taxnotes federal

Volume 183, Number 13 ■ June 24, 2024

IRS Rewards Credit Card Banks With Earlier Deductions

by Carol Conjura and Jason Binder

Reprinted from *Tax Notes Federal*, June 24, 2024, p. 2295

© 2024 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

IRS Rewards Credit Card Banks With Earlier Deductions

by Carol Conjura and Jason Binder

Carol Conjura is a partner and Jason Binder is a senior manager in the income tax and accounting group of KPMG LLP's Washington National Tax practice.

In this article, Conjura and Binder examine recent chief counsel advice regarding a bank's tax accounting for its credit card rewards program and the implications for the rewards programs of other businesses.

Copyright 2024 KPMG LLP.
All rights reserved.

In 2016, the Third Circuit handed down a taxpayer-favorable decision in *Giant Eagle*, in which a taxpayer was permitted to accelerate the deduction for its customer rewards liability.[1] Notably, the IRS promptly issued an action on decision indicating that it would follow the decision, but only for taxpayers residing in the Third Circuit (that is, Delaware, New Jersey, and Pennsylvania).[2] Relying on the Third Circuit's *Giant Eagle* decision and despite the IRS's limited acquiescence, many taxpayers — in and outside the Third Circuit's jurisdiction — have since changed their methods of accounting for their customer loyalty and rewards programs.

We analyze the IRS's recently released chief counsel advice regarding a bank's rewards program for its credit card customers and how it might apply to the rewards programs of other businesses.[3]

Background

Customer loyalty and rewards programs remain prevalent as a brand-building strategy for most consumer businesses, whether brick-and-mortar or online merchants. More and more types of consumer businesses are jumping on the customer loyalty and rewards programs bandwagon, including department stores, specialty retailers, restaurants, gas stations, automobile dealers, auto services, home services, educational services, telecommunications services, transportation, and banking services.[4] As competition for customers increases, customer loyalty and rewards programs have evolved and often provide greater flexibility. For example, some programs permit customers to accumulate points and redeem them for the products and services of not only the issuer but also the issuer's loyalty partners. Often the points either do not expire or have longer redemption periods than previous programs.

From the standpoint of generally accepted accounting principles and international financial reporting standards, the accumulated points "earned" (but not redeemed) by customers enrolled in businesses' customer loyalty and rewards programs are reflected on each business's balance sheet as liabilities. Those liabilities reduce financial statement income in the tax year when earned (by the business). That reduction is reflected in one of two ways: a deferral of a portion of the current sales giving rise to the corresponding points liability, or a financial statement expense. From a tax standpoint, however, both the tax accounting for the liability and the timing of the deduction have been the subject of recent controversy.

[1] *Giant Eagle Inc. v. Commissioner*, 822 F.3d 666 (3d Cir. 2016), *rev'g* T.C. Memo. 2014-146.

[2] AOD 2016-03, 2016-40 IRB 424.

[3] CCA 202417021 (Apr. 26, 2024).

[4] According to a survey by Lending Tree, an online lending marketplace, about 80 percent of American consumers are members of at least one customer rewards and loyalty program. *See* Dawn Papandrea, Dan Shepard, and Xiomara Martinez-White, "With Inflation Soaring, Half of Americans Think Loyalty Programs Are More Important Than Ever," Lending Tree (July 11, 2022).

For more *Tax Notes*® *Federal* content, please visit www.taxnotes.com.

© 2024 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

The All-Events Test

Generally, corporate taxpayers must use the overall accrual method of accounting in reporting their income for tax purposes. Under the accrual method, the timing of the deduction for liabilities is governed by the all-events test of section 461 and related regulations. The all-events test is satisfied in the tax year in which (1) all the events that establish the fact of the liability have occurred, (2) the amount of the liability can be determined with reasonable accuracy, and (3) economic performance regarding the liability has occurred.[5] The third requirement, economic performance, was added to the all-events test in the 1980s.[6]

