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CONSUMER BUSINESS COMPASS

GIFT CARDS: TIPS AND BEST PRACTICES FOR SUCCESSFUL MANAGEMENT

By Randy Frischer and Patricia Brandstetter

GIFT CARD SALES HAVE FLOURISHED IN RECENT YEARS, WITH ELECTRONIC PURCHASE AND REDEEMING OPTIONS AND SMART PHONE APPLICATIONS FURTHERING THE EXPANSION OF RETAIL SALES IN THIS AREA.

Our recent survey of 100 retail Chief Marketing Officers (CMOs) found that 58 percent expect gift card sales to increase this holiday season. In addition, retailers frequently issue gift cards to customers in exchange for returned goods. However, the tax, financial and legal reporting requirements for gift cards have become increasingly complex.

TAX TREATMENT

A retailer issuing a gift card receives an "advance payment" in exchange for the obligation to provide goods or services at a future date. For tax purposes, although advance payments must generally be included in gross income upon receipt, the sale of a gift card may be deferred from immediate income recognition under two exceptions: Treas. Reg. §1.451-5 and Rev. Proc. 2004-34.

Read more

DID YOU KNOW...

According to ***IHL Group***, mobile retail is a $5.5 billion international market.

Tourists this year will spend upwards of $52 billion in New York City stores, according to ***Eastern Consolidated***.

Of retailers who sell gift cards, a majority (58 percent) expect sales to increase this holiday season, according to the ***2012 BDO Retail Compass Survey of CMOs***.

Cyber Monday sales broke records again this year, hitting $1.5 billion, according to ***comScore.***

Restoration Hardware went public in November after increasing net revenue 53 percent over its last three fiscal years, ***Dow Jones*** reports.

According to the ***NRF***, in 2011, 27 percent of all jewelry store sales occurred during the holiday season - the highest percentage for any retail sector.

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GIFT CARDS: TIPS AND BEST PRACTICES

Treas. Reg. §1.451-5 applies to the sale of goods only, and allows an accrual-method taxpayer to defer recognition of advance payments until the taxable year the payments are recognized as revenue for financial reporting purposes. However, inventoriable goods may not be deferred beyond the end of the second taxable year following the year the taxpayer receives the advance payment. This effectively grants a two-year deferral.

Rev. Proc. 2004-34 allows an accrual-basis taxpayer to defer recognition of advance payments for goods, services or a mix of both, but provides for one-year deferral only: The advance payment must be included in gross income for the taxable year of receipt to the extent recognized in the financial statements for that taxable year; the remaining amount of the advance payment must be included in gross income in the subsequent taxable year.

In addition, the IRS has issued the following guidance involving gift cards:

Rev. Proc. 2011-17 provides a safe harbor method of accounting for returned merchandise: 1. A merchant may give the customer a cash refund in exchange for returned goods, reducing gross receipts in the amount of the refund, or 2. A gift card may be issued in exchange for the returned goods, treating the gift card issued as the payment of a cash refund and sale of a gift card. The retailer may account for the amount deemed received for the sale of the gift card under Treas. Reg. §1.451-5 or Rev. Proc. 2004-34.

Rev. Proc. 2011-18 modifies Rev. Proc. 2004-34 to allow taxpayers to defer revenue from the sale of gift cards that are redeemable for goods or services of the taxpayer *or a third party*. Deferral is thus permitted even when the gift cards are redeemed by a third party, related or unrelated to the selling entity, under a gift card service agreement.

Effective for taxable years ending on or after Dec. 31, 2010, taxpayers changing to the deferral method as a result of Rev. Proc. 2011-17 and Rev. Proc. 2011-18 may do so as an automatic method change. According to IRS interpretation, Treas. Reg. §1.451-5 does not apply to goods provided by entities other than the taxpayer. Taxpayers currently deferring gift card sales under the two-year deferral of Treas. Reg. §1.451-5 might consider filing an automatic consent Form 3115 to change to the one-year deferral method afforded by Rev. Proc. 2004-34.

