

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Index (UIL) No.: 451.13-04
CASE-MIS No.: TAM-107447-15

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

Company =
Country 1 =
Country 2 =
Country 3 =
Year 1 =
Year 2 =
Term 1 =
\$o =
Term 2 =
Division 1 =
Division 2 =
Division 3 =
Division 4 =

Division 5 =
Division 6 =
\$a =
\$b =
a% =
b% =
\$c =
\$d =
\$e =
\$f =
\$g =
\$h =
\$i =
\$j =
\$k =
\$l =
c% =
Period 1 =
\$m =
\$n =
Year 3 =
d% =
Year 4 =
Year 5 =
\$m =
\$n =
e% =
f% =
g% =
h% =
i% =

ISSUE:

May Company defer for up to two years, under § 1.451-5 of the Internal Revenue Regulations, the recognition of advance payment income received from the sale of unredeemed gift cards that are redeemable for goods or services.

CONCLUSION:

Income from the sale of unredeemed Company gift cards may be deferred under § 1.451-5, to the extent Company can make an appropriate estimate of the amounts

that are deferrable under § 1.451-5 using an allocation similar to that found in § 1.451-5(a)(3).

FACTS:

Company is a multinational e-commerce and physical retailer of products with operations in Country 1, Country 2, and Country 3. During the tax years at issue, Year 1 and Year 2, Company operated retail stores and associated commercial websites under various brand names from which customers could purchase its products including

Company also offers an assortment of related services including delivery, installation, repair, and certain . For example, if a customer purchases a online or at its retail store, the customer can also pay an additional fee to have Company deliver, install, or repair that . These services are related to its core businesses.

Company sells services unrelated to its core business. For example, customers can purchase repair services for not purchased from Company, can hire Company to install new that the customer did not purchase from Company, or can hire Company to install without having purchased any of the from Company. These services are unrelated to its core businesses.

Company also sells extended warranties and service contracts, which generally range in terms from Term 1 to Term 2, and are related to its core business. . The warranty or service plans are sold on behalf of a third party,

. During Year 1 and Year 2 Company earned a commission for every extended warranty or service contract it sold and recognized these commissions as commission revenue. The third party determines whether to hire Company or another to perform the repair. If Company performs the repair, the third party will reimburse Company for the cost of the repair.¹

Company sells gift cards to customers, which can be purchased in increments of \$o up to any amount and do not have an expiration date. Company does not charge customers any administrative fees to purchase or redeem a gift card. To redeem the

¹ Beginning in Year 2, Company offered prepaid cards on behalf of unrelated retailers, , which it treats as the sale of goods.

gift card, customers need only present the card at the time of checkout. At redemption, the gift card is treated as cash.² The gift cards allow the holder to spend the value of the gift card at Company retail stores or its website. Customers can use the gift cards to purchase goods, services, or a combination of goods and services. There is no limit on the number of gift cards a customer can use during a single purchase and gift cards can be used in conjunction with any other type of tender. The gift cards are activated and become available for immediate use at the time of purchase, at which time Company is obligated to provide such goods or services as demanded from the gift card holder at redemption.

Company's gift cards, regardless of amount, have the same stock keeping unit (SKU), enabling Company to track when the gift cards are purchased. Gift card balances and redemption data is tracked electronically by a third party. Company suggests that customers generally buy the same proportion of goods, services, or both goods and services with Company gift cards as they do with cash or credit cards.

During Year 1 and Year 2 Company reported revenues in six product categories or divisions: Division 1,³ Division 2,⁴ Division 3,⁵ Division 4,⁶ Division 5,⁷ and Division 6.⁸ In Year 1 and Year 2 Company reported total domestic gross revenue of \$a and \$b, respectively. Tangible product sales accounted for a% and b% of domestic revenue in Year 1 and Year 2, respectively. In contrast, services revenue accounted for h% and i% of Company's total domestic revenue in Year 1 and Year 2 respectfully.

