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Memorandum

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Supervisory Internal Revenue Agent

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Internal Revenue Agent

from: Deputy Area Counsel (Industry Programs), LMSB Area 3, RFPH
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subject: Request for Case Specific Legal Advice: Separate Gift Card Company Servicing
Affiliated Restaurants

This is to provide the requested legal assistance. Below are the facts, discussion and legal analysis. The legal conclusions reached in this opinion were informally reviewed by the national office, and informal suggestions made were incorporated in this opinion.

LEGEND

A	=
B	=
C	=
D	=
E	=
F	=
G	=
H	=
I	=
J	=

K	=
L	=
M	=
N	=
O	=
P	=
Service began auditing the taxpayer	=
Year 1	=
Year 17	=
Year 24	=
Year 25	=
Year 26	=
Year 27	=
#AA	=
#BB	=
#CC	=
#DD	=
#EE	=
#FF	=
#GG	=
#HH	=
#II	=
#JJ	=
#KK	=
#LL	=
#MM	=
#NN	=
#OO	=
# of Account	=
Interco-A	=
Date AB	=
Date AC	=
\$QA	=
\$QB	=
\$QC	=
\$QD	=
\$QE	=
\$QF	=
\$QG	=
\$QH	=
\$QI	=
\$QJ	=
\$QK	=
\$QL	=

\$QM =
\$QN =
\$QO =
\$QP =
\$QQ =
\$QR =
\$QS =

ISSUES

Whether A (A) may, under the circumstances described below, defer the recognition of income from the proceeds of gift card sales under Treas. Reg. 1.451-5 or under Rev. Proc. 2004-34.

CONCLUSIONS

It may not defer under Treas. Reg. §1.451-5 or under Rev. Proc. 2004-34.

FACTS

1. A and its affiliates

A is an S corporation and a full-service restaurant management company based in B. It maintains its books and files its income tax returns on the accrual basis with a 52-53 week fiscal year ending on the last Wednesday of the calendar year. Its financial statements are audited annually by an independent certified public accounting firm. The firm has provided an unqualified opinion for all years and has also prepared and signed A's tax returns.

A has sold gift certificates since the Service began auditing the taxpayer; in Year 24, it replaced the certificates with plastic gift cards in varying denominations. A has consistently accounted for its receipts from the sales under section 1.451-5 of the regulations. The Internal Revenue Service (the Service) has audited the returns of A and its affiliates on a number of occasions since the Service began auditing the taxpayer and, according to A, there is no record of the Service's having previously examined A's reliance on Treas. Reg. § 1.451-5.

A was incorporated in Year 1 to succeed by merger to #AA affiliated restaurant corporations. The merger did not result in a change of control or operation of the restaurants. Since the merger, A has closed all but the first of the #AA restaurants, C. In the Service began auditing the taxpayer, however, when A began selling gift certificates and accounting for them under Treas. Reg. 1.451-5, it owned and operated #OO or #JJ of the original #AA restaurants. A affiliates then owned and operated

approximately #BB restaurants.¹ All or substantially all of the restaurants participated in A's gift card (then gift certificate) program.

Today, A continues to own and operate one affiliated restaurant corporation, C (in its original leased premises in B), and manages approximately #CC other affiliated restaurants. These restaurants are owned by S corporations, partnerships and limited liability companies (taxed as partnerships). A has an equity interest (in varying amounts from nominal to substantial) in a number of these restaurants. A provides staffing, administrative, and/or management services to these restaurants. A also provides fee-based consulting services to independent restaurateurs.

For its services to these affiliate-owned restaurants, A charges a management or administrative service fee, generally #DD% of restaurant sales; it also bills for direct costs (primarily payroll and related benefit costs) incurred in providing the services to the restaurants. A's fee income for these services now constitutes the bulk of its income.

2. A's plastic gift card program

Of the #CC A-affiliated restaurants, #EE (#FF including C), participate in A's gift card program (Participating A Restaurants).² These #FF Participating A Restaurants operate under approximately #GG different concepts and trade names, with only A having title to the trade names. As are the other A affiliated restaurants, all #FF Participating A Restaurants are advertised and promoted as so-called A Restaurants, and consistent with these facts, the A gift cards are honored at all the Participating Restaurants irrespective of where the cards are sold.

