Exclusions of Income Under Claim of Right Doctrine

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We reported in 2023 on the Tax Court's conclusion regarding amounts paid, under a customer loyalty program, by hotels operated under Hyatt brands to Hyatt Hotels Corp. (T.C. Memo 2023-122). Those amounts were credited to an internal fund (the Fund) that made compensating payments to hotels at which points awarded under the program were redeemed. The Tax Court held that the amounts could not be excluded from Hyatt's gross income under the "trust fund" doctrine, but, rather, that the amounts (net of related expenses) were taxable to Hyatt.

Earlier this year, the Court of Appeals for the 7th Circuit vacated the decision of the Tax Court and remanded the case for further consideration of an alternative argument made by Hyatt for exclusion from its income of payments made to the Fund (174 F.4th 535). The Court of Appeals also disagreed with the Tax Court's interpretation of a longstanding regulation concerning the so-called "trading stamp" method of accounting, which Hyatt had sought to apply in the event that the payments were includible in its gross income.

Facts in *Hyatt*

Hyatt maintained a loyalty program under which customers enrolled in the program were awarded points for expenditures at Hyatt-brand hotels. Customers could redeem those points to pay for hotel stays, room upgrades, and other services at Hyatt-brand hotels.

When a customer enrolled in the program earned points at a Hyatt-brand hotel, the hotel was required to pay Hyatt a fee computed as a percentage of revenue derived from the customer's stay. That fee was credited to either of two accounts owned and operated by Hyatt and collectively referenced in the *Hyatt* decisions as the Fund. When a customer redeemed points awarded under the program to pay for a room or other services at a hotel, that hotel received a payment from the Fund. The Fund was also used to pay advertising costs relating to the program and to reimburse Hyatt affiliates for costs of administering the program. Fund account balances were invested in marketable securities.

Annual financial statements were prepared for the Fund and made available to third-party hotel owners of Hyatt-brand hotels. The statements described the Fund as being owned by the hotel owners. However, decisions with respect to, for example, the percentage of revenue to be paid to Hyatt for crediting to the Fund, the amounts to be disbursed from the Fund for advertising and administrative costs, and investment of the Fund were made by Hyatt, without oversight or input from the third party hotel owners. If a hotel ceased to be affiliated with Hyatt, no further payments were made to its owner from the Fund.

Hyatt's tax returns neither reported revenue from the loyalty program as gross income nor claimed deductions with respect to program expenses. Following examination of those returns, the IRS determined that the revenues from the program (net of expenses) were required to be included in Hyatt's income. The IRS made adjustments for Hyatt taxable years 2009 through 2011, the bulk of which were premised on the view that the change in the treatment of income and expenses from the program was a change in a method of accounting resulting in adjustments to be taken into account under IRC section 481(a).

Hyatt filed a petition for review of the tax deficiencies determined by the IRS and argued before the Tax Court that the contributions to the Fund were properly excluded from the income of Hyatt under the trust fund doctrine. The Tax Court observed that, for that doctrine to apply, any benefit to the person holding the assets could not be more than "incidental and secondary."

In fact, Hyatt derived substantial benefits from the loyalty program, including increased patronage at Hyatt-branded hotels, resulting increases in Hyatt revenue from revenue-based management fees, and increases in the value of those hotels (many of which were owned by Hyatt itself). In light of these circumstances, the Tax Court concluded that the trust fund doctrine did not apply and agreed with the Commissioner that program revenues (net of expenses) were required to be included in the income of Hyatt.

On appeal, Hyatt argued, and the Court of Appeals for the Seventh Circuit ultimately agreed, that the Tax Court erred in failing to consider an alternative argument by Hyatt, to the effect that, even if the “trust fund” doctrine did not apply, the revenues from the program were excludible from its income based on the “claim of right” doctrine.

The government's position before the Tax Court and the Court of Appeals was that the claim of right doctrine is a doctrine of income *inclusion*; it requires, generally, that funds received under a claim of right and without restriction must be included in the recipient's income. The government did not see the doctrine as applying to *exclude* revenue from income. The Court of Appeals disagreed, citing *Commissioner v. Indianapolis Power & Light Company* (493 U.S. 203 (1990)) as applying the substance of the doctrine when it excluded from income customer deposits received and held by an electric utility company, since the deposits were subject to refund once the customer had demonstrated acceptable credit. Although *Indianapolis Power* did not refer to the claim of right doctrine by name, subsequent decisions of the Tax Court have characterized *Indianapolis Power* as an application of that doctrine.

The Court of Appeals further noted that the borrowing of funds under a commercial loan might provide a material benefit, and result in economic gain, to the borrower, such that the funds would not be excludible from the borrower's income under the trust fund doctrine; nevertheless, it was entirely clear that amounts borrowed under such a loan would be excluded from the borrower's income under the claim of right doctrine, by reason of the borrower’s repayment obligation.

Because the Tax Court did not resolve issues relevant to whether the claim of right doctrine was applicable to exclude from Hyatt’s income amounts paid into the Fund, such as whether its use of those amounts was subject to legally enforceable restrictions, the Court of Appeals remanded the case to the Tax Court for further consideration of those issues.

The Court of Appeals also observed that the Tax Court had erred in its analysis of Hyatt's further argument that, if receipts under the program were includible in its income, Hyatt should be allowed to deduct the estimated costs of redeeming points in the same year that those points are granted, under the "trading stamp" method of accounting set forth in Treasury Reg. section 1.451-4(a)(1). Under that regulation, the trading stamp method may be available if trading stamps or premium coupons sold by a taxpayer are "redeemable by such taxpayer in merchandise, cash, or other property." Relying on a commonly understood meaning of "merchandise" as goods held for sale, the Tax Court had concluded that the words "other property" referred exclusively to other tangible property.

The Court of Appeals, however, observed that "cash" as referenced in the regulation is potentially intangible in nature, since the term presumably includes cash held in intangible form (such as bank deposits). Taking into account that "tangibility" is not a shared characteristic of "merchandise" and "cash," the appellate court concluded that it was not appropriate to interpret the regulation as requiring that the "other property" referenced in the same regulation be tangible. Accordingly, the Tax Court erred in concluding that Hyatt could not use the trading stamp method because that method is limited to rewards redeemable for cash or tangible property.

Observations

The conclusion of the Court of Appeals in *Hyatt* that receipts may be excludible from income for a reason other than the applicable of the trust fund doctrine appears sound. The court's reading of the "trading stamp" regulation as not limited to awards redeemable for tangible property also seems unsurprising, given the inherently intangible nature of much of what is understood to be "cash" and the lack of any apparent compelling rationale for barring the application of that regulation to awards redeemable for intangible property. However, it remains to be seen whether, on remand, Hyatt will prevail in its efforts to exclude receipts attributable to the loyalty program from its gross income, or (if not) whether the Commissioner will object to the application of the trading stamp accounting method in Hyatt's circumstances on other grounds.

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