Tax Issues with Customer Loyalty Reward Programs

Roger McEowen (roger.mceowen@washburn.edu) – Washburn University School of Law
July 2022
Agricultural Law and Taxation Blog, by Roger McEowen: https://lawprofessors.typepad.com/agriculturallaw/
Used with permission from the Law Professor Blog Network

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 may 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 follows the Third Circuit's decision only 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 – The *Anikeev* case

A recent Tax Court opinion provides 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, et ux. v. Comr., T.C. Memo. 2021-23.* 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.