The Votes Are In: What Happens Now?

By: Robert Peters, Duff & Phelps, LLC

In case you have been on another planet these past several weeks, two events shocked the world this month: The Cubs won the World Series after a 108-year drought and Donald Trump, who was predicted to lose in virtually all the polls, came out on top of the electoral vote in a landslide victory. (ok for those on the other side, yes he lost the popular vote, but still will be inaugurated as our 45th President come January).

But that was then and this is now… so what are all Americans turning to either celebrate the victory or ease the pain? Why of course America's favorite pastime. No, not football… shopping!

And with the holiday season upon us, this year's shopping spree is predicted to surpass all prior years.[1] Holiday sales are expected to grow to over $650 billion, or 3.7%, this year higher than the 10-year average of 2.5% and 7-year average of 3.4% growth.

Not surprisingly, gift card purchases are also expected to continue its historic growth pattern. In the aggregate, gift card sales are expected to exceed $100 billion this holiday season, an approximate 4% growth over 2015, while annual gift card sales will likely surpass $140 billion.[2] Amazingly, nearly 2/3 of all consumers will purchase a gift card this holiday season, and if you are 25-34 years old, your chances of purchasing a gift card is 85%.

Now, let's not jump to conclusions here about the rationale behind such growth, but clearly the ease of purchasing gift cards electronically may have something to do with its popularity among millenials.[3] In fact, surveys indicate approximately 70% of all consumers are more interested in purchasing electronic/digital gift cards now than 2-3 years ago. So clearly, the internet is drawing more consumers to purchase… and redeem gift cards on line. As a result, E-Gifting has experienced the largest increase in sales, rising 26% last year, and is expected to grow at an even a larger rate this holiday.[4]

1 https://nrf.com/media/press-releases/national-retail-federation-forecasts-holiday-sales-increase-36

2 CB Tower Research Study; see also https://wallethub.com/edu/gift-card-market-size/25590/

3 https://www.cardcash.com/gift-card-statistics/

4 https://blog.wirecard.com/virtual-gift-cards-are-an-opportunity-for-merchants-to-capitalize-a-huge-potential/

No doubt about it, the gift card market is significant and the product offerings are expanding geometrically. So as the holiday season ramps up, what should gift card/ certificate issuers be aware of?

1. On a positive note, electronic gift card/certificate offerings are considerably less costly to issue than physical cards that are delivered through brick and mortar locations, which require the actual card inventory to be monitored and swiped by store personnel to load and redeem;

2. Electronic cards also are relatively easy to modify to accommodate changing consumer trends as well as new and significantly increased app technology becoming available. Electronic cards/certificates also provide merchants with a wealth of data and are easier to track in event of security breaches as opposed to physical cards that can be used by anyone in possession of the card; and

3. Linking gift card purchases to rewards/loyalty programs also has proven to reap significant benefits to merchants issuing gift cards. Often times, merchants design reward/loyalty programs, which permit consumers to convert reward/loyalty points to gift card purchases, or alternatively, award additional reward points for each dollar purchased or reloaded on the gift card. Some even offer additional gift cards if the initial card purchased exceeds a minimum threshold, e.g. buy one card worth $100 and receive a $25 card for free.

While each of the above incentives can clearly be a motivator for merchants to not only enter the digital gift card world, but to also ramp up their card programs and offerings, it is important for merchants to be mindful of the following issues when rolling out or revamping existing programs.

The states want their money.

Each year billions of dollars of gift cards as well as loyalty and reward cards go unredeemed and historically, the “breakage”, or percentage of card balances went unused, ranged from 3 to as much as 12%. However, due to federal legislation that was enacted back in 2009, establishing minimum guidelines for the use of expiration dates as well as inactivity and service fees on gift cards/certificates, the breakage rates have decreased considerably.[5] In spite of the federal regulation, for many, if not most, merchants, the breakage income remains significant, oftentimes representing 1-2% of aggregate revenue, and at least 3-5% of card issuances.[6] The aggregate breakage is estimated to exceed $40-$50 billion.