A, as management company, has the right to determine which of the #FF Participating restaurants will participate in its gift card program. It also has the right to terminate a restaurant's participation in the program. If a restaurant closes or its participation in the program terminates, the restaurant has no further rights or obligations under the program other than **its right to have A reimburse it** for A gift cards honored by the restaurant before the termination.

In addition to the #FF Participating A Restaurants, approximately #HH D Restaurants of E also participate in the program by either selling and redeeming or just redeeming A's gift cards (collectively Participating Restaurants).³ Their participation stems from

¹ A holds direct minority equity interests in some of its affiliates. In general, however, the equity ownership interests of the A partners in A and its affiliates reflect their involvement in the various A restaurants. Thus, for example, an A partner could have varying equity interests in one or more A restaurants and no equity interests in other A restaurants.

² The gift cards cannot be used for payment at A affiliated F or G food service units.

³ The #JJ B area D restaurants sell and accept the gift cards for payment. The approximately #LL D Restaurants outside B only accept the gift cards for payment. All the D restaurants also sell E gift cards.

E's Year 17 acquisition of the first #II D (B area) restaurants which at that time were A affiliates participating in the gift card program. These restaurants were subsequently managed by A for several years and continued to participate in the program. The current participation of the D restaurants continues under a marketing arrangement between A and E.

A and each of the separate participating restaurants⁴ sell gift cards in various denominations⁵ to the general public. The gift cards are issued under the A nameplate only. A gift cards are accepted like cash and are applied to the holder's full check including food, beverage, tax and gratuity. A gift cards are not valid for the payment of private parties, catering events or delivery orders. The cards are not re-loadable, redeemable for cash, or replaceable if lost or stolen. They are not subject to any maintenance or non-usage fees and have no expiration dates. The Participating Restaurants remit the proceeds of all gift cards sold by them to A, honor the cards when presented to the restaurants for meals, and then present the cards to A for redemption by it in cash.

A employs four procedures for selling gift cards:

- 1) The gift cards are sold at all A -managed restaurants⁶;
- 2) The gift cards are sold online through the A website (A);
- 3) Customers can place an order for a gift card purchase through the Gift Card Sales Department which is part of A by calling #NN, or, outside B, toll-free at #MM;
- 4) Customers can complete the fax/mail-in form from the website

According to A, its gift card program was adopted to efficiently facilitate a card holder's ability to redeem the card at any of the Participating Restaurants. A customer can purchase a card at any of the Participating A Restaurants (except I, H or J) and at the #JJ B area D restaurants. The holder of the card may then redeem at the selling restaurant or any other Participating Restaurant. A's management is of the belief that the large number of choices is one of the reasons for the program's success and states that a system which requires every restaurant to clear transactions with every other restaurant would be cumbersome, inefficient and create significant accounting and cash management issues.

3. The accounting for sale and redemption of gift cards

⁴ A Gift Cards are available for purchase at all A restaurants except H, I and J. The gift cards can be **used** at all A restaurants including H, I and J.

⁵ According to the company's website, gift cards are available in \$QQ increments up to \$QS.

⁶ Except H, I, J, L or D locations outside of B.

The Participating Restaurants recognize income only from their sale of the meals (when they honor the gift cards); they have no right to any proceeds from the sale of gift cards which are not redeemed. Consistent with these principles, A and its affiliates reconcile their inter-company accounts on a monthly basis. For book and income tax purposes, A recognizes income from the sale of gift cards under Treas. Reg. 1.451-5; A thus recognizes no income on the sale or (other than at C) the redemption of the cards and, based on an aging report prepared by an independent vendor, recognizes income on unredeemed cards in the second year following the year in which the cards are sold. A recognizes gift card income only for cards presented at C. Its participating restaurants will recognize gift card income when cards are redeemed at the participating restaurant.

