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1700 NORTH MOORE STREET
SUITE 2250
ARLINGTON, VA 22209
T (703) 841-2300 F (703) 841-1184
WWW.RILA.ORG

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Michael F. Mundaca
Acting Assistant Secretary (Tax Policy)
U.S. Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

William J. Wilkins
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, N.W.
Room 3026
Washington, DC 20224

RE: Guidance addressing a retailer's inclusion of income from the sale and use of gift cards

Dear Sirs:

On November 24, 2009, the Treasury Department and the Internal Revenue Service (IRS) released the 2009-2010 priority guidance plan. A carryover Tax Accounting item from the prior year's plan is guidance addressing a retailer's inclusion of income under § 451[1] resulting from the sale and use of gift cards. The Retail Industry Leaders Association (RILA) respectfully submits these comments for your consideration regarding this guidance project.

RILA is the trade association of the world's largest and most innovative retail companies. RILA members include more than 200 retailers, product manufacturers, and service suppliers, which together account for more than $1.5 trillion in annual sales, millions of American jobs and more than 100,000 stores, manufacturing facilities and distribution centers domestically and abroad.

RILA supports and urges the issuance of guidance in this area as tax accounting for the sales of gift cards is consuming significant administrative time by both RILA members and the IRS, resulting in the inefficient use of resources by taxpayers and government alike. The sale of gift cards is a growing segment of retail businesses, and reducing uncertainty regarding tax accounting for gift cards will fuel further innovation and growth of gift-card sales.

[1] Unless otherwise specified, all "§" references are to the Internal Revenue Code of 1986 and all "Treas. Reg. §" references are to the Treasury Regulations promulgated there under, both as amended through the date of this letter.

Separate Entity Sales of Gift Cards

On June 10, 2009, the American Institute of Certified Public Accountants (AICPA) provided comments regarding this same guidance project.[2] RILA endorses the AICPA comments in their entirety. Specifically, RILA agrees with the AICPA that both Treas. Reg. § 1.451-5 and Rev. Proc. 2004-34[3] (current deferral guidance) apply to all gift cards sold regardless of whether the card is sold by a retail entity or a separate gift-card entity and regardless of whether the card is redeemed by the selling entity, a related entity or unrelated entity.

The tax policy underlying the relatively short-term deferrals provided by both Treas. Reg. § 1.451-5 and Rev. Proc. 2004-34 is a rule of administrative ease and convenience providing a matching of revenue recognition for tax purposes with revenue recognition for financial-reporting purposes. Treas. Reg. § 1.451-5(b)(1)(ii)(a) generally provides a limitation that the amount deferred for tax purposes may be taken into account no later than the time the advanced payment is included in gross receipts for purposes of financial reports. Rev. Proc. 2004-34 provides a similar conformity rule for the use of the so-called "Deferral Method," which generally requires the taxpayer to follow its applicable financial-statement treatment of an advanced payment in the year of receipt with the balance of any deferral recognized for tax purposes in the following year. There appears to be no policy justification to exclude from these deferral provisions short-term deferrals for advance payments for merchandise using gift cards simply because a gift-card company manages the gift-card program or the redeeming entity is not the same entity that sold the gift card.

In addition to RILA's support for the AICPA recommendation that deferral be provided for the advance payment for merchandise upon the sale of gift cards regardless of whether the redeeming entity is different from the original seller of the gift cards, RILA recommends that deferral be allowed in situations in which the gift-card selling company is a U.S. entity and the redeeming entity is a related foreign entity. Many U.S. retailers operate entities outside the 50 states (e.g., Canada, Mexico, Puerto Rico) where the same gift cards can be redeemed as in the United States. In this case, the policy justification for deferral is the same whether the cards are redeemed by a U.S. entity or a related foreign entity. Deferral is provided in the financial statements regardless of jurisdiction of the redeeming entity. Moreover, deferral is consistent with the requirements of both Treas. Reg. § 1.451-5 and Rev. Proc. 2004-34.

To the extent that Treasury and the IRS do not adopt this recommendation of providing that redemptions by related foreign entities do not preclude deferral, RILA recommends that a de minimis amount of redemptions by related foreign entities not disqualify deferral. For example, to the extent that redemptions made by foreign entities in the last 3 years were less than the de minimis amount of total redemptions, deferral would not be compromised.

If the overall recommendation made by the AICPA, and supported by RILA, providing deferral when the redeeming party is different than the issuing party is rejected, RILA urges Treasury and the IRS to adopt the AICPA recommendation that deferral should still apply where the

[2] *Tax Notes Today*, 2009 TNT 162-8 (June 10, 2009).
[3] Rev. Proc. 2004-34, 2004-1 C.B. 991.

redeeming entity and the issuing entity are within the same affiliated group of corporations filing a consolidated return for the reasons stated by the AICPA.

Gift Cards and Merchandise Returns

With respect to the issuance of gift cards for merchandise returns, the AICPA recommends that the transaction be treated as a rescission of the original sale with the new issuance treated as an original sale for purposes of application of the current deferral guidance. This treatment generally comports with the treatment for financial-reporting purposes. Economically, this treatment is no different than if the customer received a cash refund for returned merchandise with an immediate purchase of a gift card, in which case, deferral would be provided under the current deferral guidance.

