicle to obtain goods or services from retailers. Customers pay money for a gift card that the parties expect to be redeemed for goods or services. Any refund is dependent on a subsequent action (condition subsequent) of the cardholder and requires an affirmative action of the customer to obtain goods or services and to request a refund. Taxpayer does not acquire the payment subject to a definite obligation to pay amounts to retailers or refund any amount to a customer.

In conclusion, Taxpayer receives payments over which it exercises complete dominion and control, and over which it holds under a claim of right unless, and until, a subsequent event occurs that would require it to transfer amounts to retailers or refund amounts to a customer. Therefore, the payments that Taxpayer receives for gift cards are not deposits and are income.

ISSUE (2)

Section 1.451-1(a) of the Income Tax Regulations provides that, under an accrual method of accounting, income generally 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. In general, all events that fix the right to receive income occur upon the earliest of when (1) required performance takes place, (2) payment is due, or (3) payment is made. *See Schlude v. Commissioner*, 372 U.S. 128 (1963). Thus, when a taxpayer receives a payment for goods or services from a customer that is includible in the taxpayer's gross income under § 61, the taxpayer generally is required to include the payment in income upon receipt, even where the goods or services are to be provided in a future taxable year. § 1.451-1(a); *Schlude v. Commissioner*, *supra*. However, a taxpayer may be entitled to use one of two deferral methods for certain "advance payments".

The first deferral method is found in § 1.451-5 (the regulation). An "advance payment" under the regulation means, in relevant part, "any amount which is received in a taxable year by a taxpayer using an accrual method of accounting for purchases and sales …, pursuant to, and to be applied against, an agreement … [f]or the sale or other disposition in a future taxable year of goods held by the a taxpayer primarily for sale to

customers in the ordinary course of his trade or business". § 1.451-5(a)(1). An "agreement" includes a gift certificate that can be redeemed for goods. § 1.451-5(a)(2)(i).

The second deferral method is found in Rev. Proc. 2004-34, 2004-22, I.R.B. 991 (the revenue procedure). Section 4.01 of the revenue procedure provides that a payment received by a taxpayer is an "advance payment" if (1) including the payment in gross income for the taxable year of receipt is a permissible method of accounting for federal income tax purposes (without regard to the revenue procedure); (2) the payment is recognized by the taxpayer (in whole or in part) in revenues in its applicable financial statement for a subsequent taxable year; and (3) the payment is for, *inter alia*, services or the sale of goods (other than the sale of goods for which the taxpayer uses a method of deferral provided in § 1.451-5(b)(1)(ii) of the Income Tax Regulations).

Taxpayer asserts that the payments that it receives for the gift cards are advance payments under the regulation. Consistent with this position, Taxpayer includes the gross receipts from the sale of the gift cards in income the earlier of when a cardholder uses the card to make a purchase or the second taxable year following the taxable year the customer purchased the card. Alternatively, Taxpayer asserts that the payments are advance payments under the revenue procedure.

The field argues, and we agree, that the payments received by Taxpayer are not advance payments within the meaning of the regulation because the payments are not for the sale of goods "*held by the taxpayer* primarily for sale to customers in the ordinary course of his trade or business". § 1.451-5(a)(1) (emphasis added).

The field argues, and we agree, that the revenue procedure contemplates that, in order to meet the definition of an advance payment, the payment must be received by the same taxpayer that provides the goods or services with respect to that payment. Because Taxpayer neither holds goods for sale nor provides goods to customers who purchase gift cards, payments for the gift cards are not for the "sale of goods" and therefore are not advance payments within the meaning of the revenue procedure.

Taxpayer relies primarily on two cases for the proposition that a payment received by a taxpayer may be for the sale of goods even in cases in which the taxpayer holds no goods for sale to customers. The first case is *Epic Metals Corp. v. Commissioner*, T.C. Memo. 1984-322, *aff'd*. 770 F.2d 1069 (3rd Cir. 1985). This case involved a taxpayer that never took physical possession of the goods it sold to customers because the goods were shipped directly from the taxpayer's suppliers to the taxpayer's customers. The issue in *Epic Metals* did not involve advance payments; instead, the issue was whether the taxpayer was required to use inventory accounting under § 471. The court noted that under the § 471 regulations, the question of whether merchandise must be included in inventories is determined by whether a taxpayer ever has title to goods, not whether the taxpayer ever has physical possession of the goods. In concluding that the

taxpayer was in fact required to use inventories, the court found that the taxpayer held "momentary title" to the goods.

