Some Credit Card Points are Taxable

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Some Credit Card Points are Taxable

By: Tam Nguyen, MST Student

Konstantin Anikeev, et ux., TC Memo 2021-23

The everyday use of certain credit cards can result in the accumulation of reward points to be credited towards another purchase or a redemption against the credit card bill itself. This accumulation of reward points can result in $5 towards a purchase of groceries to $500 against your credit card statement. The reward points are a nice perk to gain by just using your credit card for purchases you would have made anyways. While you are definitely receiving what might feel like income, the IRS has historically not taxed credit card reward points programs. The IRS views credit card reward programs as a discount on purchases of goods and services. When viewed this way, it becomes more of a reduction in price for the goods and services instead of gaining new wealth from these reward points. One taxpayer’s aggressive accumulation of points from specific items purchased led him to create taxable ordinary income. This taxpayer acquired $35,665 in 2013 and $276,381 in 2014 through credit card rewards that the IRS deemed was taxable income. In this Tax Court memorandum decision, it will become obvious how complex a credit card reward program was treated when deciding if it is income or a rebate on a purchase.

Who is this mysterious taxpayer?

Mr. and Mrs. Konstantin Anikeev were the masterminds behind their grand accumulation of credit card reward points. I will mostly refer to Konstantin as his wife was not mentioned often in this case. Konstantin was a well-educated person. He earned a Bachelor of Science in Physics from the Moscow Institute of Physics & Technology (MIPT) in 1995 while graduating summa cum laude. A couple of years later in 1997, he went on to earn a Master of Science in Physics degree also from MIPT. His education would not stop there as he earned a Doctorate in Physics in 2004 from the prestigious Massachusetts Institute of Technology. For the years in which his credit card points came under scrutiny, Konstantin was working as a consultant for IBM. As it is easy to see, Konstantin was intelligent and it is no surprise he was able to see the opportunities in his credit card reward program to gain a sizeable amount of income.

What credit card did Konstantin use?

The American Express credit card with its Blue Cash Rewards Program is what Konstantin used to amass his points. The Blue Cash Rewards Program paid 1% for eligible everyday purchases and 0.5% of all other eligible purchases for the first $6,500 spent. After meeting the $6,500 threshold, the reward points multiplied significantly to 5% of everyday purchases and 1% on all other eligible purchases. For the higher percentage points, the Blue Cash Rewards Program defined eligible everyday purchases as (1) supermarkets, (2) gas stations for purchases of $400 or less of gasoline, and (3) select major drugstores. The Blue Cash Rewards Program cash rewards could be used as statement credits that could be refunded if they exceeded the balance owed. There was also no
limit to the amount of cash rewards that could be earned each year. The wide range of places where you could earn cash rewards from eligible everyday purchases and the unlimited amount of earning potential made this the card of choice for Konstantin.

**How did Konstantin use the American Express credit card to gain income?**

To accumulate the amount of cash rewards that Konstantin did required a lot of work. The credit card itself did not have a large limit as it only capped at $35,000, which meant he would have to pay off his credit card before making more purchases and redeem more points. The tactic that he used was to use the credit card to purchase prepaid Visa gift cards and reloadable debit cards. Konstantin would purchase these gift cards from places that were considered eligible everyday purchases to get the larger percentage points for each purchase. However, there were fees when purchasing gift cards that ranged from 0.8% to 1.2%. After acquiring the Visa gift cards, he would use them to purchase money orders. These money orders would then be deposited back into his bank accounts to pay off his balance on the credit cards. There were service fees to use the gift cards to purchase money orders that ranged from 0.07% to 0.33%. After a year of doing this, it took $1,208,376 of these purchases in 2013 and $5,184,033 of these purchases in 2014 to acquire the amount of cash rewards that he did. From constantly purchasing the gift cards, reloadable debit cards, and money orders, this must have been a time-consuming endeavor to reach the significant levels of rewards points that Konstantin did.

**Tax returns filed in 2013 and 2014**

The Blue Cash reward dollars were a significant source of income in the years Konstantin aggressively accumulated cash rewards. On his joint tax return in 2013, he reported $149,773 in wages, $2,338 in interest, and $299 in ordinary dividends. In 2014, he reported $161,480 in wages, $1,566 in interest, $78 in ordinary dividends, and $1,821 in capital gains. Neither of these years did Konstantin report any amount from the cash rewards even though he made over a fifth of his taxable wage amount in 2013 and close to double his wage amount in 2014 from these points. After a few years, the IRS eventually came after Konstantin for this unreported income. On March 23, 2017, the IRS issued a notice of deficiency to Konstantin determining he had additional other income of $29,775 for 2013 and $277,2275 for 2014. While that amount changed a couple of times before the court, the final tax he was liable for associated with the cash rewards was $9,928 for 2013 and $93,845 for 2014.

**Why did the IRS believe it was taxable income for Konstantin?**

As mentioned earlier, the IRS is aware that most purchases with credit cards are primarily used for everyday goods and services. Since credit card rewards points essentially just reduce the price paid, this is not an accession to wealth so it is not taxable income. Since Konstantin’s intent was to convert the gift cards and reloadable debit cards into money orders, these purchases were seen by the IRS as cash equivalents. When cash equivalents are purchased, there is no reduction in the purchase price for a good or service because their basis is equal to their face value. For example, $500 spent to buy a $500 gift card would essentially end up being $475 spent after getting the 5%
cash reward back. Without factoring in the service fees for the gift cards or money orders, this $25 difference is taxable as there is no reduction in the purchase of this cash equivalent. IRC section 61 is extremely broad and defines gross income as income from whatever source derived. This economic benefit from buying cash equivalents was deemed by the IRS to fit this IRC definition.

What was Konstantin’s position?

Konstantin argued that his purchases of Visa gift cards were in fact a product. He pointed out that each Visa gift card has a Universal Product Code (UPC). Since the Visa gift cards have a (UPC), it must be considered a product and therefore is considered a purchase that can have a purchase price adjustment without creating taxable income. Anything that Konstantin chooses to purchase with the Visa gift cards should not matter to determine if he has income.

How did the Tax Court rule in this case?

The Tax Court viewed Konstantin’s aggressive accumulation of cash rewards as an extreme test of the vagueness of the IRS policy to not tax credit card reward programs. It recognized that Konstantin clearly gained economic benefit from manipulating the American Express Blue Cash Rewards Program. The Visa gift cards, the direct purchases of money orders, and the cash infusions to reloadable debit cards were held to be treated differently as will be explained next.

The Tax Court decided that the IRS must abide by its longstanding policy to not tax credit card reward points that are generated from purchasing products or services. It also viewed the IRS argument to apply the cash equivalence doctrine as not a good fit for Konstantin’s purchase of Visa gift cards as the gift cards have product characteristics as they can be used as a substitute to credit cards. This holding made all reward points redeemed from purchases of Visa gift cards not subject to tax.

The purchase of money orders and cash infusions to reloadable debit cards are not considered a product like the Visa gift cards. The Tax Court ruled that no product or service was provided when purchasing a money order or the cash infusions to reloadable debit cards. The money orders were eligible to be deposited into Konstantin’s bank account from the moment he purchased them. The cash infusions were simply not a product purchased. Since neither of these transactions are seen as a product or service, they do not align with the IRS policy of excluding credit card reward points from taxable income. In conclusion, the Tax Court held that only the cash rewards associated with purchase of money orders and cash infusions into reloadable debit cards were not properly included in income.