DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: DEBORAH A. BUTLER
Assistant Chief Counsel (Field Service)
CC:DOM:FS

SUBJECT: Rental Payments for Shelf Space

This Field Service Advice responds to your memorandum dated February 17, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

State X	=	
Supplier 1	=	
Supplier 2	=	
Supplier 3	=	
Supplier 4	=	
Supplier 5	=	
$a	=	$
$b	=	$
$c	=	$
$d	=	$
$e	=	$
$f	=	$
$g	=	$
$h	=	$
$i	=	$

$j	=	$
$k	=	$
$l	=	$
$m	=	$
$n	=	$
$o	=	$
$p	=	$
$q	=	$
$r	=	$
$t	=	$

Q1 =
Q2 =

Product A =

Product B
=

Product C =

Product D =

Product E
=

ISSUE:

Whether characterizing certain payments received by taxpayer in connection with five contracts for the purchase of goods as advance rental for shelf space or as consideration for exclusivity over the period of the agreement will adversely affect the Service's position on the tax treatment of similar payments in other areas.

CONCLUSION:

We conclude that such a characterization will not adversely affect the Service's position on the treatment of similar payments in other areas.

FACTS:

The facts you have provided are as follows:

Taxpayer is a engaged in the business of distributing dry goods to grocery stores and sells primarily to its . The are State

X regional supermarket chains. The was formed to purchase assorted goods in bulk from manufacturers and to resell the goods to the .

Taxpayer uses the accrual method of accounting for federal income tax purposes. For both book and tax purposes, taxpayer accounts for its inventories using the cost or market, whichever is lower, inventory method along with a first-in, first-out (FIFO) cost flow assumption.

The dispute revolves around the terms of five purchase agreements entered into by taxpayer. In general, pursuant to these agreements, various vendors advance a significant amount of cash to taxpayer in exchange for taxpayer's agreement to purchase a stated dollar volume of goods from the supplier within a specified time period. If taxpayer has not reached the stated dollar volume during the period specified, the time is extended until taxpayer reaches the stated dollar volume, or taxpayer may be required to repay a pro-rata portion of the cash previously received. Additionally, the vendors are granted the right to be taxpayer's exclusive or primary supplier of goods of a specified type, i.e., taxpayer agrees not to purchase similar goods from other manufacturers during the term of the agreement. For tax purposes taxpayer recognizes the advance payments as a liability and thereafter reduces the liability through adjustments to the cost of goods sold as the goods are purchased. Taking the position the payments are "trade discounts" off the price of the goods purchased, taxpayer does not include the payments in income upon receipt. The facts of each agreement are set forth separately.

Supplier 1 Agreement: Under the Suppler 1 Agreement, taxpayer estimated it would sell $a of Supplier 1"s products during a four year period. If taxpayer failed to reach that sales level by the end of the term, the contract would be automatically extended until taxpayer purchased the agreed upon volume. Supplier 1 agreed to pay to taxpayer (among other considerations) "additional discounts totaling $b in lieu of periodic volume discounts." During the term of the agreement, taxpayer agreed Supplier 1 would be the exclusive supplier of Product A in all existing, newly remodeled, constructed, and acquired stores. Taxpayer also agreed to maintain a stated minimum amount of shelf space for Supplier 1 products in each of its stores. The contract has no definite termination date. In addition, the contract does not state that taxpayer has any obligation to return or repay "unearned" credits. Nothing in the agreement evidences any intent that the transaction be construed as a loan.

The Supplier 1 Agreement states that during the term of the agreement the average lineal footage of each Supplier 1 department will at least equal the average lineal footage in existing stores.

Supplier 2 Agreement: Under the Supplier 2 Agreement, taxpayer agreed to purchase exclusively from Supplier 2 a substantial volume of Product B during a four year period. Taxpayer agreed to purchase from Supplier 2 at least $c of

Product B during the period of the agreement. In exchange for this promise, Supplier 2 agreed to give taxpayer an allowance, described in the agreement as an "unearned advance allowance" of $d, $e to be paid upon the execution of the agreement and $f to be paid on the first, second, and third anniversary of the agreement if taxpayer has established an adequate warehouse distribution system. If taxpayer failed to purchase at least $c of Product B, then taxpayer agreed to reimburse Supplier 2 on a pro-rata basis for any portion of the amount advanced to it but not earned.

During the period of the agreement, taxpayer agreed to sell only Product B, to use its best efforts to promote and purchase for resale Product B, and to maintain a stated minimum amount of Product B shelf space. To secure performance of taxpayer's obligations, including repayment of unearned allowances, Supplier 2 received a first security interest in all Supplier 2 inventory purchased by taxpayer and notes, i.e., accounts receivable, etc., arising therefrom. The Supplier 2 Agreement does not, however, contain language sufficient to establish a bona fide debtor-creditor relationship. No interest was required to be paid on unearned premiums and security for repayment of unearned prepaid allowances was limited to Supplier 2 products.