The second case is *Straight v. Commssioner*, *unpublished order dated* May 6, 1999, 1999 WL 33587419, 1999 Tax Ct. Memo LEXIS 488, *rev'g in part on reconsideration* T.C. Memo. 1997-569. The relevant issue in this case was whether a taxpayer held goods for sale for purposes of § 1.451-5 where the taxpayer never had physical possession of the goods and never held title to the goods. However, in this unpublished order the court found that the government had conceded the issue by failing to address it on brief. Thus, while the court found for the taxpayer, the issue had been deemed conceded and was not reached on the merits.

Taxpayer asserts that its situation is similar to the taxpayers in *Epic Metals* and *Straight* because Taxpayer is required to provide goods to the retail customers, and Taxpayer has contracted with the retailers to provide those goods. Thus, while Taxpayer never takes title to the goods, Taxpayer provides goods to customers within the meaning of both the regulation and the revenue procedure.

Epic Metals is distinguishable from the present case both because *Epic Metals* did not involve § 1.451-5 and because Taxpayer never has even momentary title to goods. Furthermore, unlike in both *Epic Metals* and *Straight*, Taxpayer does not hold itself out as selling goods or otherwise providing goods to customers. Taxpayer's assertion that it is contractually obligated to provide goods to customers does not reflect either the form or the substance of the agreement entered into with the retailers. It is clear from the agreement that Taxpayer's business is to sell gift cards (not retail goods) and to manage the gift card program. With respect to liabilities pertaining to the gift cards, the agreement states:

> [Taxpayer] shall be solely liable and obligated to the purchasers or holders of the [gift cards] for the value of all [gift cards] and similar cards sold to [the retailers'] customers. [The retailers] shall be liable to [Taxpayer] to accept the balance on any [gift card] or such other similar card as payment for goods and services in its retail outlets. [The retailers] shall have no liability to purchasers or holders of the [gift cards] with respect to the sale of the [gift cards] or the redemption of the balances remaining on the [gift cards] for goods or services. [Taxpayer] shall not reduce the balance due to the customer on the card for any reason except for the amount used by customers to purchases goods and services from [the retailers].

Thus, Taxpayer's sole liability with respect to the gift cards relates to the value on the cards, not to the provision of retail goods. The agreement specifically states that the goods and services are to be purchased from the retailers rather than Taxpayer. In addition to the terms of the agreement, it is also clear from Taxpayer's actual operations that Taxpayer is not selling goods to customers. Throughout the entire process of purchasing and redeeming gift cards, Taxpayer has no interaction with customers—the

customers purchase the gift cards at the retailers and then return to the retailers to obtain goods, and they likely are completely unaware of the existence of Taxpayer or the role it plays in the transactions. Taxpayer also does not have inventory costs related to the goods and does not show a profit from sales of goods to customers.

Finally, Taxpayer argues that the definition of an advance payment in the revenue procedure, as a payment for the "sale of goods", should be interpreted broadly to apply to situations in which goods are provided by a taxpayer other than the taxpayer receiving the payment. Unlike the definition of an advance payment in the regulation, the revenue procedure does not explicitly require that the payment be for goods "held for sale by the taxpayer". We disagree that the revenue procedure should be interpreted in this manner. Rather, as an administrative exception to the well established principle that items of gross income are includible in income no later than when received, *see Schlude*, *supra*, the revenue procedure applies only to taxpayers who fall expressly within its scope. Specifically, the revenue procedure applies only to taxpayers who receive payments for sales of goods, and nothing in the revenue procedure indicates that the activities of one taxpayer may be imputed to or combined with a second taxpayer in order to fall within its scope, even where the two taxpayers are related entities or are members of an affiliated group. Taxpayer does not hold itself out to retail customers as a seller of goods, and in fact does not sell goods to customers.

ISSUE (3)

Taxpayer asserts that, if the payments from sales of gift cards are includible in income on receipt, the corresponding liabilities should be deductible by Taxpayer at the same time.

Section 1.461-1(a)(2)(i) of the Income Tax Regulations 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 the 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 with respect to the liability. 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).

The field argues, and we agree, that Taxpayer's liability to make a payment to a retailer with respect to a gift card is contingent and is not fixed until the customer redeems the gift card at the retailer.

Taxpayer argues that the liabilities in this case are not contingent, citing as authority *United States v. Hughes Properties, Inc.*, 476 U.S. 593 (1986), and *Gold Coast Hotel & Casino v. United States*, 158 F.3d 484 (9th Cir. 1998). The courts in *Hughes Properties* and *Gold Coast* determined that a casino's liability for a slot machine payout, which was governed by certain state gaming regulations, was a fixed liability even though the payout would not occur until a future date. The court determined that the event creating the liability was, in *Hughes Properties,* the last play of the slot machine before the end of the tax year and, in *Gold Coast*, the accumulation by a club member of the minimum number of points needed to redeem a prize, at which time a fixed liability was incurred pursuant to state gaming regulations mandating payouts.

