TAX ISSUES WITH CUSTOMER LOYALTY/REWARD PROGRAMS

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Overview

Many companies, including agribusiness retailers, utilize customer loyalty programs as a means of attracting and keeping customers. Under the typical program, each time a customer or "member" buys a product or service, the customer earns "reward points." The reward points accumulate and are computed as a percentage of the customer's purchases. When accumulated points reach a designated threshold, they can then be used to buy an item from the retailer or can be used as a discount on a subsequent purchase (e.g., cents per gallon of off a fuel purchase). Some programs make be structured such that a reward card is given to the customer after purchases have reached the threshold amount. The reward card typically has no cash value and expires within a year of being issued.

A "loyalty rewards" program is a cost to the retailer and a benefit to the customer, triggering tax issues for both.

Tax issues associated with customer "loyalty" programs – it's the topic of today's post.

Treasury Regulations – Impact on Retailers

When is economic performance? Treasury Regulation §1.461-4(g)(3) addresses the treatment of rebates and refunds and specifies that economic performance occurs when payment is made to the person to whom the liability is owed. The IRS position is that a retailer cannot claim a deduction until the points are actually redeemed because the event fixing the retailer's liability occurs when a member reaches the minimum number of points for redemption *and* actually redeems the points. *Internal Revenue Manual 4.43.1.12.6.5(5); Priv. Ltr. Rul. 200849015 (Dec. 5, 2008).* But, for an accrual basis taxpayer, the taxpayer's liability becomes fixed (and, hence, a deduction can be claimed) when the customers earn the rewards. *Giant Eagle, Inc. v. Comr., 822 F.3d 666 (3d Cir. 2016), rev'g., T.C. Memo. 2014-146.* A deduction is not deferred until the customer redeems the rewards.

Note: The IRS does not agree on this point and only follows the Third Circuit's decision in cases appealable to the Third Circuit that cannot be distinguished. *A.O.D. 2016-03 (Oct. 3, 2016).*

Two requirements. Treasury Regulation §1.451-4 addresses trading stamps and premium coupons that are issued with sales and are redeemable in cash, merchandise or "other property." Most retailer customer loyalty programs likely satisfy both tests. The National Office of IRS, in a matter involving an accrual basis supermarket chain that had a rewards program that allowed customers to get a certain amount of gas for free depending on purchases of products, said that the supermarket could take a current deduction for the value of the gas rewards. *F.S.A. 20180101F (Nov. 7, 2017).* The IRS reached that result by concluding that the gas rewards were being redeemed for "other property." *Treas. Reg. §1,451-4(a)(1).* Clearly, the rewards were issued on the basis of purchases.

Loyalty reward programs that might not satisfy the "redeemable in cash, merchandise or other property test" might be programs that provide customers with cents-off coupons. With these programs, the IRS could argue that a customer's right to redeem the coupon is conditioned on a future purchase and, as a result, the coupon liability should be matched to the later sale when the liability becomes fixed and determinable and economic performance occurs. *I.R.C. §461.*

Timing of deduction. The regulation provides that the estimated redemption costs of premium coupons issued in connection with the sale of merchandise is deductible *in the year of the merchandise sale*, even though the reserves for future estimated redemption costs are not fixed and determinable and don't otherwise meet the economic performance rules of the all-events test. *Internal Revenue Manual 4.43.1.12.6.5(4).*

Retailers with loyalty programs that satisfy the two tests of Treas. Reg. §1.451-4 may find the use of this method preferential from a tax standpoint. For retailers that can qualify but are not presently using the Treas. Reg. §1.451-4 approach, a method change is required. The method change is achieved by using the advance consent procedures of Rev. Proc. 97-27. 1997-1 C.B. 680. If a loyalty program does not meet the requirements to use Treas. Reg. §451-4, the redemption liability is treated as a deduction and not as an exclusion from income. Thus, the redemption liability is taken into account in the tax year in which the liability becomes fixed and determinable and economic performance occurs under I.R.C. §461. That will, in general, be the year in which the customer redeems the loyalty rewards.