Participating Restaurants

When a gift card is sold at a participating restaurant, the participating restaurant books the sale of the gift card as a debit to cash and a credit to gift cards sold. Because the participating restaurant is obligated to remit upon receipt the cash received to A, the participating restaurant records a liability by debiting Gift Cards Sold and crediting Interco with A. The transfer of the cash is recorded by debiting Interco with A and crediting Cash. The table below illustrates the participating restaurant's accounting entries:

Debit	Credit
Cash	Gift cards sold
Gift Cards sold	Interco - A
Interco – A	Cash

It is clear participating restaurants merely receive and immediately surrender the cash back to A when gift cards are sold at these locations.

A

Separately, on the books of A, the sale of the gift card by a participating restaurant is recorded as a debit to Interco Store (receivable) and a credit to gift card liability. The gift card liability entry is made because A records and holds the liabilities for sales of gift cards for all of the entities instead of each entity maintaining its own liability for outstanding gift cards. Because A receives the cash from the participating restaurants upon the sale of the gift cards, A debits cash and credits Interco Store, as set forth below:

Debit	Credit
Interco - Store (Receivable)	Gift Card Liability
Cash	Interco - Store

A gift cards/certificates can be redeemed at any participating restaurants regardless of where the gift cards/certificates were purchased. When a gift card is redeemed for a meal at a participating restaurant, A is obligated to transfer the amount of the redemption to that restaurant which, as previously stated, may or may not have been the restaurant where the gift card was initially purchased. The participating restaurant records on its books a debit to Gift Card Redeemed and a credit to Sales thereby reporting income from the sale of goods upon redemption of the gift card. In addition, the restaurant records a debit to Interco with A and a credit to Gift Card Redeemed for the same amount as the previous entry. The final entry is a debit to Cash and a credit to Interco with A to eliminate the inter-company between the store and A and to record the receipt of cash from A. A fourth entry would be a debit to CGS and a credit to Inventory.

Participating Restaurant:

Debit	Credit
Gift Card Redeemed	Sales
Interco-A	Gift Card Redeemed
Cash	Interco - A
CGS	Inventory

Separately, on the books of A the redemption of the gift card is recorded as a debit to Gift Card Liability and credit to Interco Store. The transfer of the cash to the store is recorded as a debit to Interco Store and Credit to Cash.

A:

Debit	Credit
Gift Card Liability	Interco - Store
Interco – Store	Cash

A has furnished a chart of the accounting for the sale and redemption of gift cards by it and its Affiliates, including cards redeemed after the expiration of the two-year period.

A's Year 27 Federal Income Tax Return

a. A as a restaurant management company

On its tax returns, A lists its business activity as Restaurant Management. As part of its management services to the Participating A Restaurants, A does the following:

- Maintains separate books of account

- Purchases and maintains liability insurance
- Provides a data processing network and the personnel to maintain and administer all data processing functions
- Prepares checks for payments for all purchases which clear through a common disbursing account with all restaurants reimbursing the account
- Provides lines of credit to the restaurants and advances funds for temporary working capital
- Manages the gift card program and acts as a clearing house for sales and redemptions of gift cards
- Contracts with credit card and gift card processors for all the Participating Restaurants

K, a paymaster entity created by A, performs the following:

- Employs all employees and provides and administers all employee fringe benefit programs for approximately #KK employees.
- Provides payroll processing services

b. A's deferral of gross income from gift card sales under Treas. Reg. 1.451-5.

As reported on the Year 27 income tax returns, sales at Participating A Restaurants totaled approximately \$QA. Gift card sales for A and the Participating Restaurants for the year totaled \$QB, and gift card redemptions totaled \$QC. Under Treas. Reg. 1.451-5, A included \$QR in income in its Year 27 income tax return representing revenues from gift cards sold in Year 25 and succeeding and not redeemed by year-end Year 27.

c. Cost of Goods Sold and Liability

On both its Schedule A, Cost of Goods Sold, and its Schedule L, Balance Sheet, A reports inventory of \$QD and \$QE at the beginning and end of Year 27, respectively. These amounts are broken down as follows:

	Beginning of Year	End of Year
Food (<i>at C</i>)	\$QF	\$QG
Liquor (<i>at C</i>)	\$QH	\$QI
Merchandise <i>at A</i>	\$QJ	\$QK
Total	\$QD	\$QE

