

Gift cards: Opportunities and issues for retailers



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Introduction

Gift card sales have surged in recent years. With electronic or virtual gift cards and mobile applications that allow consumers to purchase and redeem gift cards from their mobile/smart phones, sales only continue to grow. While consumers flock to them for their flexibility, businesses have embraced them as a means to increase sales. Not only are buyers spurred into making new purchases, but they often spend more than the gift card amount. For retailers, gift cards can also be instrumental to improving cash flow and managing inventory.

Perhaps the greatest benefit to retailers is that a sizable number of consumer gift card purchases are never redeemed. Estimates of the percentage of gift card balances that remain unredeemed — otherwise known as breakage — range from 10 to 19 percent. While gift card breakage has certain accounting and state escheat implications, since it affects income recognition, these unredeemed dollars can have a significant influence on many companies' bottom lines.

But with the growth in the use of gift cards comes an uptick in scrutiny and regulation, especially within the past year. For consumers, there is increased protection under Title IV of the Credit Card Accountability, Responsibility and Disclosure Act of 2009 (CARD Act), which went into effect in early 2010. The CARD Act restricts gift card issuers from charging fees on cards for 12 months and extends card expiration until five years after purchase. In addition, the Federal Reserve Board (FRB) and the IRS have recently issued new rules for companies with gift card programs, providing much-needed guidance.

“Gift cards have become an area of both opportunity and risk for retailers. They have come to provide a critical source of earnings, yet at the same time, the regulatory environment, including tax and financial reporting for gift cards, has become increasingly complex. The bottom line is that financial executives within the retail industry cannot afford to be blindsided by tax, regulatory and financial reporting changes in this area,” cautions Giles Sutton, State and Local Tax (SALT) partner and national Retail Tax practice leader.

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Giles Sutton
State and Local Tax Partner and National Retail Tax Practice Leader

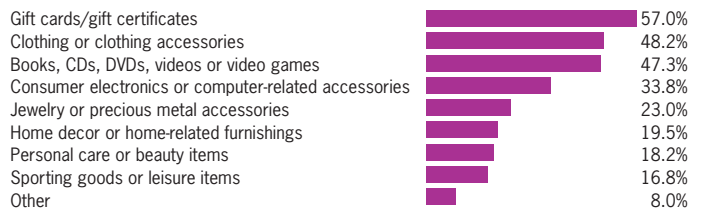


Growth of gift cards

As the National Retail Federation (NRF) observes in a discussion of its first holiday survey, gift cards have been the most popular holiday gift request for four years running.¹ And shoppers agree: 77.3 percent of them were likely to purchase one or more gift cards during the 2010 holiday season, according to another NRF survey, *2010 Gift Card Consumer Intentions & Actions Survey*, which was conducted by BIGresearch.² The survey predicted that total spending on gift cards during 2010 would reach \$24.78 billion — a hefty sum that translates to average amounts of \$41.48 per gift card (up from \$39.80 in 2009) and \$145.61 in total purchases of gift cards (up from \$139.91 in 2009).³

Among the popular destinations for those planning to purchase gift cards were department stores (39.2 percent), bookstores (23.7 percent) and electronics stores (19 percent). Others expected to buy gift cards from restaurants (33.4 percent) and coffee shops (13.9 percent). Still others planned gift card purchases at entertainment venues such as movie theaters (14.1 percent). Many holiday shoppers (45.8 percent) purchased gift cards so that recipients could choose their own gifts. Convenience was a consideration for 17.8 percent of shoppers choosing gift cards.⁴

Gifts adults want to receive — 2010*



*Respondents were able to select more than one answer.

Data from the 2010 NRF Holiday Consumer Spending Report.

Conducted for NRF by BIGresearch®, Consumer Intentions & Actions® Survey, N = 8767, 10/5-10/12/10

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¹ www.nrf.com/modules.php?name=News&op=viewlive&sp_id=1033

² *Id.*

³ *Id.*

⁴ *Id.*

Dining is high on the list for many consumers purchasing gift cards. Analysis conducted by First Data shows that from January through June 2010, quick-service restaurants posted a 14 percent increase from H1 2009 levels in the dollar values of gift cards sold, while casual-dining restaurants enjoyed a 6.1 percent increase from H1 2009 levels in the number of gift cards sold.⁵