As a threshold matter, courts have held that the first prong of the all-events test requires that events necessary to establish the fact of a liability must have occurred by year-end. A taxpayer may not "deduct an estimate of an anticipated expense, no matter how statistically certain, if it is based on events that have not occurred by the close of the taxable year."[7]

The treatment of rewards liabilities under the all-events test was most recently judicially considered by the Third Circuit in *Giant Eagle*, which held that a taxpayer's anticipated liability for unredeemed gasoline discounts was fixed in the year earned. Importantly, the act of redemption was not an event necessary to fix the liability.[8]

The liability in *Giant Eagle* involved a gasoline discount program that entitled a customer to receive a "discount coupon" for a 10 cents per gallon reduction in price for every $50 spent on groceries. The Third Circuit, reversing the Tax Court, concluded that the grocery chain's liability became fixed immediately upon the customer's purchase of the groceries required to earn the points. At that time, the Third Circuit reasoned, the grocery chain, under the written terms of the program, entered into a unilateral contract requiring it to redeem the points upon demand. The court appeared to give weight to the fact that the taxpayer had not reserved the right to revoke any loyalty points already earned by customers (and had never done or even considered doing so in the history of the program).

The IRS issued an AOD, disagreeing with the Third Circuit's *Giant Eagle* decision and reiterating the IRS's position that the liability in that case remained "conditional."[9] The position expressed by the IRS in the AOD is that the gas station's liability remained conditional because (in the IRS's view) it required the customer to make a future purchase of gasoline, and, in the government's view, that would be something more than a purely ministerial act. In deciding against the taxpayer, the Tax Court had noted in its opinion, which was ultimately reversed by the Third Circuit, that it was theoretically possible for a customer to accumulate enough points to get free gas, but that did not sway the Tax Court.[10]

To support its position, the IRS pointed to the fact that the coupons expired (only) three months after the last day of the month in which they were issued. Thus, the Tax Court and the IRS, in viewing the redemption as a condition precedent, relied heavily on the practical probability of outcome. In contrast, the Third Circuit placed overriding weight on the existence of the taxpayer's contractual promise.

IRS Position on Credit Card Rewards

On April 26, the IRS Office of the Chief Counsel released CCA 202417021. The taxpayer discussed in the memo is a federally chartered bank that issues credit cards to cardholders. Under a written agreement with the taxpayer, cardholders earn rewards by making purchases with their cards. Rewards are denominated in miles, points, or cash value, which can then be redeemed for cash, statement credits, travel, gift

[5] Section 461.

[6] *See* section 461(h), added by the Deficit Reduction Act of 1984 (July 18, 1984).

[7] *United States v. General Dynamics Corp.*, 481 U.S. 239 (1987). *Cf. United States v. Hughes Properties Inc.*, 476 U.S. 593 (1986) (casino jackpot liability was unconditionally fixed under Nevada law); and *Gold Coast Hotel & Casino v. United States*, 158 F.3d 484 (9th Cir. 1998) (casino points liability was fixed and unconditional under state gaming regulations once a member accumulated the minimum number of points).

[8] *Giant Eagle*, 822 F.3d 666, *rev'g* T.C. Memo. 2014-146.

[9] AOD 2016-03.

[10] *Giant Eagle*, T.C. Memo. 2014-146, at 1012-1013.

For more *Tax Notes*® *Federal* content, please visit www.taxnotes.com.

cards to third-party vendors, and other goods or services.[11] The taxpayer's rewards program does not have redemption thresholds, and rewards become redeemable immediately upon their receipt, which occurs at the close of the cardholder's billing period without any additional purchase required.[12]

Under its current method of accounting, the taxpayer deducted its redemption liability when the rewards were redeemed. The taxpayer was seeking the consent of the IRS National Office to change its method of accounting. Under its proposed method, the taxpayer would deduct the credit card reward liability in the tax year the rewards were earned, rather than redeemed, by its cardholders, provided that the rewards are redeemed within eight and one-half months after the end of that tax year.

