



Sourcing of income received from issuing and selling of stored value cards, gift cards, gift certificates and similar items for apportionment purposes

LR: 2012-5-CBT – Issued June 29, 2012

Tax: Corporation Business Tax

The taxpayer requested a Letter Ruling regarding the application of the New Jersey Corporation Business Tax Act to the sourcing of income resulting from the issuing and selling of stored value cards, gift cards, gift certificates and similar items for purposes of the apportionment provisions set forth in N.J.S.A. 54:10A-6 ("Section 6" of the New Jersey Corporation Business Tax Act, N.J.S.A. 54:10A-1, et seq. (the "CBT").

Facts

The taxpayer is incorporated in Florida and is affiliated with a group of national retailers that sell consumer goods at store locations throughout the country (the "Retail Affiliates").

The taxpayer maintains an office and business operations in New Jersey and employs at least five individuals at its business location. The taxpayer is engaged in the business of issuing and selling stored value cards, gift cards, gift certificates and similar items that can be loaded and reloaded with monetary value, or that represent specified monetary or other value such as merchandise credits (which are deemed to be a return of merchandise for cash and a purchase of a gift card under IRS Rev. Proc. 2011-17), and can be redeemed by owners of the cards for merchandise or services purchased at the various store locations of the Retail Affiliates (collectively referred to as "gift cards").

Through an agreement among the taxpayer and its Retail Affiliates, the taxpayer's gift cards are sold by the Retail Affiliates at their various store locations throughout the country. Retail Affiliates maintain an inventory of inactive gift cards at each of their store locations for purchase by consumers. At the point of purchase by the consumer, the gift card is activated at the store location of the Retail Affiliate. Upon purchase and activation of the gift card, the taxpayer pays a commission to the particular Retail Affiliate for the activation.

The taxpayer also sells its gift cards to or through certain unrelated third parties. One group consists of third-party purchasers, referred to as "business-to-business" ("B2B") customers, who purchase gift cards from the taxpayer in bulk and use them for their own business purposes, such as fundraising activities or reward programs. The gift cards purchased by B2B customers find their way into the hands of consumers throughout the country and those consumers redeem them to purchase merchandise at the store locations of the Retail Affiliates. The gift cards sold to B2B customers are purchased at a discount and are activated in bulk at the time of sale.

The second group of unrelated third parties consists of third-party business partners referred to as "Aggregators." Inactive gift cards are sold at a discount and shipped to the Aggregators who then distribute the gift cards to third-party retailers throughout the country such as supermarkets or drugstores, for ultimate sale to the public. Upon the purchase of a Gift Card by a consumer from a third-party retailer, the gift card is activated by a third-party retailer at the

point of sale. Upon activation, the Aggregator remits the value of the gift card to the taxpayer net of an agreed fee. The consumer then redeems the gift card to purchase merchandise at the store location of the Retail Affiliates.

A large part of the taxpayer's gift card database and recordkeeping functions are outsourced to a third-party financial company located outside of New Jersey. The third-party financial company manages activations, reporting and card production for the taxpayer. The taxpayer pays a fee for these third-party services.

The taxpayer maintains records that identify where gift card redemptions take place at the store locations of Retail Affiliates on a state-by-state basis. However, the taxpayer does not have the ability to determine where all gift card activations take place on a state-by-state basis.

When a gift card is activated at the point of sale, the taxpayer records a cash asset and a corresponding liability on its books. Upon the use and redemption of gift cards by consumers to purchase merchandise at the various store locations of the Retail Affiliates, the taxpayer reimburses Retail Affiliates for the amount of the redemption and receives a redemption fee from the Retail Affiliate for each redemption transaction. The activation or redemption of a gift card does not produce taxable income to the taxpayer. Rather the receipt of redemption fees paid by Retail Affiliates is income to the taxpayer.

Taxable income also is periodically recognized by the taxpayer from (1) a percentage of the gift card payments it receives, referred to as "breakage." (Breakage is a statistical calculation which determines the income to be recognized resulting from dormant gift cards which by law are not subject to escheat); and (2) any gift card balances which remain unredeemed after one (1) year pursuant to the advance payment deferral rule in IRS Rev. Proc. 2004-34.

In conclusion, the taxpayer will recognize and report for tax purposes the following streams of income:

1. Gift card payments attributable to breakage and deferred unredeemed gift card balances.
2. Income from redemption fees paid by Retail Affiliates upon consumer redemption events at the various store locations of the Retail Affiliates.
3. Miscellaneous investment income, if any, from the investment of cash on hand.

Issues

1. Whether redemption fees received by the taxpayer attributable to consumer gift card redemption events at Retail Affiliate store locations in New Jersey are to be sourced to the numerator of the Section 6 sales fraction.
2. Whether the taxpayer's income recognized from gift card payments attributable to breakage and deferred unredeemed gift card balances are to be sourced to the numerator of the Section 6 sales fraction based on the percentage of gift card redemption fees sourced to New Jersey.