In Year 1 Company sold \$c in gift cards. Of that amount, customers redeemed and Company recognized \$d in gift cards during Year 1. Of the Year 1 balance, \$e were redeemed and recognized in Year 2. Of the Year 1 remainder, \$f of gift cards were redeemed and recognized in Year 4. At the end of Year 4, \$g of gift cards purchased in Year 1, or d%, were unredeemed.

Similarly, in Year 2 Company sold \$h in gift cards. Of that amount, customers redeemed and Company recognized \$i in gift cards during Year 2. Of the Year 2 balance, \$j were redeemed and recognized in Year 4. Of the Year 2 remainder, \$k of

² The gift cards cannot be redeemed for cash and customers cannot use the gift cards to make payments against their Company credit card balances.

³ Division 1 consists of revenue from the sale of

⁴ Division 2 includes revenue from the sale of

⁵ Division 3 includes revenue from the sale of

⁶ Division 4 includes revenue from the sale of

⁷ Division 5 includes revenue from the sale of

⁸ Division 6 includes revenue from the sale of

gift cards were redeemed and recognized in Year 5. At the end of Year 5, \$l of gift cards purchased in Year 2, or d%, were unredeemed.

Historically, customers redeem c% of all Company gift cards within Period 1 of being issued. Company determines its breakage rate, the amount of gift cards never redeemed, using historical redemption patterns. After Period 1, for financial statement purposes, Company recognizes breakage income for those gift cards for which the likelihood of redemption is remote. For gift cards issued in Year 1, Company recognized breakage income in the amount of \$m in Year 4. For gift cards issued in Year 2, Company recognized breakage income in the amount of \$n in Year 5.

LAW AND ANALYSIS:

Section 446(a) of the Internal Revenue Code provides that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes its income in keeping its books. Section 446(b) provides that if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.

Section 451(a) provides that the amount of any item of gross income shall be included in the gross income for the tax year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

Section 1.451-1(a) provides that income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy.

Section 1.451-5(a)(1) provides that for purposes of § 1.451-5, the term “advance payment” means any amount which is received in a tax year by a taxpayer using an accrual method of accounting for purchases and sales, pursuant to, and to be applied against an agreement for the sale or other disposition in a future tax year of goods held by a taxpayer primarily for sale to customers in the ordinary course of his trade or business.

Section 1.451-5(a)(2)(i) provides that the term “agreement” includes a gift certificate that can be redeemed for goods. The regulation also provides that the term includes agreements which obligate a taxpayer to sell goods in a future taxable year and which also contain an obligation to perform services that are to be performed as an integral part of such sales.

Section 1.451-5(a)(3) provides that if an agreement for the sale of goods in a future taxable year also obligates the taxpayer to perform services that are not to be performed as an integral part of the sale of goods, then the amount received will only be treated as an “advance payment” to the extent such amount is properly allocable to the obligation to sell goods. The portion of the amount not so allocable will not be considered an “advance payment” to which § 1.451-5 applies.

Section § 1.451-5(a)(3) further provides that if the amount not so allocable is less than 5 percent of the total contract price, such amount will be treated as so allocable to the extent that such treatment does not result in delaying the time at which the taxpayer would otherwise accrue the amounts.

Section 1.451-5(b) provides that advance payments must be included in income either in the tax year of receipt, or except as provided by § 1.451-5(c), in the tax year in which properly accruable under the taxpayer’s method of accounting for tax purposes if such method results in including advance payments in gross receipts no later than the time such advance payments are included in gross receipts for purposes of all of the taxpayer’s reports to shareholders, partners, beneficiaries, other proprietors, and for credit purposes.