Several factors contribute to the growing popularity of gift cards among quick-service restaurants. *QSR* magazine notes that many consumers are looking for value pricing, especially given the recession. Loyalty programs account for another portion of the growth. And during 2010, many quick-serves, in a bid to market themselves to entities that conduct fundraising activities, sold gift cards in bulk.⁶



⁵ www.firstdata.com/downloads/thought-leadership/gift-card-2010-first-half-recap.pdf

⁶ www.qsrmagazine.com/news/loyalty-programs-bulk-sales-fuel-gift-card-growth

Gift cards and state tax nexus

Gift cards can create state income tax problems for retailers. For gift card issuers to be subject to state taxation, the issuer must have nexus — a physical or economic presence sufficient to establish jurisdiction to tax — in that state. It is important for companies to understand what establishes nexus in the various states in which their gift cards are sold, since each state’s rules differ.

In general, the sale of a company’s gift card from a noncompany-owned venue, such as the sale of gift cards through third-party retailers in a state where the company does not otherwise have a physical presence, may cause state income tax exposure to the issuing retailer. For example, if the gift card is issued pursuant to a license granted by the retailer, then the retailer may have economic nexus in the states where the cards are sold. Economic nexus means that the state of sale will have jurisdiction to tax the issuer, based on the gift card issuer’s intent to access the taxing state’s market.

Gift cards, although they represent intangible value, are nonetheless physical objects (with the exception of virtual gift cards). Physical presence creates nexus in states in which property is present. Gift cards often contain specific disclaimers such as “This card is the property of the issuer until sold at retail to a consumer.” Further, if a company’s sale of a gift card is made on a consignment basis, in which the issuer retains title to the cards until they are sold to the customer, then gift cards may create nexus for the issuer in the state or states in which they are offered for sale, since the issuer would own property in the state in which the gift cards are present. This can prove problematic because in third-party arrangements, the issuer frequently may not know where its gift cards are offered for sale and, therefore, where it might have nexus.

“Many gift cards sold at larger stores — for example, a Starbucks card sold at the supermarket — are considered owned by the issuer until the purchase transaction. But that gift card’s presence on a shelf in that store, even if the card is issued and owned by a company otherwise without a presence in that state, gives the issuer physical nexus in some states,” explains Sutton. “This is a particularly important issue when one related party is issuing the gift card and another related party is selling the card, and the entity issuing the gift card assumes it has no nexus outside its state of commercial domicile.”

It is important for companies to understand what establishes nexus in the various states in which their gift cards are sold, since each state’s rules differ.

Gift cards and state escheat rules

The increasing popularity of gift cards also makes the management of escheat — or unclaimed property — liabilities an important issue. All U.S. states and the District of Columbia, as well as Puerto Rico, Guam, the U.S. Virgin Islands and certain other foreign jurisdictions, have explicit unclaimed property reporting requirements. Unclaimed property liability is not a tax, but rather a liability under state succession laws relating to property rights.

Because unclaimed property liability is not a tax, tax nexus rules do not apply. Rather, states have the authority to claim unclaimed property through the derivative rights doctrine. Under this doctrine, states acquire the same rights to unclaimed property as the owner held in the property. If the property cannot be returned to its owner, the state claims all of the rights over the property that the owner had, takes the property and holds it in a custodial capacity for the owner. In recent years, a number of states have intensified their pursuit of unclaimed property as a method of raising additional revenue.

A company's unclaimed property liability represents the property that the company holds for others that is deemed abandoned under states' governing escheat laws. Property is deemed abandoned after it has been left unclaimed for a certain period of time, referred to as the dormancy period, which varies among states. Upon expiration of the dormancy period, most states require the property holder, if practicable, to attempt to contact the owner in order to return the property. Any property that remains unclaimed after such due diligence must be reported and turned over to the appropriate state, based on the following priority rules established by the U.S. Supreme Court:

- **First priority rule** — The jurisdiction of the owner's last known address is entitled to custody of the unclaimed property.
- **Second priority rule** — If the owner's address is unknown, or if the state of the owner's last known address does not provide for escheat of the property, the jurisdiction in which the holder is domiciled is entitled to custody of the unclaimed property.

