



Revisiting the Tax Treatment of Customer Loyalty and Rewards Programs

Customer loyalty and rewards programs have and will continue to represent a significant liability for many consumer-oriented businesses, including retailers and service providers. The tax accounting treatment of these programs has been the subject of controversy and uncertainty because the financial accounting treatment may result in the recognition of a liability, while the tax rules allow a current deduction only in more limited situations. This article reviews a recent decision of the U.S. Court of Appeals for the Third Circuit that highlights the tax accounting issues and provides guidance that may be helpful for taxpayers, particularly those in Delaware, New Jersey, and Pennsylvania (the states within the Third Circuit). In addition, the article explains why pending mandatory changes in the financial accounting treatment of customer revenue make this an ideal time to re-evaluate the tax accounting treatment of these programs as an important component of the transition to the new financial accounting standards.

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Background

Customer loyalty and rewards programs historically required a customer to collect "trading stamps," box tops, or similar items redeemable for cash or merchandise. Today, numerous programs are in existence. In general, under these programs, each time a customer makes a purchase of a product or service, points are earned that can be redeemed for free or discounted merchandise or services, or cash. Customer loyalty and rewards programs are in place now at a wide variety of companies including retailers, telecommunications companies, airlines, hotels, automobile rental companies, and credit card issuers. Online merchants also engage in these programs to attract and retain customers.

Given the evolution of these programs, a recent decision in the Third Circuit, and the potential tax impact of new financial accounting standards for revenue recognition issued by the International Accounting Standards Board (“IASB”) and the Financial Accounting Standards Board (“FASB”), companies should carefully review current tax treatments for their customer loyalty and rewards programs.

Section 1.451-4 of the Treasury Regulations

To date, many companies have assessed whether their customer loyalty and rewards programs qualify for the more favorable tax treatment under section 1.451-4. This regulation effectively provides a limited exception to the all-events test and economic performance rules, and permits a deduction from gross sales equal to the taxpayer’s costs of any “merchandise, cash, or other property” for which the trading stamps or premium coupons may be redeemed.

To qualify under the regulation, a taxpayer must meet several requirements. The coupon must be: (1) redeemable in merchandise, cash, or other property; (2) issued with sales; and (3) in the nature of a trading stamp or premium coupon. As a result, the more traditional “trading stamp” and box top programs may be afforded favorable treatment under the regulation whereas the more contemporary point-based programs often run afoul of one or more of these requirements. For example, in Revenue Ruling 78-212¹ a taxpayer’s coupons issued at the time of sale were denied favorable treatment under section 1.451-4 because the coupons were redeemable for discounts on future purchases of product rather than for merchandise, cash, or other property. In *Capital One Financial Corp.*,² a credit card issuer awarded points with each dollar charged. The Tax Court found the taxpayer did not issue those points with a sale but rather with the purchase of a note receivable. Nevertheless, we have seen a number of recent programs receive favorable treatment under section 1.451-4, particularly when the reward is expressed in terms of dollars that may be redeemed for a variety of merchandise.

For those companies unable to meet the provisions of section 1.451-4, there may be alternatives to achieving similarly favorable tax treatment with respect to their customer loyalty and rewards programs.

Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the “Code”) or the applicable regulations promulgated pursuant to the Code (the “regulations”).

¹ 1978-1 C.B. 139.

² 133 T.C. 136 (2009).

The All-Events Test: An In-Depth Look at the Third Circuit's Decision in *Giant Eagle*

The Third Circuit recently upheld the ability of a grocery chain to accrue a current deduction for the estimated cost of redeemable loyalty points in the year during which those points are earned by the customer. If the appeal is finalized (see footnote 10 below), the Third Circuit's holding and analysis should be of particular interest to taxpayers located in the states of Delaware, New Jersey, and Pennsylvania (the territory within which the jurisprudence of the Third Circuit controls).

In *Giant Eagle, Inc. v. Commissioner*,³ the Third Circuit considered a customer loyalty program under which customers earned loyalty points based upon their total expenditures for groceries during that month. The shopper could redeem each point earned for 10 cents off one gallon of gasoline purchased from the taxpayer within the next three months. Redeeming the points required the shopper to purchase gasoline from the taxpayer within the three-month window and to press a button electing to use the points at the time of that fuel purchase. The points were not redeemable in cash.

The taxpayer took the position that the loyalty points became a fixed liability under the first prong of the all-events test in the year during which the points were earned by the shopper. The IRS disagreed, instead taking the position that the liability does not become fixed unless and until the shopper purchases gasoline within the three-month window and elects to apply the accrued points to that purchase. The IRS did not question whether other elements of the all-events test had been satisfied, challenging only whether the liability was "fixed" under the first prong.