The Food and Liquor inventories represent the food and liquor property of C. The food and liquor properties of the Participating Restaurants are reported on the tax returns of the affiliated restaurants. A's merchandise inventories represent non-food items, principally on-line personality-test credits, human resource supplies, office supplies and manager log books. A acquires non-food merchandise on a bulk basis and then distributes/sells the merchandise and allocates the cost to C and its affiliated and managed restaurants, including the Participating A Restaurants.

d. Basis for determining outstanding gift cards

A's tax and audited balance sheets report the entire liability for all outstanding gift cards, whether sold by A or the other Participating Restaurants. At the beginning and end of Year 27, the reported liabilities for the unredeemed gift cards were \$QL and \$QM, respectively. Those amounts were determined by adjusting the beginning balance for cash receipts and cash disbursements resulting from the sale and redemption of gift cards and were verified using generally accepted auditing standards.

A management has stated that, due to the high demand for the gift cards during the year-end holiday season, gift cards are activated by A before being distributed to the other Participating Restaurants and sold by them.⁷ A management believes the procedure is necessary because: (i) the unusually high volume of gift cards sold during the holiday season makes it logistically impractical to activate cards as sold; (ii) it

⁷ A has acknowledged the following: A changed its process for issuing gift cards in Year 24. Prior to Year 24, the company activated gift cards at the time they were sold. In Year 24, A began to activate cards prior to issuing them to the stores in order to make the process more efficient and to free-up store managers' time. A states that the problem with the change is that A's gift card system tracks outstanding gift cards based on activation date rather than sale date. This does not present A a problem in determining the gift card liability because management can subtract its gift card inventory from the total gift cards activated to arrive at the true number of gift certificates outstanding. This is a problem when **estimating the amount of income to recognize in a particular year because the inventory is not aged by activation date. This makes it difficult for management to determine when the gift cards currently outstanding were actually sold.** (Emphasis added).

enables the restaurant managers to concentrate on running their respective restaurants during the busy season and (iii) the procedure minimizes the possibility of the restaurants' selling non-activated cards that would create problems on redemption.

Participating Restaurants who do not sell "activated" gift cards at year end can return the unsold activated cards to A. A then places the returned cards into its inventory of activated but not sold gift cards. At any point during the year, a Participating Restaurant can request additional gift cards from A in any denomination. A may then transfer from inventory previously activated gift cards that had been returned to it from one Participating Restaurant and send those back out to a different Participating Restaurant.

During the Year 27 year, A activated gift cards totaling \$QN. Of those activated, \$QO in gift cards was outstanding at year-end, and gift card sales totaled \$QB. A total of \$QP reflects the value of cards sold in Year 27 that were redeemed during the year.

A uses an outside vendor to track the issuance and aging of the gift cards. A also attempts to track the aging of the gift cards and the gift card liability in-house using spreadsheets and other programs. The outside vendor information provided to the Internal Revenue Service at the opening conference shows by year/month activated and denomination/type, the total dollar amount of the gift cards outstanding, the total dollar amount issued/activated, and the total dollar value of the outstanding cards.

Because A accounts for all sales of cards and related liabilities on its books, A has stated that it does not presently track individual gift cards. Although it would be a very time consuming process, A has indicated, however, that it has the ability in most instances to determine whether an individual card was sold to the general public by A or transferred to a Participating Restaurant that sold the card to the general public. A also has stated that in most instances it can determine when and where an individual card is sold by referring to shipping records which show the numerical sequences shipped to the various Participating Restaurants but has failed to provide this information.

As noted above, A's liability for unredeemed gift cards was \$QL and \$QM for tax years ended Year 26 and Year 27, respectively. Under A's present method of accounting for both tax and financial reporting purposes, the receipts from the sales of the unredeemed cards were shown as liabilities and reported in general ledger account(s) # of Account of A and not on the balance sheets of any of its affiliated Participating Restaurants. A's general ledger account(s) are included on the tax return as part of Other Current Liabilities on Schedule L, the Balance Sheet.