As a result of these rules, the holder's state of domicile often has a claim to estimated unclaimed property for years in which there are incomplete books and records. Certain states have also adopted a transaction rule, which has not yet been considered by the U.S. Supreme Court, whereby the state in which the transaction that created the unclaimed property occurred claims custody of the property when the owner's most recent address is unknown and the holder is domiciled in a state that does not provide for the escheat of the property.

Many states such as Arizona and Maryland have either fully or partially exempted gift cards as a property type subject to escheat laws. However, a number of other states, including Delaware and New York, generally continue to treat dormant unredeemed balances on gift cards as unclaimed property. Because the company's state of domicile has a claim to unclaimed property with no last known address, and because gift cards are often sold without recording the owner's address, a company that issues gift cards may face a significant escheat liability, depending on its state of domicile.



“Reviewing specific state rules is necessary to determine whether a business is required to report and remit unclaimed property,” says David Glad, SALT manager. “Since state escheat laws change frequently, it is important to revisit the relevant rules in your state.”

In recent years, a number of states have intensified their pursuit of unclaimed property as a method of raising additional revenue.

⁷ N.J. Stat. Ann. 46:30B-1 et seq.

⁸ P.L. 2010, c.25.

⁹ P.L. 2010, c.25 § 5c, N.J. Stat. Ann. 46:30B-42.1(c).

¹⁰ *Id.*

¹¹ The implementation date was initially extended to Sept. 1, 2010, then to Oct. 1, 2010, and then to Nov. 1, 2010. To accommodate ongoing litigation over the new law, the implementation date was eventually extended to Nov. 15, 2010. Treasury Announcement FY 2011-01, *Notice of Temporary Exemption of Certain Provisions of A-3002 until September 1, 2010* (N.J. State Treasurer, July 1, 2010); Treasury Announcement FY 2011-02, *Notice of Temporary Exemption of Certain Provisions of L.2010, c.25 until October 1, 2010* (N.J. State Treasurer, Aug. 26, 2010); Treasury Announcement FY 2011-03, *Guidance on Implementation and Notice of Exemption from Certain Provisions of L.2010, c.25* (N.J. State Treasurer, Sept. 23, 2010). *American Express Travel Related Services Company, Inc. v. Sidamon-Eristoff*, No. 10-4890, 2010 U.S. Dist. LEXIS 120153 at *2 fn 1 (D. N.J. Nov. 13, 2010).

¹² Treasury Announcement FY 2011-03, *Guidance on Implementation and Notice of Exemption from Certain Provisions of L.2010, c.25* (N.J. State Treasurer, Sept. 23, 2010).

¹³ *American Express*, 2010 U.S. Dist. LEXIS 120153 at *18; <http://dockets.justia.com/docket/newjersey/njdce/3:2010cv04890/246952/>.

¹⁴ *American Express*, 2010 U.S. Dist. LEXIS 120153 at *108, 142.

Changing state laws: New Jersey’s new unclaimed property rules

State laws related to unclaimed property change frequently; therefore, it is important for a company to stay current on these laws to determine whether it is required to report and remit unclaimed property.

For example, in June 2010, New Jersey amended its Uniform Unclaimed Property Act to add, for the first time, stored value cards such as gift cards as a type of property subject to escheat.^{7,8} A controversial place-of-purchase provision of the new law mandates that issuers of stored value cards must obtain the name and address of the purchaser or owner of each stored value card issued or sold and must, at a minimum, maintain a record of the ZIP code of the owner or purchaser.⁹ The provision further states, in apparent contradiction to the U.S. Supreme Court’s second priority rule, that if the stored value card issuer does not have the name and address of the card’s purchaser or owner, that address will be assumed to be the address of the New Jersey business where the stored value card was purchased or issued.¹⁰

To study the impact of the new law, the state treasurer continued to extend the law’s implementation date.¹¹ On Sept. 23, 2010, the state treasurer issued guidance stating that New Jersey would only assert custody over unredeemed balances of stored value cards if the issuer was domiciled in a state that exempts such cards.¹²

The guidance also states that the place-of-purchase provision would be applied retroactively so that the state would claim unredeemed balances of stored value cards issued prior to the date of the announcement. On the same day, American Express Travel Related Services Co. Inc. and others filed separate lawsuits against New Jersey, seeking a preliminary injunction to bar enforcement of various provisions of the new law.¹³ On Nov. 13, 2010, the court granted a preliminary injunction against the place-of-purchase presumption. Among other reasons, the court stated that the presumption appeared to be pre-empted by the U.S. Supreme Court’s priority rules.¹⁴ In addition, the court stated that the presumption may harm plaintiffs that were domiciled in states that exempted unredeemed balances of stored value cards, as those plaintiffs would now be required to remit cards with no last known address to New Jersey if the cards were sold in the state.

