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Deferral of income denied for restaurant gift card (10/15/2009)

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Deferral of income denied for restaurant gift card

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In a Legal Memo, IRS has concluded that a full-service restaurant management company couldn't defer, under [Reg. § 1.451-5](#) or [Rev Proc 2004-34, 2004-1 CB 991](#), the recognition of income from the proceeds of gift card sales redeemed in restaurants that it didn't own.

Background. [Reg. § 1.451-5](#) allows a taxpayer to defer the inclusion of advance payments in gross income beyond the tax year of receipt. For sales of inventoriable goods, the deferral generally is limited to the second tax year following the year substantial advance payments are received. [Rev Proc 2004-34, 2004-1 CB 991](#), allows a qualifying taxpayer to defer advance payments for services (and for certain non-services and combinations of services and non-services) to the tax year succeeding the tax year of receipt to the extent the taxpayer establishes that the advance payments aren't recognized in revenues in its applicable financial statement in the tax year of receipt; or, if the taxpayer doesn't have an applicable financial statement, the payment is not earned in the tax year of receipt

Facts. A, an S corporation, is a full-service restaurant management company that owns and operates one affiliated restaurant corporation, C, and manages a number of other affiliated restaurants. These restaurants are owned by S corporations, partnerships and limited liability companies (LLCs) taxed as partnerships. A has an equity interest in varying amounts from nominal to substantial in a number of these restaurants—a 70% ownership interest in one LLC and a 50% interest in another, a 53% ownership in a limited partnership, and a 50% ownership in a corporation. A provides staffing, administrative, and/or management services to these affiliated restaurants. And A also provides fee-based consulting services to independent restaurateurs.

A instituted a program under which a customer can purchase a gift card at most of the participating restaurants that can be redeemed at any of the participating restaurants. A and each of the separate participating restaurants sold gift cards in various denominations to the general public. The gift cards are accepted like cash and applied to the holder's full check, including food, beverage, tax and gratuity. The participating restaurants honor the cards when presented to them for meals, and then present the cards to A for redemption by it in cash. 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.

A and its affiliates reconcile their intercompany accounts on a monthly basis. For book and income tax purposes, A recognizes income from the sale of gift cards under [Reg. § 1.451-5](#). Thus, A recognizes no income on the sale or (other than at C) the redemption of the cards and 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 recognize gift card income when cards are redeemed at their restaurant.

In addition to the entities in which A has a significant equity interest, the participating restaurants include 20 in which it has no equity interest and other restaurant owning entities in which A has a minority (in many cases nominal) interest.

No deferral for gift card income. The IRS Memo concludes that A couldn't defer income under [Reg. § 1.451-1](#) with regard to restaurants that belong to other entities. To qualify for the 2-year deferral of [Reg. § 1.451-1](#), a taxpayer must receive an advance payment for the sale of goods properly includible in his inventory or with respect to an agreement (e.g., a gift card) which can be satisfied with goods. A wasn't the owner of the restaurants—although it may have a variable, sometimes nominal sometimes substantial, equity interest in many, but not necessarily in most of the restaurants. Where there was an intermediary or a completely independent owner entity between A and the restaurant in question, the IRS Memo found that A was simply a full-service restaurant management company. Except for those meals served in its own restaurant (C), A wasn't the owner of the inventory (the food) that was to be redeemed with the gift card sale proceeds—the advance payments under [Reg. § 1.451-1](#).

Consequently, the amount received wasn't an "advance payment" under [Reg. § 1.451-5\(a\)\(1\)](#) because A wasn't redeeming gift cards with its own goods held for sale. A didn't have inventoriable goods on hand to be consumed in the restaurants that it did not own, at which the gift cards were redeemed. A was only in the business of providing management services and gift card selling services, not supplying or selling its own meals. It transferred cash to the seller of the meals, when a customer redeemed the gift card through the sale of its own goods.

The IRS Memo also concluded that A couldn't defer income under [Rev Proc 2004-34](#). This revenue procedure requires a taxpayer to be able to determine the extent to which advance payments are recognized in revenues in its applicable financial statement in the tax year of receipt. If it can't, it must include the advance payment in gross income for the tax year of receipt to the extent earned in that tax year. The remaining amount of the advance payment must then be included in gross income in accordance with [Rev Proc 2004-34, Sec. 5.02\(1\)\(a\)\(ii\)](#) (i.e., the remaining amount of the advance payment is included in gross income for the next succeeding tax year). Since A didn't itself provide the meals consumed in the restaurants that it didn't own, the deferral method wasn't available. The IRS Memo reasoned that 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 A did own, was only meant to be consumed in the restaurant that it owned, C. The restaurants that A did not own had their own separate food inventory.

If C, which A owned and operated directly, was the only restaurant at which the gift card could be redeemed, the IRS Memo reasoned that there wouldn't be a deferral problem with respect to that restaurant. But since the gift cards could be redeemed in C and many other restaurants that weren't owned by A, the IRS Memo concluded that A couldn't meet the requirements of [Reg. § 1.451-5](#). A had no idea what amount of gift card restaurant sales would be redeemed at other person's restaurants. While it's conceivable that A could compute a historical average of redemptions at its own restaurant C, there was no

way to actually track at the time of the gift card sale, without setting up a separate gift card program under which the card was only valid at A's owned restaurants. And, even if the company-owned restaurant could track a historical average, it's only clear that A has inventorial goods on hand with respect to its own restaurant, C. A's own inventory can't be ascribed to separate entities, i.e., the separately owned restaurants. The separately owned restaurants do not own A's inventory and vice-versa. Where the separately owned restaurants are the owners of their own inventory, they aren't using A's inventory (food inventory) to satisfy their own restaurant meal sales.

The IRS Memo also rejected A's argument that the fact that A had a partnership interest or an equity interest in other entities that own restaurants should allow it to defer the gift card income. The entities that were incorporated under state law were separate legal entities. The interests held by A were merely investments and didn't satisfy the requirements under [Reg. § 1.451-5](#) or [Rev Proc 2004-34](#) for deferral of the recognition of income from the sale of gift cards. Similarly, the partnerships were entities that were separate from their partners. And while a partnership isn't a separate entity in the sense that partnership income flows through to its partners, partnerships must compute their own income from the operation of the restaurants. The computation of a partnership's operating income, through meal sales and consumption of the partnership's food inventory, is separate from A's computation of its own corporate income and its own inventory.

References: For advance payments received by accrual basis taxpayers, see [FTC 2d/FIN ¶ G-2540](#) et seq.; [United States Tax Reporter ¶ 4514.166](#); [TaxDesk ¶ 441,708](#) et seq.; [TG ¶ 6208](#) et seq.