On Date AB an Information Document Request (IDR) was issued to A requesting documentation which shows, of the reported outstanding liability for each year, how much relates to gift cards sold by A itself. On Date AB, the P of the company stated that, due to its tracking system, A presently does not determine how much of the liability relates to sales by A and how much relates to sales by the other Participating Restaurants because some cards are activated before they are sold and A does not

track the liability by individual store. According to A, it may be possible to create a computer program to accomplish this analysis but to date such analysis has not been furnished.

On Date AC A provided a written response to this IDR. A states that the following restaurants each sell A Gift Cards. They are, as follows: A Corporate, C, restaurants in which A has an equity ownership interest and other affiliated restaurants in which A has no ownership interest, plus #JJ (#JJ) D restaurants. All cards entitle the purchaser the right to redeem the cards at any of the Participating A Restaurants. The Examiners possess an exhibit which provides the amount of the liability that related to the gift cards sold by A Corporate and C. Because the amount of liability representing gift cards sold by A Corporate and C is a number not ordinarily used by the taxpayer, the response to the request was determined based on the average gift card redemption rate per year for ALL gift cards sold multiplied by the gift cards sold by A and C.

Summary of A's ownership interest in restaurants selling A's gift cards.

In researching this opinion, we examined an Excel worksheet schedule and an "Attachment to IDR #19" that shows A's relationship and equity interest in the entities that own restaurants that honor A's gift cards.⁸ The schedule lists, approximately, #EE separate Subchapter S corporations, limited liability companies, limited partnerships, and other partnerships, that own A gift card honoring restaurants. The schedule shows that the limited liability companies file partnership returns (Form 1065). A has a 70% ownership interest in one LLC (M), a 53% ownership in one limited partnership (O), a 50% ownership interest in one LLC (L) and a 50% ownership in one corporation (N). The taxpayer, A, had no equity interest in 20 of the restaurant-owning entities. The taxpayer has a minority (in many instances a nominal) interest in the other restaurant-owning entities. The accuracy of the exact number of restaurants in each of the categories is irrelevant and immaterial, for purposes of this opinion. The material fact is that the taxpayer, A, does not own these restaurants itself, but only has an equity interest or no interest at all.

⁸ This list of restaurants does not include C, which is owned by A, the taxpayer.

LAW AND ANALYSIS

Restaurants owned by an intermediary or independent entity.

As to restaurants that belong to other entities, the separate gift card company problem is clear. As to these, A, the taxpayer, is not the owner of the restaurant (although it may have a variable, sometimes nominal sometimes substantial, equity interest in many but not necessarily in most of the restaurants). In our opinion, in cases where there is an intermediary or a completely independent owner entity between the taxpayer, A, and the restaurant in question, the taxpayer is simply a full-service restaurant management company. It is not the owner of the inventory (the food) that will be redeemed with the gift card sale proceeds (the advance payments under Treas. Reg. §1.451-1). The taxpayer, A, is not the party that will be making the food sales, except for those meals served in its own restaurant, C. Consequently, the taxpayer, A, can not convincingly argue that those other restaurants' food inventories should be deemed to be a supplement to, i.e., a source of its own food inventory, for purposes of Treas. Reg. §1.451-1.

I.R.C. § 451(a)⁹ provides the general rule for the taxable year of inclusion of items of income and provides that “[t]he amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.” Under this general rule, a taxpayer should include income in the year in which received. Similarly, a taxpayer should include in income the full amount of the sales price of a gift card during the taxable year in which sold, unless it has properly elected the deferral provisions permitted for sales of gift cards by Treas. Reg. § 1.451-5 or Rev. Proc. 2004-34 (which will be discussed later).

