

# Gift Card Update

## Federal Reserve Board Issues Final Gift Card Regulations; IRS May Permit Income Deferral for Certain Giftcos

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The popularity and use of gift cards has increased significantly in recent years, allowing businesses to increase sales and providing consumers with more flexibility in purchasing goods. Recent regulatory action by the Federal Reserve Board (FRB) and advice issued by the Internal Revenue Service (IRS) have provided much needed guidance for companies that operate gift card programs.

### FRB Final Gift Card Regulations

On March 23, 2010, the FRB issued final regulations governing gift certificates, store gift cards, and general-use prepaid cards or certificates. The FRB first proposed gift card regulations in November 2009 and received more than 230 letters weighing in on its proposal. The final rules amend Regulation E<sup>3</sup> to implement the gift card provisions of the Credit Card Accountability Responsibility and Disclosure Act of 2009 (Credit CARD Act). These regulations ap-

ply to all gift cards (defined below) sold on or after August 22, 2010.

Generally, the rules: (1) limit dormancy, inactivity or service fees, (2) require certain disclosures and (3) prohibit expiration dates less than five years after issuance of gift cards. The FRB also issued Official Staff Commentary of the new rules, which provides detailed examples and descriptions of the new requirements, and which provide a safe harbor from liability for those who comply with it.

### Products Covered

The final rules apply to gift certificates, store gift cards and general-use prepaid

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cards, as those terms are defined in the Credit CARD Act. Covered products include retail gift cards, which can be used to buy goods or services at a single merchant or affiliated group of merchants, and network branded gift cards that are redeemable at any merchant that accepts the card brand. Significantly, gift certificates, store gift cards and general-use prepaid cards subject to the law do not need to be in a card format. The final rules apply to a device with a chip or other embedded mechanism that links the device to stored funds, such as a mobile phone or sticker containing a contactless chip that enables a consumer to access the funds.

### Restrictions on Dormancy, Inactivity or Service fees.

The final rules restrict dormancy, inactivity or service fees with respect to a gift card. Dormancy, inactivity and service fees may only be assessed for a gift card if: (1) there has been at least one year of inactivity on the card; (2) no more than one such fee is charged per month; and (3) the consumer is given clear and conspicuous disclosures about the fees. Fees subject to the restrictions would include monthly maintenance or service fees, balance inquiry fees and transaction-based fees such as reload fees, ATM fees and point-of-sale fees. The FRB declined to limit the amount of service and dormancy fees even though it was authorized to do so, but said it will continue to monitor the gift card market and may impose caps on fees or other restrictions in the future.

### Restrictions on Expiration Dates

The final rules prohibit the sale or issuance of a gift certificate, store gift card or general-use prepaid card that has an expiration date of less than five years after the date a certificate or card is issued or the date funds are last loaded. The expiration date restrictions apply to a consumer's funds, and not to the certificate or card itself. The final rule also includes provisions intended to give consumers a reasonable opportunity to purchase a certificate or card with at least five years before the certificate or card expiration date. Fees for replacing an expired certificate or card or for re-

funding the remaining balance, if the underlying funds remain valid, are prohibited.

### Exclusions

The following are excluded from the definition of gift certificates, store gift cards and general-use prepaid cards: cards used solely for telephone services (but not cards that can be redeemed for mobile phone applications or mobile Internet access); cards that are reloadable and not marketed or labeled as gift cards or gift certificates; loyalty, award and promotional cards; cards not marketed to the general public; certificates issued in paper form only; and cards redeemable solely for admission to specific events or venues.

In addition, the final rules contain detailed requirements for qualifying for the reloadable-and-not-marketed-as-gift-cards exclusion and detailed rules for providing disclosures on non-physical cards.

The final rules do not apply to cards for services or experiences (such as a massage or a hotel stay) as long as the card does not state a denominated amount (such as "a \$50 value"), nor do they apply to cards that provide discounts (such as cards for 20 percent off).

Rebate cards are considered a type of loyalty, award or promotional card. Specifically, the final rules differ from the proposed rules by requiring additional disclosures for cards issued as part of loyalty, award or promotional programs (including labeling the front of the card as being issued as part of a loyalty, award or promotional program; disclosing fees and expiration dates; and providing a toll-free telephone number or website address).

### Pre-emption

Lastly, the final rules preempt state laws that are "inconsistent" with the rules; a state law is not inconsistent with the rules if it provides greater consumer protection.

### Tax Treatment of Gift Card

On March 5, 2010, the IRS released the latest in a series of nonbinding advice affecting gift card operations. In this welcome development in what has otherwise been a relatively taxpayer-unfriend-

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ly area, the IRS, in a field attorney advice, concluded that payments received by a gift card company (a Giftco) established as a single-member LLC that is wholly-owned by a merchandise retailer may be deferred beyond the year of receipt.<sup>4</sup> This advice confirms what many taxpayers have been advocating—the activities of a disregarded entity should be treated in the same manner as the activities of its owner and should not affect an election to defer the recognition of proceeds from the sale of gifts cards.