The Supplier 2 Agreement states that on average at least linear feet of Product B shelf space must be maintained at member stores.

Supplier 3 Agreement: Under the Supplier 3 Agreement, taxpayer agreed to purchase from Supplier 3 a substantial volume of Product C. The term of the agreement began upon its execution and terminates when taxpayer has made net wholesale purchases from Supplier 3 in the amount of $g. Upon execution of the agreement, Supplier 3 agreed to issue taxpayer a "Placement Allowance" in the amount of $h, which represents a payment of $i for each of Q1 existing stores that Supplier 3 supplies pursuant to this agreement. In addition, Supplier 3 will issue to each store a "credit memo" equal to the opening order of each taxpayer store. Also, Supplier 3 will issue to each store a credit equal to the wholesale value of competitors' Product C in a store when the store is assigned to Supplier 3. If any store ceases to operate prior to the conclusion of the agreement period, taxpayer must refund to Supplier 3 a pro-rata portion of the amount paid with respect to that store. This refund amount is to be calculated by multiplying the amount paid to the store in question (i.e., the $i received for each store plus the credits referred to above) by a fraction, the numerator of which is $g less the total amount of net wholesale purchases of Supplier 3 merchandise made by taxpayer's stores as a group at the time the store ceases to operate, and the denominator of which is $g. During the period of the agreement, taxpayer agreed to maintain Supplier 3 as the primary supplier of Product C to all of its member stores.

The agreement has no definite termination date. No interest is required to be paid on unearned premiums that are repaid to Supplier 3. Supplier 3 did not demand any security for repayment of unearned prepaid allowances and the agreement lacks sufficient indicia of a loan.

The Supplier 3 Agreement does not state a specific linear footage requirement in the body of the agreement. However, a sheet entitled “
” makes reference to $ for opening orders for a total amount of $

Supplier 4 Agreement: Under the Supplier 4 Agreement, taxpayer agreed to purchase $j of Product D. The agreement was to remain in effect until taxpayer did so. In addition to other considerations, Supplier 4 agreed to pay to taxpayer “incentive payments” equal to $k cash and $l in free products. Of this total amount, $m cash and $n in free products was payable upon the execution of the agreement. The remainder was payable when the taxpayer reached successive “volume targets” (e.g., at the $o level. $p cash will be paid and $q worth of free goods shipped). If the agreement terminated prior to taxpayer’s having purchased $j worth of Product D due to the inability of either taxpayer or Supplier 4 to further perform, taxpayer was obligated to “repay any unearned prepaid allowances on a pro-rata basis.” During the term of the agreement, taxpayer agreed to maintain Supplier 4 as its primary supplier of Product D.

The contract has no definite termination date. Further, no interest is required to be paid on unearned premiums that are repaid to Supplier 4. In addition, Supplier 4 did not obtain any security for repayment of unearned prepaid allowances. The contract provides taxpayer is obligated to repay any unearned prepaid allowance if the agreement terminates due to the inability of either taxpayer or Supplier 4 to perform. However, the contract lacks any other indicia of a loan or a debtor-creditor relationship.

Supplier 5 Agreement: Under the Supplier 5 Agreement, taxpayer agreed to purchase Q2 units of Product E exclusively from Supplier 5. The agreement has an initial term of three years that was to “continue thereafter on a year-to-year basis; provided that following the end of the initial term either party may terminate the agreement on the anniversary date on 90 days notice.” Supplier 5 provided taxpayer with incentives, including a payment of $r, made upon execution of the agreement, which represented a “Product Purchase Allowance for the first year of the Agreement.” The $r payment was called an “advance” and was evidenced by a promissory note attached to the agreement. The agreement contains a provision that states taxpayer “earns” $s of this advance for each unit purchased from Supplier 5 during the term of the contract. In the event taxpayer fails to purchase the stated amount of Product E, taxpayer is contractually obligated to return to Supplier 5 the unearned portion of the advance. If Supplier 5 believes taxpayer will not meet its obligations to meet purchase requirements, Supplier 5 may offset all payments made by taxpayer against the advance until taxpayer purchases Q2 units of Product E. The agreement also provides taxpayer will satisfy all of its requirements for generic Product E with Supplier 5's generic products.

The Supplier 5 agreement contains some evidence the parties intended to create a bona fide debtor-creditor relationship. The agreement contains a promissory note that states taxpayer promises to repay Supplier 5 an amount equal to the amount of the "product purchase allowance" advanced to taxpayer at the time the contract was executed.

