State Law & State Taxation Corner

*By John A. Biek**

Unredeemed Gift Cards and Stored Value Cards Present Unclaimed Property and Income Tax Issues

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Introduction

Electronic gift cards and stored value cards, and, to a lesser extent, paper gift certificates (hereinafter referred to collectively as "gift cards") have become a significant feature of the retail landscape. In 2006 alone, retailers and financial institutions issued and sold more than $82 billion of gift cards, a 20-percent increase over gift card sales in 2005.[1] Approximately $59 billion of these gift cards were issued by the retailers themselves, or by their special purpose gift card subsidiaries, as "closed loop" gift cards that are redeemable only for the goods or services sold by the retailer. The other $23 billion of these gift cards were issued by financial institutions as "open loop" gift cards, which typically carry the logo of Visa, Mastercard, American Express or Discover and are accepted as payment by any merchant that processes sale transactions through that payment network.[2] Gift card sales for 2007 were estimated to top $97 billion.[3]

The exponential growth in U.S. gift card sales has attracted the attention of state legislatures, which have been busy enacting a hodge podge of state consumer protection statutes to address perceived abuses resulting from the imposition of expiration dates or dormancy service fees on gift cards. Many of these state legislatures have also addressed the unclaimed property treatment of the unredeemed balances (commonly referred to as the "breakage") on gift cards, which is commonly estimated to amount to 10 percent of gift card sales, or $8 billion to $9 billion annually.[4] Many of these states have enacted an unclaimed property exemption for breakage on gift cards that comply with the limitations on expiration

dates and dormancy service fees found in the state's consumer protection laws. The evolution of these state consumer protection and unclaimed property rules for gift cards is discussed in this article.

The Internal Revenue Service is now examining a series of federal income tax issues related to gift cards. Three of the most significant issues are (1) whether the proceeds from sales of gift cards constitute deposits that the issuer of the gift cards may exclude from its income or taxable advance payments for future sales of merchandise or services; (2) if the gift card proceeds represent advance payments, whether the issuer is allowed to defer recognizing the proceeds as income under the two-year deferral period of Reg. §1.451-5 or the one-year deferral period of Rev. Proc. 2004-34;[5] and (3) whether the gift card issuer is required to recognize gift card proceeds as income at the end of the applicable deferral period if the issuer subsequently will be required to report and deliver the breakage to states pursuant to their abandoned property laws. As the gift card industry has evolved, questions have arisen about whether the deferral periods of Reg. §1.451-5 and Rev. Proc. 2004-34 apply at all to gift cards issued by special purpose subsidiaries of retailers or by financial institutions.

The Internal Revenue Service has now begun to address some of these questions in a recently published Field Attorney Advice (FAA) and an Industry Director's Directive (IDD).[6] The IDD represents another step in the IRS's efforts to centralize its management of gift card issues, requiring an agent who identifies certain gift card issues in the course of an examination of a taxpayer's return to raise such issues on audit and to contact the IRS's technical advisers for coordination of the issues.

This column discusses these important federal income tax issues for gift card issuers.

The Evolution of State Unclaimed Property and Consumer Protection Rules for Gift Cards

State Attempts to Escheat Gift Card Breakage in the 1990s

State abandoned property laws apply broadly to liabilities that a business (referred to as the "holder") still owes to a payee such as a customer, vendor, employee or shareholder (referred to as the "owner") at the end of the "statutory dormancy period" prescribed in the state's law.[7] Many of these state abandoned property laws are based on one or more of the three "uniform acts" drafted by the National Conference of Commissioners on Uniform State Laws ("NCCUSL").[8] Section 2(a) of the 1981 Uniform Unclaimed Property Act (the "1981 Uniform Act") provides in its "general escheat provision" that:

> Except as otherwise provided by this Act, all intangible property, including any income or increment derived therefrom, less any lawful changes, that is held, issued or owing in the ordinary course of a holder's business and has remained unclaimed by the owner for more than 5 years after it becomes payable or distributable is presumed abandoned.[9]

Section 1(13) of the 1995 Uniform Unclaimed Property Act (the "1995 Uniform Act") defines escheatable "property" to mean "a fixed and certain interest in intangible property that is held, issued, or owed in the course of a holder's business," and then presumes that property to be abandoned if it remains unclaimed by the apparent owner at the end of the applicable statutory dormancy period set forth in Section 2(a) of the 1995 Uniform Act.[10] The state takes custody of the unclaimed property that the holder delivers to the state in perpetuity until the owner (or a holder that has returned the property to the owner) comes forward to claim the property from the custodial state.

The 1981 and 1995 Uniform Acts include gift certificates among the types of "property" that are considered to be escheatable to the states.[11] Moreover, the 1981 Uniform Act specifically provides that "a gift certificate . . . issued in the ordinary course of an issuer's business which remains unclaimed by the owner for more than 5 years after becoming payable or distributable is presumed abandoned" in the amount of the purchase price of the unredeemed gift certificate.[12] The 1995 Uniform Act presumes gift certificates to be abandoned three years after December 31st of the year in which the gift certificate was sold.[13] If the gift certificate was redeemable only for merchandise, the 1995 Uniform Act only requires the holder to report 60 percent of the breakage on the gift certificate, allowing the holder to retain the other 40 percent as some approximation of the gross profit that the holder would have earned if the owner of the gift certificate had redeemed

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the instrument to purchase merchandise from the holder.[14] The Delaware Abandoned Property Law presumes unredeemed gift certificates to be abandoned after five years, with merchandise only gift certificates then being reportable to the state in an amount equal to the face value of the unredeemed gift certificate multiplied by the holder's cost-of-goods-sold percentage.[15]

In light of these specific unclaimed property rules, it is not surprising that state unclaimed property audits of retailers in the mid to late-1990s often focused on unredeemed gift certificates. The contract audit firms that the states were utilizing to perform these unclaimed property audits knew that major U.S. retailers had recorded substantial amounts of liabilities associated with breakage on their books, and this breakage would, in most instances, be reportable to the state of incorporation of the retailer. Under the priority rules established in the United States Supreme Court's decision in *Texas v. New Jersey*,[16] and reaffirmed in *Delaware v. New York*,[17] an item of unclaimed property is claimable, first, by the state of last-known address of the owner of the unclaimed property, as shown in the holder's business records.[18] If the owner's state of last-known address is unknown, or if that state does not have abandoned property laws that will apply to the property, then the holder's state of corporate domicile (*i.e.,* its state of incorporation) has the next best claim to take custody of the item of unclaimed property.[19] Because retailers in the mid-1990s were generally selling paper gift certificates in "over the counter" transactions, without obtaining name or address information regarding the purchaser or recipient of the gift certificate, the retailer's state of incorporation was in a position to claim custody of all of the gift certificate breakage in the retailer's books and records. This priority rule was very good to Delaware, the state of incorporation of many major U.S. chain retailers.

