# WASHINGTON UPDATE

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February 15, 2017

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## The IRS Issues Legal Advice Regarding Customer Loyalty and Rewards Programs

The Internal Revenue Service ("IRS") has recently issued Legal Advice from the office of its Associate Chief Counsel setting forth its position that an accrual method taxpayer cannot account for the costs of redeeming points in its "hybrid coupon" customer rewards program under the Treas. Reg. § 1.451-4 rules that apply to "premium" coupons. The IRS reasoned that hybrid coupons, *i.e.*, coupons that may be redeemed for either products or used as a discount on a product purchase, are **not** the functional equivalent of premium coupons, which are exchanged for a certain product, and, therefore, they cannot be treated as such for deduction purposes. This legal advice memorandum is important to companies that operate loyalty programs, because if their programs can meet the definition of a "premium" coupon, they would be allowed to deduct their reasonable estimated redemption costs from gross receipts with respect to sales with which they issue points. (The regulations in question are old, and they refer to trading stamps or premium coupons instead of their current equivalent, points.)

In general, a taxpayer on the accrual method of accounting may not claim a deduction for an expenditure until it satisfies a three-part test under Treas. Reg. § 1.461-1(a)(2). One of those parts is the "all events" test, which provides that a deduction is not available until the tax year in which all events have occurred that establish the fact of the liability. *See* Treas. Reg. § 1.461-1(a)(2) (i). This rule prohibits a taxpayer from deducting estimated future costs. In effect, the all events test frequently requires payment before a taxpayer may deduct costs, even the taxpayer is on the accrual method of accounting.

There is an exception to this "all events" test and rule for deductibility, however, when a taxpayer issues "premium" coupons or trading stamps with sales, where the coupons are redeemable by such taxpayer in merchandise, cash, or other property. *See* Treas. Reg. § 1.451-4(a)(1). For tax purposes, according to the Joint Committee on Taxation's explanation of former Code Section 466 (which the Tax Reform Act of 1986 repealed), a premium coupon is one that is issued in connection with the sale of some item and which entitles the holder to tender it (or multiple premium coupons) in exchange for a product of the customer's choice, often selected from a catalog, in order to promote the sale of the product with which the coupon is issued.

In computing the income from such sales under the exception, the taxpayer would subtract from gross receipts with respect to sales with which premium coupons or stamps are issued an amount equal to: (i) The cost to the taxpayer of the merchandise, cash, and other property used for redemptions in the tax year; (ii) Plus, the net addition to (or less the net subtraction from) the provision for future redemptions during the tax year. In other words, the taxpayer would be allowed to deduct its reasonable estimated redemption costs from gross receipts with respect to sales with which trading stamps or premium coupons are issued instead of having to wait until their redemption.

In Rev. Rul. 78-212, 1978-1 C.B. 139, the IRS ruled that Treas. Reg. § 1.451-4 did **not** apply to "discount coupon" expenses (*i.e.*, expenses associated with coupons that provide discounts on the sales price of certain products purchased in the future), however, reasoning that the right of redemption must be unconditional, with nothing further required from the consumer. *See, e.g., Mooney Aircraft, Inc. v. U.S.*, 420 F2d 400 (5th Cir. 1970). The IRS indicated in Rev. Rul. 78-212 that the intent of Treas. Reg. § 1.451-4 is to match, in the same tax year, revenues with the expenses incurred in producing those revenues. Implicit in this concept of "matching" is that the issuance of a coupon with the sale of a product creates an incidental obligation in an accrual method taxpayer that unconditionally requires the taxpayer to incur additional expenses at some future time, which is the case for premium coupons but not for discount coupons.

With that background, the IRS Associate Chief Counsel's Office recently issued memorandum advice with respect to the timing of the deduction for "hybrid" coupons, those that have some of the characteristics of premium coupons as well as discount coupons in that they allow a customer either to redeem points for products or to use them as a discount on a purchase of a product. According to the memorandum, the taxpayer involved uses the accrual method and has a points-based loyalty rewards program that is designed to enhance its sales. Membership in the rewards program is free, and no purchase is necessary to become a member. Under the rewards program, members earn points in connection with the purchase of qualifying products and services from retail stores or on-line portals at the time of the purchase. Members earn one point for every $1 spent on qualifying purchases. Each point has a "value" of 1¢, but points are not redeemable for cash and expire five years after the date earned. Accumulated points can be redeemed towards the purchase of products, which, depending on the number of points redeemed, can either be free or discounted.

Under its current accounting method, the taxpayer deducts the cost of points in the year its members redeem those points, *i.e.*, under the "all events" test set forth in Treas. Reg. § 1.461-1(a)(2)(i). The taxpayer proposed instead to subtract, from gross receipts for sales in the tax year in which points are issued, an amount equal to: (i) The cost to the taxpayer of merchandise, cash, and other property used for redemptions in the tax year; (ii) Plus or minus, the net addition to, or net subtraction from, the provision for future redemptions during the tax year.

The Associate Chief Counsel's memo addresses whether these "hybrid" coupons that allow a member either to redeem points for products or to use them as a discount on a purchase of a product can be treated as "premium" coupons under Treas. Reg. § 1.451-4. After reviewing the all events test and the exception to it in Treas. Reg. § 1.451-4, the Associate Chief Counsel's memo concludes that Treas. Reg. § 1.451-4 is reserved solely for premium coupons and trading stamps. "Hybrid" coupons that allow a member either to redeem points for products or to use them as a discount on a purchase of a product do not qualify as "premium" coupons under Treas. Reg. § 1.451-4. The points reward system the taxpayer used is not analogous to premium coupons, and, therefore, these hybrid coupons cannot be treated as such for purposes of Treas. Reg. § 1.451-4.

