Federal Bar Association Tax Conference

Topics for Panel Discussion on Advance Payments Priority Guidance Plan Project

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Discussion Topics

1. Treas. Reg. § 1.451-4

a. Background

i. Treas. Reg. § 1.451-4 permits a taxpayer that issues trading stamps or coupons with sales of merchandise to deduct currently the estimated cost of redeeming the trading stamps or coupons.

ii. This provision represents an exception from the all-events test and the economic performance requirement in I.R.C. section 461(h).

iii. Will the IRS continue to allow this exception in situations where it applies?

b. Scope of Provision

i. *Capital One Financial Corp. v. Commissioner*, 133 T.C. 136 (2009), *aff'd* 659 F.3d 316 (4th Cir. 2011). In this case, the court held that the issuance of award points under a customer loyalty program maintained by a bank issuing credit cards does not qualify for Treas. Reg. § 1.451-4 because the award points are not issued with sales of merchandise.

c. Alternative All-Events Test Argument

i. In *Gold Coast Hotel and Casino v. United States*, 158 F.3d 484 (9th Cir. 1998), the taxpayer was permitted to deduct the cost of redeeming customers' award points in the year the points were issued to customers. Under section 461(h), a taxpayer relying on this case would be limited to a deduction for points redeemed within 8 ½ months after the end of the taxable year in which the points were issued to customers.

ii. In *Giant Eagle, Inc. v. Commissioner*, T.C. Memo. 2014-146, the Tax Court rejected a current deduction for award points issued under a program requiring the customer to purchase additional gasoline at the taxpayer's store and use the award points as a discount off of the purchase price of the additional gasoline. The court held that the requirement that a purchase additional gasoline in order to use the reward points and need for the taxpayer to set the daily price for the gasoline before the customer could redeem the award points were both contingencies preventing the satisfaction of the "all-events test."

iii. Assuming the holding in *Giant Eagle* is sustained, where does this leave customer loyalty programs that make totally free merchandise (or services) available for redemption of award points?

d. Potential New Approach

i. In ASU 606, Revenue from Contracts with Customers, Example 52, the new approach to customer loyalty programs for financial reporting purposes is to treat a portion of the consideration received from the original sale of merchandise or services as deferred revenue allocable to the award points, based on the relative value of the award points.

ii. The deferred revenue would be recognized when the points are redeemed by a customer or the points expire unused.

iii. Would the IRS consider following this approach for tax purposes in a manner similar to gift cards?

iv. Consider the application of this approach to other types of liabilities (e.g., chargebacks) that are recorded as an adjustment to revenue for financial accounting purposes.

v. Discuss the issues.

II. Treas. Reg. § 1.451-5 v. Rev. Proc. 2004-34

a. Background

i. Under Treas. Reg. § 1.451-5, advance payments for the sale of goods may be deferred until the goods are furnished to the customer, without a time limit on the deferral, assuming the financial conformity requirement is satisfied.

ii. However, there is a two-year time limit on the length of the permitted deferral of revenue, if the amount of the advance payments received exceeds the expected cost of the goods to be provided to the customer, as in the case of gift certificates.

iii. In contrast, under Rev. Proc. 2004-34, advance payments for the performance of good or services may be deferred, but only for up to one taxable year beyond the year of receipt of the advance payments

b. Potential Changes

i. Would the IRS consider merging the two provisions, so that the same rules would apply to goods and services?

ii. If so, which deferral period would prevail under a unified structure?

iii. Under a unified deferral regime, which definition of advance payments would prevail?

iv. How would the estimated cost of goods sold or the estimated cost of performance be handled?

c. Open Issues

i. As in the case of gift certificates, there is an issue in cases where the advance payments are received by one affiliate in a consolidated group, but the merchandise or services will be provided by another entity in the consolidated group. Would the IRS consider extending the deferral rules on a consolidated group basis in Rev. Proc. 2011-18, 2011-5 I.R.B. 443, to Treas. Reg. § 1.451-5?

ii. In some circumstances, advance payments that are deferred for tax and financial reporting purposes might never be recognized for GAAP purposes. Would the IRS consider relief from the financial conformity requirement in those circumstances?

iii. Would the IRS provide guidance regarding which party will recognize revenue from advance payments that were deferred under Rev. Proc. 2004-34 or Treas. Reg. § 1.451-5 for federal income tax purposes to the extent not previously taken into account by the target when the amount of the deferred revenue obligation is adjusted in a stock acquisition?

iv. ASU 606 contains many new rules for revenue recognition under GAAP. The new rules may require changes to the tax deferral methods under Treas. Reg. § 1.451-5 and/or Rev. Proc. 2004-34? What kind of guidance is being considered by the IRS?

v. There has been a long-standing problem when a contract with an advance payment is assumed by a purchaser as part of the purchase of a trade or business in which the contract resides. Would the IRS be willing to clarify how that transaction is handled both from the seller's and purchaser's perspective?

vi. As part of the foregoing issue, there is uncertainty as to the determination of whether there is an advance payment or an assumed liability with respect contracts in progress, where a purchaser of a business acquires numerous contracts in progress from the seller. In that circumstance, it is frequently the case that it is not possible for the purchaser to evaluate the profitability of each contract at the time of acquisition of the business. In fact, it may turn out that in some of the contracts, the seller received an amount of consideration prior to the sale of the business such that the purchaser incurring is likely to incur a loss to complete the contract, whereas in other contracts, the purchaser may receive a greater amount of consideration following the acquisition than the expected cost to complete the contract. Would the IRS provide guidance on how to handle that type of situation?