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Nor did the expiration dates on many of these gift certificates prevent the breakage from being presumed abandoned under state unclaimed property laws. Many states had adopted "anti-limitations" or "private escheat" provisions based on the following provision from the 1981 Uniform Act:

> The expiration, before or after the effective date of this Act, of any period of time specified by contract, statute, or court order, during which a claim for money or property can be made or during which an action or proceeding may be commenced or enforced to obtain payment of a claim for money or to recover property, does not prevent the money or property from being presumed abandoned or affect any duty to report or to pay or deliver abandoned property to the administrator as required by this Act.[20]

This anti-limitations provision was inspired, in part, by *People v. Marshall Field & Co.*,[21] a case in which the Illinois Appellate Court held that it would violate public policy if Marshall Field were able to circumvent the application of the Illinois Uniform Disposition of Unclaimed Property Act to the breakage on Marshall Field's gift certificates by shortening the expiration date on the gift certificates so that they expired before the Illinois statutory dormancy period had run. The Delaware Abandoned Property Law targeted expiration dates on gift certificates more directly by defining the term "period of dormancy" with regard to gift certificates to be the shorter of five years or "the expiration period, if any, of the gift certificate less 1 day."[22] This special Delaware rule ensured that breakage on gift certificates was presumed abandoned under the Delaware Abandoned Property Law before the gift certificate had expired.

Retailer Efforts to Limit Treatment of Gift Card Breakage as Unclaimed Property

Retailers took a couple of approaches to minimize their unclaimed property liability for gift card breakage. First, some retailers began to apply dormancy service fees to the balances on their gift cards in order to reduce the amount of breakage that remained on the cards when the statutory dormancy period had run. Whereas expiration periods on gift cards could be disregarded under the state anti-limitations provisions, retailers noticed that dormancy service fees are not explicitly mentioned in the anti-limitations

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provisions. Under many state abandoned property laws, dormancy service fees arguably reduced the value of the unclaimed property that the holder was required to report to the state as long as the dormancy service fee provision had been agreed to by the purchaser or owner of the gift card, the service fee was reasonable in amount, and, most crucially, the retailer consistently applied the dormancy service fee charge against owners of unredeemed gift cards (*i.e.,* the retailer did not wait until the end of the statutory dormancy period to deduct the dormancy service fees from the unredeemed balance on the gift card).[23] However, these dormancy service fees on gift cards proved to be unpopular with consumers.

Another possible solution to minimizing a retailer's unclaimed property liability with respect to unredeemed gift cards was for the retailer to form a special purpose gift card subsidiary under the laws of a state that exempted gift card breakage and have that subsidiary issue the gift cards that would be redeemable for purchases of merchandise or services at the retailer's stores. The gift card transactions were structured so that the gift card subsidiary bore the obligation to pay the unredeemed value of the gift card, with the revenues and expenses associated with the gift card being recorded on the books of the gift card subsidiary. The retailer could act as an agent of the gift card subsidiary to help it market and sell its gift cards and to accept the gift cards as payment for purchases of goods or services at the stores of the retailer.

If the gift card subsidiary was properly structured, the gift card subsidiary should be treated as the holder of the gift card breakage, with the obligation to report that breakage as unclaimed property to the appropriate state or states. However, if the gift card subsidiary did not have last-known addresses of the owners of the unredeemed gift cards, and if the gift card subsidiary's state of incorporation exempted gift card breakage under its abandoned property laws, the gift card subsidiary could take the position that it was not required to report the breakage to any state. Many major retailers implemented such gift card subsidiaries because they helped to improve the operations of the retailer's gift card program, as well as serving to reduce the amount of gift card breakage that the retailer would otherwise be required to report and deliver to the states. To date, state abandoned property administrators have been willing to respect these gift card subsidiary structures as long as they were properly implemented, with the result that it has become less common to see retailers escheating gift card breakage to the states.

The California Gift Card Legislation

In the late 1990s, gift cards became the target of state consumer protection legislation. This trend commenced, as is so often the case, in California with the enactment of A.B. 2466 in 1996. This legislation added Section 1749.5 to the California consumer protection laws, to make it "unlawful for any person or entity to sell a gift certificate to a purchaser containing an expiration date."[24] Section 1749.5 provides three exceptions to this expiration date prohibition applicable to: (1) gift certificates distributed to a consumer pursuant to an awards, loyalty or promotional program without any monetary consideration or other thing of value being given by the consumer in exchange for the gift certificate; (2) gift certificates sold below face value at a volume discount to employers or to nonprofit or charitable organizations for fundraising purposes if the expiration date is not more than 30 days after the date on which the gift certificate was sold; and (3) gift certificates issued for a food product.[25] To qualify for these three exceptions, the expiration date must appear in capital letters in at least 10-point font on the front of the gift card.[26] The term "gift certificate" was defined in Section 1749.45 of the California consumer protection laws to include gift cards (other than gift cards that are usable with multiple unaffiliated sellers of goods or services, such as a gift card issued by a shopping mall operator that is redeemable at the various retail stores within the shopping mall).

A.B. 2466 also added a new Section 1520.5 to the California Unclaimed Property Law providing that any gift certificate that satisfies the consumer protection restrictions of Section 1749.5 is *not* subject to the general escheat provision in the Unclaimed Property Law.[27] Section 1520.5 is in effect an exemption for gift card breakage. It appears that the California Legislature recognized that if it was going to require that issuers of gift cards honor the balances on the gift cards in perpetuity (by prohibiting expiration dates on the gift cards), it would be inappropriate for California to claim custody of the gift card breakage funds that the issuer would need in the event that the gift cards were redeemed.

As of January 1, 2004, Section 1749.5 was amended to generally provide that it is also unlawful to sell a gift certificate with "a service fee, including, but not limited to, a service fee for dormancy."[28] An exception

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was provided for a *de minimis* $1 per month fee to be deducted from gift card balances of $5 or less that have not been utilized for 24 consecutive months.[29] This rule was added to the California consumer protection laws in response to *Freeman v. Wal-Mart Stores, Inc.*,[30] which had held that Wal-Mart was not violating the Section 1749.5 prohibition on expiration dates by deducting a $1.00 per month service fee from Wal-Mart shopping card balances that had not been utilized for 24 consecutive months because the California Court of Appeals found that the service fee provision was neither an indirect expiration date nor unconscionable.

Thus, as the law currently stands in California, gift cards generally may not have expiration dates or dormancy service fee provisions, but the breakage on such "consumer friendly" gift cards does not escheat to the state either. Because California is the most populous state in the country, most national retailers have chosen to forego imposing expiration dates and dormancy service fees on their gift cards in order to have one type of gift card that complies with the consumer protection laws of all the states. If a retailer were to attempt to market two types of gift cards, one gift card with an expiration date or dormancy service fee provision that could be sold in states that allow such provisions, and the other gift card without an expiration date or dormancy service fee provision for sale in California, it probably would prove to be impractical, and the retailer might end up having to waive the expiration date and dormancy service fee provisions anyway. For example, if a gift card with an expiration date or dormancy service fee provision were given to a recipient who lives in California, or the owner of such a gift card were to redeem it at a store in California, it is likely that the California Attorney General would contend that the California consumer protection laws apply to the gift card.

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Other State Consumer Protection Laws for Gift Cards

The California consumer protection law prohibitions on expiration dates and dormancy service fees on gift cards quickly became commonplace, as other states adopted similar legislation. The political appeal of such legislation was irresistible, as state legislators railed against the unfairness of their constituents losing the value of their gift cards because of their failure to use them in a more timely manner. Retailers would risk suffering a consumer backlash if they opposed the enactment of these consumer protection laws. It was also not lost on retailers that they would benefit from the gift card breakage exemptions that were frequently included in the gift card legislation.