In the chief counsel advice, the IRS first stated that a requirement that a customer must make an additional purchase to redeem a reward is a condition precedent that is not a ministerial act. That results in a reward liability not being fixed for purposes of the first prong of the all-events test. The IRS then distinguished the credit card rewards program from the fuel perks program in *Giant Eagle*. According to the Tax Court in *Giant Eagle*:

> For every qualifying $50 spent, a customer earned a single fuelperk! Each fuelperk! was redeemable for a 10-cent reduction in the retail price per gallon of gasoline or diesel fuel (*internal citation omitted*) acquired in one transaction of up to 30 gallons at GetGo gas stations. To redeem fuelperks!, customers were required to swipe their advantage cards when purchasing gas and elect, by pushing a button, to use their fuelperks! Fuelperks! could be, and were required to be, aggregated, so that all available fuelperks! would be used to reduce the gas price to the greatest extent possible, *possibly reducing the price for a gallon of gas to zero*. Accumulated fuelperks! in excess of the then-current price per gallon of gasoline would be saved on the customer's advantage card. [Emphasis added.][13]

In distinguishing the cases, the IRS stated that because the credit card rewards at issue are immediately redeemable for a predetermined amount of cash or a statement credit, there is no condition precedent. In contrast, according to the IRS, rewards programs that do not provide redemption options that include cash or a statement credit but require an additional purchase (whether the customer receives a partial or complete discount) are considered to have a condition precedent so that the accrued reward liabilities are not fixed for purposes of the all-events test until the rewards are actually redeemed.

CCA 202417021 next turned to a discussion regarding the economic performance requirement — the third (and final) prong of the all-events test. The IRS noted that, under the applicable regulations, if the liability of a taxpayer is to pay a rebate, refund, or similar payment to another person (whether paid in property, money, or as a reduction in the price of goods or services to be provided in the future by the taxpayer), "economic performance" occurs when payment is made to the person to which the liability is owed.[14] The IRS then stated its conclusion that the taxpayer bank's credit card rewards that are redeemable for cash, a statement credit, or other goods or services are "a rebate, refund, *or similar payment*" for purposes of reg. section 1.461-4(g)(3) (emphasis added).

In the IRS's view, while the rewards do not technically constitute a rebate, they are sufficiently similar to a rebate to constitute a "similar payment" under reg. section 1.461-4(g)(3). Thus, the chief counsel advice concludes

[11] Procedurally, cardholders redeem their rewards through contacting the bank directly by phone or by visiting the bank's website or mobile app.

[12] A traditional rewards program operates effectively with cliffs for redemption opportunities. For example, a traditional hotel rewards program may offer, as its absolute minimum reward available, one free night of lodging once a program member accumulated 10,000 program points. In other words, any program members that had between one and 9,999 program points would be in possession of "earned" program points but would be unable to redeem those points until they accumulate 10,000 points. Each point was valued at $0.01 for redemption purposes, and a cardholder could use the taxpayer's app to request a redemption of reward points by inputting the number of points that the cardholder wants to redeem.

[13] *Giant Eagle*, T.C. Memo. 2014-146, at 1011.

[14] Reg. section 1.461-4(g)(3) and (8), Example (2).

© 2024 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

that, for the taxpayer's credit card rewards, "economic performance" for the all-events test is satisfied under reg. section 1.461-4(g)(3) in the tax year when the redemption payment is made. But for the potential availability of the recurring item exception, the time when a rewards liability is fixed and determinable under the all-events test would thus have otherwise become a moot point for tax years after the enactment of section 461(h).

Regarding the taxpayer's eligibility for the recurring item exception, the IRS referred to section 461(h)(3) and reg. section 1.461-5, which, under certain circumstances, allow a taxpayer to treat a liability as incurred before the time that economic performance occurs by adopting the recurring item exception as a method of accounting for recurring items. Reg. section 1.461-5(b) provides that a liability is treated as incurred for a tax year if:

- as of the end of the tax year, all events have occurred that establish the fact of the liability (that is, it is "fixed") and the amount of the liability can be determined with reasonable accuracy (that is, it is "determinable");
- economic performance occurs on or before either the earlier of the date the taxpayer files a timely (including extensions) filed return or the 15th day of the ninth month after the close of that tax year;
- the liability is recurring in nature; and
- either the amount of the liability is not material, or the accrual of the liability for that tax year results in a better matching of the liability with the income to which it relates (than would result from accruing the liability for the tax year in which economic performance actually occurs).