Although certain provisions of the new law are currently not being implemented as a result of the preliminary injunction, the litigation is ongoing and other provisions are now in effect. New Jersey’s recent changes are a reminder that gift card issuers must continually monitor their state’s unclaimed property laws.

Breakage and GAAP accounting

Retailers routinely sell gift cards to individuals with the expectation that a certain portion of these cards will never be used — breakage — which mostly results from lost cards. If the card does not fall under specific state escheat rules, the question arises as to when companies can recognize income from breakage for financial statement purposes under GAAP. (Note that if the amounts must be remitted to a government agency under state escheat rules, no income will be recognized as breakage under GAAP.)

But if these transactions are not covered under state escheat rules, the question arises as to when companies can recognize revenue for gift cards that are not used. In most transactions, GAAP does not allow a company to derecognize a liability until the company is relieved from the liability — in this case, when the gift card is used. However, a special exception has been made for gift cards: When the company can establish that the chance of redemption is remote and estimate the amount that will not be used, the company can recognize that breakage.

The SEC staff has described two acceptable methods for recognizing breakage: specific identification and homogenous pool. Using specific identification, companies can recognize breakage income when the chance of redemption of a specific card is remote. There are no hard-and-fast rules related to how long a card needs to be inactive, but typically retailers using this method wait at least two years prior to recognizing breakage income.

Using the second method, homogenous pool, companies can recognize the expected unused percentage as breakage income in proportion to the amount of redemptions over the card's estimated useful life, based on historical patterns. To use this method, all of the following conditions must be met: (1) The pool of cards using this method, for which historical redemption patterns exist must be homogenous. (2) There must be only a remote likelihood that the customer will require full performance. (3) The amount of breakage can be reasonably and objectively determined. (4) The estimated time period of actual gift card redemptions can be reasonably and objectively determined.

“For companies to recognize revenue from breakage, they need to have accurate current and historical redemption data to support that there is a remote chance of the cardholder redeeming that card.”

Bill Bishop
Audit Manager

“For companies to recognize revenue from breakage, they need to have accurate current and historical redemption data to support that there is a remote chance of the cardholder redeeming that card,” says Bill Bishop, Audit manager. “Most retailers use a third party to manage their gift card programs, and these third parties typically provide this data, but companies that administer their own gift card programs have to track redemption on their own.”

There is an additional question for companies about where to recognize breakage on the income statement. Many retailers recognize the breakage as part of net sales, while others recognize it as a reduction of selling, general and administrative costs. While there is not currently any specific literature addressing the classification, Grant Thornton LLP has seen an increased number of comment letters from the SEC staff requesting registrants to substantiate their classification if outside of revenue.

Companies should include robust disclosures such as (1) whether the gift cards have any expiration dates or monthly fees; (2) the policy for recognizing breakage income, including method, timing and amount; (3) consideration of state escheat laws; (4) the amount of breakage income recognized during the year; (5) the amount of unredeemed cards; and (6) where on the income statement that amount is included.



Federal tax treatment of gift card revenue

In recent years, the IRS has issued two industry director directives on the examination of gift cards and gift certificates (collectively referred to as gift cards) in the retail and hospitality industries. In those directives, the IRS announced its plans to focus on revenue recognition in connection with gift card sales. In addition to the directives, the IRS issued advice to field offices (field advice) discussing revenue recognition issues arising from the sale of gift cards in specific fact patterns. Specifically, one major revenue recognition issue raised by the directives and the field advice arises when the entity that sells a gift card will not be the entity that actually satisfies the gift card obligation (as in the case of a gift card company) or where the entity that is selling the gift card might not be the entity that satisfies the gift card obligation (such as when a franchisor-franchisee relationship exists). As discussed below, while the field advice had reached conclusions unfavorable to taxpayers on these issues, a recently issued IRS revenue procedure provides taxpayers with the opportunity to obtain a more favorable outcome.