As a result of this legislative activity, at least 10 states, including California, Connecticut, Florida, Maine, Minnesota, Montana, New Hampshire, Oregon, Rhode Island and Washington State, prohibit expiration dates and dormancy service fees altogether on gift cards.[31]

The consumer protection laws of a second group of states, including Hawaii, Illinois, Louisiana, Massachusetts, Michigan, New Mexico, North Dakota and Oklahoma, specify a minimum expiration period on gift cards, while prohibiting dormancy service fees altogether on gift cards.[32]

A third group of states, including Arkansas, Kentucky, Maryland, New Jersey, Ohio and Tennessee, specify a minimum period within which a gift card may not either expire or be depleted by deductions for dormancy service charges.[33]

Kansas prohibits expiration periods of less than five years on gift cards and deductions of dormancy service fees from gift card balances within the first 12 months.[34]

Nevada, New York, North Carolina and Texas prohibit dormancy service fees from being deducted from gift card balances within the initial 12 months after the sale of the gift card, while allowing a properly disclosed expiration period of any duration on the gift card.[35]

The Vermont consumer protection laws require that the expiration period on a gift card be at least three years without addressing dormancy service fees.[36]

A number of other states have enacted consumer protection laws that authorize expiration periods and/or dormancy service fee provisions on gift cards as long as they are adequately disclosed to the purchaser and owner of the gift card.[37]

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Another recent trend has been for states to require issuers of gift cards to offer consumers a cash refund of the small balances remaining on their gift cards. So far, California, Maine, Massachusetts, Rhode Island, Vermont and Washington have enacted such cash-out rules.[38] The general rule remains, however, that gift cards are redeemable for merchandise or services, not cash.

State Unclaimed Property Exemptions for Gift Cards

As mentioned earlier, many of the state consumer protection laws on gift card expiration dates and dormancy service fees were enacted in conjunction with an unclaimed property exemption for gift cards that comply with the consumer protection limitations. When these exemptions are added to the exemptions of other states that are *not* conditioned on the gift card being "consumer friendly," the majority of the states currently do not claim custody of gift card breakage. Indeed, more than 30 states, including Alabama, Arizona, Arkansas, California, Colorado, Connecticut, Florida, Idaho, Illinois, Indiana, Kansas, Maryland, Massachusetts, Michigan, Minnesota, Montana, Nebraska, Nevada, New Hampshire, New Jersey, North Carolina, North Dakota, Ohio, Oregon, Pennsylvania, Rhode Island, South Carolina, Tennessee, Texas, Utah, Virginia, Washington, Wisconsin and Wyoming, now exempt breakage on gift cards, at least if the gift card was issued by a retailer of tangible personal property and the gift card does not have an expiration date or dormancy service fee provision.[39] This list includes all of the major states except for New York, which presumes gift card breakage abandoned, at its face value, after five years.[40]

> The tax treatment of gift card receipts depends upon whether they are properly characterized as an advance payment for goods or services or as deposits.

Another six or eight states, including Delaware, require a holder to report only a portion of the value of unredeemed merchandise-only gift certificate or gift cards as unclaimed property.[41]

There are some nuances to these state gift card exemptions. For example, the Alabama and Arkansas exemption statutes make reference to the gift card being issued by "a person primarily engaged in selling tangible personal property at retail."[42] This language raises a question as to whether breakage on gift cards issued by a special purpose gift card subsidiary of the retailer would qualify for the Alabama and Arkansas unclaimed property exemptions, although the abandoned property administrators of those two states have not appeared to take that position. It probably would be difficult for a financial institution or other company issuing "open loop" gift cards to claim the benefit of the Alabama and Arkansas exemption because these types of gift card issuers would not be viewed as retailers within the commonly understood meaning of that term. Similarly, the new Florida gift card exemption does not apply to gift cards issued by financial institutions or money transmitters.[43]

According to an opinion of the Colorado Attorney General, reloadable gift cards are not considered to be "gift certificates" that could qualify for the Colorado gift card exemption.[44] If other states adopt this position, it would significantly restrict the application of unclaimed property gift card exemptions because many retailer gift cards are capable of being reloaded with additional value. It should be pointed out, however, that many state gift card statutes provide a definition of "gift certificate" that would appear to include reloadable gift cards, so Colorado may ultimately turn out to be the exception to the rule.

Gift Cards Issued by Financial Institutions

The National Bank Act provides that a federally chartered bank shall have the power to "exercise by its board of directors or duly authorized officers or agents, subject to law, all such incidental powers as shall be necessary to carry out the business of banking,"[45] and the federal Office of the Comptroller of the Currency (the "OCC"), which regulates federally chartered banks, has issued guidelines requiring the disclosure of expiration dates and administrative fees on gift cards issued and sold by federally chartered banks.[46] The OCC expects issuers and sellers of gift cards to make disclosures in materials accompanying the sale of the gift card of (1) the name of the card-issuing bank; (2) fees not disclosed on the face of the gift card; (3) the procedures for obtaining a replacement gift card; (4) any restrictions on use of the gift card; (5) instances in which purchase authorization may be denied; (6) the importance of tracking the remaining card balance; (7) whether the gift card

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may be used in transactions with a price exceeding the remaining card value and, if not, how the remaining card value can be redeemed; (8) information on how the dispute resolution process is initiated; and (9) information regarding any existing policies of the financial institution for revoking or changing the terms of the gift card.[47]

Similarly, the federal Home Owners' Loan Act,[48] as interpreted by the federal Office of Thrift Supervision (the "OTS"), allows expiration dates and service fees on the gift cards issued by federally chartered savings and loan associations as long as gift card's terms and conditions are adequately disclosed to the consumer.[49]

A detailed discussion of the preemptive effect of these federal statutes and regulations on the application of state consumer protection laws and abandoned property laws to gift cards issued by federally chartered financial institutions is beyond the scope of this article.[50] However, the First Circuit and Second Circuit Court of Appeals did conclude in *SPGGC, LLC v. Ayotte*[51] and *SPGGC, LLC v. Blumenthal*[52] that state gift card law limitations on expiration dates and dormancy service fees would *not* apply to the extent that the federally chartered financial institution was receiving the benefit of the breakage or deducted service fees on the gift cards.

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Federal Income Tax Issues for Gift Cards

As a result of the increasing volume of gift card sales and confusion as to the proper tax reporting, the IRS is paying increased attention to a variety of federal income tax issues related to the issuance of gift cards. While much of the basic authority is this area is not new, there remain a number of open issues, especially as it applies to the issuance of gift cards by separate gift card subsidiaries and/or financial institutions.

A threshold issue in the tax treatment of gift card receipts is whether such receipts constitute advance payments for goods and services, and thus, are includible in gross income, or whether such amounts represent nontaxable deposits. As discussed below, notwithstanding taxpayer arguments to the contrary, the IRS has generally taken the position that gift card receipts are taxable as advance payments for goods and services.

Assuming that gift card revenues constitute advance payments for goods or services, the question then is whether the gift card issuer must recognize gift card revenues upon receipt or may defer their recognition until a later year. In general, the IRS seems to be of the view that a taxpayer may only defer recognition of its gift card revenues if it satisfies the requirements of Reg. §1.451-5 or Rev. Proc. 2004-34. As discussed below, the ability of separate gift card subsidiaries and/or financial institutions to qualify for these deferral regimes is subject to debate. Moreover, some taxpayers have sought to defer recognition beyond the period prescribed by these authorities where the unredeemed gift card balances will escheat to the state, arguing that in this situation they should not be required to recognize income until the earlier of the date of the redemption of the gift card or when the unredeemed gift card balances will be reported and delivered as unclaimed property to the state.