The promissory note states the principal of the loan is non-interest bearing. It also indicates a portion of the purchase price of goods acquired by the taxpayer under the purchase agreement will be designated as repayment of the $r "loan," with $s of the purchase price of each unit of Product E being applied against the "debt." The note also provides if taxpayer defaults under the agreement, it will be liable for the unpaid principal plus interest. If taxpayer fails to repay the outstanding balance after thirty days, interest begins accruing on this amount at the rate of %.

No interest is required to be paid on unearned premiums that are refunded within 30 days of default. Also there is no security for repayment of the promissory note. The promissory note has no definite termination date. Finally, towards the end of the 3-year initial term, taxpayer had paid down only % of the note. Nevertheless, Supplier 5 agreed the "balance of $t would be eliminated" provided taxpayer maintained Supplier 5 products for an additional twelve month period.

The Supplier 5 Agreement requires taxpayer to maintain certain fixtures in the stores such as . The agreement states that for or , payments will be determined by the size of the fixture and number of rows available.

At the heart of the dispute are the federal income tax consequences of these lump-sum cash payments and the contractual clauses granting the various vendors the status of exclusive or primary supplier. Taxpayer characterizes the cash payments as "advance trade discounts" which under Treas. Reg. § 1.471-3(b) are properly accounted for as offsets to cost. Citing Commissioner v. Indianapolis Power and Light Co., 493 U.S. 203 (1990), taxpayer also argues the lump-sum cash payments are in the nature of loans or deposits from the vendors that must be repaid if the terms of the agreement are not met, and therefore, do not constitute gross income upon receipt. The examining agent characterizes the cash payments as gross income received from the vendors in payment for the exclusive right to supply taxpayer with goods of a specific type. Citing Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955), the examining agent argues that since taxpayer alone controls whether or not the requisite purchases are made, the payments are an accession to wealth, clearly realized and over which taxpayer has complete dominion and control.

LAW AND ANALYSIS:

I.R.C. § 61 defines gross income as “all income from whatever source derived.” See Treas. Reg. § 1.61-1(a).

Construing similar language, the Supreme Court in Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955) held punitive damages in a fraud action and the punitive portion of a treble damages recovery in an antitrust action were includable in gross income. The Court held the statutory language evidenced Congress’s intent to tax all gains except those specifically exempted. Id. at 430. In concluding the recoveries were taxable gains, the Court described them as “undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion.” Id. at 431.

Section 451 sets forth the general rule that the amount of any item of gross income shall be included in 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.

Treas. Reg. § 1.451-1(a) provides that under an accrual method of accounting, income is includable in gross income when all events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy.

The right to receive income becomes fixed at the earliest of (1) required performance; (2) the date payment becomes due; or (3) the date payment is made. See e.g., Rev. Rul. 84-31, 1984-1 C.B. 127.

The Service, pursuant to section 446(b) has consistently argued that cash payments received for services or goods prior to performance may not be deferred unless approval is granted in advance by the Commissioner. Generally, deferral of cash payments received does not clearly reflect income and the payments received by the taxpayer are includable in income in the year received, whether earned or not. Schlude v. Commissioner, 372 U.S. 128 (1963); American Automobile Ass’n v. United States, 367 U.S. 687 (1961); Automobile Club of Michigan v. Commissioner, 353 U.S. 180 (1957), S. Garber Inc. v. Commissioner, 51 T.C. 733 (1969); Farrara v. Commissioner, 44 T.C. 189 (1965); Straight v. Commissioner, T.C. Memo. 1997-569.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

We understand the proper tax treatment of the lump-sum payments made to taxpayer in the instant case was the subject of a Technical Advice Memorandum (TAM) 9719005, dated January 10, 1997. The TAM concluded the payments were includable in income upon receipt. Based on the terms and conditions of the five agreements, the Service was not persuaded that the payments were for trade discounts and not exclusive supplier rights or some other conditions. The TAM also held the payments could not be characterized as loans or deposits, because taxpayer had no fixed obligation to return the funds, and taxpayer controlled the circumstances under which it might have to return the payments. Although the TAM analyzed the trade discount, loan, and deposit issues, it did not address the possibility the payments may be characterized as “rental payments” for shelf space, also known as “slotting allowances.” Accordingly, you are requesting a field service advice on the “slotting allowance” aspects of this case.

Specifically, your FSA request asks whether characterizing the payments as advance rental for shelf space or as consideration for exclusivity over the period of the agreement, will adversely affect the Service’s position on the tax treatment of similar payments in other areas. For the reasons described below, we conclude that such a characterization will not adversely affect the Service’s position on the treatment of similar payments in other areas.