While many retailers automatically assume that the unused card balances create a windfall profit and can be recorded as income, in the absence of careful planning, many have come to learn that reaping the financial benefits can be fraught with minefields.

First, there is the matter of state unclaimed property laws. In approximately 35 states plus the District of Columbia, if certain conditions are satisfied the unredeemed gift card balances could be exempt/excluded from unclaimed property reporting (remittance). Specifically, these conditions expressly require that the gift cards not contain expiration dates or inactivity fees. But, despite these exemptions, there remains a number of jurisdictions, including New York, New Jersey, Georgia, Delaware and many others, where some portion, or the entire amount of the unredeemed gift card balance is required to be remitted to the state as unclaimed property once the card balance remains inactive for 3 or 5 years.

5 The Federal Card Act amended the Electronic Fund Transfer Act, the law became effective on January 31, 2011 and included the general requirement that an expiration date cannot be imposed earlier than five years after issuance date, nor an inactivity fee unless the card has remained unused (inactive) for at least one year.

6 By way of example, Nordstrom in its annual report disclosed a breakage rate of approximately 3%, Guess Inc.'s breakage rate was disclosed as being 4.7-5.7%. Starbucks disclosed its aggregate breakage income for 2015 exceeded $39 million.

Determining which state's law governs can be a tricky matter. Under rules that have been in place for well over 50 years, the state laws that govern is based on a court approved priority scheme. The state with the first priority claim over an unredeemed cards, would be the state of the card owners address… as reflected in the books and records of the card issuer. And if there is no address recorded in the card issuers books and records, then the state of incorporation of the card issuer has a second priority jurisdiction over the unredeemed card balance.

Historically, in an overwhelming number of circumstances, the actual address of someone who purchases a gift card is unknown. This is because the cards have been purchased with a credit card, or no address information is captured by the merchant. In these situations, unclaimed property law of the state in which the card issuer is incorporated governs. And where are the overwhelming majority of companies incorporated? Delaware, one those states, which require the unredeemed balances to be remitted as unclaimed property. So it should not come as a surprise that Delaware has been among the most aggressive states attempting to enforce its unclaimed property law against retailers that have incorporated in the state, as well as those that may have planned to avoid the state's rules by transferring the gift card program to either a captive entity or third party provider. One major case currently pending in the courts involves a whistle blower law suit that was brought by Delaware, under the state's False Claim Act, against approximately 25 major retailers. The state is seeking the imposition of triple damages in the form of interest and penalties, if successful.[7] Delaware, and other jurisdictions have also launched multistate audits of retailers incorporated in Delaware, that have issued gift cards in the past and failed to remit the unredeemed card balances as unclaimed property under the state's reporting guidelines.

In addition, the advent of the internet and the proliferation of digital gift cards present some unique problems to retailers. Many, in their gift card planning, have taken steps to insure that gift cards are issued from an entity that is incorporated in a state that does not require the escheat of unredeemed gift card balances invoking the second priority rule. If, however, the cards are issued electronically and customer information, including actual address information, is captured by the retailer in order to mail the cards, or for other marketing reasons, then the first priority rules will apply and the retailer will be required to follow the separate rules for every state in which their card owners reside. Many organizations have failed to distinguish their online sales (where customer address information is captured) from sales made at brick and mortal locations where such information is not requested and have run afoul of the first priority rules and the requirement to file with the state of the owners' addresses rather than the application of their exempt state of incorporation.

And then there is the matter of Loyalty and Reward programs.

