

AN ALERT FROM THE BDO FEDERAL TAX PRACTICE

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## FEDERAL TAX

### ► SUBJECT

## IRS RELEASES FAVORABLE GUIDANCE ON DEFERRAL OF GIFT CARD SALES AND GIFT CARDS ISSUED FOR RETURNED MERCHANDISE

### ► SIGNIFICANCE

The popularity of gift cards and gift certificates (collectively referred to as “gift cards”) has increased dramatically in recent years. For taxpayers in the retail or hospitality industries, in particular, the sale of gift cards is a widespread business practice. A taxpayer issuing a gift card receives an “advance payment” in exchange for the obligation to provide goods or services at a future date. The sale of a gift card is not immediately recognized as income for financial reporting purposes. Although advance payments must generally be included in gross income upon receipt for tax purposes, the sale of a gift card may be deferred from immediate income recognition under two exceptions: Rev. Proc. 2004-34 and Treas. Reg. § 1.451-5. An accrual-method taxpayer that sells a gift card to a customer and later redeems the gift card itself by providing goods or services to the holder can defer recognizing the advance payment from the sale of the gift card, either under the one-year deferral method of Rev. Proc. 2004-34 or the two-year deferral method of Treas. Reg. § 1.451-5(c).

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The manner in which taxpayers market, sell to customers, and redeem gift cards has also evolved over time. Today, gift cards are commonly sold by one entity (typically a gift card company that manages the gift card program) and redeemed either by an affiliated party or an unrelated third party under a gift card service agreement. In the past two years, the Internal Revenue Service has taken an unfavorable position in informal guidance that deferral is not permitted under either Rev. Proc. 2004-34 or Treas. Reg. § 1.451-5 in situations where the entity selling the gift card is not the one ultimately providing the goods or services in redemption of the gift card. Controversy has also arisen relating to the tax treatment of gift cards issued for returns of inventoriable goods. On January 5, 2011, the Service issued two taxpayer-favorable revenue procedures - Rev. Proc. 2011-17 (gift cards issued for returned merchandise) and Rev. Proc. 2011-18 (gift cards redeemable by the taxpayer or a third party). Collectively, these revenue procedures provide certainty in this area, reduce controversy, and prescribe the procedures by which taxpayers may file a Form 3115, Application for Change in Method of Accounting, to request a change to a method of accounting prescribed in the procedures.

## ► DATE/TIMING

Rev. Proc. 2011-17 and Rev. Proc. 2011-18 are effective for taxable years ending on or after December 31, 2010.

## ► AFFECTED TAXPAYERS

Rev. Proc. 2011-17 applies to taxpayers engaged in the trade or business of selling goods at retail that use an overall accrual method of accounting and issue gift cards in exchange for returned goods.

Rev. Proc. 2011-18 applies to an accrual-method taxpayer that receives an advance payment for an eligible gift card sale. The term “eligible gift card sale” means the sale of a gift card if: (1) the taxpayer is primarily liable to the customer, or holder of the gift card, for the value of the card until redemption or expiration; and (2) the gift card is redeemable by the taxpayer or by any other entity that is legally obligated to the taxpayer to accept the gift card from a customer as payment for goods or services.

## ► 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 is permitted under either Treas. Reg. § 1.451-5 or Rev. Proc. 2004-34.

Treas. Reg. § 1.451-5 generally allows accrual-method taxpayers a limited deferral for advance payments received for the sale of goods only. The 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 for 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 second exception, 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 services and/or the sale of goods in gross income until the taxable year following the taxable 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 statement purposes.