▶BEWARE OF ESCHEAT

Retailers' short-term cash flows benefit greatly where gift cards are never redeemed. This gift card "breakage," i.e., unredeemed balances, may create legal reporting and remittance requirements for retailers under unclaimed property (escheat) laws in various states, including Delaware and New York. State escheat laws entail a "due diligence" obligation to attempt to return unclaimed property to its owner after expiration of a statutory dormancy period. The dormancy period for unredeemed values ranges from two to five years in the various jurisdictions, and escheat ranges from 60 percent to 100 percent of the value. Some states exempt cards with minor values or cards with clearly stated expiration dates. While online registration systems for gift cards may be helpful in meeting escheat reporting obligations, the transferability of gift cards raises complex legal issues.

To avoid potential unclaimed property liability, and to claim deferral under Treas. Reg. §1.451-5 (which rules out goods provided by third parties), companies often establish a separate gift card management company in the form of a single-member LLC, located in a state with favorable escheat laws. However, any such arrangement must serve a valid business purpose to withstand challenge by the IRS. The subsidiary must have its own management, accounting, board of directors and anything else that avoids being considered a "sham."

It should be noted that for financial statement purposes under GAAP, no income from unredeemed value is recognized if amounts are remitted to a government agency under state escheat laws. If no escheat laws apply, GAAP rules would generally not allow for de-recognition of a liability until relief from the liability, i.e., use of the gift card. However, under a special exception for gift cards, where a company can establish that the chance of the customer redeeming the gift card is remote, the revenue from breakage is recognized.

▶NEXUS CONSIDERATIONS

Gift cards can also create state nexus – a physical or economic presence sufficient to establish jurisdiction to tax in the state. For example, if gift cards are issued pursuant to a license granted by the retailer, the retailer may be considered to have economic nexus in certain states where the cards are sold. Gift cards, although representing intangible value, are (unless issued electronically) physical objects whose presence in a store may create nexus for tax purposes, even if the issuer otherwise has no presence in that state. It is therefore vitally important for retailers to understand nexus requirements in the respective states where their gift cards are sold.

With sales of gift cards surging, retailers' strategies to maximize earnings should include knowledge of the rules to achieve deferral of revenue for federal income tax purposes, minimizing breakage subject to state escheat laws and awareness of state income tax consequences of issuing and distributing gift cards.

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AS RETAILERS ASSESS SANDY'S DAMAGES, A FEW TIPS FOR RECOVERY

By Clark Schweers and Drew Olson

During the holiday season, retailers need to keep their goods moving. Across the nation, retail employees work overtime to get inventory onto store shelves in time for the holiday rush. With a 4.7 percent increase forecast for holiday sales this year, according to our *Retail Compass Survey of CMOs*, retailers will need to be functioning at full speed to meet demand.

Unfortunately, Superstorm Sandy did not have this in mind.

According to IHS, the research and economic analysis firm, Sandy could result in up to $50 billion in economic losses, including between $10 and $30 billion in lost business, underlining the significant business interruption challenges for retailers.

Out of necessity, these companies will have to rebuild—and rebuild better, with improved infrastructure, more adequate insurance policies and a bit of additional foresight. This process will be specific to each company, but here are a few lessons that retailers may want to consider in the wake of Sandy:

1. **No location is free from a catastrophic risk.** The sentiment of "this will never happen here" needs to be replaced with "if this happens here, what is the impact?" It is the risk management department that should be identifying the potential risks and working with finance and operations to assess if the costs of limiting the risks outweigh the likelihood of the risk occurring. It is a cost/benefit affair. Clearly, with Superstorm Sandy, the costs of preventing storm surge in New York City would be massive, but moving critical equipment from at-risk floors may have saved hundreds of millions of dollars. Sometimes common sense preventions are the best mitigating factor to a risk from a cost perspective.