Reg. section 1.461-5(b)(5)(ii) provides further that, for liabilities subject to reg. section 1.461-4(g)(3) — that is, rebates, refunds, and "similar amounts" — the matching requirement of reg. section 1.461-5(b)(1)(iv)(B) is deemed to be satisfied. Thus, the IRS concluded that the taxpayer's credit card reward liability was eligible for the recurring item exception in reg. section 1.461-5 because the liability is fixed and determinable, recurring, and the accrual of the liability for that tax year is deemed to result in a better matching of the liability with the income to which it relates (than would result from accruing the liability for the tax year in which economic performance actually occurs).

Chief Counsel's Conclusion

The chief counsel's taxpayer-favorable conclusion that cash rewards become fixed in the year earned makes sense because the taxpayer's obligation to redeem customers' earned rewards for their established cash value (or in the form of a statement credit) was, in fact, unconditional at year-end. However, the IRS's disparate treatment of noncash rewards and its reasoning for not reaching the same conclusion do not seem to line up easily with the facts.

In the chief counsel advice, the IRS concluded that a taxpayer's liability for noncash rewards should suffer the same fate as befell the taxpayer's liability for gas points in *Giant Eagle*, at least as the Tax Court decided the issue, before reversal by the Third Circuit. However, in the context of noncash rewards, the IRS's disagreement with the Third Circuit and its agreement with the Tax Court both rely on an implicit assumption regarding the operation of noncash rewards, that is, that they must always be considered conditioned on a future purchase. The IRS's reasoning seems overbroad here.

In *Giant Eagle*, the Tax Court based its taxpayer-unfavorable holding on the fact that the right of redemption without a purchase by the retail chain's customers was not unconditional at year-end. The chief counsel advice fails to acknowledge the fundamental differences and similarities between:

- a right that is, in fact, conditioned on a future purchase (that is, a customer *must* in all events come out of pocket when redeeming the reward, thus the right is conditional in all events);
- a right that might ultimately require a future purchase, but that cannot be determined at year-end (that is, the customer might have to come out of pocket, and thus the right is not in all events unconditional); and
- a right that is, in fact, *not* conditioned on a future purchase (that is, the customer in all events is not required to come out of pocket to redeem the points).

© 2024 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

For more *Tax Notes*® *Federal* content, please visit www.taxnotes.com.

© 2024 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

In *Giant Eagle*, the Tax Court correctly noted that theoretically it is possible for a customer to accumulate enough points to obtain free gas *without* having to make a future purchase of gas. Nevertheless, the Tax Court concluded that the taxpayer did not have a fixed right. The key fact for the Tax Court appears to have been that the possibility that the customer could redeem the points for free gas (without any additional purchase) was not a certainty *at year-end*; instead, it would become certain only at the time of redemption (in the following tax year). That is because the points were only redeemable for gas, and the price per gallon of gas could change after year-end, so only at the time of redemption would it be possible to determine whether the customer could get free gas or would have to make an additional purchase of gas to redeem the points.

Consider, for example, a customer who, in the taxpayer's current tax year (Y1), had accumulated enough points to obtain a discount of $2 per gallon up to a full tank for one vehicle. While the price per gallon of gas certainly varies throughout Y1, assume coincidentally that it is $2 on the last day of Y1. In those circumstances, it would appear at year-end that the taxpayer could redeem the points for up to a full tank of free gas for one vehicle, but only if the customer redeemed all the points on the last day of the year. However, if the customer chose *not* to redeem the points before year-end of Y1, the price of gas certainly also could rise above $2 at any time after year-end and before the day of redemption (or expiration).