In addition to the aforementioned issues, another issue raised in the directives was how a taxpayer should recognize revenue where it issues a gift card in exchange for returned merchandise. When merchandise is returned and a gift card is issued in exchange for the returned merchandise, most companies reverse the revenue from the sale of the item and record deferred revenue related to the gift card liability. Initially, the IRS indicated — informally — that it would not allow a taxpayer to apply this treatment for tax purposes. Instead, the IRS felt that the revenue from the original sale should not have been reversed. Fortunately, the IRS recently released a revenue procedure that resolves this issue in a taxpayer-favorable manner.

This section describes both of these factual situations in more detail as well as the IRS activity in this area.

Use of a gift card company

Because of the potential unclaimed property liability that may result from the issuance of gift cards, many companies establish a separate gift card management company and locate it in a state with favorable escheat rules. Typically gift card management companies will earn income either from a service fee related to issuing cards or from the gift cards' breakage. There are two main revenue recognition issues that arise when a taxpayer uses a gift card management company. The first issue is whether the gift card company should recognize revenue at all from the sale of gift cards. Specifically, some taxpayers have argued that since the gift card company is liable to pay over the cash from gift card sales, it does not recognize revenue as a result of the sale of the gift cards. Taxpayers in those situations argue that the cash received from the gift card sale is in the nature of a deposit.

The second issue, assuming that the sale of gift cards creates revenue for the gift card company, is whether the gift card company may defer revenue from the sale of gift cards under either Treasury Regulation (Treas. Reg.) § 1.451-5, which allows a two-year deferral for advance payments related to goods, or Revenue Procedure (Rev. Proc.) 2004-34, which allows a one-year deferral for advance payments related to goods or services, or a combination thereof.

The IRS has issued field attorney advice and a Technical Advice Memorandum discussing these revenue recognition issues in the context of a gift card company.

Field attorney advice 20082801F and Technical Advice Memorandum 200849015

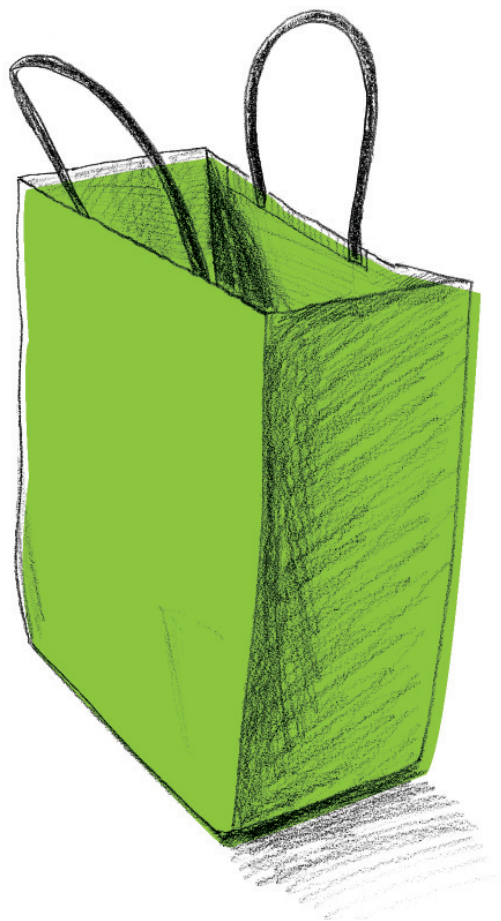
Field attorney advice (FAA) 20082801F and Technical Advice Memorandum (TAM) 200849015 issued by the IRS address several revenue recognition issues that arise in connection with the sale of gift cards by a gift card company. The gift card companies described in both the FAA and the TAM were separate, wholly owned subsidiaries of the respective taxpayers that did not hold inventory of their own and did not provide services to customers. The FAA and TAM both discussed whether the cash received by the gift card companies was required to be recognized in income upon receipt. The FAA and TAM stated that the gift card companies received the cash under claim of right and therefore had income from the sale of gift cards. The IRS specifically rejected the taxpayers' argument that the money received by the gift card companies was a deposit.

