

ACTION REQUIRED: Gift Card Accounting Rules Have Changed

Calendar year sellers and issuers of gift cards should immediately review their accounting to determine whether they should change their method of accounting to get the benefit of new, taxpayer-friendly rules. True Partners can help with the analysis and filings.

The use of gift cards in the United States has exploded in recent years. While there is no consensus about the overall size of the market, one source cited by the Federal Reserve Board estimated that nearly \$250 billion was loaded onto all types of prepaid cards in 2008. Generally, the IRS required card issuers to recognize income as advance payments taxable in the year of receipt, subject to two narrow exceptions:

(1) Regulatory Exception – Accrual method taxpayers may defer recognition of prepaid income until the taxable year that payments are recognized under the taxpayer’s method of financial accounting, provided that deferral for the sale of the taxpayer’s inventoriable goods cannot extend beyond the end of the second taxable year following the receipt of the advance payments, or



(2) Procedural Exception – Accrual method taxpayers receiving advance payments for goods and services may defer recognizing income to the extent that the taxpayer defers recognizing the payments as revenue in its financial statements, but in any event no later than the taxable year succeeding the taxable year of receiving the advance payments.

Recognizing that the way in which gift cards have been marketed, sold, and redeemed has evolved in recent years, the IRS recently issued two new taxpayer-friendly revenue procedures.

Refunds for Returned Merchandise

Generally, an accrual method taxpayer issuing a cash refund for returned merchandise reduces its gross receipts when the refund is paid. But if the merchant issues a gift card instead of cash, there was a question as to whether such a reduction was

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correct because the merchant did not have a fixed liability—it was conditioned on the future redemption of the gift card.

Recognizing that the two situations are economically equivalent, the IRS in Rev. Proc. 2011-17 announced that it will now permit taxpayers to treat gift cards issued for returned goods as the payment of a cash refund and sale of a gift card.

Sale of Gift Cards Redeemable From Taxpayer or Third Party

Previously the IRS only allowed deferral of income from the sale of gift cards where the card was redeemable only for the goods or services of the issuer of the card. Thus, no deferral was possible where another entity (such as affiliate of the seller or another merchant under a gift card service agreement) could redeem the card.

The IRS has recognized that gift cards are now commonly sold by one retailer and redeemed either by that retailer or by others (related or unrelated to the seller) under a gift card service agreement. Such agreements require participating merchants to accept the gift card as payment for its goods or services and the gift card seller is obligated to reimburse the participating merchant for the sales price of the goods or services purchased with the gift card. In Revenue Procedure 2011-18, the IRS concluded that a taxpayer who sells gift cards

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redeemable through other entities may defer recognition of income under the Procedural Exception described above.

Both of these changes are effective for taxable years ending on or after December 31, 2010, although if a taxpayer used one of these newly-permitted methods of accounting in a previous taxable year, the IRS will not challenge the use of that method either in an examination, in appeals, or before the U.S. Tax Court.

Taxpayers who change their treatment of gift cards under either of these revenue procedures will have a change in method of accounting and must obtain the consent of the IRS by filing a Form 3115 and following the appropriate automatic consent procedures.



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