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## ► HIGHLIGHTS

Rev. Proc. 2011-17 provides a safe harbor method of accounting for the treatment of gift cards issued to customers in exchange for returned merchandise. The guidance points out that merchants handle returns of inventoriable goods in one of two ways. First, the merchant may give the customer a cash refund in exchange for the returned goods. A taxpayer that pays an immediate cash refund for returned goods has incurred a refund liability under section 461 and therefore may reduce gross receipts for the amount of the refund. If the customer uses the refund to purchase a gift card, the taxpayer has received an advance payment from the sale of a gift card and may defer recognition of the income under either Treas. Reg. § 1.451-5 or Rev. Proc. 2004-34. Second, a taxpayer may issue a gift card to a customer in exchange for returned goods. Notwithstanding its view that this gift card issuance is not fixed due to a future redemption of the gift card, the Service will permit a taxpayer within the scope of Rev. Proc. 2011-17 to treat gift cards issued for returned goods as the payment of a cash refund and sale of a gift card. Hence, 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. A taxpayer may use this method whether or not it is the taxpayer's policy to provide a cash refund for returned goods. The Service's reasons for providing the safe harbor are to avoid disputes about the proper characterization of gift cards issued for returned goods, provide better matching of income and costs, and simplify recordkeeping.

A change in the treatment of gift cards issued as a refund for returned goods to the one-year deferral method of Rev. Proc. 2004-34 and the Rev. Proc. 2011-17 safe harbor is a combined automatic-consent method change (automatic #84 and new #156) under Rev. Proc. 2008-52. However, a change to the two-year deferral of Treas. Reg. § 1.451-5(c) and the safe harbor is a combined advance-consent method change under Rev. Proc. 97-27. Transition rules are provided for taxpayers that are within the scope and that have previously filed an advance-consent change on or before January 5, 2011. More importantly, the Service will not challenge a taxpayer's use of the method of accounting permitted by Rev. Proc. 2011-17 in a taxable year ending before December 31, 2010. If the use of such a method is an issue under consideration in an examination, at appeals, or before the United States Tax Court, the Service will not further pursue the issue.

Rev. Proc. 2011-18 modifies Rev. Proc. 2004-34 to allow taxpayers to defer revenue from the sale of gift cards that are redeemable for goods or services of the taxpayer or a third party. Therefore, deferral is permitted even when the gift cards will be redeemed by a third party, related or unrelated to the selling entity, under a gift card service agreement. The Service acknowledges several types of gift card arrangements. For example, 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. In addition, 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. The Service and Treasury have concluded that, provided the other requirements of Rev. Proc. 2004-34 are met, a taxpayer that sells gift cards redeemable through other entities should be treated in the same manner as a taxpayer that sells gift cards redeemable only by that entity. Accordingly, by modifying the definition of an advance payment in Rev. Proc. 2004-34, the Service permits a taxpayer to file an automatic-consent method change (automatic #84) to the one-year deferral method. For taxable years ending before December 31, 2010, the Service will not raise upon examination the issue of whether the deferral method provided by Rev. Proc. 2004-34 can apply to "eligible gift card sales" as defined above. Moreover, if the taxpayer's use of the deferral method for such sales is an issue under consideration in an examination, at appeals, or before the United States Tax Court, the Service will not further pursue the issue.

## ► LIMITATIONS ON SCOPE OF RELIEF

Although it expanded the scope of Rev. Proc. 2004-34 to include retailers that sell gift cards that are redeemed by a third party, Rev. Proc. 2011-18 does not modify Treas. Reg. § 1.451-5 to allow deferral of advance payments received under additional types of gift card arrangements where the entity issuing the gift card is not the entity redeeming the gift card. Hence, no two-year deferral is permitted under this revenue procedure. The Service does not provide any legal analysis for that position, other than to cite Treas. Reg. § 1.451-5 which applies only to "an arrangement for the sale or other disposition in a future taxable year of goods held by the taxpayer primarily for sale to customers in the ordinary course of

his trade or business.” According to the Service’s interpretation, goods provided by entities other than the taxpayer issuing the gift card are not “held by the taxpayer” for sale as required by Treas. Reg. § 1.451-5. In light of this recent guidance, affected taxpayers with such “eligible gift card sales” that are currently deferring gift card sales under the two-year deferral of Treas. Reg. § 1.451-5(c) may wish to consider filing an automatic consent Form 3115 to change to the one-year deferral method afforded by Rev. Proc. 2004-34 in order to secure prior-year audit protection and a four-year spread of any positive section 481(a) adjustment. An automatic consent Form 3115 must be attached to the timely filed (including extensions) federal tax return and a copy of the Form 3115 must be filed with the IRS national office on or before the filing date of that return.

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