

PUBLICATION

Gift Card Management — When Income Tax and State Unclaimed Property Laws Converge

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As we emerge from the 2009 holiday shopping season, the popularity of gift card programs for retailers, restaurants and other hospitality businesses and their customers has become even more apparent. "Breakage," that portion of gift card balances that is not redeemed for food, beverage or merchandise, also can be an important short-term cash flow benefit for the card issuer. Yet, a number of states will treat unredeemed gift card balances as unclaimed property. As a result, some issuers of gift cards have used separate entities to manage their gift card programs to achieve intended unclaimed property compliance benefits. In turn, how these gift card management entities recognize income from gift card sales has caught the attention of the Internal Revenue Service (IRS).

IRS's LMSB Audit Initiative

In 2007, the IRS's Large and Mid-Size Business Division (LMSB) issued a directive to its revenue agents in the field announcing an audit initiative targeting what the IRS viewed as improper treatment in recognition of income from sales of gift cards and gift certificates by restaurants and retailers.¹ The directive clarifies that, although a sale of a gift card is income for financial statement accounting purposes when the card is redeemed, income is generally recognized for tax purposes when the card is sold. However, if a taxpayer can properly use the "advance payment" deferral rules of Treas. Reg. § 1.451-5 and Rev. Proc. 2004-34,² then unredeemed gift card income can be deferred up to the last day of the second tax year following the year of sale. Among other requirements, IRS rules require the seller of the gift card to also be the seller of the merchandise for which a card balance is redeemed.

State Unclaimed Property Laws

Roughly half of the states treat balances on gift cards or certificates that have not been redeemed for a period of years, usually three to five years after issuance, as unclaimed property. These states require the "holder," the card issuer, to report and pay to the state the unredeemed balance upon expiration of the "dormancy period" when the unredeemed gift card balance is deemed abandoned by the owner. Thus, while unredeemed gift card balances may be taken into income for tax purposes, that balance also may be unclaimed property payable to a state.

Another group of states will not treat unredeemed gift card balances as unclaimed property, depending on requirements that may vary by state.

A holder may determine whether unredeemed gift card balances are escheatable as unclaimed property, and to which state, based on statutory unclaimed property reporting priority rules of the states where the holder is legally domiciled and/or engages in commercial activities. These priority rules are patterned after the priority rule for escheat of intangible property established by the U.S. Supreme Court in *Texas v. New Jersey*, 379 U.S. 674, 681-682 (1965), and affirmed in *Delaware v. New York*, 507 U.S. 490 (1993).

As a result, a popular unclaimed property compliance management technique has been for holders to establish separate gift card management companies or other entities. These companies/other entities manage a gift

card program from the purchase and design of cards to the sale of cards, tracking, redemptions and other aspects of marketing gift cards. Depending on where it is domiciled and other factors, the management company/other entity also may be intended to enhance unclaimed property compliance with respect to unredeemed gift card balances.

IRS Field and Legal Advice

In field advice,³ the IRS has held that separate gift card management subsidiaries of their parent company retailers could not defer income recognition of gift card sales as "advance payments" under Treas. Reg. § 1.451-5 and Rev. Proc. 2004-34. Because the gift card management subsidiaries were issuers of gift cards but did not own the merchandise for which the gift card balances were redeemed, income from those sales could not be deferred.

More recently, the IRS ruled that a full-service restaurant management company could not defer the recognition of income from its gift card sales that were redeemed in restaurants that the management company did not own.⁴ The restaurants were owned by separate entities that were corporations wholly, partially or not owned by the management company. The management company also held interests in entities treated as partnerships for federal tax purposes. The IRS reasoned that under state law, property titled in the name of a corporation is an asset of the corporation, not its shareholders. Since the food and beverages of the restaurant corporations were owned by those corporations - not the management company - gift cards were not redeemed for goods owned by the management company. Thus, the income deferral rule could not apply. Likewise, the same reasoning and conclusion were applied by the IRS to the restaurant entities that were treated as partnerships for federal tax purposes.

Whether the same result would be applied by the IRS to a gift card management entity that is disregarded as a separate entity for federal tax purposes, such as a single member limited liability company (SMLLC), is not addressed in the field advice. Because of certain administrative and commercial practicalities, SMLLCs have become more popular as gift card management entities for unclaimed property compliance management purposes.

While the IRS field advice is not binding on taxpayers and cannot be cited or relied on as precedent, the advice does reflect the current IRS audit and litigation position that implements the LMSB directive previously described. Restaurants, retailers and other gift card issuers should review their gift card programs and the associated income tax and unclaimed property consequences, especially if they have implemented, or are contemplating, gift card management entities.

¹ Industry Director Directive on the Planning and Examination of Gift Card/Certificate Issues in the Retail, Food & Beverage Industries, May 23, 2007. <http://www.irs.gov/businesses/article/0,,id=170842,00.html>.

² 2004-1 C.B. 991.

³ Technical Advice Memorandum (TAM) 200849015 (Dec. 5, 2008) and Field Attorney Advice (FAA) 20082801F (March 26, 2007).

⁴ IRS Legal Memorandum 20093801F (Sept. 18, 2009).