Treatment of Gift Card Receipts as Income

The tax treatment of gift card receipts depends upon whether they are properly characterized as an advance payment for goods or services or as deposits. In general, subject to limited deferral rules, a taxpayer is required to take advance payments for goods or services into income in the tax year in which the advance payments are received.[53]

On the other hand, deposits are generally not includible in income. The distinction between advance payments and deposits depends upon the facts and circumstances. However, a key issue is the nature of the rights and obligations that the issuer assumes when the gift cards are issued.

The leading case distinguishing advance payments from deposits is *Indianapolis Power & Light Co.*[54] In *Indianapolis Power & Light*, the Supreme Court considered the question of whether customer deposits held by the taxpayer, a regulated utility, to assure prompt payment of electric bills by certain of its customers represented advance payments for electric service, in which case the customer deposits would be includible in income upon receipt. The deposits in question were required from customers whose credit was poor, the deposits paid interest if held for six months or more, and they were refundable to the customer prior to termination of service if the customer demonstrated an acceptable level of credit. The Supreme Court concluded in *Indianapolis Power & Light* that the customer deposits did *not* constitute advance payments for electric service, noting that the utility did not have complete dominion over such deposits but rather was required to refund the deposits either at the time that service was termi-

nated or when the customer established good credit. Distinguishing the deposits in question from advance payments, the Supreme Court stated that: "[t]he individual who makes an advance payment retains no right to insist upon the return of the funds; so long as the recipient fulfills the terms of the bargain, the money is its to keep." The Supreme Court went on to explain, however, that "[t]he customer who submits a deposit to the utility . . . retains the right to insist upon repayment in cash; he may *choose* to apply the money to the purchase of electricity but he assumes no obligation to do so, and the utility therefore acquires no unfettered 'dominion' over the money at the time of receipt."[55]

The IRS generally takes the position that gift card revenues are *not* deposits that would be excludable from the income of the gift card issuer. In the IRS's recently issued FAA 20082801F,[56] the taxpayer was a separate gift card subsidiary that was formed to manage a gift card program on behalf of its parent corporation. The gift cards issued by the gift card subsidiary were sold at participating retail stores that were owned by the parent corporation or third parties. The gift cards were nonrefundable, did not expire and did not accrue service fees. When a gift card was sold at a participating retail store, the store was contractually obligated to remit the proceeds of the gift card sales transaction to the gift card subsidiary; when a gift card was redeemed by its owner in a purchase transaction at a participating retail store, the gift card subsidiary was contractually obligated to reimburse the retail store for the amount of the gift card balance that the retail store had credited to the price of the merchandise purchased at the retail store.

The gift card subsidiary in FAA 20082801F sought to rely on *Indianapolis Power & Light* to support its position that its gift card revenues did not have to be included in gross income. However, the IRS rejected this argument, concluding that even though the amounts that the gift card subsidiary had received from the sale of its gift cards were subject to the possibility of return (to the extent that that gift cards were redeemed), the gift card receipts were not placed out of the control of the gift card subsidiary and, for that reason, they were includible in the gift card subsidiary's gross income. In reaching this conclusion, the IRS cited *North American Oil Consolidated v. Burnet*[57] for the proposition that amounts received under a claim of right and without restriction to their disposition constitute income in the year of receipt, even though the taxpayer might ultimately be required to restore an equivalent amount.

The IRS reaffirmed its position in a recently issued IDD addressing gift card issues.[58] The IDD notes that most gift cards state that they may be used towards the purchase of products from the taxpayer and are not exchangeable for cash, and the IDD then goes on to state that "[t]he fact that a customer may subsequently receive the remaining balance on a card in cash upon his redemption of the gift card/certificate, in violation of the card/certificate's written terms, does not change the character of the gift card/certificate income as an advance payment." If a taxpayer has treated gift card sales revenues as deposits that are excludible from gross income, the IDD requires the auditor to bring this issue to the attention of the IRS's technical advisers.[59]

Rev. Proc. 2004-34 provides an alternative deferral method for advance payments received by certain accrual method taxpayers.

Based upon the foregoing analysis, gift card issuers who seek to exclude gift card sales receipts from income under the authority of *Indianapolis Power & Light* should expect the IRS to challenge this position on audit, at least in those situations where the gift card by its terms is redeemable only for goods or services and not for cash.[60]

Deferral Rules for Gift Card Revenues

In general, under an accrual method of accounting, revenues are includable in gross income when all the events have occurred that fix the right to receive them and the amount thereof can be determined with reasonable accuracy.[61] Notwithstanding the foregoing general rule, the IRS has repeatedly taken the position that advance payments for goods or services are reportable by an accrual method taxpayer when received, if receipt occurs prior to the time that such payments would otherwise be accrued.[62]

However, the IRS has issued administrative guidance allowing for the deferred recognition of advance payments in two situations, as discussed below. While these authorities generally would allow the deferral of gift card revenues received by issuers who hold title to the goods used to redeem the gift cards,

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their applicability to gift card revenues received by a separate gift card subsidiary and/or with respect to gift cards issued by a financial institution is somewhat more problematic.

Deferral of Gift Card Revenues Under Reg. §1.451-5

Under certain conditions, Reg. §1.451-5 permits the deferred recognition as income of advance payments received for goods held for sale in the ordinary course of the taxpayer's trade or business.[63] In general, such advance payments can be included in income in the tax year in which they are properly accruable under the taxpayer's method of accounting for tax purposes if such method results in the advance payments being included in gross receipts no later than the time that such advance payments are included in gross receipts for purposes of the taxpayer's financial reports.[64]

However, where a taxpayer receives substantial[65] advance payments with respect to an agreement (such as a gift card or gift certificate) that can be satisfied with goods that cannot be identified in such tax year, and the taxpayer has on hand (or available to him through his normal source of supply) goods in sufficient quantity to satisfy the agreement, then all advance payments received with respect to such agreement that have not previously been included in income in accordance with the taxpayer's accrual method of accounting must be included in income no later than in the second tax year following the year in which the substantial advance payments were received.[66]

For purposes of Reg. §1.451-5, "advance payments" are defined as "amounts received . . . for purchases and sales pursuant to . . . an agreement for the sale or other disposition . . . of goods *held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.*"[67] Consequently, while a merchant that issues gift cards redeemable for its own merchandise could defer recognition of gift card revenues under Reg. §1.451-5 if it elects such accounting method, it would appear that a separate gift card subsidiary and/or a financial institution would not be allowed to account for its gift card revenues as "advance payments" reportable under Reg. §1.451-5(a)(1). This is because the gift card subsidiary or financial institution does not directly own the inventory of merchandise for which the gift cards that it issues may be redeemed.

Although there is limited authority on this issue, that which exists supports the above conclusion. In the FAA 20082801F discussed earlier,[68] the IRS addressed the issue of whether a separate gift card subsidiary would be entitled to defer recognition of gift card revenues for the two-year deferral period provided in Reg. §1.451-5. In this FAA, a parent corporation formed a wholly owned subsidiary to manage its gift card sales. Gift cards were sold at participating parent–and independently owned retail stores, all of which did business under the parent's trade name. Under the gift card program, participating retailers were obligated to remit the gift card sales proceeds to the gift card subsidiary and when a gift card was redeemed, the gift card subsidiary was contractually obligated to transfer the amount of the purchase to the retailer where the merchandise was purchased. Based upon these facts, the IRS concluded that the gift card subsidiary did *not* qualify for the deferral under Reg. §1.451-5 because the subsidiary would not be redeeming gift cards with its own goods held for sale—rather the subsidiary would be transferring cash to the retailer that made the sale of its goods and accepted the balance on the gift card as payment for the goods.