Section 1.451-5(c)(1)(i) provides that if a taxpayer receives an advance payment in a tax year with respect to an agreement for the sale of goods properly includible in his inventory, or with respect to an agreement (such as a gift certificate) which can be satisfied with goods or a type of goods that cannot be identified in such tax year, and on the last day of such tax year the taxpayer in accounting for advance payments pursuant to a method described in § 1.451-5(b)(1)(ii) for tax purposes, has received “substantial advance payments” with respect to such agreement, and has on hand (or available to him in such year through his normal source of supply) goods of substantially similar kind and in sufficient quantity to satisfy the agreement in such year, then all advance payments received with respect to such agreement by the last day of the second tax year following the year in which such substantial advance payments are received, and not previously included in income in accordance with the taxpayer’s accrual method of accounting, must be included in income in such second tax year.

Section 1.451-5(c)(3) provides that advance payments received in a tax year with respect to an agreement (such as a gift certificate) under which the goods or type of goods to be sold are not identifiable in such year shall be treated as “substantial advance payments” when received.

Sales of warranty contracts are generally treated as sales of services. See, Rev. Proc. 97-38, 1997-2 C.B. 479.

This technical advice request presents the question of whether all or a portion of the amounts received for gift cards which are redeemable for both merchandise and services constitute advance payments under § 1.451-5(a).

Company's position is that amounts paid for its gift cards, including those redeemable for services, are advance payments under § 1.451-5, which provides a two-year deferral of such amounts if the exception under § 1.451-5(c) for inventoriable goods applies. If the exception applies, then the amounts received for gift cards must be included in gross income by the last day of the second tax year following the year that payments are received.⁹ Since tax year ending Year 3, Company has deferred recognition of revenue from the sale of gift cards until the earlier of (i) redemption of the gift card, or (ii) the last day of the second taxable year after issuance of the gift card.

If amounts received for gift card sales are not advance payments for purposes of § 1.451-5, then the regulation will not apply and, under § 451(a), such amounts must be included in gross income in the tax year of receipt.¹⁰ Thus, it is necessary to consider whether the amounts the taxpayer receives for gift cards are advance payments within the deferral rules of § 1.451-5(a).

The regulations define the term "advance payment" to include any amount received in a tax year pursuant to and to be applied against an agreement for the sale or other disposition in a future tax year of goods held by a taxpayer primarily for sale to customers.

a. An advance payment requires "an agreement"

First, is the payment an amount received pursuant to an "agreement?" Section 1.451-5(a)(2)(i) provides that the term "agreement" includes a gift certificate that can be redeemed for goods. The amounts here were received for the sale of gift cards. If the gift cards can be redeemed for goods they are similarly an agreement under the regulation.¹¹ Company's gift cards are redeemable for goods, warranties, delivery and installation, and other services. The word "can" ordinarily means may, not must. See, Random House Dictionary of the English Language (2d ed. 1987). Reading "can" in § 1.451-5(a)(2)(i) to mean "must" would exclude from the regulation any retailer whose gift cards could be redeemed for non-integral services or other items. Given the ubiquitous sale of warranty and other services with goods purchased from retailers, such a reading of the regulation is too restrictive. The regulation should be

⁹ For purposes of the inventoriable goods exception of § 1.451-5(c), we assume and therefore decline to discuss whether the Company keeps on hand goods available for sale in the ordinary course of business because of its nature as a retail merchant.

¹⁰ If properly elected, Company's gift cards would appear to be deferrable under Revenue Procedure 2004-34, 2004-1 C.B. 991.

¹¹ Indeed, in Rev. Proc. 2011-18, 2011-1 C.B. 443, the Service treated gift cards and gift certificates as payments for goods or services to be provided in the future.

interpreted to apply to gift cards, like Company's, that can be redeemed for goods but can also be redeemed for other items, as well as to gift cards that can only be redeemed for goods.

b. The payment must be "applied against" the agreement

Second, is the payment "applied against" such agreement? Because the amounts are received for the gift cards the balance of which is applied against purchases in future taxable years, this second requirement is satisfied.

c. The agreement must be for the sale of goods

Third, is the agreement for the sale of "goods held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business?" Thus, it is necessary to determine whether a gift card which can be redeemed in part for services or other items can still be considered an agreement for the sale of "goods." That is, does the ability to redeem the gift cards for services or other items render the gift cards outside of the scope of § 1.451-5(a)?