The FAA and TAM further held that the gift card companies could not rely on Treas. Reg. § 1.451-5 or Rev. Proc. 2004-34 to defer revenue recognition. Both cases denied the taxpayers the ability to use Treas. Reg. § 1.451-5 because the gift card companies did not have inventory of their own. The FAA and the TAM each disallowed the use of Rev. Proc. 2004-34, but for different reasons. The FAA held that the taxpayer could not rely on Rev. Proc. 2004-34 to defer revenue recognition because the gift card company was unable to determine the extent to which the amounts received would be recognized as revenue in the gift card company's applicable financial statements in a particular year. The TAM stated that Rev. Proc. 2004-34 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. Accordingly, both taxpayers were denied the use of Treas. Reg. § 1.451-5 and Rev. Proc. 2004-34 to avoid the immediate recognition of income.

When merchandise is returned and a gift card is issued in exchange for the returned merchandise, most companies reverse the revenue from the sale of the item and record deferred revenue related to the gift card liability.

Use of a single-member LLC

In FAA 20100901F, the IRS held that a taxpayer that used a single-member LLC (an entity disregarded for federal income tax purposes) could use either of the deferral provisions discussed above, where the gift cards are sold by its single-member LLC and the inventory is held by the owner of the single-member LLC. In short, use of a single-member LLC avoids the revenue deferral issue discussed in the Technical Advice Memorandum and the field attorney advice above.



Franchisor-franchisee situations

In the case of a gift card company, the entity selling the gift card will not provide the goods or services that relate to the gift card. There are other situations where entities sell gift cards that may or may not be satisfied by them. FAA 20093801F involved a corporate taxpayer in the restaurant business. The restaurant chain was made up of both corporate-owned restaurants and franchisee-owned restaurants. The corporate taxpayer sold gift cards that could be redeemed at either corporate-owned or franchisee-owned stores. The corporate taxpayer did provide goods and services with which the gift card liability could be satisfied. However, the taxpayer did not know whether and to what extent the gift card purchasers would redeem gift cards at its corporate-owned stores.

The corporate taxpayer took the position that it had to recognize revenue in connection with the gift cards only if the gift cards were redeemed at corporate stores. The IRS disagreed and held that the amounts received for the gift cards were required to be taken into income upon receipt. As part of its analysis, the IRS held that the taxpayer could not use the deferral provisions in Treas. Reg. § 1.451-5 or Rev. Proc. 2004-34 because the taxpayer did not know whether gift cards would ultimately be redeemed at the taxpayer's restaurants or at franchisee restaurants. In the IRS's view, in order to rely on Rev. Proc. 2004-34 or Treas. Reg. § 1.451-5, the taxpayer must be the entity that will provide the services or goods to the customer. In the IRS's view, the fact that the taxpayer has, in some instances, passed along that obligation to the franchisee makes the taxpayer ineligible to use either deferral provision. Hence, the fact that the gift cards might not be redeemed at the corporate-owned stores was enough to render the payments ineligible for deferral under either Treas. Reg. § 1.451-5 or Rev. Proc. 2004-34.

Reading between the lines: What does the recent IRS guidance mean for gift card issuers?

Recent IRS guidance

In January 2011, the IRS issued two taxpayer-favorable revenue procedures relating to gift card sales.

Rev. Proc. 2011-18 relates to taxpayers that sell gift cards that are redeemable for the goods or services of either the taxpayer or a third party. Because of the aforementioned TAM and FAA, it was unclear, prior to the publication of Rev. Proc. 2011-18, whether such taxpayers could rely on Rev. Proc. 2004-34 to defer revenue recognition in connection with the sale of gift cards. Rev. Proc. 2011-18 clarifies that a taxpayer that sells gift cards that are redeemable for goods or services of either the taxpayer or a third party may rely on Rev. Proc. 2004-34 to defer revenue recognition, assuming that all of the other requirements of Rev. Proc. 2004-34 are met.

In providing this favorable result, Rev. Proc. 2011-18 modified the definition of advance payments in Rev. Proc. 2004-34 to allow deferral under that provision but did not modify Treas. Reg. § 1.451-5 to allow revenue deferral. Rev. Proc. 2011-18 allows a taxpayer to defer revenue under Rev. Proc. 2004-34 related to eligible gift card sales. A sale of a gift card is an eligible gift card sale only if (1) the taxpayer is primarily liable to the cardholder for the value of the gift card until redemption or expiration and (2) the gift card is redeemable by the taxpayer or by any other entity legally obligated to the taxpayer to accept the gift card from a customer.