Likewise, in *Straight v. Commissioner,*[69] the Tax Court held that an accrual basis taxpayer that received customer deposits in connection with its sale of panelized house kits could not defer reporting such deposits under Reg. §1.451-5. In so holding, the Tax Court noted that the house kits were manufactured by a related corporation and shipped directly to taxpayer's customers without the taxpayer taking title to the house kits. Because the house kits were not inventory of the taxpayer held for sale to its customers, the Tax Court concluded that the deposits were not advance payments that would be eligible for deferral under Reg. §1.451-5.

While most practitioners would probably agree with the conclusion that a taxpayer who did not acquire title to the goods used to redeem its gift card is not entitled to defer recognition of gift card revenues under Reg. §1.451-5, it is less clear whether there is a similar requirement in Rev. Proc. 2004-34, discussed below.

Deferral of Gift Card Revenues Under Rev. Proc. 2004-34

Rev. Proc. 2004-34 provides an alternative deferral method for advance payments received by certain accrual method taxpayers.[70] In general, under Rev. Proc. 2004-34, qualifying taxpayers are allowed, for federal income tax purposes, to defer the recognition of certain advance payments for goods and services

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for up to one year (*i.e.,* until the tax year immediately following the tax year in which the advance payment is received) if the taxpayer's recognition of such amounts is deferred for at least as long in the taxpayer's "applicable financial statement."[71]

For purposes of Rev. Proc. 2004-34, the term "advance payment" includes, among other things, a payment for services, for the sale of goods (other than for the sale of goods with respect to which the taxpayer uses a method of deferral provided in Reg. §1.451-5(b)(1)(ii)), or for some combination thereof, but an "advance payment" does *not* include, among other things, payments with respect to financial instruments (*e.g.,* debt instruments, deposits, letters of credit, credit card agreements).

Unlike the definition of advance payments in Reg. §1.451-5, an advance payment for a sale of goods under Rev. Proc. 2004-34 does not *specifically* require that the goods be held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business. The absence of this requirement suggests that advance payments received with respect to the sale of gift cards issued by separate gift card companies or financial institutions that do not hold title to the goods used to redeem such cards might qualify for the one-year deferral period provided by Rev. Proc. 2004-34 (assuming that all other requirements are met). In FAA 20082801F, the IRS appeared to leave open the possibility that the sales proceeds of gift cards issued by a retailer's special purpose gift card subsidiary could qualify for the one-year deferral under Rev. Proc. 2004-34 if the gift card subsidiary had historical data to show when its gift card revenues were includible in its financial statements.[72]

Issuers of gift cards face significant state unclaimed property and consumer protection compliance issues.

However, informal conversations that the authors have had with certain IRS personnel and the recently issued IDD suggest that the IRS is considering taking the position that the entity issuing the gift cards must have goods for sale in the ordinary course of its trade or business in order to be eligible to defer gift card revenues under both Reg. §1.451-5 and Rev. Proc. 2004-34. The IDD does not resolve the issue of whether a gift card subsidiary may qualify for the one-year deferral under Rev. Proc. 2004-34, but does identify the primary gift card subsidiary issue as whether the subsidiary has goods for sale in the ordinary course of its trade or business and thus is eligible to elect deferral under either Reg. §1.451-5 or Rev. Proc. 2004-34; a revenue agent who identifies a gift card subsidiary issue is required to raise it on audit and to contact IRS technical advisers for coordination of the issue.

In order to qualify under Rev. Proc. 2004-34, the taxpayer must also be able to determine the extent to which advance payments are recognized as revenues in its applicable financial statement in the tax year of receipt (or, if the taxpayer does not have an applicable financial statement, the extent to which advance payments are earned). If the taxpayer is unable to determine the extent to which a payment is earned in the tax year of receipt, the taxpayer may determine the amount on a statistical basis if adequate data is available to the taxpayer. The Rev. Proc. provides the following examples to illustrate these rules.

> F, a hair styling salon, receives advance payments for gift cards that may later be redeemed at the salon for hair styling services or hair care products. The gift cards may not be redeemed for cash and have no expiration date. In its applicable financial statement, F recognizes advance payments for gift cards in revenues when redeemed. F is not able to determine the extent to which advance payments are recognized in revenues in its applicable financial statement for the year of receipt. Furthermore, F does not determine the extent to which payments are earned for the tax year of receipt. Accordingly, F may not use the deferral method of Rev. Proc. 2004-34 for these advance payments.
>
> Assume the same facts as above, except that the gift cards expire 12 months after the date of sale. F does not accept expired gift cards and F recognizes unredeemed gift cards in revenues in its applicable financial statement for the tax year in which the cards expire. Because F tracks the sale date and the expiration date of the cards for purposes of its applicable financial statement, F is able to determine the extent to which advance payments are recognized in revenues for the tax year of receipt and is allowed to use the deferral method for these advance payments.[73]

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As noted above, FAA 20082801F illustrates the difficulty that a newly formed entity may experience in applying these rules to defer its recognition of gift card revenues as income. In this FAA, the IRS held that a newly formed gift card subsidiary was not entitled to defer recognition of gift card revenues under Rev. Proc. 2004-34 where it could not determine the extent to which the amounts received would be recognized as revenues in its applicable financial statement and, due to its brief existence, did not have adequate statistical data available.

Recognition of Gift Card Revenues that Will Have to Be Escheated to States

The interplay of the state unclaimed property rules and the tax accounting rules raises another issue, namely whether a taxpayer who will be required to escheat gift card breakage to a state can defer the recognition of the associated revenues as income beyond the deferral periods provided by Reg. §1.451-5 and Rev. Proc. 2004-34. The recent IDD indicates that some taxpayers have argued that, in this situation, they should not have to recognize income until the earlier of the date that the gift card balance is redeemed or when the gift card balances has to be reported and delivered to the state. Unfortunately, the IDD does not go on to address the issue.[74] However, for the reasons discussed below, it appears that a further deferral of gift card revenues is probably not available.

Reg. §1.451-5(c) provides that where a taxpayer receives substantial advance payments with respect to a gift card that can be satisfied with goods that cannot be identified in such tax year, and the taxpayer has on hand (or available to him through his normal source of supply) goods in sufficient quantity to satisfy purchases made with the gift card, then all advance payments received with respect to such gift card that have not previously been included in income in accordance with the taxpayer's accrual method of accounting must be included in income no later than in the second tax year following the year in which the substantial advance payments are received. The regulations provide no exception that would delay the recognition of gift card revenues until the date that the associated gift card breakage will have to be escheated to the states.

There is no case law specifically dealing with the recognition of gift card revenues that will escheat to the state. Although there are some authorities regarding the tax consequences of other types of escheatable unclaimed property which might be read to support a longer deferral period, such authorities are ultimately distinguishable. In *Bituminous Casualty Corp. v. Commissioner*,[75] the Tax Court considered whether the taxpayer, an insurance company, was required to restore to income all or any portion of its reserves for unpaid drafts and checks that had been issued in payment of claims and claim expenses. The drafts and checks in question were treated by the taxpayer as liabilities and not taken into income. Although most drafts and checks were cashed promptly, the taxpayer paid all drafts and checks no matter when they were presented for payment. Drafts and checks not presented for payment were subject to escheat. Based upon these facts, the Tax Court held that the taxpayer's reserve should not be disallowed because the taxpayer had a clear liability to pay the amounts reflected in the reserve either to the payee or to a state under the appropriate abandoned property laws.