As the example in the preceding paragraph illustrates, the Tax Court's finding in *Giant Eagle* that the taxpayer's liability was not an "absolute certainty" reflects that, as of year-end, it was not possible to conclude that the customer would not have to come out of pocket to redeem the points. In this sense, there is insufficient difference between a liability that is, in fact, conditioned on a future purchase (when, regardless of the facts, the taxpayer *must* pay something for the product it obtains upon redemption) and a liability the satisfaction of which *might* require a future purchase when redeemed. In either case, the taxpayer's liability cannot be described factually as "unconditional as of the last day of the tax year."

In contrast, there is a relevant difference between these two situations, on the one hand, and, on the other, a situation in which the taxpayer's liability, although exclusively subject to satisfaction in merchandise or services, does not require an additional outlay by the customer. The IRS treats the liability in that latter case as conditional, even though it is not conditioned on a future purchase (that is, because the customer in all events may redeem the points for a free item, even though they may *choose* instead to apply the points as a discount). The ability to obtain a free item negates the argument that the customer "must" purchase an item — because the customer does not have to make a purchase.

To summarize, for federal income tax purposes no distinction should be drawn between a cash and noncash rewards liability insofar as satisfying the all-events test when the customer has a right to obtain a free item of some kind but also has an option to redeem the points to partially pay for the item. Regardless of whether hybrid coupons are redeemable for cash (or a statement credit), from an all-events test standpoint, the customer's right is not conditional on a future purchase. From the taxpayer's standpoint, the only difference should be that, if rewards are redeemed for cash, the amount of the taxpayer's liability is measured in money rather than in kind.

Redemptions Beyond the Recurring Item Exception's Horizon

In *Giant Eagle*, because the coupons expired (only) three months after the last day of the month in which they were issued, the taxpayer's liability would always be satisfied or extinguished within the recurring item exception window (eight and one-half months after the year earned), so no amount of the liability would be deferred beyond the year earned. However, the points accumulated in many rewards programs are not set to expire and might not be redeemed for many years after they were earned. That makes it necessary to determine whether the recurring item exception applies to successive years or only the year following the year earned.

In describing the requirements of the recurring item exception, section 461(h)(3)(A) provides that a liability shall be treated as

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

incurred during any tax year if the all-events test is otherwise met "during such tax year" and economic performance occurs within the shorter of a reasonable period, or eight and one-half months, after the close of that tax year. That language indicates that the recurring item exception applies only to the tax year *in which* the liability becomes fixed and determinable, and therefore could not be applied to successive years for the same liability.

Consider, for example, a taxpayer that operates a customer rewards program in which points are earned on every qualifying purchase, points are redeemable for cash, redemptions require no additional purchases (or any other non-ministerial acts), and the points expire if unredeemed five years from the date on which they are earned. Assume that a customer of the taxpayer earns points on October 30 of Y1 but does not redeem them until exactly three and a half years later, that is, on April 30 of Y4. The taxpayer's liability regarding the customer's earned points is fixed and determinable beginning on October 30 of Y1 and remains so as of the end of each of the taxpayer's Y1, Y2, and Y3 tax years. Based on the statutory language, the taxpayer would not be able to accelerate the Y4 redemption to Y3 because the liability did not become fixed in Y3.

However, as noted, the regulations under section 461(h) provide a more liberal rule. Reg. section 1.461-5(b) provides that a liability is treated as incurred for a tax year if, "as of the end of" the tax year, all events have occurred that establish the fact of the liability (that is, it is fixed) and the amount of the liability can be determined with reasonable accuracy (that is, it is determinable). Thus, under the regulations, the recurring item exception applies to any year in which the liability is fixed and determinable on a cumulative basis as of the end of the year.

Does that language difference create a disconnect between the statute and the regulations? No. That is because Treasury was given blanket authority in section 461(h) to deviate from the statute. Section 461(h)(1) provides that "in determining whether an amount has been incurred with respect to any item during any taxable year, the all-events test shall not be treated as met any earlier than when economic performance with respect to such item occurs." Section 461(h)(2) further provides, "*Except as provided in regulations prescribed by the Secretary*, the time when economic performance occurs shall be determined under the following principles" (emphasis added).

