

To: Our Clients and Friends

January 6, 2011

IRS Issues Guidance Relating to the Tax Treatment of Gift Cards

On January 5, 2011, the IRS issued two revenue procedures that address certain federal income tax consequences relating to (1) taxpayers that issue, but do not themselves redeem, gift cards and (2) retailers that provide gift cards in exchange for returned merchandise.

Rev. Proc. 2011-18 – Income Tax Deferral for Special Purpose Gift Card Entities

In Rev. Proc. 2011-18, the IRS modified previously issued Rev. Proc. 2004-34 to address the income tax consequences to “special purpose gift card entities”—i.e., taxpayers that issue gift cards that are redeemed by another retailer in exchange for that retailer’s goods or services. Generally, Rev. Proc. 2004-34 grants an accrual method taxpayer a one-year deferral upon receiving advance payments in exchange for goods and services it provides in a subsequent year (as long as the taxpayer does not include such payments in income in the year of receipt for financial accounting purposes).

Rev. Proc. 2011-18 acknowledges that many retailers that accept gift cards as payment for their goods and services are not the same legal entity as the issuer of the gift cards. Rather, such gift cards are often sold by a related entity with the special purpose of issuing gift cards that will be honored by retailers with whom the entity has a gift card service agreement. Consequently, Rev. Proc. 2011-18 clarifies that, subject to certain limitations, *special purpose gift card entities may use the one-year deferral method even though another entity redeems the gift cards.*

Specifically, Rev. Proc. 2011-18 refers to the following situations:

- Members of an affiliated group of corporations may establish a gift card subsidiary to sell gift cards that may be redeemed for goods or services provided by the gift card subsidiary or other members of the affiliated group.
- A franchisor, purchasing cooperative, not-for-profit membership organization, or franchisee may sell gift cards that may be redeemed for goods or services provided by independently-owned franchisees or members.

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- A restaurant management company may sell gift cards that may be redeemed by participating restaurants in different geographic locations or with different trade names.
- A retailer may issue a gift card that may be redeemed for merchandise at the retailer's stores, retail stores operated by a related party, or retail stores operated by unrelated parties.

However, Rev. Proc. 2011-18 warns that its holding does not equally apply to Treas. Reg. §1.451-5 which allows, generally, a two-year deferral to an accrual method taxpayer that receives advance payments in exchange for goods that it provides in a subsequent year. The revenue procedure expressly states that *the two-year deferral only applies where the taxpayer receiving the advance payments also provides the goods.*

Rev. Proc. 2011-17 – Gift Cards Issued in Exchange for Merchandise

In Rev. Proc. 2011-17, the IRS addressed the income tax consequences to retailers that issue gift cards in exchange for returned merchandise. Generally, Rev. Proc. 2011-17 provides that a taxpayer may treat its issuance of a gift card in exchange for returned goods as (1) the payment of a cash refund in the amount of the gift card, and (2) the sale of a new gift card, which may be subject to the deferral provisions of Treas. Reg. §1.451-5 and Rev. Proc. 2004-34 (as discussed above). This treatment generally permits a taxpayer to immediately reduce its gross receipts by the amount of the gift card (because the taxpayer is treated as having made an immediate cash refund), while deferring recognition of the advance payment on the deemed sale of the new gift card. However, based on Rev. Proc. 2011-18 (discussed above), it appears that the two-year deferral permitted by Treas. Reg. §1.451-5 may not be available where the gift card is issued by a special purpose gift card entity (because of the requirement that such issuer hold goods primarily for sale to customers in the ordinary course of its trade or business).

Accounting Methods

Both revenue procedures provide that the tax accounting treatments discussed therein are accounting methods for income tax purposes and are therefore subject to the rules regarding accounting method changes. However, the revenue procedures indicate that, in most instances, taxpayers will be eligible to change their accounting methods using the IRS's automatic consent procedures.

Effective Times

Both revenue procedures are effective for tax years ending on or after December 31, 2010. However, each revenue procedure states that, with respect to prior tax years, the IRS will not take a position that is inconsistent with the revenue procedures.

Recommendations

We recommend clients review the tax treatment of the items discussed above for compliance with these revenue procedures. If you have any questions, or would like additional information on this topic, please do not hesitate to contact any of the following attorneys:

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