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Hyatt Hotels: Are Omissions from Gross Income an Accounting Method?

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The IRS often determines upon audit that a business has over a period of years failed to report properly items of income or expense. In that case, the ability of the government to assert additional tax with respect to each year under audit is commonly limited by Internal Revenue Code (Code) section 6501, under which tax must generally be assessed within 3 years after the return for the relevant period is filed.

Code sections 446 and 481(a), however, provide the IRS with an additional, powerful tool relevant to many such situations. If a taxpayer uses a "method of accounting" that "does not clearly reflect income," the IRS may require that a different accounting method be used that does clearly reflect income, and that such adjustments be made in connection with application of the new method as are necessary to prevent items from being duplicated or omitted.

Those adjustments may, under Reg. section 1.481-1, take into account in a year for which the statute of limitations is "open" amounts received or expenses incurred in years that are otherwise time-barred under section 6501. To apply section 481(a), however, it must be established that the taxpayer's failure to account properly for income or expense results from a "method of accounting."

In *Hyatt Hotels Corporation v. Commissioner* (TC Memo 2023-122), the Tax Court agreed with the government's assertion that Hyatt Hotels Corporation and its subsidiaries (Hyatt) failed to account as required for receipts and expenditures related to a customer awards program. The court concluded, however, that the failure to account for the program resulted in a permanent (lifetime) omission from income and therefore was *not* an accounting method affecting the timing of income or deductions. Consequently, section 481(a) could not be applied by the government to determine a tax deficiency on the basis of a change in accounting method that would take into account adjustments to income and expense attributable to years prior to the years before the court.

FACTS IN *HYATT*

Since 1987, Hyatt had maintained a customer awards program (the program) under which travelers (program members) staying at Hyatt brand hotels were awarded points that could be applied for free stays at such hotels. To finance the program, Hyatt brand hotels were required to make payments to an operating fund (the fund) owned by a Hyatt subsidiary as points were awarded, and payments were made from the fund to the hotels at which the points were used.

The fund was also used to pay advertising and administrative costs that Hyatt determined to be related to the program, including the costs of maintaining the program member database (which Hyatt owned and considered to be valuable to its business), and the program was otherwise administered by Hyatt.

During the years at issue, Hyatt owned 20% to 25% of Hyatt-branded hotels; 75-80% of Hyatt-branded hotels were owned by third party hotel owners (TPHOs) that entered into management or franchise agreements with Hyatt. Hyatt therefore benefited from the program as a hotel owner as well as through its management of the program and ownership of the fund and overall ownership and management of the Hyatt brand.

The assets of the fund were held and invested through third party custodians and investment advisers engaged and directed by Hyatt.

When a TPHO withdrew its hotel from affiliation with Hyatt, no payment was made to the hotel or its owner from the fund.

An outside accounting firm prepared annual financial statements for the fund, and those statements were made available to the TPHOs. However, the TPHOs did not have any control over the use of the fund to pay for program administrative costs and advertising, or with respect to investment of the fund.

Although the assets and liabilities of the fund, and related investment gains and interest, were reflected on the financial statements of Hyatt prepared under GAAP, Hyatt's consolidated Form 1120 federal tax return did not include payments received by Hyatt under the program, or interest accrued and investment gains realized with respect to the fund; and Hyatt did not claim any deductions with respect to fund expenses.

Hyatt sent an annual letter to each TPHO that described the structure of the program and the fund and stated the aggregate amount of program payments made by the TPHO, but recommended that the TPHOs consult their tax advisers regarding how to treat those payments for federal income tax purposes.

A majority of the TPHOs deducted the payments made by them under the program in the year the payments were made to the fund. Hyatt personnel, however, believed that payments into the fund were not currently deductible by the TPHOs, because the "economic performance" requirement for deductibility under Code section 461(h) would not be met before amounts were paid from the fund.

Following audit of Hyatt's returns for 2009 through 2011, the IRS asserted tax deficiencies on the basis that payments into the fund were includible in the income of Hyatt, except to the extent of deductible expenses paid from the fund.

The IRS viewed this as a change in method of accounting and made an adjustment to Hyatt's income with respect to 2009 under section 481(a) of approximately $223 million, to account for program revenue (net of expenses paid from the fund) that had been omitted from Hyatt's income from 1987 onward. Hyatt filed a petition for review of the deficiencies by the Tax Court.

DISCUSSION

Hyatt asserted that its treatment of the program and the fund was consistent with *Seven-Up Co. v. Commissioner* (14 T.C. 965 (1950)) and other cases, discussed in the *Hyatt* opinion, that applied a "trust fund doctrine" to collective funds established by or for the benefit of distributors or retailers of a product, but frequently with some assistance or participation of the product manufacturer, primarily to improve product sales.

