

Part III

Administrative, Procedural, and Miscellaneous

26 CFR 601.204: Changes in accounting periods and in methods of accounting.
(Also Part 1: §§ 446, 451; 1.446-1, 1.451-1.)

Rev. Proc. 2011-18

SECTION 1. PURPOSE

This revenue procedure allows taxpayers to defer recognizing in gross income advance payments received from the sale of gift cards that are redeemable for goods or services of the taxpayer or a third party. This revenue procedure modifies and clarifies Rev. Proc. 2004-34, 2004-1 C.B. 991.

SECTION 2. BACKGROUND

.01 The sale of gift cards and gift certificates is a widespread business practice in many industries, especially retail. For income tax purposes, payment for a gift certificate or gift card is viewed as payment for goods or services to be provided in the future.

.02 In general, amounts received by an accrual method taxpayer for goods or services to be provided in the future (advance payments) must be included in gross income in the taxable year of receipt. See § 451; Schlude v. Commissioner, 372 U.S.

128 (1963); Rev. Rul. 84-31, 1984-1 C.B. 127. Two exceptions to this general rule are provided by § 1.451-5 of the Income Tax Regulations and Rev. Proc. 2004-34.

.03 Section 1.451-5 generally allows accrual method taxpayers a limited deferral for advance payments received for the sale of goods. The taxpayer may defer recognition of this income until the taxable year that the payments are recognized in revenues under the taxpayer's method of accounting for financial reporting purposes. However, § 1.451-5(c) provides that a taxpayer generally may not defer advance payments for inventorable goods beyond the end of the second taxable year following the year the taxpayer receives substantial advance payments.

.04 Rev. Proc. 2004-34 provides a "deferral method" of accounting that allows an accrual method taxpayer receiving advance payments for goods or services to defer recognizing income to the extent the taxpayer defers recognizing the payments as revenues in its "applicable financial statement." If the taxpayer does not include advance payments as revenues in its applicable financial statement in the year of receipt, the taxpayer must include the advance payments in gross income in the next succeeding taxable year.

.05 The manner in which retailers market, sell to customers, and redeem (that is, accept as payment for goods or services) gift cards has evolved over time. Historically, a single retailer would sell a gift certificate or gift card to a buyer and would redeem the card or certificate itself by providing goods or services to the holder. Under Rev. Proc. 2004-34, the retailer could defer recognizing the advance payment from the sale of the gift card. Today, however, gift cards are commonly sold by one retailer and redeemed either by that retailer or by others (related or unrelated to the selling entity) under a gift

card service agreement.

.06 A taxpayer that sells gift cards (gift card entity) typically operates its gift card program under a service agreement with participating merchants. For example:

- Members of an affiliated group of corporations may establish a gift card subsidiary to sell gift cards that may be redeemed for goods or services provided by the gift card subsidiary or other members of the affiliated group;
- A franchisor, purchasing cooperative, not-for-profit membership organization, or franchisee may sell gift cards that may be redeemed for goods or services provided by independently-owned franchisees or members;
- A restaurant management company may sell gift cards that may be redeemed by participating restaurants in different geographic locations or with different trade names; or
- A retailer may issue a gift card that may be redeemed for merchandise at the retailer's stores, retail stores operated by a related party, or retail stores operated by unrelated parties.

.07 Although gift card entity structures and gift card service agreements can vary widely, it is common for a gift card entity to receive and hold the proceeds from gift card sales until a customer uses the card to purchase merchandise or services. If a customer uses a gift card to purchase merchandise or services from a participating merchant, the participating merchant is obligated to accept the gift card as payment for its goods or services and the gift card entity is obligated to reimburse the participating merchant for the sales price of the goods or services purchased with the gift card. Under the terms of a typical gift card service agreement, the gift card entity is primarily

liable to the customer for the value of the gift card until the card expires or is redeemed.

.08 The Service and the Treasury Department have concluded that, provided the other requirements of Rev. Proc. 2004-34 are met, a taxpayer that sells gift cards redeemable through other entities should be treated the same as a taxpayer that sells gift cards redeemable only by that taxpayer. Accordingly, this revenue procedure modifies the definition of advance payments in Rev. Proc. 2004-34 to allow deferral of advance payments received under additional types of gift card arrangements. This revenue procedure, however, does not modify § 1.451-5 to allow deferral of advance payments received under additional types of gift card arrangements. Section 1.451-5 applies only to “an agreement for the sale or other disposition in a future taxable year of goods held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.” Goods provided by entities other than the taxpayer issuing the gift card are not “held by the taxpayer” for sale as required by § 1.451-5.