Allowing a new deferral period is also consistent with this economic treatment. In general, tax policy should attempt to achieve a result consistent with the economics of a transaction unless that treatment is proscribed by a specific provision of the Internal Revenue Code. Because both Treas. Reg. § 1.451-5 and Rev. Proc. 2004-34 are administratively provided exceptions to the realization principle and are not precluded by any specific provision of the Internal Revenue Code, providing a rule for returned-merchandise transaction that is consistent with the economics of the transaction should be achievable.

As previously discussed, it appears that one of the policy objectives of the current deferral guidance is to provide matching with financial-reporting recognition. This policy objective is furthered by treating the returned merchandise as a rescission of the original sale with a new sale of a gift card, since this treatment generally comports with financial reporting of the transaction. For these reasons RILA recommends that guidance be provide allowing taxpayers, for tax purposes, to account for a gift card issued in exchange for returned merchandise as a new sale of a gift card subject to the provisions of any applicable deferral guidance.

Gift Cards and Services

In some circumstances, gift cards may be redeemed for merchandise or certain services (e.g., assembly, repair, delivery, etc.). Because Rev. Proc. 2004-34 applies to both goods and services, it is not an obstacle to achieving conformity with financial reporting at least with respect to the year of the sale of the gift card pursuant to the requirements of the revenue procedure. However, by its terms, Treas. Reg. § 1.451-5 applies only to advance payments for goods.[4] Nevertheless, Treas. Reg. § 1.451-5(a)(2) extends deferral to services that are performed as an integral part of the sale of goods. To the extent services are performed as part of the agreement that are not an integral part of the sale of goods, Treas. Reg. § 1.451-5(a)(3) extends deferral only to a de minimis amount of services provided, which the regulations define as less than 5 percent of the total contract price.

RILA respectfully requests that guidance be provided clarifying that deferral of revenue under Treas. Reg. § 1.451-5 is not disallowed solely by the fact that gift cards may be redeemed for

[4] Treas. Reg. § 1.451-5 by its terms also applies to certain long-term contracts not germane to retail transactions and the recommendations made in this comment letter by RILA.

services in addition to goods. Both the regulation and Rev. Proc. 2004-34 clearly contemplate and support such guidance. Specifically, the regulation contemplates a de minimis amount of services may be provided, whereas Rev. Proc. 2004-34 contemplates no limitation on the amount of services. To reconcile these differing approaches, RILA recommends that the de minimis threshold under Treas. Reg. § 1.451-5 be increased to an appropriate level to reflect today's current environment and applied to the total amount of gift-card revenue deferred during the year.

Notwithstanding the threshold for the de minimis rule, the application of the rule requires retailers to know what portion of the gift card will redeemed for services, a fact that cannot be determined with certainty upon the sale of a gift card. A reasonably reliable estimate, however, can be made based on past history. In order to meet the de minimis rule of Treas. Reg. § 1.451-5(a)(3), retail entities should be permitted to estimate the amount of services for which gift cards will be redeemed at issuance. RILA recommends the following safe-harbor: if the average amount of gift cards redeemed for services during the prior 3 years is less than the de minimis threshold, the safe- harbor method is deemed satisfied for the current year. The proposed averaging method is consistent with 3-year averages used in other provisions of the tax law to provide reasonably accurate estimates – for example a similar approach is used within the simplified resale method with the historic absorption ratio under Treas. Reg. § 1.263A-3(d)(4).

Bulk Sales of Gift Cards

Often bulk sales of gift cards are made to third parties and held for sale in retail stores. The third party activates the gift card upon the sale to a customer and remits the funds to the issuer of the gift card. The third party earns a commission for their services of displaying, activating and remitting funds with respect to the cards. RILA submits that the accounting for this transaction should be no different than a sale of a gift card directly by the gift-card issuer and should be afforded any applicable deferral under either current deferral guidance or guidance to be issued.

In instances of bulk sales, the transaction is not complete until the ultimate redemption of the gift card by a customer. Until that time, the retailer continues to bear the liability for the gift card as well as the obligations for its redemption. The sale to an intermediary third party should not be treated as a closed transaction.

In addition, RILA respectfully requests that guidance make clear that the tax accounting for the commission expense is governed by the rules provided in § 461 and applicable regulations and is deductible when the commission is fixed, determinable and economically performed in accordance with those rules. There is no provision under current law to require deferral of the commission expense solely because revenue associated with the advanced payment for the gift card is deferred under current deferral guidance.

Conclusion

RILA appreciates this opportunity to provide comments on the important guidance project regarding tax accounting for the sale and use of gift cards. We look forward to the issuance of that guidance and appreciate your efforts to reduce the administrative burden caused by the current uncertainty and controversy in this area. In the interim, RILA and its members are happy to provide further information to assist in the issuance of this guidance and welcome any questions in this regard.

Sincerely,

John Emling
Senior Vice President, Government Affairs

cc:

Mr. Josh Odintz
Tax Legislative Counsel
U.S. Department of the Treasury

Mr. George Blaine
Associate Chief Counsel, Income Tax & Accounting
Internal Revenue Service

Mr. Brandon Carlton
Attorney Advisor
U.S. Department of Treasury

Mr. Eric Lucas
Attorney Advisor
U.S. Department of Treasury

Mr. Scott Dinwiddie
Special Counsel to Associate Chief Counsel, Income Tax & Accounting
Internal Revenue Service