In a memorandum opinion, the Tax Court agreed with the IRS.⁴ The Tax Court held that the shopper's additional purchase of gasoline operates as a condition precedent to the grocery store's liability becoming fixed for purposes of the all-events test. The court viewed the loyalty points as a discount available in the event of a future purchase.

³ 2016 U.S. App LEXIS 8399 (3d Cir. May 6, 2016).

⁴ *Giant Eagle, Inc. v. Commissioner*, T.C. Memo 2014-146.

Similarly, the Tax Court likewise rejected the taxpayer's alternative argument that the value of the points could be deducted in the year earned under the "trading stamp" regulations discussed above. The Tax Court concluded that Giant Eagle's loyalty points operated as a discount applicable to future purchases, rather than being redeemable in "merchandise, cash, or other property."

In a decision issued on May 6, 2016, the Third Circuit reversed the Tax Court. In a divided opinion, the Third Circuit instead concluded that the grocery chain's liability becomes fixed immediately upon the customer's purchase of the groceries required to earn the points. At that time, the Third Circuit reasoned, the grocery chain enters into a unilateral contract requiring it to redeem the points upon demand, under the written terms of the program. The court appeared to give weight to the fact that the taxpayer had not reserved the right to revoke any loyalty points already earned by customers, and had never done or considered doing so in the history of the program.

The court also looked to other decisions to support its conclusions. As did the Tax Court, the Third Circuit considered the U.S. Supreme Court's landmark decisions in *General Dynamics*⁵ and *Hughes Properties*.⁶ Ultimately, the Third Circuit concluded that decisions such as those in *Massachusetts Mutual* (future policyholder dividends guaranteed by board of directors),⁷ *Gold Coast* (slot club points),⁸ and *Lukens Steel* (payments to fund under terms of collective bargaining agreement)⁹ supported its position that the grocery chain had entered into a unilateral contract binding it to performance as soon as the shopper made the required purchase of groceries and earned the points. The fact that some shoppers ultimately will not redeem the points, and that the identity of those shoppers cannot be ascertained at year-end, was held irrelevant by the majority.

One member of the three-judge panel dissented. The dissent agreed with the Tax Court that the grocery chain does not have an immediate and immutable obligation immediately upon the shopper's purchase of

⁵ 481 U.S. 239 (1987).

⁶ 476 U.S. 593 (1986).

⁷ 782 F.3d 1354 (Fed. Cir. 2015).

⁸ 158 F.3d 484 (9th Cir. 1998).

⁹ 442 F.2d 1131 (3d Cir. 1971).

groceries. The dissent noted that unlike the facts in the cases relied upon by the majority, the taxpayer's obligations would not remain on its books permanently unless and until the points were redeemed. Instead, the liability would be extinguished if the points were not redeemed through the required gasoline purchase within the three-month window. The dissent was also troubled by the majority's analysis of the points program as a "group liability" rather than considering the grocery chain's obligation to each customer in his or her individual capacity as the counter-party to a unilateral contract.

As did the Tax Court, however, the dissent disagreed with the taxpayer's alternative argument that the "trading stamps" regulations would apply.

Procedurally, the Department of Justice has until June 20 to request a rehearing of the Third Circuit panel decision.¹⁰ If a rehearing is requested and granted, it is possible that the Third Circuit would reverse its May 6 decision. If it does not do so and the appeal is finalized, taxpayers in the Third Circuit will have an opportunity to revisit their application of the all-events test to loyalty programs in light of *Giant Eagle*. Potential beneficiaries include any company offering customer loyalty programs, with the ultimate benefit of course depending on the taxpayer's specific facts. In anticipation of the opinion being finalized or upheld, such companies should consider assessing the potential benefits now, with a view to pursuing method change requests in reliance upon that decision.

Regardless of whether the Third Circuit opinion is reconsidered by that court, taxpayers outside Delaware, New Jersey, and Pennsylvania should consider the case with a greater degree of caution. The IRS has not acquiesced to *Giant Eagle*, meaning it has not indicated whether it will follow that decision in other states. Likewise, the Tax Court is not bound to follow the jurisprudence of the Third Circuit outside of those three states. While the Tax Court's decision in *Giant Eagle* was issued as a memorandum opinion rather than as a regular opinion of the court, taxpayers outside the Third Circuit should bear in mind the Tax Court's reasoning and holding in the case when deciding whether and how to modify their present treatment of similar loyalty programs in light of *Giant Eagle*.