Treas. Reg. § 1.451-5 provides a method of accounting for advance payments for the sale of goods. Treas. Reg. § 1.451-5(a) provides that advance sales are taken into account either when a taxpayer receives payment for the advance sale or in the tax year when the advance payment is properly accruable under the taxpayer's method of accounting. An exception to the general rule of Treas. Reg. § 1.451-5(a) is Treas. Reg. § 1.451-5(c), the exemption for inventorial goods. This section of the regulation provides that if certain conditions are met the income from the sale of a gift card need not be recognized until the end of the second year after the card is sold. The regulation provides as follows:

Sec. 1.451-5 Advance Payments for goods and long-term contracts

(a) Advance payment defined. (1) For purposes of this section, the term “advance payment” means any amount which is received in a taxable year by the

⁹ All section references are to the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

taxpayer using an accrual method of accounting for purchases and sales or a long term contract method of accounting, pursuant to, and to be applied against, an agreement:

(i) For the sale or other disposition in a future taxable year of goods held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or

(ii) For the building, installing, constructing or manufacturing by the taxpayer of items where the agreement is not completed within such taxable year.

(2) For purposes of subparagraph (1) of this paragraph:

(i) The term “agreement” includes (a) a gift certificate that can be redeemed for goods, and (b) an agreement which obligates a taxpayer to perform activities described in subparagraph (1)(i) or (ii) of this paragraph and which also contains an obligation to perform services that are to be performed as an integral part of such activities; and

(ii) Amounts due and payable are considered “received.”

(b) Taxable year of inclusion. – (1) *In general.* Advance payments must be included in income either –

(i) In the taxable year of receipt; or

(ii) Except as provided in paragraph (c) of this section . . .

(c) Exemption for inventorial goods. (1)(i) If a taxpayer receives an advance payment in a taxable year with respect to an agreement for the sale of goods properly includible in his inventory or with respect to an agreement (such as a gift certificate) which can be satisfied with goods or a type of goods that cannot be identified in such taxable year, and on the last day of such taxable year the taxpayer –

(a) Is accounting for advance payments pursuant to a method described in paragraph (b)(1)(ii) of this section for tax purposes.

(b) Has received “substantial advance payments” (as described in subparagraph (3) of this paragraph) with respect to such agreement, and

(c) Has on hand (or available to him in such year through his normal source of supply) goods of substantially similar kind and in sufficient quantity to satisfy the agreement in such year, then all advance payments received with respect to such agreement by the last day of the second taxable year following the year in

which such substantial advance payments are received, and not previously included in income in accordance with the taxpayer's accrual method of accounting must be included in income in such second taxable year.

In order to qualify for the 2-year deferral of Treas. Reg. §1.451-5(c), a taxpayer must receive an advance payment for the sale of goods properly includible in his inventory or with respect to an agreement (such as a gift card) which can be satisfied with goods. The regulation first requires that a taxpayer receive an advance payment. An advance payment is any amount received by a taxpayer using an accrual method of accounting for purchases and sales and to be applied against an agreement. The regulation next requires that the amount is applied to an agreement. An agreement exists because the amount (cash) is exchanged for a gift card. Gift certificates, and by extension gift cards, are specifically within the definition of agreement under Treas. Reg. § 1.451-5(a)(2)(i).

The taxpayer, A, does not qualify for the deferral available under § 1.451-5, as to restaurants that are not owned by the taxpayer because the amount received is not an "advance payment" under § 1.451-5(a)(1) since the taxpayer, A, will not be redeeming gift cards with its own goods held for sale. In other words, the taxpayer, A, only owns and will supply the inventory for the restaurant that it owns, i.e., C. It does not have inventorial goods on hand to be consumed in the restaurants that it does not own, at which the gift cards will be redeemed. As to these other restaurants, the taxpayer, A, is only in the business of providing management services and gift card selling services, not supplying or selling its own meals. It will be transferring cash to the seller of the meals, when a customer redeems the gift card through the sale of its own goods.

May the taxpayer, A, utilize the accounting method of Rev. Proc. 2004-34 to defer gift card proceeds for gift cards that may be redeemed at restaurants owned by others?

The answer is no. Rev. Proc. 2004-34 provides that for taxpayers deferring recognition of income under this procedure, it is appropriate to retain the limited one-year deferral that was previously allowed under Rev. Proc. 71-21. Although Rev. Proc. 71-21 dealt with services, Rev. Proc. 2004-34 specifically includes advance payments for goods.