The facts of the present case are more analogous to the facts of *General Dynamics*, *supra*, in which the Supreme Court held that an employer's liability to make a payment under a self-insured medical plan was not fixed until an employee filed a claim for payment. Similarly, in *Chrysler Corp. v. Commissioner*, 436 F.3d 644 (6th Cir. 2006), *aff'g* T.C. Memo. 2000-283, the court held that a warranty liability was fixed not by the mere existence of the warranty, but instead by the filing of a valid warranty claim. In so holding, the court stated that it agreed with the lower court's opinion that *Hughes Properties*, read in light of *General Dynamics*, stands for the "proposition that '[t]he first prong of the all event events test may be met when a statute has the effect of irrevocably setting aside a specific amount … by the close of the tax year and to be paid at a future date.'" *Id.* at 650 (quoting *Chrysler Corp. v. Commissioner*, T.C. Memo. 2000-283). The court noted that the focus in *Hughes Properties* remained on when the last event occurred that fixed the liability. Applying this analysis to the warranty liability at issue, the court concluded that, as in *General Dynamics*, the liability remained only a potential liability until it was firmly established by the filing of a claim.

Until a customer returns to a retailer and redeems a gift card, Taxpayer faces only a contingent liability to pay an amount to the retailer. Furthermore, there is no law which "has the effect of irrevocably setting aside a specific amount, as if it were to be put into an escrow account, by the close of the tax year", *Id.*, as was the case in *Hughes Properties* and *Gold Coast*.

Finally, Taxpayer argues that its liability to pay the retailer should be deductible at the same time that the gift card income is includible in gross income because this is the only timing that results in a clear reflection of income. *See* § 446(b). Taxpayer cites *Johnson v. Commissioner*, 184 F.3d 786 (8th Cir. 1999), *aff'g in part and rev'g in part* 108 T.C. 448 (1997), as authority for this proposition. In *Johnson*, the taxpayer paid a portion of the proceeds of sales of vehicle service contracts to an escrow fund. A portion of these proceeds in turn were paid as a fee for administrative services (administrative fee). The Tax Court had held that the taxpayer was not entitled to deduct the administrative fee on payment because the services provided for the fee were be to performed in a future year. The appellate court reversed the Tax Court, and in so holding stated:

> If taxpayers are going to be required to take into income the entire amount paid into the escrow fund in the year of receipt and payment, we think, as a matter of fairness, that they should also be allowed to deduct, in that year, the entire amount of the fee paid to the Administrator…. We hold only that what is sauce for the goose is sauce for the gander. In the tax year in which the fees are paid to the Administrator, all events have occurred that establish liability for that payment, and the amount of the liability can be determined with reasonable accuracy. The Commissioner argues that economic performance has not yet occurred with respect to the liability, because the services in connection with which the Administrator must incur costs have not yet all been performed. See Treas. Reg. § 1.461-4(d)(4)(i). While this is certainly true in the abstract, the question in this case is whether the method of accounting proposed by the Commissioner clearly reflects income. To answer that question both income and deductions must be considered. If the income is to be recognized, and we have upheld the Commissioner's decision on this point, the deduction associated with it should also be recognized.

We do not think that *Johnson* is persuasive on this issue. First, the court cited no law in its holding, and the court explicitly disregarded the economic performance regulations promulgated under § 461(h). Second, clear reflection of income principles do not require taxpayers to deduct liabilities for services to be provided in the future at the same time as the related payments are includible in income. *See, e.g., Simplified Tax Records, Inc. v. Commissioner*, 41 T.C. 75 (1963). Nevertheless, *Johnson* is distinguishable from the present case because the *Johnson* court found that the liability was fixed in the year of payment, *i.e.*, all events had occurred to establish the fact of the liability and the amount thereof could be determined with reasonable accuracy. In the present case, Taxpayer's liability is contingent and is not fixed until the customer returns to a retailer and redeems the gift card. *United States v. General Dynamics*, *supra*.

Taxpayer has no liability to pay a retailer an amount with respect to a gift card unless and until a customer returns and redeems the card at a retailer. Thus, the return of the customer and redemption of the gift card is a condition precedent to the establishment of Taxpayer's liability. Taxpayer may deduct the liability to make the payment to the retailer no earlier than the time at which all events have occurred that establish the fact of the liability; namely, no earlier than when the customer redeems the gift card at the retailer.

CAVEAT:

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.