2. **Create an emergency energy plan (or refine the current one)** that accounts for total loss of the energy needed for your retail operations. An energy plan may call for alternative energy capacity from generators for retailers' distribution centers. Also, most retailers lease their retail space, so as part of an energy plan, they should consult with their landlords to better understand any existing energy contingency plans that the landlord already has. Finally, it may be the case that more astute retailers will be back to business while their neighbors are still dealing with disaster recovery. Hillary Clinton famously stated, "It takes a village," which also applies to retailers as neighboring businesses help attract customers to that retailer. As a result, a detailed energy plan should also involve thorough consultation with neighbors on their recovery response plans.

3. **Be aware of any changes to insurance and regulatory policies** that go into effect after a disaster. Rationing, curfews and specific business requirements may all affect daily operations and should be consistently monitored. In New Jersey, for instance, Governor Chris Christie signed an executive order directing "insurers to be flexible on due dates for claim filings and premium payments; and lenders to be flexible on due dates for loan payments, and on late fees." Similarly, several state insurance regulators stated that Sandy was not a hurricane when it made landfall and hurricane deductibles should not apply. It should be noted that a Named Storm may not be defined as a hurricane in many policies. Situations like these are critical to understanding the insurance provisions and should be accounted for as businesses seek to recoup losses.

4. **Create a fall-back system for internal and external communications.** Regular updates should be available to employees across various channels in case traditional communication channels are lost. During Superstorm Sandy, many people experienced loss of cellular service but still had access to visit a company's website for updates. Likewise, many people lost connection to company servers, which is why personal emails should be kept on file. External communications can be crucial as well. After Sandy, many produce retailers were forced to throw away large amounts of food for insurance purposes (to limit litigation risk of someone falling ill to contaminated food). However, by failing to effectively communicate that message to their customers and the general public, they invited harsh criticism from those who thought the goods should have been donated. Having a communication plan for these types of scenarios will limit the risk of reputational harm.

5. **Consider inventory and supply chain strategies.** In the case of disasters, inventory can be similar to a financial portfolio – the more diverse, the less risk. Retailers that house their inventory in multiple locations and various regions are less vulnerable to the adverse effects of one local event. By regionalizing supply chains, companies can plan for unaffected regions to compensate for impacted locations that have been debilitated.

6. **Assess insurance policies** to determine whether or not mitigation actions are covered by your provider. Business interruption policies can cover lost profits, extra expenses incurred to mitigate losses, expenses for relocation and certain fixed costs due to a disaster. Retailers should start by assessing their current plan and, using lessons learned from past events, determine the best insurance policy for their specific business needs.

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2012-2013 CALENDAR

The following is a list of upcoming conferences and seminars of interest for retail and consumer product executives:

UPCOMING BDO SPONSORED EVENTS:

FashInvest Annual Capital Conference

December 11, 2012
LIM College
New York, N.Y.

Capital Roundtables Private Equity Investing in Retail & E-Commerce Companies Event

December 12, 2012
The University Club
New York, N.Y.

WWD Apparel & Retail CEO Summit

January 7-8, 2013
Plaza Hotel
New York, N.Y.

JANUARY

Jan. 13-16
NRF 102nd Annual Convention and EXPO
Jacob K. Javits Center
New York, N.Y.

Jan. 15
RAMA CMO Summit
W Times Square
New York, N.Y.

Jan. 24-25
ICSC - Thomson Reuters Global Retail Real Estate Forum
The Thomson Reuters Building
London, UK

FEBRUARY

Feb. 17-20
IFA Annual Conference
MGM Grand
Las Vegas, Nev.

Feb. 27-29
Retail Supply Chain Conference – Logistics 2013
Gaylord Palms Resort & Convention Center
Orlando, Fla.

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BDO RETAIL AND CONSUMER PRODUCTS PRACTICE

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