A number of states exclude from its definition of unclaimed property loyalty, rewards or promotional gift cards. Also, under the previous mentioned Federal Card Act, provided certain requirements are satisfied loyalty, reward and promotional gift cards may include expiration dates and inactivity fees. The fundamental problem for retailers is that under most states' unclaimed property laws, there are little or no definitions of what constitutes a royalty, rewards or promotional card. So retailers must interpret their various card offerings, including rewards and loyalty programs without clear guidance as to whether the programs meet the definition of a gift card, which in virtually all states is reportable as unclaimed property if there is an expiration date or inactivity fee imposed, or meets the definition as an exempt loyalty, reward or promotional cards There are also instances where the lines between an exempt loyalty or reward program and an unredeemed gift card could be crossed if any portion of the rewards or loyalty card can be redeemed for cash. In such instances, all bets are off and the "reward" program would be considered a gift card subject to a state's unclaimed property rules.

7 *The State of Delaware and William Sean French v. Card Compliant, LLC. et al.*, Del. Superior Court, Case No. N13C-06-289 FSS, March 14, 2014

And finally there are the Accounting and Tax Requirements

From a regulatory perspective both the US and International accounting standards boards have issued new proposed guidelines on how and when gift card breakage income is recognized for financial reporting purposes. Prior to the adoption of these rules there had been considerable diversity and uncertainty over how, if ever, the breakage could be recognized. Under the US proposed rulemaking most card issuers will be entitled to recognize the breakage income (1) proportionally in earnings as redemptions occur or (2) when redemption is remote, if the amounts do not constitute unclaimed property.[8] And, for loyalty and rewards programs, no surprise here, the rules governing the recognition of revenue and costs under US GAAP differ as do those under the IRS tax rules regarding when the breakage income is recognized for income tax purposes, often times requiring the acceleration of breakage for income tax purposes over that recognized in the financial statements. And, it is left to be seen whether these rules are amended based on the promises by our President elect to simplify the tax code and reduce regulations.

Not to be out done, many states have different guidelines on whether or not the loyalty or reward or promotional card/certificate is subject to sales/use tax. The rules vary by state, but certain certificates or rewards used to reduce the retail price can nevertheless, still be subject to sales tax.

So What's a Gift Card/ Loyalty Program Sponsor to Do?

Some considerations for both new gift card and loyalty program issuers as well as those that may have been in existence for a long period of time:

1. Be mindful of the financial, tax and regulatory implications that extend beyond the marketing of new loyalty, rewards and promotion programs;

2. In light of the increased scrutiny by the states on the formation and operation of captive gift card companies, review the economic substance behind any such entities that may have been in existence for years;

3. Seek possible alternative legal structures or arrangements that will help to mitigate possible challenge by some of the more aggressive jurisdictions, most notably Delaware;

4. Include multiple stakeholders in the decision making process including marketing, financial, tax and IT personnel so that there is common understanding of the potential challenges as opportunities of initiating or expanding a gift card, loyalty or rewards program; and most importantly

5. Seek professional advice to ensure that the anticipated benefits from the introduction or expansion of existing gift card programs, including digital and on line offerings will be realized.

8 See FASB Accounting Standards Update (ASU), No. 2016-04, Liabilities-Extinguishments of Liabilities, March, 2016, ASU No. 2014-09 Revenue from Contracts with Customers, issued May, 2014.

DUFF & PHELPS

For more information of the tax, financial, unclaimed property and regulatory implications of Gift, Incentive and Rewards Programs contact:

Robert Peters
Managing Director, State Tax
+1 312 697 4924
robert.peters@duffandphelps.com

For more information please visit:
www.duffandphelps.com

About Duff & Phelps
Duff & Phelps is the premier global valuation and corporate finance advisor with expertise in complex valuation, disputes and investigations, M&A, real estate, restructuring, and compliance and regulatory consulting. The firm's more than 2,000 employees serve a diverse range of clients from offices around the world. For more information, visit www.duffandphelps.com.

M&A advisory, capital raising and secondary market advisory services in the United States are provided by Duff & Phelps Securities, LLC. Member FINRA/SIPC. Pagemill Partners is a Division of Duff & Phelps Securities, LLC. M&A advisory and capital raising advisory services are provided in a number of European countries through Duff & Phelps Securities Ltd, UK, which includes branches in Ireland and Germany. Duff & Phelps Securities Ltd, UK, is regulated by the Financial Conduct Authority.