¹⁰ If desired, a request for rehearing must be filed within 45 days in civil cases in which the United States or a U.S. agency is a party. F.R. App. P. 40(a)(1)(A) and (B).

The New Revenue Recognition Standard and Revenue Procedure 2004-34

In May 2014, FASB and the IASB each released new accounting standards addressing when revenue from most types of contracts with customers is recognized for financial statement purposes.¹¹ These new standards replace much of the existing U.S. Generally Accepted Accounting Principles (“GAAP”) and International Financial Reporting Standards (“IFRS”) guidance for recognizing revenue from customer contracts with a new five-step model. The new standards are causing companies to examine how they account for customer loyalty and rewards programs; these evaluations will often trigger changes to tax treatment.

At present, companies typically recognize the entire amount of the transaction price as revenue for financial accounting purposes at the time the good or service is sold, with no corresponding amount allocated to customer loyalty points to be redeemed in the future. Concurrently, the companies also typically recognize the full amount of the estimated cost to provide the goods or services underlying the loyalty program as a current expense for financial accounting purposes. Under Topic 606, companies will generally allocate a portion of the transaction price to the customer loyalty points as a separate “performance obligation,” thus deferring a portion of the revenue until those points are redeemed or expire.

This deferral for financial accounting purposes may facilitate a similar deferral for tax purposes under Revenue Procedure 2004-34. Revenue Procedure 2004-34 permits deferring income from advance payments for up to one year for tax purposes, but only to the extent the revenue also is deferred for book purposes. The deferral may be used for advance payments for services, goods, the use of intellectual property, and certain other items. Because the “deferral method” of Revenue Procedure 2004-34 directly ties the timing of income recognition for tax purposes to the

¹¹ Accounting Standards Update No. 2014-09—Revenue From Contracts with Customers (“Topic 606”). KPMG has available a complimentary reference guide on Topic 606, *Revenue Issues In-Depth: IFRS and US GAAP* (2d Edition May 2016), available at <http://www.kpmg-institutes.com/institutes/financial-reporting-network/articles/campaigns/revenue-recognition-campaign.html>.

timing of revenue recognition for book purposes, a Topic 606 driven change in the financial accounting treatment of a company's loyalty rewards program also may directly affect the tax treatment of those programs.

The IRS typically views changes in the application of Revenue Procedure 2004-34 resulting from changes in the associated financial accounting treatment as a change in accounting method requiring IRS consent.¹² As a consequence, companies currently using the deferral method of Revenue Procedure 2004-34 that are contemplating financial accounting modifications under Topic 606 to their customer loyalty programs must comply with applicable IRS procedures for any resulting tax accounting method changes as well. Otherwise, even inadvertent changes in the tax treatment of these programs may result in IRS audit exposure for the companies.

Those entities that currently account for loyalty points as deferred revenue, even before the adoption of Topic 606, may have an opportunity to change immediately to the deferral method of accounting for tax purposes. A change in method of accounting of this nature is eligible for the automatic consent procedures of Revenue Procedure 2015-13¹³ and Revenue Procedure 2016-29.¹⁴

The new financial accounting standard is effective for annual reporting periods beginning after December 15, 2017, for public business entities, certain not-for-profit entities, and certain employee benefit plans. Other entities must comply with the new standards in annual reporting periods beginning after December 15, 2018. Given that the new standards may result in retrospective or cumulative catch-up adjustments, however, many companies have already begun assessing the potential impact of Topic 606 upon their customer revenue for both financial and tax reporting purposes. The potential impact to a company's customer loyalty and rewards programs should be an integral part of any assessment.

¹² See CCA 201011009.

¹³ 2015-5 I.R.B. 419.

¹⁴ 2016-21 I.R.B. 880.

Conclusion

Given the evolution of customer loyalty and rewards programs, the recent decision in the Third Circuit, and the pending financial accounting impact of the new Topic 606 revenue recognition standard, taxpayers should revisit the tax treatment of their customer loyalty and rewards programs. Taxpayers unable to meet the requirements of section 1.451-4, should consider the Third Circuit's decision in *Giant Eagle*. Taxpayers outside the jurisdiction of the Third Circuit, however, should consider that case with a greater degree of caution. Taxpayers also should carefully review whether and how a change in the financial accounting treatment of customer revenue could affect their present tax treatment of customer loyalty programs, identify and assess the available options, and undertake any required procedural steps necessitated by those changes.

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