Likewise in GCM 36076,[76] the IRS held that a stock brokerage firm was not required to take unclaimed dividends and interest into income where such amounts would escheat to the state if not claimed in five years. In so holding, the IRS noted that because the abandoned property laws in this case were self-executing, such dividends and interest represented a liability owed by the taxpayer to the state and, thus, all events had not occurred to fix the taxpayer's right to receive such items as income.

On the other hand, in *Fidelity-Philadelphia Trust Company*,[77] the Tax Court required the taxpayer to take unclaimed bank account funds into income where the taxpayer had transferred the unclaimed funds to its surplus account, indicating that such amounts probably would never be paid to the owners of the bank account funds, and also evidencing the taxpayer's dominion and control over the unclaimed funds. The Tax Court rejected the taxpayer's claim that it should not be required to recognize the bank account funds as income because the unclaimed amounts were subject to state abandoned property laws, noting that those laws were not self-executing and that no state had initiated a claim to the unclaimed funds. The Tax Court also noted that if the taxpayer were ultimately required to escheat the unclaimed funds in a subsequent year, it would be allowed to claim a deduction for the payment to the state in that tax year.

While the *Bituminous Casualty Corp.* case and GCM 36076 might lend some support for not re-

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quiring a gift card issuer to recognize income with respect to gift card receipts that the issuer will be have to report to a state, it has to be noted that those authorities did not involve advance payments. Instead, the reserves in *Bituminous Casualty Corp.* and the unclaimed dividend funds in GCM 36076 represented liabilities of the taxpayer that rightly should not have to be included in the taxpayer's income until the liability had ceased. In contrast, proceeds from the sales of gift cards belong to the issuer in a way that is not true of the types of unclaimed property involved in *Bituminous Casualty Corp.* and GCM 36076. Thus, the IRS considers gift card revenues to be advance payments (rather than deposits) that are includible in the issuer's income as provided for by Code Sec. 451, Reg. §1.451-5 and Rev. Proc. 2004-34. None of these authorities allow deferral until the time that the issuer is obligated to escheat the gift card breakage to a state. This well may be because Congress and the IRS did not think about state unclaimed property laws.

Conclusion

Issuers of gift cards face significant state unclaimed property and consumer protection compliance issues. While the issuer needs to determine what exposure it has to states to report and deliver breakage on the gift cards as unclaimed property, the issuer could have greater exposure for issuing gift cards with expiration periods or dormancy service charges that violate state consumer protection laws, particularly in a state like California whose consumer protection laws are frequently enforced by class action lawsuits. However, issuers of gift cards also have to come to grips with the income tax consequences of realizing gift card revenues. The IRS is focusing on these income tax issues, but it needs to provide a lot more guidance in this area.

Endnotes

* *The author gratefully acknowledges the contributions of partner Andrea M. Despotes and Kathleen A. Salzer of Neal, Gerber & Eisenberg LLP to this article.*

1 *See* Montgomery County, Maryland, Office of Consumer Protection, *Gift Cards 2007: Best and Worst Retail Cards; A Deeper View of Bank Cards Doesn't Improve Their Look* at p. 1 (Nov. 2007), available at *www.montgomerycountymd.gov/content/ocp/giftcards2007.final.pdf* (hereinafter referred to as the "Montgomery County Gift Card Report") (citing gift card sales estimates of The TowerGroup, a subsidiary of MasterCard).

2 *Id. See also* Philip Keitel, *The Laws, Regulations, Guidelines, and Industry Practices that Protect Consumers Who Use Gift Cards,* Federal Reserve Bank of Philadelphia (July 2008), available at *www.philadelphiafed.org/payment-cards-center/pubications/discussion-papers/2008/D2008JulyGiftCard.pdf* (hereinafter referred to as the "Federal Reserve Bank White Paper"), for a discussion of the types of gift cards that are being sold to consumers.

3 Nanette Byrnes, *The Scramble for Gift Card Cash,* Business Week at p.1 (Jan. 24, 2008).

4 *See* Montgomery County Gift Card Report at p. 1.

5 Rev. Proc. 2004-34, IRB 2004-22, 991, 2004-1 CB 991.

6 FAA 20082801F (dated Mar. 26, 2007, but published on July 15, 2008); Tier II Industry Director's Directive on the Planning and Examination of Gift Card/Certificate Issues in the Retail and Food & Beverage Industries # 2, LMSB Control No. 4-0808-042 (Oct. 3, 2008).

7 Statutory dormancy periods vary by state and by the type of unclaimed property at issue. These periods currently range from as short as one year for uncashed payroll checks to three to five (or even fifteen) years for other types of unclaimed property. The trend has been for states to adopt shorter dormancy periods in order to accelerate the holder's reporting of unclaimed property to the state.

8 The three uniform acts are the 1954 Uniform Disposition of Unclaimed Property Act, which was revised in 1966, the 1981 Uniform Unclaimed Property Act and the 1995 Uniform Unclaimed Property Act.

9 1981 Uniform Act §2(a).

10 1995 Uniform Act §§1(13) and 2(a).

11 Section 1(10) of the 1981 Uniform Act provides a typical list of examples of "intangible property" that escheats to the state, which includes monies, checks, drafts, deposits, interest, dividends, credit balances, customer overpayments, gift certificates, security deposits, refunds, credit memos, unpaid wages, unused airline tickets, unidentified remittances, stocks and other intangible ownership interests in business associations, monies deposited to redeem or make distributions with respect to stocks, bonds, coupons and other securities, amounts due and payable under the terms of insurance policies, and amounts payable under employee retirement and other benefit plans. Section 1(13) of the 1995 Uniform Act provides similar examples of "property" that escheats under its provisions.

12 1981 Uniform Act §14(a) and (b).

13 1995 Uniform Act §2(7).

14 *Id.*

15 Del. Code tit. 12, §1198(8).

16 *Texas v. New Jersey*, SCt, 379 US 674, 85 SCt 626 (1965).

17 *Delaware v. New York*, SCt, 507 US 490, 113 SCt 1550 (1993).

18 Under Section 1(11) of the 1981 Uniform Act, an owner's last-known address is an address that is sufficient to deliver mail to the owner. The 1995 Uniform Act relaxes this rule to require only some indication in the holder's records that the owner's last-known address was located in a particular state. *See* Commissioners' Comment to Section 1 of the 1995 Uniform Act. Under the Supreme Court's priority rule case law, the state where the transaction occurred that gave rise to the abandoned property may not presume that it also is the state of the owner's last-known address. *See Pennsylvania v. New York,* 407 U.S. 206 (1972).

19 The 1981 and 1995 Uniform Acts have added a third priority rule, the so-called "transactional rule," which allows the state where the transaction occurred that gave rise to the abandoned property to claim the property if neither the state of the owner's last-known address nor the holder's state of corporate domicile will lay claim to the property under its abandoned property laws. *See* 1995 Uniform Act §4(6); 1981 Uniform Act §3(6). The Supreme Court declined to adopt the transactional rule in *Texas v. New Jersey*, and the courts have not yet addressed the validity of the transactional rule.

20 1981 Uniform Act §29(a). Section 19(a) of the 1995 Uniform Act includes a similar anti-limitations provision.

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Endnotes

[21] *People v. Marshall Field & Co.*, Ill. App., 83 IllApp 3d 811, 404 NE2d 368 (1980).