In Section 4 of Rev. Proc. 2004-34, "Advance Payments" are defined as payment for the sale of goods. Income is "received" by the taxpayer if it is actually or constructively received, or if it is due and payable to the taxpayer. "Next Succeeding Taxable Year" is defined as the taxable year immediately following the taxable year in which the advance payment is received by the taxpayer.

Section 5 of this Rev. Proc. provides two permissible methods for accounting for advance payments. The first method is Full Inclusion, and the second is the Deferral Method.

Under the Deferral Method, the taxpayer must include in income the amount received in the taxable year of receipt to the extent recognized in revenues in its applicable financial

statement (form 10-K or the Annual Statement to Shareholders) and must include the remaining amount of the advance payment in gross income no later than the "Next Succeeding Taxable Year."

A taxpayer using the deferral method must be able to determine the extent to which advance payments are recognized in revenues in its applicable financial statement in the taxable year of receipt. If the taxpayer is not able to determine the extent to which advance payments are recognized in revenues in its applicable financial statements for the taxable year of receipt, it must include the advance payment in gross income for the taxable year of receipt to the extent earned in that taxable year and include the remaining amount of the advance payment in gross income in accordance with section 5.02(1)(a)(ii) of the Rev. Proc. (the remaining amount of the advance payment is included in gross income for the next succeeding taxable year). See section 5.02(3) of the Rev. Proc.

Rev. Proc. 2004-34 provides several methods for determining the extent to which a payment is earned in the taxable year of receipt, including a statistical basis, and any method that in the opinion of the Commissioner results in a clear reflection of income.

In Example 7 of Rev. Proc. 2004-34, the taxpayer did not determine the portion of the advance payments for gift cards that was earned in the year of receipt, and was not allowed to use the deferral method. Instead, the taxpayer was required to use the Full Inclusion Method.

Since the taxpayer does not itself provide the meals consumed in the restaurants that it does not own, the deferral method is not available. We believe that in order to get deferral treatment, the taxpayer, A, must have inventory (meals to be furnished) to redeem gift cards, and not simply be a clearinghouse for gift card receipts and redemptions. The goods (food inventory) that the taxpayer does own, is only the one meant to be consumed in the restaurant(s) that it owns, C. The separately owned restaurants have their own food inventory.

Restaurant owned by the taxpayer.

A, apparently, owns and operates C directly. In other words, there is no intermediary owner entity, with respect to this restaurant. If this was the only restaurant where the gift card could be redeemed, there would be no separate gift card company problem with respect to this restaurant. However, the gift cards can be redeemed in both the restaurant(s) owned by the taxpayer A, i.e., at C, and in many other restaurants that are not owned by the taxpayer. This situation does present a separate gift card company problem.

The answer to the question of deferral often depends on the contractual relationship between the parties. In the instant case, the taxpayer can use Treas. Reg. §1.451-5 with respect to gift cards that can only be used at its owned restaurant(s). However, with

respect to cards that can be used in restaurants owned by others, it is our opinion that the taxpayer can not meet the requirements of Treas. Reg. §1.451-5. This is because the taxpayer has no idea what amount of gift card restaurant sales will be redeemed at other person's restaurants. It is conceivable that the taxpayer could compute a historical average of redemptions at its own restaurant(s), C, but there is no way to actually track at the time of the gift card sale, without setting up a separate gift card program pursuant to which the card is only valid at taxpayer's owned restaurants.

Furthermore, even if the company-owned restaurant can track a historical average, it is only clear that the taxpayer, A, has inventorial goods on hand, with respect to its own restaurant(s), C. The taxpayer's own inventory can not be ascribed to separate entities, i.e., the separately owned restaurants. The separately owned restaurants do not own the taxpayer's inventory and vice-versa. Where separately owned restaurants are the owners of their own inventory, these separate restaurants are not using the taxpayer's inventory (food inventory) to satisfy their own restaurant meal sales. Therefore, the taxpayer, A, cannot qualify for use of the accounting method at Treas. Reg. § 1.451-5 for gift card revenue, when these gift cards can be used to purchase from separately owned restaurants.