Tax Issues for Customers

Anikeev, et ux. v. Comr., T.C. Memo. 2021-23

In 2021, the Tax Court issued an opinion providing guidance on how a taxpayer, as a user of a rewards program is to report the transactions on the taxpayer's return, and whether the IRS "rebate rule" is applicable. In *Anikeev,* the petitioners, husband and wife, spent over $6 million on their credit card between 2013 and 2014. Nearly all of these purchases were for Visa gift cards, money orders or prepaid debit card reloads that the couple later used to pay the credit card bill. The credit card earned them five percent cash back on certain purchases after they spent $6,500 in a single calendar year. Before purchases were sufficient for them to reach the five percent level, the card earned one percent cash back on certain purchases.

Rewards were issued in the form of "rewards dollars" that could be redeemed for gift cards and statement credits. In 2013, the petitioners redeemed $36,200 in rewards dollars from the card as statement credits in 2013 and $277,275 in 2014. The petitioners did not report these amounts as income for either year. The IRS audited and took the position that the earnings should have been reported as "other income" as an exception to the IRS "rebate rule." Under the rule, when a seller makes a payment to a customer, it's generally seen as a "price adjustment to the basis of the property." It's a purchase incentive that is *not* treated as income. Instead, the incentive is treated as a *reduction of the purchase price* of what is purchased with the rewards or points. Thus, points and cashback earned on spending are viewed as a non-taxable purchase price adjustment. The petitioners cited this rule, pointing out that the "manner of purchase of something…does not constitute an accession of wealth. The IRS, however, claimed that the rewards were taxable upon receipt irrespective of how the gift cards were later used.

The Tax Court noted that the gift cards were a "product." Thus, the portion of their reward dollars associated with gift card purchases weren't taxable. However, the Tax Court held that the petitioners' direct purchases of money orders and reloads of cash into the debit cards using their credit card was different in that the petitioners were buying "cash equivalents" rather than a rebate on a purchase. Thus, the transaction did not involve the purchase of a product subject to a price adjustment. The purchase of a cash equivalent was different than obtaining a product or service. Because there was no product or service obtained in connection with *direct* money order purchases and cash reloads, the reward dollars associated with those purchases were for taxable cash infusions.

The Tax Court also noted that the petitioners' practice would most often have been ignored if it had not been for the petitioners' "manipulation" of the rewards program using cash equivalents. Thus, the longstanding IRS rule of not taxing credit card points did not apply. Importantly, the Tax Court held that reward points become taxable when massive amounts of cash equivalents are purchased to generate wealth. The petitioners did this by buying money orders and funding prepaid debit cards with a credit card for cash back, and then immediately paying the credit card bill.

Note: The Tax Court stated that it would like to see some reform in this area that provides guidance on the issue of credit card rewards and the profiting from buying cash equivalents with a credit card.

Tax Issues for Retailers

Hyatt Hotels Corporation & Subsidiaries v. Comr., T.C. Memo. 2023-122

Facts of the case. In *Hyatt*, the petitioner established a "Gold Passport" rewards program in 1987 that provided its customers with reward points redeemable for free future stays at its hotels (the petitioner own about 25 percent of its branded hotels with the balance owned by third parties who license the petitioner's IP and/or management services). Under the program, the petitioner required hotel owners to make payments into an operating fund (Fund) when a customer earned "points." The petitioner was the custodian of the Fund and compensated a hotel owner out of the Fund when a guest redeemed reward points for free stays. The petitioner determined the rate of compensation. The petitioner invested portions of the Fund's unused balance in marketable securities which generated gains and interest. In 2011, the petitioner changed the compensation formula to increase the amount it could hold for investment. The petitioner also used the Fund to pay administrative and advertising expenses that it determined were related to the rewards program.

The points could not be redeemed for cash and were not transferrable. In addition, any particular member hotel could not get the payments to the Fund back except by providing free stays to members. The Fund allocated from 46-61 percent to reward point redemptions. Fund statements described the funds as belonging to the hotel owners that paid into the Fund. The petitioner's Form

10-K filed with the SEC treated the Fund as a "variable interest entity" eligible for consolidated reporting. When the petitioner provided management services to member hotels, payments into the Fund were reported as "expenses."