3. Whether any miscellaneous investment income earned by the taxpayer from the investment of cash on hand is to be sourced to the numerator of the Section 6 sales fraction based on the percentage of gift card redemption fees sourced to New Jersey.

Discussion

The apportionment of income under the Corporation Business Tax Act is calculated by applying the business allocation factor set forth at N.J.S.A. 54:10A-6. The sales fraction in Section 6 is determined by including receipts from sales attributable to New Jersey in the numerator and by sourcing the total amount of receipts everywhere in the denominator of the sales fraction.

Intangible income integrated in a multistate trade or business is to be sourced to New Jersey to the extent that income is generated from customers or markets in New Jersey under N.J.A.C. 18:7-8.12(e) which states that: "Intangible income not apportioned by other provisions of these rules is included in the numerator of the receipts fraction where the taxable situs of the intangible is in this State. The taxable situs of an intangible is the commercial domicile of the owner or creditor unless the intangible has been integrated with a business carried on in this State.

Example: The taxpayer has its domicile outside this State. It is in the business of lending money, some of which is loaned to New Jersey residents. Interest income recognized from such loans is income derived from sources within this State and, as such, is earned in New Jersey. That interest income is includable in the numerator of the receipts fraction.

The integration of the business in New Jersey would lead to a market or consumer based apportionment approach for (1) gift card payments attributable to breakage and deferred unredeemed gift card balances and (2) income from redemption fees paid by Retail Affiliates upon consumer redemption events at the various store locations of the Retail Affiliates.

Taxpayer's sales of gift cards to, and the distribution of those gift cards by, Aggregators and B2B customers is a multistate business. The gift cards sold or otherwise transferred to consumers throughout the country are used by those consumers at the various store locations of the taxpayer's Retail Affiliates. The taxpayer's gift card assets and liabilities are directly related and integrated with the taxpayer's multistate sales activities and the sales activities of, and the redemption of gift cards at, its Retail Affiliates.

Therefore, based on the foregoing, the taxpayer is required to source the income it receives for redemption fees paid by Retail Affiliates attributable to retail transactions at the various store locations at the Retail Affiliates using the "market sourcing" approach described in the regulations. The redemption fees attributable to consumer gift card redemption events at Retail Affiliate store locations in New Jersey will be sourced to the numerator of the Section 6 sales fraction and total redemption fees from all sources to the denominator of the Section 6 sales fraction.

Income from gift card payments attributable to breakage and deferred unredeemed gift card balances should also be sourced in accordance with the "market sourcing" approach.

The taxpayer's state-by-state redemption data should be used to allocate and source this income stream because the taxpayer is unable to determine where all gift card activations take place on a state-by-state basis. The taxpayer's redemption data is an accurate representation of the sourcing for this income stream for purposes of the Section 6 sales fraction.

Moreover, the Division recognizes the need for market-based sourcing due to recent technological advances and contemporary business models that have caused other alternative apportionment methodologies to become obsolete. For example, the information required to implement the allocation of special industries under N.J.A.C. 18:7-8.10 is typically unavailable to many modern businesses.

However, the investment of cash on hand that relates to and is held in connection with the taxpayer's multistate trade or business should be sourced to the commercial domicile of the owner or creditor unless the intangible has been integrated with a business carried on in another state. N.J.A.C. 18:7-8.12(e). The commercial domicile is in New Jersey because the cash on hand is managed from the taxpayer's New Jersey office. Income from this cash investment is sourced to New Jersey because the cash investment is not integrated with a trade or business carried on in another state. The investment activities relating to the cash on hand are completely separate from the sale and redemption of gift cards.

The taxpayer is seeking relief under N.J.S.A. 54:10A-8 when requesting that the investment income from cash on hand should not be sourced to its commercial domicile in New Jersey. A formal request for relief under N.J.S.A. 54:10A-8 must be requested in the format set forth at N.J.A.C. 18:7-10.1. An anonymous taxpayer identity would not qualify as a formal request under N.J.A.C. 18:7-10.1.

Therefore, the investment income from the cash on hand should not be sourced to the numerator of the Section 6 sales fraction in the same percentage as its other business receipts.

Conclusion

1. Redemption fees received by the taxpayer attributable to consumer gift card redemption events at Retail Affiliate store locations in New Jersey are to be sourced to the numerator of the Section 6 sales fraction.
2. The taxpayer's income recognized from gift card payments attributable to breakage and deferred unredeemed gift card balances are to be sourced to the numerator of the Section 6 sales fraction based on the percentage of gift card redemption fees sourced to New Jersey.
3. Any miscellaneous investment income earned by The taxpayer from the investment of cash on hand is sourced to the commercial domicile in New Jersey because the investment of the cash on hand is managed from the the taxpayer's New Jersey office.

A Letter Ruling is limited to the facts set forth therein and is binding on the Division of Taxation only with respect to the person or entity to whom it is issued and only if the person or entity fully and accurately describes all relevant facts. A Letter Ruling is based on the law, regulations,

and Division policies in effect as of the date the Letter Ruling is issued or for the specific time period at issue in the Letter Ruling.