Court Rules on Tax Treatment of Hotel Rewards Program Fund

October 19, 2023

The recent Tax Court opinion in *Hyatt Hotels Corporation v. Commissioner of Internal Revenue*[1] informs a federal income taxpayer about its tax responsibility for funds for a guest reward program: when the taxpayer will be treated as fund trustee; the tax accounting method to use for the funds; and eligibility to use the trading stamp accounting method to accelerate deductions for the obligation to fund rewards that guests redeem. The case teaches three lessons:

- If a taxpayer asserts that it holds a fund for a rewards program in trust, the taxpayer is subject to income tax on the trust fund unless its use of the fund is legally restricted, and such use does not directly benefit the taxpayer.
- If a taxpayer's practice for all taxable years never includes an income item and never deducts a related expense, the taxpayer's practice is not an accounting method, and the IRS cannot make an adjustment in a current taxable year to account for all the omissions made in past taxable years.
- A taxpayer that sponsors a program that rewards a service is not eligible for the trading stamp accounting method and cannot use that method to deduct an estimate of the cost of its future obligation to provide rewards.

The Hyatt Guest Rewards Program: A hotel guest enrolled in the Hyatt rewards program earned reward points by paying for a stay at a participating Hyatt hotel. Thereafter, the guest could redeem the reward points for a future stay at no charge at a participating Hyatt hotel. Hyatt retained the power to change the terms of the rewards program and did so from time-to-time.

The Participating Hyatt Hotels: Hyatt owned about one-fourth of the hotels that participated in the rewards program. The remaining three-fourths of the participating hotels – the non-owned hotels – licensed Hyatt trademarks and purchased Hyatt business services. These non-owned hotels were obligated to participate in the rewards program.

The Fund: A participating hotel made a payment to Hyatt when a guest who was enrolled in the rewards program paid for a stay at a participating hotel. The participating hotel received a payment – a compensation payment – from Hyatt when the guest redeemed reward points for a free stay at the participating hotel. Hyatt maintained a separate fund (the "Fund") in a Hyatt subsidiary to deposit the payments from participating hotels and to make compensation payments to the participating hotels. Hyatt invested the balance in the Fund in marketable securities from which gains were realized and interest accrued.

Hyatt's Income Tax Treatment: Hyatt did not reflect in income the amounts to which the Fund was entitled, nor did it reflect as expenses amounts that the Fund was obligated to pay.[2] Hyatt treated itself as trustee of the Fund on the theory that it lacked any beneficial ownership in the Fund or in the investment earnings.

IRS Examination: The IRS examined Hyatt's 2009, 2010, and 2011 tax returns and rejected Hyatt's trustee argument. It treated the Fund inflows as includable income when Hyatt became entitled to them and the Fund outflows as deductible expenses when Hyatt was obligated to make the compensation payments. Additionally, the IRS treated this change in tax reporting as an involuntary change in Hyatt's accounting method. Doing so resulted in an increase in 2009 income of $200 million, which reflected the 2009 positive balance of all the inflows and outflows since the program inception in 1987.

Continued

Tax Court Proceeding: Hyatt petitioned the Tax Court to set aside the income adjustments. It made three arguments. First, Hyatt had no beneficial interest in the Fund. Second, even if Hyatt had a beneficial interest in the Fund, Hyatt's treatment of the Fund was not an accounting method so that the IRS could not include in Hyatt's income the $200 million total balance of the fund as of 2009. Third, even if the first two theories failed, Hyatt could account for the Fund using the trading stamp accounting method, which allows an offset against current income of an estimate of future expenses.

Trustee Argument: The Tax Court rejected Hyatt's argument that it was only a trustee of the Fund. A taxpayer is treated as trustee if it satisfies two tests. First, the taxpayer must receive funds subject to a legally enforceable restriction that they be spent in their entirety for a specific purpose. Second, the taxpayer must not profit, realize gain, or benefit from spending the funds for the specific purpose. The court found that Hyatt failed the first test by retaining the power to determine the amounts that the non-owned hotels paid into the Fund and the amounts that Hyatt withdrew from the Fund.

The court also found that Hyatt failed the second test because it derived direct benefits from the Fund. While a benefit that is incidental and indirect is not considered, Hyatt directly benefited by shifting part of the cost of what should have been its own advertising to the Fund. That use directly benefited Hyatt by reducing its cost of advertising the Hyatt brand, which in turn enhanced the value of its trademark and customer goodwill.

Accounting Method Argument: The court agreed with Hyatt that totally excluding deposits and withdrawals from income was not an accounting method, and since it was not, the IRS could not true-up the income in an amount of $200 million for all years since program inception in 1987. An accounting method involves the timing of income inclusion and expense deduction. A change in accounting method ensures that when an accounting method is changed, items are not twice included or twice deducted. That risk does not exist when a taxpayer merely excludes items from income and expense as Hyatt had done, because, if the program were to exist forever, the changes would be permanent.

The IRS argued that if the court did not permit the IRS to treat Hyatt's reporting of Fund inflows and outflows as an accounting method, Hyatt would have a windfall because it would be able to deduct a future compensation payment related to the $200 million of deposits on hand that Hyatt had never included in income. The court replied that Hyatt still has a duty to report items consistently and a duty to clearly reflect income. These duties might prevent Hyatt from permanently excluding $200 million from income in future tax returns. The court said that resolution of the windfall issue must await presentation of a future tax year when the asserted windfall occurs.

Trading Stamp Argument: Finally, the Tax Court ruled that the trading stamp exception for an accrual method taxpayer does not apply to a reward program providing services. An accrual method taxpayer deducts the amount of an expense for a service when all events establish the fact of the liability for the service, the amount can be determined with reasonable accuracy, and the service is performed. Thus, under this general rule, Hyatt could not deduct the cost of a service provided by a non-owned hotel to a guest who used reward points until the hotel provided the service to the guest.

Hyatt argued that the trading stamp accounting method is an exception to the accrual method for services and that it permitted an acceleration of the deduction to the year in which paying guests earned reward points. The trading stamp exception allows an accrual method taxpayer that issues a promise of a reward to its customers to currently offset sales revenue with the estimated cost of future reward redemptions. The exception applies, however, if the redemption is in

merchandise, cash, or other property,[3] but not if it is a service. The court characterized hotel accommodations as a service and ruled that Hyatt was ineligible for the trading stamp exception.

Please contact your Miller Canfield attorney or the authors of this alert if you wish to discuss the matter further.

[1] T.C. Memo. 2023-122 (Oct. 2, 2023).

[2] For Hyatt-owned hotels, Hyatt essentially recorded compensation payments to the hotel from the Fund as hotel income and payments by the hotel to the Fund as hotel expenses.

[3] Treas. Reg. §1.451-4(a)(1)(ii).