In essence, by including the phrase "except as provided in regulations prescribed by the Secretary" at the beginning of section 461(h)(2), Congress established an order of precedence regarding the economic performance requirement of section 461(h), in which the statute itself defers to the regulations thereunder. So someone could not reasonably argue that the statute trumps application of the recurring item exception to customer rewards and loyalty programs.

Another Regulatory Exception to the All-Events Test

Reg. section 1.451-4 provides a special method of accounting for trading stamps and premium coupons. If a taxpayer's customer rewards and loyalty program qualifies for this special method of accounting, the taxpayer can reduce its current revenue by an amount equal to its estimated future cost of redemptions (that is, the full anticipated liability without regard to the all-events test). Although the regulation was issued long before the advent of today's customer loyalty programs, its overall framework and policy appear at first glance to be a good fit.[15] However, thus far the IRS has three times successfully challenged in court taxpayers' attempts to use this special method in the context of different types of programs.

In *Capital One*,[16] the Fourth Circuit denied a taxpayer's use of the special method because the points the taxpayer issued to customers in credit card transactions did not meet the regulatory requirement of being issued "with sales." In *Giant Eagle*, the Tax Court held that the taxpayer's gas rewards issued with sales at the taxpayer's grocery chain, while issued "with sales," did not qualify as "premium coupons" because the use of

[15] Reg. section 1.451-4 was added by T.D. 6282 (Dec. 24, 1957), whereas it was not until the 1980s that customer rewards and loyalty programs achieved ubiquity.

[16] *Capital One Financial Corp. and Subsidiaries v. Commissioner*, 659 F.3d 316 (4th Cir. 2011), *aff'g* 133 T.C. 136 (2009), and 130 T.C. 147 (2008).

© 2024 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

© 2024 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

the points was considered to be conditioned on a future purchase of gas. According to the government, even though a customer could theoretically accumulate sufficient points to be able to get free gas without coming out of pocket, the points were more properly characterized as discount coupons rather than premium coupons, and the Tax Court agreed.

More recently, in *Hyatt*,[17] without addressing the premium coupon versus discount coupon issue, the Tax Court held that the hotel chain's Gold Passport rewards program did not meet the requirement in the regulation that the premium coupons be redeemable in "merchandise, cash, or other property." Acknowledging that a customer's right to a hotel stay could be considered intangible property in the form of a license, the court applied principles of construction to adopt a narrow construction of the list in the trading stamps regulation as including within the definition of "other property" only other forms of property that were similar to "merchandise" and therefore as including only tangible forms of property. That reasoning of the court is questionable given that most forms of tangible property provided to customers would be considered merchandise, thus making the inclusion of "other property" redundant.

Common-Law Trust Doctrine

Hyatt is important especially insofar as the Tax Court considered not only application of the special method of accounting available to taxpayers with liabilities for trading stamps or premium coupons under reg. section 1.451-4, but also (as alternative grounds for preventing a mismatch of income and expense) the applicability of a common-law exclusion from gross income that dates back to 1950. In *Seven-Up*,[18] the Tax Court recognized a specific exclusion from gross income,[19] which has come to be known as the trust fund doctrine.[20]

The trust fund doctrine applies to an amount when a taxpayer: (1) receives funds in trust, subject to a legally enforceable restriction that they be spent in their entirety for a specific purpose; and (2) does not profit, gain, or benefit from spending the funds for that purpose.[21] When both elements of the trust fund doctrine are present, the taxpayer is deemed to be a mere conduit or custodian of funds and not the beneficial owner for federal income tax purposes.[22] Thus, the funds are not characterized as gross income of the taxpayer and, conversely, the future expenditure is not a deductible expense.