Significance of taxpayer being an S corporation shareholder, a partner or a limited partner, or a member of limited liability companies that own restaurants, that redeem the gift cards at issue.

In our opinion, the fact that taxpayer has a partnership interest or an equity interest in other entities that own restaurants does not allow the taxpayer to defer the gift card income. Purportedly, A has a 70% ownership interest in one LLC (M), a 53% ownership interest in one limited partnership (O), a 50% ownership interest in one LLC (L) and a 50% ownership interest in one corporation (N), that redeem the gift cards in question. In addition, the taxpayer had no equity interest in approximately 20 of the restaurant owning entities. The taxpayer has a minority (in many instances a nominal) interest in the other restaurant owning entities.

The taxpayer argues that by virtue of its equity interest in many of these entities it can attribute to itself their inventory for purposes of obtaining deferral under Treas. Reg. §1.451-1. For the following reasons, we are of the opinion that the authority does not support the taxpayer's position. First, the entities that are incorporated under state law are separate legal entities. Property titled in the name of a corporation is the asset of that corporation, and is not the property of the corporation's shareholders. Thus, the assets of the restaurant-corporations are owned by those restaurant-corporations rather than the shareholders. The taxpayer does not operate any restaurant-corporation other than C and is an investor-shareholder in those entities. The interests held by taxpayer are merely investments and do not satisfy the requirements under § 1.451-5 or Rev. Proc. 2004-34 for deferral of the recognition of income from the sale of gift cards.

Our opinion is the same for the entities that are treated as partnerships under federal tax law.¹⁰ Each of these partnerships is an entity that is separate from its partners. Similar to the status of shareholders (see discussion above), partners are not mere co-owners of property. In this case, the partners own interests in partnerships carrying on an active business, operating restaurants. These partnerships each have their own separate partnership accounting. Treas. Reg. §§ 1.761-1(a) and 301.7701-3(a).

However, a partnership is not a separate entity in the sense that partnership income flows through to its partners, who are then taxed on that income. I.R.C. §§701 and 702. But even when examining the status of a partnership from this perspective, the amount and character of a partnership's income is calculated using an entity approach. Specifically, I.R.C. §702(b) provides that the character of certain items of income, deduction, or credit is determined at the partnership level (an entity approach).¹¹ Similarly, with certain exceptions inapplicable to this case, a partnership's taxable income is computed in the same way as the taxable income of an individual. I.R.C. §703(a). The partnerships must compute their own income from the operation of the restaurants, and this income (or loss) flows through to the taxpayer. In this case, the computation of the partnership's operating income, through meal sales and consumption of the partnership's food inventory, is separate from the taxpayer's computation of its own corporate income and its own inventory.¹²

In addition, as a general rule, Subchapter K uses an entity approach in the rules relating to partnership accounting methods. See, for example, I.R.C. §706(a). In this case, when advance payments must be recognized is a method of accounting. It is thus determined at the partnership and not the partner level.


In summary, it is our opinion that the taxpayer can not obtain the requisite inventory via its equity ownership interests in the S corporations, partnerships, or limited liability companies via attribution rules, as suggested by the taxpayer.

¹⁰ Except for one member limited liability companies, which are not at issue in this case, limited liability companies are taxed as partnerships unless they elect to be taxed as corporations. Treas. Reg. §301.7701-3(b)(1).

¹¹ In the case of S Corporations, I.R.C. §1366(a) essentially provides identical treatment to that provided by I.R.C. §702.

¹² The taxpayer, A, simply takes into account its own share of the partnership's I.R.C. §702(a)(8) bottom-line income and of separately stated items, under I.R.C. §702(a)(1) through I.R.C. §702(a)(7).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS



This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

This opinion benefited from the assistance of Technical Advisors Phillip J. Hofmann and Maria A. Montani. The Service's position was informally reviewed by, or discussed with Industry Counsel (Retail) Carol B. McClure, Associate Industry Counsel (Retail) Benjamin W. McClendon, and Chief Counsel's national office (CC:ITA:B02 and CC:PSI:B03). If you have any questions, please call Food & Beverage Industry Counsel Rogelio A. Villageliu at .

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