[22] Del. Code tit. 12, §1198(8).

[23] Section 5 of the 1995 Uniform Act authorizes dormancy service charges if these three requirements are satisfied, while the 1981 Uniform Act applied these three requirements to certain types of unclaimed property such as funds in dormant bank accounts and uncashed bank checks, traveler's checks and money orders. *See* 1981 Uniform Act §§4(c), 5(b) and 6(c). In addition, a number of other 1981 Uniform Act provisions allowed "lawful charges" to be deducted from the value of unclaimed property reported and remitted to the state. *See, e.g.,* 1981 Uniform Act §2(a).

In *Freeman v. Wal-Mart Stores, Inc.,* 111 Cal. App. 4th 660 (2003), the California Court of Appeals held that the retailer's dormancy service fee provision on its gift cards was not the functional equivalent of an expiration date, which would have been prohibited by the California consumer protection statutes.

[24] Cal. Civ. Code §1749.5

[25] Cal. Civ. Code §1749.5(c).

[26] *Id.*

[27] Cal. Civ. Proc. Code §1520.5.

[28] Cal. Civ. Code §1749.5(a)(2).

[29] Cal. Civ. Code §1749.5(e).

[30] *Freeman v. Wal-Mart Stores, Inc.,* Cal. App., 111 Cal. App. 4th 660, 3 Cal. Rptr. 3d 860 (2003).

[31] *See* Cal. Civ. Code §1749.5 (with certain exceptions, expiration periods and dormancy service fees on gift cards are generally prohibited); Conn. Gen. Stat. §§42-460 and 3-65c (expiration dates and dormancy service fees on gift cards are prohibited); Fla. Stat. §501.95 (with certain exceptions, expiration dates and dormancy service fees on gift cards are prohibited); Me. Rev. Stat. tit. 33, §1953(1)(G) (expiration dates and dormancy service fees on gift cards are prohibited); Minn. Stat. §325G.53 (prohibits expiration dates or dormancy service fees on gift cards); Mont. Code §30-14-108 (no expiration dates or dormancy service fees on gift cards); N.H. Rev. Stat. §358-A:2, XIII (no expiration dates on gift cards with a value of $100 or less and no dormancy service fees on a gift card regardless of its value); Ore. Rev. Stat. §646.608 (no expiration dates or dormancy service fees on gift cards); R.I. Gen. Laws §6-13-12 (prohibits expiration dates and dormancy service fees on gift cards); Wash. Rev. Code §19.240.020 (generally prohibits expiration dates and dormancy service fees on gift cards).

[32] *See* Haw. Rev. Stat. §481B-13 (expiration period on gift cards cannot be shorter than two years); 765 ILCS 505/2SS (expiration period on gift cards cannot be less than five years); La. Rev. Stat. §51:1423 (five-year minimum expiration period on gift cards); Mass. Gen. Laws ch. 266, §75C; Mass. Gen. Laws ch. 200A, §15D, 15E and 15F (expiration period on gift cards may not be less than seven years); Mich. Comp. Laws §§445.903f and 445.903g (expiration period on gift cards cannot be less than five years); 2007 N.M. Chapter 125 (expiration period on gift cards cannot be less than 60 months); N.D. Cent. Code §51-29-02 (no expiration period of less than six years on gift cards); Okla. Stat. tit. 15, §797 (no expiration period of less than 60 months on gift cards).

[33] *See* Ark. Code §44-7402 (two years); Ky. Rev. Stat. §367.890 (one year); Md. Com. Law Code §14-1319 (four years); N.J. Rev. Stat. 56:8-110 (two years); Ohio Rev. Code §1349.61 (two years); Tenn. Code §47-18-127 (two years).

[34] Kan. Stat. §50-6,108.

[35] Nev. Rev. Stat. §598.0921(1)(a) and (b); N.Y. Gen. Business Law §396-i; N.C. Gen. Stat. §66-67.5; Tex. Business & Commerce Code ch. 604.

[36] Vt. Stat. tit. 8, §§2701-2711.

[37] *See, e.g.,* Ariz. Rev. Stat. §44-7402; Ga. Code §10-1-393(b)(33); N.Y. Gen. Business Law §396-i; Utah Code §§13-11-4(2)(v), (4)(a) and (4)(b); Va. Code §59.1-531.

[38] *See* Cal. Civ. Code §1749.5(b)(2) (a gift certificate with a cash value of less than $10.00 is redeemable in cash for its cash value); Me. Rev. Stat. tit. 33, §1953(1)(G) (if gift obligation is redeemed in person and has a remaining balance of less than $5.00, the merchant must refund the remaining balance in cash if the consumer requests it); Mass. Gen. Laws ch. 200A, §5D (cash out requirements apply to (i) reloadable gift cards with a remaining balance of $5.00 or less and (ii) non-reloadable gift cards with a remaining balance of less than 10 percent of the original face value); R.I. Gen. Laws §6-13-12 (requires issuers of gift cards to cash out remaining balances of less than $1.00 on gift cards); Vt. Stat. tit. 8, §§2701-2711 (if the remaining balance on a gift card is less than $1.00, the remaining balance is redeemable in cash upon request of the consumer); Wash. Rev. Code §19.240.020(3) (gift card balances of less than $5.00 are redeemable for cash upon request of the consumer).

[39] *See* Ala. Code §35-12-73(b)(1); Ariz. Rev. Stat. §44-301(15); Ark. Stat. §18-28-201(13)(B); Cal. Civ. Proc. Code §1520.5; Colo. Rev. Stat. §38-13-108.4; Conn. Gen. Stat. §3-73a(e); Fla. Stat. §§717.1045 and 717.102; Idaho Code §14-502(2)(b) and (e) (gift certificates valued at $50 or less or having expiration dates are exempt); 765 ILCS 1025/10.6; Ind. Code §32-34-1-1(f); Kan. L. 1999, ch. 100; Md. Com. Law Code §17-10(m)(1); Mass. Gen. Laws, ch. 200A, §5D; Mich. Comp. Laws §567.235; Minn. Stat. §345.39, subd. 1; 2007 Mont. H.B. 755 (Montana does not escheat gift certificates if the holder sold no more than $200,000 of gift certificates the past fiscal year); Neb. Rev. Stat. §69-1305.03; Nev. Rev. Stat. §120A.520; N.H. Rev. Stat. §471-C:16 (gift certificates valued at $100 or less are exempt); *Matter of Nov. 8, 1996, Determination of State of New Jersey, Dept. of Treasury, Unclaimed Property Office*, N.J. Super, 309 N.J. Super. 272, 706 A2d 1177 (1998); N.C. Gen. Stat. §§116B-53(c)(8) and 116B-54(b); 1997 N.D. Laws 393; Ohio Rev. Code §169.01(B)(2)(d); 1997 Ore. Laws 416; H.B. 2591; 72 Pa. Cons. Stat. §1301.6(1); R.I. Gen. Laws §§33-21.1-1(10)(ii), 33-21.1-14; 2001 S.C. H.B. 3657; Tenn. Code §66-29-135; Tex. Prop. Code §72.1016; Utah Code §67-4a-211 (gift certificates valued at $25 or less are exempt); Va. Code §55-210.8:1; Wash. Rev. Code §63.29.140; Wis. Act 109 (2001); Wyo. Stat. §34-24-114 (gift certificates valued at $100 or less are exempt).