Hyatt argued that the trust fund doctrine applied to its rewards program, and the Tax Court's opinion considered that argument before later turning to the applicability of reg. section 1.451-4. To illustrate the application of the trust fund doctrine's second requirement — that is, the "no primary benefit" test — the Tax Court in *Hyatt* set up the following hypothetical:

> If, upon the completion of an hotel, its directors created a trust requiring twenty per cent of the proceeds of the rentals from all rooms to be placed in trust for the purchase of land for the building of a golf course, tennis courts and swimming pool and providing that all fees exacted from guests for the use of these facilities be paid

[17] *Hyatt Hotels Corp. and Subsidiaries v. Commissioner*, T.C. Memo. 2023-122.

[18] *Seven-Up Co. v. Commissioner*, 14 T.C. 965, 979 (1950).

[19] Section 61 broadly defines gross income as "all income from whatever source derived." Courts narrowly construe any exclusions from this sweeping definition. *See Commissioner v. Schleier*, 515 U.S. 323, 328 (1995).

[20] In *Seven-Up*, the taxpayer created and maintained a collective fund for the purpose of paying for national advertising of its signature soft drink beverage (7-Up). *Seven-Up*, 14 T.C. at 968-971. Some third-party bottlers of 7-Up, to which the taxpayer regularly sold 7-Up extract, voluntarily contributed to the fund, which was then used to pay for national advertising. The Tax Court considered whether the payments into the fund were includable in the taxpayer's gross income, characterizing them as neither "for services rendered or to be rendered" by the taxpayer nor "part of the purchase price of the [7-Up] extract." Thus, the Tax Court concluded that the payments were not includable in gross income, reasoning that the taxpayer did not gain or profit because of the fully offsetting restriction on its use of the fund.

[21] *See Ford Dealers Advertising Fund Inc. Jacksonville Division v. Commissioner*, 55 T.C. 761, 771 (1971), *aff'd*, 456 F.2d 2555 (5th Cir. 1972). Technically, under the trust fund doctrine, any benefit inuring to the taxpayer from use of any amount in a purported trust fund cannot be more than "incidental and secondary." *See, e.g.*, *Angelus Funeral Home v. Commissioner*, 47 T.C. 391 (1967), *aff'd*, 407 F.2d 210 (9th Cir. 1969).

[22] *See Hyatt*, T.C. Memo. 2023-122 (and cases cited therein).

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

into the trust but that, upon the final payment for such facilities, they be deeded to the hotel corporation in trust forever, could it be reasonably argued that, although for the use and benefit of hotel guests, the hotel corporation did not also benefit?

The *Hyatt* court concluded that "the fees paid by hotel guests would still constitute income to the hotel, because its use of the fees directly enhanced the value of its property, rather than incidentally doing so as a byproduct of benefiting the hotel guests."

Turning to the relevant facts, the *Hyatt* court noted that the hotel chain mandated that third-party hotel owners operating Hyatt-branded properties (TPHOs) participate in the Hyatt program and pay into the Hyatt fund. Also, the hotel chain controlled the amounts of program payments into, and compensation payments out of, the fund; decided how to invest the fund, accrued interest, and realized investment gains from holding the fund; and determined whether advertising or administrative costs would be paid for by the fund; all without oversight or input from the TPHOs.

The Hyatt court's attempt to distinguish the facts from earlier taxpayer-favorable cases in this regard is not entirely satisfactory in that the taxpayers in the earlier cases equally owned brand IP that would also in all instances be enhanced by the program.

Conclusion

Taxpayers will likely continue to face IRS challenges to the tax accounting for customer loyalty and rewards program liabilities, even when the taxpayer's method clearly reflects income by matching the income from customer sales with the related redemption expense. Absent the applicability of the special method for premium coupons and trading stamp companies or the trust fund doctrine, the economic performance requirement eliminates the possibility that a taxpayer could accelerate the deduction for these liabilities for more than one year.

It seems unnecessarily harsh for the IRS to continue its stance of treating rewards liabilities that are not redeemable for cash as always being considered conditioned on a future purchase. There is a relevant factual distinction between those rewards liabilities that are not unconditional at year-end and those that are not conditioned on a future purchase.[23] ■

[23]The foregoing information is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the author(s) only and does not necessarily represent the views or professional advice of KPMG LLP.

Copyright 2024 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

© 2024 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.