The memo notes that premium coupons are generally coupons that are exchanged for a single product. A customer who does not have enough premium coupons to acquire a certain product must make additional purchases to collect more coupons until the customer can obtain the product, which ensures that the coupons are used to promote the sale of the product with respect to which the coupon is issued. Hybrid coupons, on the other hand, promote not just the sales of the products with which they are issued but also products bought in the future at a discount. The memo also notes that a customer could potentially acquire enough hybrid coupons to bring the price of an item to zero, which is similar to the effect of accumulating sufficient discount coupons. As a result, the IRS concludes that hybrid coupons more closely resemble discount coupons than premium coupons in that the most salient characteristic of both hybrid and discount coupons is a price reduction.

Applicability of Premium Coupon Rules to Current Loyalty Programs

Most customer loyalty programs that retailers operate should qualify as premium coupons under Treas. Reg. § 1.451-4, which would allow retailers to deduct their reasonable estimated redemption costs from gross receipts with respect to sales with which they issue points. While there are several types of retailer loyalty programs, they typically provide (1) free merchandise when a customer's purchases reach a certain level (for example, after ten to fifteen purchases), (2) discount coupons that a customer earns after making a certain number of purchases and which can be applied to a future purchase of merchandise, or (3) points with a specified dollar value that can be accumulated and used to purchase merchandise. Such programs should satisfy the two basic requirements of the regulations in that, (1) the "premium coupons" are issued with sales, and (2) they are redeemable by the taxpayer in merchandise, cash, or other property.

Typical loyalty programs that should be deemed to satisfy requirements of Treas. Reg. § 1.451-4 are ones that allow customers to earn points with purchases and redeem accumulated points for an item of merchandise or other property of their choice that requires no additional consideration. Alternatively, programs under which a customer must make a certain number of purchases to receive a free item should also satisfy the requirements of the regulation. This type of program may include, to cite one example, loyalty cards that offer a free item after the purchase of a certain number of similar items.

On the other hand, customer loyalty programs that banks or credit card issuers use probably would not qualify as premium coupons. Under these programs, credit card holders earn points for using their credit cards to make purchases. The credit card holders can typically use the points earned to redeem them for items ranging from merchandise and gift cards from a variety of vendors to airline miles and hotel stays. The primary reason credit card issuers would not be permitted to use the method provided in Treas. Reg. § 1.451-4 for their loyalty programs is that the points are not issued "with sales" as the regulation requires. *See, e.g., Capital One Financial Corp. v. Commissioner*, 659 F.3d 316 (4th Cir. 2011), *aff'g* 133 T.C. 136 (2009).

In *Capital One*, the bank's cardholders earned miles for purchases made with their credit cards. Cardholders who accumulated a certain number of miles could redeem them for an airline ticket Capital One would purchase on their behalf. The Fourth Circuit and the Tax Court held that Capital One did not issue the points "with sales," but in connection with its business of providing lending services. The Fourth Circuit also noted that Capital One did not have gross receipts with respect to sales with which the points were issued, as Treas. Reg. § 1.451-4 requires. Although Capital One derived its gross receipts from lending services, it issued the points with respect to purchases cardholders made from merchants and other third parties. As a result, Capital One's obligation to redeem the points was a general liability, and the company could deduct the points only when it satisfied the all events test, namely, in the year it redeemed the points.

Most loyalty programs in the travel or hospitality business should also qualify for the preferential tax treatment provided to premium coupons under Treas. Reg. § 1.451-4. Hotels, casinos and other gaming establishments, restaurants, and airlines offer points to their customers in a variety of ways. Hotels generally offer points for stays at their properties, while airlines issue frequent flier points or miles for flights. Restaurants offer points to customers for meals purchased, and casinos and other gaming establishments sometimes offer points based on gambling activity.

Restaurants, airlines, and hotels should be able to satisfy the regulation and have points issued under their loyalty programs treated as premium coupons. Restaurants can satisfy the "with sales" requirement of Treas. Reg. § 1.451-4 when they issue points with the sale of meals. Likewise, hotels and airlines can satisfy the "with sales" requirement through the issuance of points for hotel stays and frequent flier points or miles for flights, respectively. The gaming industry may find it more difficult to meet the "with sales" requirement if the points are earned for activities other than sales. (Some gaming companies try to circumvent this problem by operating separate trading stamp companies that would allow them to satisfy the requirements of Treas. Reg. § 1.451-4 without having to meet the "with sales" requirement that is imposed on companies that are not trading stamp companies.)

Even if the "with sales" or trading stamp company requirements are otherwise met, the regulation requires that the stamps or coupons issued by the taxpayer be redeemable by the taxpayer in merchandise, cash, or other property. It is unclear if

taxpayers who offer only "intangible" rewards, such as airline tickets, cruises, and hotel stays, would satisfy the regulation's requirement that the stamps or coupons be redeemable in "merchandise, cash, or other property." While intangible rewards should qualify as other property, the matter is not entirely settled, and travel and hospitality companies should at least be aware of this issue.