Rev. Proc. 2011-17 relates to taxpayers that issue gift cards to customers in exchange for returned merchandise and provides a safe harbor method of accounting for such transactions. Taxpayers that meet the scope of Rev. Proc. 2011-17 may treat gift cards issued for returned goods as the payment of a cash refund by the taxpayer followed by the sale of a gift card to the customer who made the return. Taxpayers that are engaged in the trade or business of selling goods at retail, that use an overall accrual method of accounting, and that issue gift cards in exchange for returned goods are eligible to use this method. Under this method, the taxpayer may account for the amount deemed received for the sale of the gift card under Treas. Reg. § 1.451-5 or Rev. Proc. 2004-34, if otherwise eligible.

The recent IRS guidance provides certainty to taxpayers regarding many gift card issues. Although the guidance is not favorable in all respects, companies with gift card programs should consider filing a change in method of accounting to obtain a limited deferral of income related to gift cards and to receive favorable treatment with respect to gift cards issued for returns. Alternatively, there is the ability in certain situations to obtain more favorable treatment related to income recognition through restructuring, as with the use of a single-member LLC. Taxpayers that continue to use a method inconsistent with the guidance run the risk that the IRS will challenge such a method upon examination.

Rev. Proc. 2011-18 and Rev. Proc. 2011-17 are effective for tax years ending on or after Dec. 31, 2010 (the effective date). For taxable years ending before the effective date, the IRS will not raise the issue of whether a taxpayer may use the method described in Rev. Proc. 2011-17 or whether a taxpayer may defer revenue under Rev. Proc. 2004-34 in connection with eligible gift card sales. If a taxpayer's use of the method described in Rev. Proc. 2011-17 or a deferral method for eligible gift card sales is an issue under consideration in examination, in appeals, or before the U.S. Tax Court in a taxable year that ends before Dec. 31, 2010, the IRS will not pursue the issue further.

Both revenue procedures provide that accounting method changes made to a permissible method under either of those revenue procedures may generally be made via the automatic accounting method change procedures. However, a taxpayer that wishes to use the deferral provisions of Treas. Reg. § 1.451-5 can use the method described in Rev. Proc. 2011-17 but must do so using the advance consent accounting method change procedures. Furthermore, both revenue procedures waive certain scope limitations for a taxpayer's first or second taxable year ending on or after Dec. 31, 2010.

Mitigation of exposure: Next steps

Given that the IRS did not provide relief in the context of Treas. Reg. § 1.451-5, taxpayers fitting into one of the above fact patterns that are using Treas. Reg. § 1.451-5 might want to change from that method to the deferral method outlined in Rev. Proc. 2004-34. Alternatively, a taxpayer that desires to use Treas. Reg. § 1.451-5 might consider setting up its gift card company as a single-member LLC, assuming that this structure provides the company with the favorable escheat treatment it desires.

Another area of risk could exist if a company merely uses its book method of accounting for gift cards as its tax method. Usually, a taxpayer's financial statement method of accounting for gift cards will not be a permissible method of accounting for tax purposes. These taxpayers, too, might want to consider asking for a change in accounting method.

Such method changes could provide audit protection and spread an unfavorable Internal Revenue Code Section 481(a) adjustment over four taxable years. A Section 481(a) adjustment is a catch-up adjustment that is required for most changes in accounting method.

Looking ahead

The popularity of gift cards shows no sign of abating and will likely continue to grow as more consumers begin to use gift cards via convenient new mobile applications and to enjoy heightened consumer protections under the CARD Act. The benefits to gift card issuers remain numerous: increased sales, improved inventory management, better cash flow and higher profitability. While there is also more scrutiny of gift cards from the IRS and the FRB, the new rules mean more clarity for gift card issuers with respect to federal tax accounting rules and the financial accounting treatment of advance payments.

While many companies have done a significant amount of work in the past to ensure that they are able to recognize gift card breakage income, companies must continue to evaluate and monitor the legislative changes in the various states in which they operate. The last thing retailers want is to have a financial restatement that is due to lack of awareness of changes in state laws affecting gift cards.

“With the increasing sales and use of gift cards, retailers will continue to focus on maximizing revenue and earnings from gift card sales. Maximizing earnings is dependent on minimizing breakage subject to state escheat laws, managing state income tax consequences of issuing and distributing gift cards, and achieving the ability to defer revenue from the sale of gift cards for federal income tax purposes,” concludes Sutton. “These will be ongoing issues for retailers for the foreseeable future.”



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