The petitioner did not report the Fund's revenue into gross income with respect to the hotels it did not own and did not claim any deductions for expenses paid on the basis that petitioner was a mere trustee, agent or conduit for hotel owners rather than a true owner of the Fund. But, the petitioner did claim deductions for its share of program expenses associated with the 25 percent of hotels that it owned. The petitioner reported Fund assets and liabilities on a consolidated basis on Schedule L. The petitioner's Form 1120 did not state that it was using the trading stamp method or include any statement concerning Treas. Reg. §1.451-4. The petitioner's position was that third-party owners should make their own decision about tax treatment of the money they paid to the Fund.

Note: Most third-party owners simply deducted payments to the Fund when paid regardless of whether economic performance would have occurred for expenses accrued for redemption, advertising and operating costs.

The IRS audited and took the position that the petitioner was using an improper accounting method which triggered an I.R.C. §481 adjustment requiring the including in the petitioner's income the cumulative amounts from 1987 (Fund revenue less expenditures). The IRS asserted an adjustment of $222.5 million and additional adjustments in 2010 and 2011. The petitioner disagreed and filed a Tax Court petition.

Fund revenue includible in income. The Tax Court determined that the amounts the petitioner received related to the customer reward program (i.e., Fund revenue) were revenue includible in gross income because of the petitioner's significant control over the Fund. That control indicated that the petitioner had retained a beneficial interest in the Fund, and the exception under the "trust fund" doctrine established in *Seven-Up Co. v. Comr., 14 T.C. 965 (1950), acq., 1950-2 C.B. 4,* did not apply.

Note: The "trust fund" doctrine allows for the exclusion from gross income of funds received in trust, subject to a legally enforceable restriction that the funds be spent entirely for a specific purpose, where the taxpayer does not profit, gain or benefit from spending the funds for that purpose. In *Hyatt,* the Tax Court determined that the trust fund doctrine did not apply because the petitioner: 1) mandated participation and payments into the Fund; 2) controlled the amounts of program payments to the Fund and the payments from the Fund; 3) made the decisions as to how Fund amounts were to be invested; 4) accrued interest and realized gains on investments in the Fund; and 5) decided whether Fund amounts would cover advertising and/or administrative costs. In other words, the petitioner received more than "incidental and secondary" benefits from the Fund.

In addition, the Tax Court pointed out that the petitioner benefited directly from the Fund based, in part, on the Fund generating goodwill among customers that lead to increased bookings and royalties and fees. Indeed, the petitioner owned approximately 25 percent of the hotels that paid into the fund which indicated a clear benefit to the petitioner's own interests.

No I.R.C. §481 adjustment. However, in a major win for the petitioner, the Tax Court also determined that the petitioner's treatment of Fund revenue and expenses did *not* amount to the adoption of a method of accounting. Thus, no I.R.C. §481 adjustment was required. The petitioner's consistent and total exclusion of Fund revenue and expense did not involve timing and, therefore, was not a method of accounting. The petitioner had simply excluded the Fund amounts from gross income and would have continued to do so if the Fund had ended and the amounts in the Fund distributed to member hotels.

Note: The normal statute of limitation of I.R.C. §6501 does not apply when an accounting method change has occurred. Had the petitioner adopted an impermissible accounting method, the IRS would not have been time-barred to make adjustments.

Trading stamp method inapplicable. As for the application of the "trading stamp method" of reporting income and expense, the petitioner claimed that Fund gross receipts should be offset by both the current year reward redemptions and the estimated cost of future tax year reward redemptions (i.e., an acceleration of deduction beyond actual program costs). The Tax Court disagreed on the basis that a hotel stay, which is either characterized as a license or a leasehold, would not qualify as merchandise, cash or other property as the trading stamp method required. The Tax Court also clarified that "other property" for purposes of Treas. Reg. §1.451-4 means property similar to merchandise or cash. "Other property" is not a hotel stay. It is, rather, tangible property.

Conclusion

The *Anikeev* and *Hyatt* cases lay down good "markers" for tax advisers with clients that offer loyalty reward programs to customers. Retail businesses that offer such programs will want to ensure that their program is structured in a manner that can fit within the trust fund doctrine's exception for excluding program funds from gross income. *Hyatt* is basically a win for the taxpayer, because most of the adjustments that IRS proposed were time-barred once the Tax Court determined that a method of accounting had not been adopted.

For retailers with customer reward programs, conforming closely to the "trust fund doctrine" is essential to achieving the desired tax treatment.