SECTION 3. MODIFICATIONS TO REV. PROC. 2004-34

.01 Section 4.01(3) of Rev. Proc. 2004-34 is modified to revise paragraph (h), revise paragraph (i) and redesignate it as paragraph (j), and add a new paragraph (i). As modified, the provisions read as follows:

.01 Advance Payment. Except as provided in section 4.02 of this revenue procedure, a payment received by a taxpayer is an “advance payment” if –

* * *

(3) the payment is for –

* * *

(h) memberships in an organization (other than memberships for which an election under § 456 is in effect);

- (i) an eligible gift card sale; or
- (j) any combination of items described in subparagraphs (a) through (i) of this section 4.01(3).

* * *

.02 Section 4 of Rev. Proc. 2004-34 is modified to add new sections 4.07 and 4.08 to read as follows:

.07 Eligible Gift Card Sale. An eligible gift card sale is the sale of a gift card (or gift certificate) if: (1) the taxpayer is primarily liable to the customer (or holder of the gift card) for the value of the card until redemption or expiration, and (2) the gift card is redeemable by the taxpayer or by any other entity that is legally obligated to the taxpayer to accept the gift card from a customer as payment for items listed in sections 4.01(3)(a)–(j) of this revenue procedure;

.08 Financial Statement for Consolidated Group Members. If the taxpayer is a member of an affiliated group of corporations that files a consolidated return for federal income tax purposes, the group's financial statement (as defined in section 4.06 of this revenue procedure) is a financial statement of the taxpayer.

.03 Section 5.03 of Rev. Proc. 2004-34 is modified to add the following new Examples 23, 24, and 25 to read as follows:

Example 23. R corporation operates department stores. U corporation, V corporation, and W corporation are wholly owned domestic subsidiaries of R that file a consolidated federal income tax return with R. X corporation is a controlled foreign subsidiary of R that is prohibited from filing a consolidated return with R. U sells Brand A goods, V sells Brand B goods, X sells Brand C goods, and Z is an unrelated entity that sells Brand D goods. W administers a gift card program for the R consolidated

group, X, and Z. Pursuant to the underlying agreements, W issues gift cards that are redeemable for goods or services offered by U, V, X, and Z. In addition, U, V, X, and Z sell gift cards to customers on behalf of W and remit amounts received to W. The agreements provide that W is primarily liable to the customer for the value of the gift card until redemption, and U, V, X, and Z are obligated to accept the gift card as payment for goods or services. When a customer purchases goods or services with a gift card at U, V, X, or Z, W reimburses that entity for the sales price of the goods or services purchased with the gift card, up to the total gift card value. In Year 1, W sells gift cards with a total value of \$900,000, and, at the end of Year 1, the unredeemed balance of the gift cards is \$100,000. In the consolidated group's applicable financial statement, the group recognizes revenue from the sale of a gift card when the gift card is redeemed. W tracks sales and redemptions of gift cards electronically, is able to determine the extent to which advance payments are recognized in revenues in its consolidated applicable financial statement for the taxable year of receipt, and meets the requirements of section 5.02(1)(b)(i) of this revenue procedure. The payments W receives from the sale of gift cards are advance payments because they are payments for eligible gift card sales under section 4.01(3)(i) of this revenue procedure and meet the requirements of sections 4.01(1) and (2). Thus, W is eligible to use the Deferral Method. At the end of Year 1, W recognizes \$800,000 in income in its consolidated applicable financial statement. Under the Deferral Method, W must include \$800,000 of the payments from gift card sales in gross income in Year 1 and the remaining \$100,000 of the payments in gross income in Year 2.

Example 24. W is a Subchapter S corporation that operates an affiliated

restaurant corporation and manages other affiliated restaurants. These other restaurants are owned by other Subchapter S corporations, partnerships, and limited liability companies. W has a partnership interest or an equity interest in some of the restaurants. W administers a gift card program for participating restaurants. Each participating restaurant operates under a different trade name. Under the gift card program, W and each of the participating restaurants sell gift cards, which are issued with W's brand name and are redeemable at all participating restaurants. Participating restaurants sell the gift cards to customers and remit the proceeds to W. W is primarily liable to the customer for the value of the gift card until redemption, and the participating restaurants are obligated under an agreement with W to accept the gift card as payment for food, beverages, taxes, and gratuities. When a customer uses a gift card to make a purchase at a participating restaurant, W is obligated to reimburse that restaurant for the amount of the purchase, up to the total gift card value. In W's applicable financial statement, W recognizes revenue from the sale of a gift card when a gift card is redeemed at a participating restaurant. W tracks sales and redemptions of gift cards electronically, is able to determine the extent to which advance payments are recognized in revenues in its applicable financial statement for the taxable year of receipt, and meets the requirements of section 5.02(1)(b)(i) of this revenue procedure. The payments W receives from the sale of gift cards are advance payments because they are payments for eligible gift card sales under section 4.01(3)(i) of this revenue procedure and meet the requirements of sections 4.01(1) and (2). Thus, W is eligible to use the Deferral Method.