### The State Escheatment Issue and the Unintended Tax Consequences That Resulted

A potential downside for businesses that operate gift card programs is that some states treat unredeemed balances on gifts cards as unclaimed property after a certain time period (usually three to five years) and demand payment over of unredeemed balances under state escheat laws. Certain states have attempted to enforce escheatment of gift cards under the state unclaimed property law, following modifications of the unclaimed property laws to specify a shorter escheatment period applicable to gift cards.<sup>5</sup>

In response to its proposed rules, the FRB received substantial commentary regarding whether or not the new FRB gift card rules would preempt state escheatment laws, since the FRB under the CARD Act has the authority to preempt state laws to the extent that the state law is inconsistent with the federal law. The FRB did not answer the question in the final rules but instead stated that upon request for a preemption determination with respect to a particular state's escheat law, it would apply the standards set forth in § 205.12(b)(2) to determine whether such a law is inconsistent with § 205.20.

In response to these escheatment issues, a number of businesses established Giftcos in states that have no escheat laws or that do not apply them to gift card balances. These Giftcos issue the gift cards and manage the gift card program, handling such responsibilities as the marketing, selling, tracking and redeeming of the gift cards.

An unforeseen consequence of the proliferation of Giftcos recently came to light when the

IRS began examining the proper tax treatment of proceeds from the sales of gift cards and challenging elections to defer the recognition of payments received by Giftcos.<sup>6</sup> The controversy has centered primarily around whether the proceeds are taxed immediately or may be deferred beyond the year of receipt. Under Treas. Reg. § 1.451-5, recognition of “advance payments for goods,” including gift cards, may be deferred for up to two years if: (1) the taxpayer's tax accounting method is consistent with its method of accounting for all other purposes and that method permits such deferral; (2) the gift card is redeemable for goods included in inventory by the issuer of the card; and (3) the issuer has sufficient inventory on hand to satisfy all outstanding gifts cards. A taxpayer meeting these requirements must attach to its tax return for each year a schedule reflecting specific information on payments received from gift card sales. Deferral is also available for up to one year under Rev. Proc. 2004-34 if: (1) the taxpayer's tax accounting method is consistent with its method of accounting for all other purposes and that method permits such deferral; (2) the gift card is redeemable for goods and/or services (subject to certain exclusions, such as rent and insurance premiums); and (3) the taxpayer can determine the extent to which advance payments are recognized in revenue in the year of receipt. For taxpayers with substantial and growing gift card sales, the ability to defer income for up to two years could result in significant tax savings.

The IRS has identified four issues relating to gift cards that warrant particular attention from its Examiners: compliance with Treas. Reg. § 1.451-5, changes in accounting method to use the income deferral method, the use of estimates for determining the amount of unredeemed gift cards for reporting purposes and the use of Giftcos. Through a series of administrative pronouncements, the IRS advanced its view that deferral was not available where a corporate Giftco did not directly own or maintain inventories or where the gift cards could be redeemed in establishments not owned by the Giftco.<sup>7</sup> This non-binding view became one focus for the Internal Revenue Service Advisory Council (the Council).<sup>8</sup>

In its 2009 Public Report, the Council requested that the IRS provide public guidance on the correct tax treatment of gift card sales. It specifically identified the uncertainty surrounding the use of Giftcos and advised Treasury and the IRS to fully understand the “clearly non-tax motivated reasons for using Giftcos,” to be willing to read existing authorities expansively to accommodate evolving business practices and to give careful consideration to whether any justifiable tax policy exists for penalizing Giftcos simply because the goods needed to satisfy gift card redemptions are “owned” by a related entity.

## Next Steps

Even though the FRB final rules provide much needed guidance and contemplate many more kinds of cards, and formats, than state laws do, a careful review of the final rules and the Official Staff Commentary is paramount for the success of any gift card program in order to assure compliance by the August 22, 2010, implementation date.

As noted above, the recently released IRS field service advice allowing deferral in situations involving the use of single-member LLCs is welcome guidance from the IRS. However, the IRS’s advice is neither binding nor the public guidance requested by the Council, and issues remain as to the proper tax treatment of gift card programs. Given the current status of gift card issues, taxpayers should seek appropriate guidance from their advisors.

4. Discussion of these laws and potential challenges to them are beyond the scope of this article.
5. Industry Director Directive on the Planning and Examination of Gift Card/Certificate Issues in the Retail Food, & Beverage Industries, LMSB-04-0507-039 (May 23, 2007); Industry Director’s Directive on the Planning and Examination of Gift Card/Certificate Issues in the Retail and Food & Beverage Industries #2, LMSB-4-0808-042 (Oct. 3, 2008). The IRS also has developed a form Information Document Request (IDR) for use by revenue agents in commencing an examination of a taxpayer’s gift card program. It requests detailed information on the gift card program, including whether a Giftco is used to manage the program. Gift Card Information Document Request (IDR), LMSB-4-0608-038 (Rev. 06-2008).
6. See FAA 20093801F (Jan. 16, 2009); TAM 200849015 (Aug. 22, 2008); FAA 20082801F (July 11, 2008).
7. The Council’s primary purpose is to provide an organized public forum for senior IRS executives and representatives of the public to discuss relevant tax administration issues. It reviews existing tax policy and recommends policies with respect to emerging tax administration issues. It suggests operational improvements, offers constructive observations regarding current or proposed IRS policies, programs and procedures, and advises the Commissioner with respect to issues having substantive effect on federal tax administration.

## NOTES

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2. 12 CFR Part 205.
3. FAA 20100901F (Jan. 7, 2010). The FAA was coordinated between industry counsel for the retail and food and beverage industries.