The court described the trust fund doctrine as supporting the exclusion from income of funds held in trust and the income therefrom where the taxpayer (1) receives funds subject to an enforceable restriction that they be spent entirely for a specific purpose, and (2) does not profit (at least directly) from the expenditure of the funds.

The court found the cases applying the trust fund doctrine to be distinguishable from Hyatt's situation, taking into account the extent of Hyatt's control over the magnitude of the payments into the fund, and the scope of the discretion exercised by Hyatt as to expenditures chargeable to the fund and the fund assets' investment and use.

In addition, the court concluded that Hyatt benefited directly from the program and the fund in multiple respects, including through its ownership of many hotels that benefited directly from the marketing expenditures paid from the fund, through the positive impact of the program on the value of the goodwill associated with the Hyatt business, and through development and maintenance of the program member database used by Hyatt for marketing and other decision making in its business.

Accordingly, the court concluded that the trust fund doctrine did not apply. However, most of the tax deficiency asserted by the government was attributable to its application of section 481(a) to include in Hyatt's income for 2009 revenue from years prior to 2009 as a one-time adjustment to avoid omission of income in connection with implementation of a change in accounting method.

Hyatt asserted that an adjustment under section 481(a) was not permissible, because the adjustment was not due solely to a method of accounting with respect to a "material item" within the meaning of Reg. section 1.481-1(a)(1). This term is further defined in Reg. section 1.446-1(e)(2)(ii)*(a)* as "any item that involves the proper *time for* the inclusion of the item in income or the taking of a deduction" (emphasis added).

Hyatt argued that, under the so-called "lifetime income" test, its treatment of fund revenue and expenses should *not* be considered a method of accounting, because the treatment of the fund by Hyatt had the effect of Hyatt's *permanent exclusion* of items from income over the course of Hyatt's "lifetime."

The government asserted, conversely, that its approach to treatment of the fund would not affect Hyatt's lifetime taxable income. The government argued that under either Hyatt's historical approach to treatment of the program and the fund, or the government's approach, the treatment of fund income and expenses would ultimately result in no aggregate lifetime taxable income to Hyatt, such that the effect of the government's approach would be to change only the timing, rather than the overall amount, of income included.

After a discussion of cases on point, the court largely agreed with Hyatt's formulation and application of the lifetime income test, and concluded that Hyatt's approach would have resulted in a permanent exclusion of income and expenses of the program, at least if the program continued in perpetuity.

The court further found to be credible Hyatt's assertions (based in part on Hyatt's prior communications with its auditors and with state taxing authorities) that, if the program was terminated, the remaining balance of the fund would be returned to the hotel owners, without Hyatt reporting income or expenses attributable to the fund even in the context of a liquidation. That provided further support for Hyatt's argument that its treatment of the fund resulted in a permanent exclusion of income rather than a change in the timing of income. Thus, the adjustment premised on the application of section 481(a) was not sustained.

Hyatt also asserted that, under the so-called "trading stamp method" described in Reg. section 1.451-4, it should be permitted to subtract from gross receipts attributable to the program not only current compensatory payments to the hotels for the use of reward points, but also the estimated cost of future redemptions of points.

The court, however, interpreted this regulation as intended to provide a narrow exception to the all events test for accrual method taxpayers that applies only where (1) the taxpayer issues trading stamps or coupons in connection with sales and (2) such stamps or coupons are redeemable "in merchandise, cash, or other property" (Reg. section 1.451-4(a)(1)). The court noted that "merchandise" is generally understood to refer to tangible property held for sale.

It further concluded that the hotel room stays offered by Hyatt hotels in redemption of points were in the nature of a license (or conceivably a lease, depending on state law) for the use of property, and therefore services, and concluded that the hotel stays were not "merchandise, cash, or other property." Accordingly, the trading stamp method did not apply.

OBSERVATIONS

Hyatt underscores that even an approach to accounting for income and expenses that has been applied consistently by a taxpayer over many years is not necessarily a "method of accounting" subject to the government's broad power to impose adjustments under section 481(a). It also illustrates the counter-intuitive rule that a taxpayer can sometimes enjoy a procedural advantage when its accounting for an item results in an erroneous permanent exclusion from income, rather than an erroneous mere deferral of income.

Taking into account the large amounts of tax revenue potentially at stake in cases involving involuntary adjustments to methods of accounting, it seems certain that there will be further controversies and court decisions regarding whether a proposed adjustment exceeds the government's powers under this provision.

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