[40] N.Y. Abandoned Property Law §1315(1). In *In the Matter of Kimberley's A Day Spa, Ltd.,* N.Y. SCt, 810 NYS2d 616 (2006), the trial court held that New York could claim expired gift certificates as unclaimed property even though the gift certificates had expired before the five-year statutory dormancy period had run.

[41] Delaware requires the holder to report merchandise-only gift certificates at the holder's cost-of-goods sold value for the merchandise that would have been provided if the gift certificate had been redeemed (*i.e.,* the holder's gross profit margin is exempt). Del. Code, tit. 12., §1198(10). Maine, Missouri, Montana, New Mexico, North Carolina and Tennessee (for gift certificates with expiration dates), and West Virginia have adopted the 1995 Uniform Act provision that only treats 60 percent of the face value of an unredeemed gift certificate or gift card as unclaimed property. Me. Rev. Stat., tit. 33, §1953(1)(G); Mo. Rev. Stat. §447.505(5); Mont. Code §70-9-803(g); N.M. Stat. §7-8A-2(a)(7); N.C. Gen. Stat. §§116B-53(c)(8) and 116B-54(b); Tenn. Code §66-29-135; W. Va. Code §36-8-2(7).

[42] Ala. Code §35-12-73(b)(1); Ark. Code §18-28-201(13)(B).

[43] Fla. Stat. §717.1045.

[44] Colo. Atty Gen. Op. No. 05-01 (Apr. 13, 2005).

[45] National Bank Act, 12 USC §24, Seventh.

[46] OCC Bulletin 2006-34, *Gift Card Disclosures* (Aug. 14, 2006), *available at www.occ.treas.gov/ftp/bulletin/2006-34.doc*; OCC Bulletin No. 96-48, *Stored Value Card Systems* (Sept. 10, 1996), *available at www.occ.treas.gov/ftp/bulletin/96-48.txt*.

[47] OCC Bulletin 2006-34 at 2-3. The OCC guidelines on disclosures of terms and conditions for financial institution-issued gift cards are discussed in detail in the Federal Reserve Bank White Paper at pages 18-21.

[48] Home Owners' Loan Act, 12 USC §1461 *et seq.*

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ENDNOTES

[49] *Id.* at 535, *citing* Office of Thrift Supervision, *Gift Card Programs* (Feb. 28, 2007), *available at http://www.ots.treas.gov/docs/2/25254.pdf* at 2.

[50] For an in-depth discussion of this issue, *see* John A. Biek, *Federal Preemption Issues for Financial Institutions under State Abandoned Property and Consumer Protection Laws,* 21 J. TAX'N & REG. OF FIN. INSTITUTIONS 5 (Jan./Feb. 2008).

[51] *SPGGC, LLC v. Ayotte,* CA-1, 488 F3d 525 (2007), *aff'g* DC N.H., 443 FSupp2d 197 (2006).

[52] *SPGGC, LLC v. Blumenthal,* CA-2, 505 F.3d 183 (2007), *aff'g in part and vacating in part,* DC Conn., 408 FSupp2d 87 (2006).

[53] *See, e.g., M.E. Schlude,* SCt, 63-1 USTC ¶9284, 372 US 128, 83 SCt 601; *American Automobile Ass'n,* SCt, 61-2 USTC ¶9517, 367 US 687, 81 SCt 1727; *Automobile Club of Michigan v. Commissioner,* SCt, 57-1 USTC ¶9593, 353 US 180, 77 SCt 707.

[54] *Indianapolis Power & Light Co.,* SCt, 90-1 USTC ¶50,007, 493 US 203, 110 SCt 589 (1989).

[55] *Id.* at 212.

[56] FAA 20082801F (dated Mar. 26, 2007, but published on July 15, 2008).

[57] *North American Oil Consolidated v. Burnet,* SCt, 3 USTC ¶943, 286 US 417, 53 SCt 613 (1932).

[58] Tier II Industry Director's Directive on the Planning and Examination of Gift Card/Certificate Issues in the Retail and Food & Beverage Industries # 2, LMSB Control No. 4-0808-042 (Oct. 3, 2008).

[59] The IDD also identifies certain other issues that require referral to IRS technical advisers, including reloadable gift cards and deferral of unredeemed gift card income where such cards escheat to the state. In the case of reloadable gift cards, examining agents are instructed to determine whether the taxpayer's accounting system takes into account the actual dates when money is added to the card for purposes of the income deferral; thus, apparently, the deferral rules apply separately to each tranche of value added to a gift card. The IDD also raises (but does not resolve) the issue of whether a taxpayer who will be required to escheat gift card breakage to a state may defer recognition of such income until the earlier of the date that the gift card is redeemed or when the breakage is delivered as unclaimed property to the state.

[60] Where the gift cards are redeemable for cash, an argument may be made that there is no income recognized upon their sale. *See, e.g.,* LTR 9743037 (July 28, 1997) (sales and exchanges of electronic cash cards for U.S. dollars did not give rise to taxable income where the electronic money was sold and redeemed at par).

[61] Reg. §1.451-1(a).

[62] This treatment of advance payments for tax purposes is distinctly different from their treatment for financial accounting purposes. In general, for financial accounting purposes, income is not recognized until the good or services are provided.

[63] Reg. §1.451-5.

[64] Reg. §1.451-5(b)(1).

[65] For purposes of this rule, advance payments received in a tax year with respect to a gift card are automatically treated as "substantial" if the goods or type of goods to be sold are not identifiable in the year in which the gift card is sold.

[66] Reg. §1.451-5(c).

[67] Reg. §1.451-5(a)(1) (emphasis added).

[68] FAA 20082801F (dated Mar. 26, 2007, but published on July 15, 2008).

[69] *D.K. Straight,* 74 TCM 1457, Dec. 52,417(M), TC Memo. 1997-569.

[70] Rev. Proc. 2004-34, IRB 2004-22, 991, 2004-1 CB 991.

[71] For this purpose, a taxpayer's applicable financial statement includes (1) a financial statement required to be filed with the Securities and Exchange Commission ("SEC") (*e.g.,* a 10-K or annual statement to shareholders) and (2) a certified audited financial statement that is accompanied by the report of an independent certified public accountant that is used for credit purposes, reporting to shareholders or any other substantial non-tax purpose, or (3) a financial statement (other than a tax return) required to be provided to the federal or state government or any federal or state agency (other than the SEC or the IRS).

[72] As discussed below, the IRS concluded that because the gift card subsidiary at issue in FAA 20082801F did not have that data, it was required to recognize its gift card revenues as income for federal income tax purposes for the tax year in which the gift cards were sold.

[73] Rev. Proc. 2004-34, IRB 2004-22, 991, 2004-1 CB 991, section 5.03, examples 7 and 8.

[74] The IRS's guidance in the IDD is opaque, stating, "Some taxpayers argue that since they have to either redeem the gift card/certificate or escheat the balances to a state, they should not recognize income until the earlier of those two events. The technical advisor can help you determine whether this position comports with the income deferral methodology under Treas. Reg. §1.451-5." *Tier II Industry Director's Directive on the Planning and Examination of Gift Card/Certificate Issues in the Retail and Food & Beverage Industries # 2,* LMSB Control No. 4-0808-042 (Oct. 3, 2008).

[75] *Bituminous Casualty Corp. v. Commissioner,* 57 TC 58, Dec. 31,031, *acq.* 1973-2 CB 1 (1971).

[76] GCM 36076 (Nov. 11, 1974).

[77] *Fidelity-Philadelphia Tr. Co.,* 23 TC 527, Dec. 20,727 (1954).

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