Example 25. X is a corporation that operates for the benefit of its franchisee

members, who own and operate domestic and international individual member hotels. X collects membership fees from the member hotels in exchange for providing a wide variety of management support services, which include making reservations for customers at the various member hotels. X also administers a gift card program for its members by selling gift cards that may be redeemed for hotel rooms and food or beverages provided by any member hotel. The agreements underlying the gift card program provide that X is entitled to the proceeds from the sale of the gift cards, must reimburse the member hotel for the value of a gift card redeemed, and until redemption remains primarily liable to the customer for the value of the card. In X's applicable financial statement, X recognizes payments from the sale of a gift card when the card is redeemed. X tracks sales and redemptions of gift cards electronically, is able to determine the extent to which advance payments are recognized in revenues in its applicable financial statement for the taxable year of receipt, and meets the requirements of section 5.02(1)(b)(i) of this revenue procedure. The payments X receives from the sale of gift cards are advance payments because they are payments for eligible gift card sales under section 4.01(3)(i) of this revenue procedure and meet the requirements of sections 4.01(1) and (2). Thus, X is eligible to use the Deferral Method.

SECTION 4. EFFECTIVE DATE

This revenue procedure is effective for taxable years ending on or after December 31, 2010.

SECTION 5. AUDIT PROTECTION

For taxable years ending before December 31, 2010, the Service will not raise

upon examination the issue of whether the Deferral Method provided in section 5 of Rev. Proc. 2004-34 can apply to eligible gift card sales as defined in section 4.07 of that revenue procedure. Moreover, if the taxpayer's use of the Deferral Method for eligible gift card sales is an issue under consideration in examination, appeals, or before the U.S. Tax Court in a taxable year that ends before December 31, 2010, the Service will not further pursue the issue.

SECTION 6. CHANGE IN METHOD OF ACCOUNTING

.01 Consent to change.

(1) Automatic consent. A taxpayer that wants to change its method of accounting to one of the permissible methods of accounting for advance payments for eligible gift card sales (except methods under section 5.02(3)(b)(i) or (iii) of Rev. Proc. 2004-34) makes the change under section 15.07 of Rev. Proc. 2008-52, 2008-2 C.B. 587, as modified, amplified, and clarified by Rev. Proc. 2009-39, 2009-2 C.B. 362, or its successor.

(2) Advance consent. A taxpayer that wants to use the Deferral Method for payments for which a method under section 5.02(3)(b)(i) or (iii) of Rev. Proc. 2004-34 applies must follow the change in method of accounting procedures in Rev. Proc. 97-27.

.02 Transition rules. If a taxpayer has timely requested consent on or before January 5, 2011, under Rev. Proc. 97-27, 1997-1 C.B. 680, to change its method of accounting for advance payments for eligible gift card sales and the Form 3115, Application for Change in Accounting Method, is pending with the national office, the taxpayer may convert its Form 3115 to an application for automatic consent under Rev. Proc. 2008-52, if otherwise eligible. The taxpayer must notify the national office of the

conversion before the national office issues a letter ruling under Rev. Proc. 97-27. If the taxpayer converts the Form 3115 under this section 4.02 before the national office has ruled on the Form 3115, the national office will return the Form 3115 to the taxpayer and refund the user fee.

.03 Scope limitations waived. The scope limitations in section 4.02 of Rev. Proc. 2008-52 do not apply to this change in method of accounting for a taxpayer's first or second taxable year ending on or after December 31, 2010. If a taxpayer is under examination, before an appeals office, or before a federal court for any income tax issue when the taxpayer files the copy of the Form 3115 with the national office, the taxpayer must provide a copy of the Form 3115 to the examining agent, appeals officer, or counsel for the government, as appropriate, at the same time. The Form 3115 must contain the name(s) and telephone number(s) of the examining agent, appeals officer, or counsel for the government, as appropriate.

SECTION 7. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2004-34 is modified and clarified.

SECTION 8. DRAFTING INFORMATION

The principal author of this revenue procedure is Jamie J. Kim of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information regarding this revenue procedure, contact Jamie J. Kim or Susie K. Bird at (202) 622-4950 (not a toll-free call).