Section 1.451-5(a)(2)(i) provides in relevant part that an "agreement" includes contracts that obligate a taxpayer to perform services that are integral to a sale of goods.

Section 1.451-5(a)(3) provides in relevant part that if a taxpayer receives an amount pursuant to an agreement that not only obligates the taxpayer to provide goods, but also obligates the taxpayer to perform non-integral services, such amount will be treated as an "advance payment" only to the extent such amount is properly allocable to the obligation to provide goods. If the amount not so allocable is less than 5 percent of the total contract price, such amount will be treated as so allocable if such treatment does not result in delaying the time at which the taxpayer would otherwise accrue the amounts attributable to such activities (hereinafter referred to as "de minimis").¹²

Section 1.451-5(a)(3) is written in the present tense and contemplates a taxpayer receiving an amount pursuant to an agreement to provide goods in the future where a proper allocation can be made in the taxable year in which the advance payment is received. Thus, the subparagraph applies to agreements with specific terms that provide a basis for a proper allocation. Company's gift cards, however, leave to the discretion of the customer the choice of what items the gift card will be redeemed for and preserves for the customer that discretion until the time when the gift card is redeemed. Until Company's gift cards are redeemed, for any individual gift card

¹² Although not addressed in the submission, we proceed with our analysis under the assumption that the amount not so allocable, if any, does not result in delaying the time at which the taxpayer would otherwise accrue the amounts attributable to such activities.

Company cannot know whether it will be redeemed for services and other items that are not integral to a sale of goods by the company. These items may or may not be de minimis in amount and thus, may or may not be properly allocable to a sale of goods under the rules of § 1.451-5(a)(3), were it applicable. If not integral or properly allocable to the sale of goods these items cannot be considered “goods” within the meaning of § 1.451-5(a), which is an exception to the general rule of income recognition and should be narrowly interpreted. Thus, for a gift card outstanding at the end of the taxable year in which it is purchased, an amount cannot be properly allocated to the provision of goods under the language of § 1.451-5(a)(3) because what the card will be redeemed for is unknown.

The analysis, however, does not stop here. The inclusion in 1.451-5(a)(2)(i), that gift cards “can” be redeemed for goods may only be given effect by inferring a process similar to § 1.451-5(a)(3) and treating the totality of Company’s outstanding gift cards at the end of the taxable year of their sale as if they represented a single agreement, and then estimating amounts properly allocable to the sale of goods, integral services, and the amount not so allocable for these gift cards representing a future sale¹³. Accordingly, gift cards that can be redeemed for goods and non-integral services are eligible to apply allocation rules similar to those described in § 1.451-5(a)(3) by treating the total of the Company’s outstanding gift cards at the end of the taxable year of their sale as a single agreement and allowing estimates to be used for the application of § 1.451-5(a)(3). Applying this approach to Company’s gift cards, it is eligible to defer amounts received for its gift cards to the extent it can make an appropriate estimate of the amounts that are deferrable under § 1.451-5.

Company in its submission did not propose an estimation “methodology”, and offered to work with the field to derive an acceptable method of estimation that is both administrable and auditable. Whether Company’s particular methods of estimating is appropriate is a question of fact to be determined by the field. No opinion is expressed on the issue of how this estimation is made or on any other issue not directly addressed above.

CAVEAT(S):

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

¹³ An advance payment is defined in § 1.451-5(a)(1)(i) as an amount received for the sale or other disposition in a future taxable year of goods held by the taxpayer. Thus, for gift cards sold during a taxable year, the cards outstanding at the end of the taxable year represent the only gift card amounts potentially deferrable under the regulation.