The FSA request indicates that your expert witnesses view these payments from an economic standpoint, as “rental payments” for shelf space. If not characterized as rental for shelf space, you plan to argue that they are in consideration for exclusivity over the periods of the agreement, rather than as trade discounts for goods purchased, as discussed in the TAM. You are concerned about making the slotting allowance argument because the Food Industry Specialization Program (Food ISP) at one point had been considering a coordinated issue paper with respect to slotting allowances. Because this ISP paper would have taken the position that the manufacturer/vendor must capitalize the slotting allowances for tax purposes, you wanted to coordinate this issue with the National Office “to ensure the Service does not unnecessarily open itself up to criticism for taking inconsistent positions with respect to the same transactions.”

The Food ISP originally proposed a coordinated issue paper on slotting allowances in 1994. The primary issue raised in the draft position paper was whether a shelf space allowance was currently deductible under section 162 or capitalizable under section 263. Although many variations appear to exist, a shelf space allowance generally is compensation paid by a manufacturer or wholesaler to a retailer for the privilege of using retail space in the retailer’s store. While the form of compensation varies (e.g., cash payment, reduced purchase price, or trade credits) it is usually paid to acquire shelf space for a product. The Food ISP undertook a national Information Gathering Project (IGP) on the shelf space issue to determine the factual background and context in which shelf space allowances are made.

Upon reviewing the gathered data, the Service concluded that in most instances slotting allowances were not appropriately characterized as capital expenditures under section 263; rather these payments were properly deductible under section

162. The IGP lead the Service to conclude that slotting allowances did not typically result in a significant long-term benefit to the payor. It appeared the retailers unilaterally set the conditions upon which the shelf space was made available to a product- -notwithstanding the payment of a slotting allowance. Thus, the Service determined that in the typical case, slotting allowances were not capital expenditures although there may be some cases where the facts would warrant capitalization. Even so, the Service believed an ISP paper on this issue was not appropriate. Accordingly, a position paper on slotting allowances was never issued. Because the ISP paper was never issued, arguing that the payments in issue constitute slotting allowances includable in income upon receipt would not constitute an inconsistent position with respect to the same transactions. [redacted] As noted earlier, Agreement 1 states that during the term of the agreement the average lineal footage of each Supplier 1 department will at least equal the average lineal footage in existing stores. The Supplier 2 Agreement states that on average at least [redacted] will be maintained at member stores. Thus, we concur the lump-sum payments for Agreements 1 and 2 could arguably be considered slotting allowances.

[redacted] No specific linear footage requirement appears in the body of the agreement. However, a sheet entitled “Meeting Competition Proposal” makes reference to $[redacted] for opening orders for a total amount of $[redacted]. It appears this payment may have been paid for shelf space in addition to the $h payment in issue. [redacted]

With respect to the Supplier 4 Agreement, no space requirements are mentioned in the agreement. Supplier 4 states the agreement is reached for the purpose of becoming taxpayer’s primary supplier of Product D. [redacted]

We turn now to the Supplier 5 Agreement. The agreement requires taxpayer to maintain certain fixtures in the stores to hold its Product E. The required fixtures include such items as [redacted]. However, the agreement states that some of these fixtures are currently supplied to taxpayer by Supplier 5. The agreement notes that new fixtures will be ordered pursuant to an implementation schedule. Further, prior to delivering the new fixtures the current fixturing will be removed and salvaged from taxpayer's stores. [redacted]

We understand that taxpayer may rely on the proposed issue paper on slotting allowances to argue that similar treatment by both the payor and payee results in a proper matching of income and deduction. As previously discussed, the never issued paper proposed allowing the payor for shelf space to deduct advance payments ratably. It is our understanding that taxpayer may rely on that position to argue it should recognize income at the same time the manufacturer claims a deduction resulting in symmetry. Obviously, we would argue that the proposed paper was never issued so it cannot be relied upon.

It is possible, however, that taxpayer may cite Rev. Rul. 98-39, 1998-2 C.B. 198, for the symmetry proposition. Revenue Ruling 98-39, which deals with the timing of a deduction for advertising expenses, provides that in a transaction where one taxpayer is accruing a liability to pay another taxpayer, the last event necessary to establish the fact of liability under the all events test of Treas. Reg. §1.461-1(a)(2)(i) is the same event that fixes the right to receive income under the all events test of Treas. Reg. §1.451-1(a). We note this revenue ruling should not be read to conclude the Service is looking for symmetry in taxable transactions. It only provides that the determination of whether an amount is a "fixed liability" is the same for the income and deduction side. It does not affect the rest of the test.

The deduction and corresponding income are "fixed" at the same time. However, the fact that the deduction is "fixed" does not mean the liability is incurred before economic performance. Assuming that the transaction in this case is correctly characterized as a rental transaction, economic performance occurs over time under Treas. Reg. §1.461-4(d)(3). Further, as the economic performance rules under section 461(h) do not apply to the accrual of income section 451, taxpayer may well be required to accrue income before the manufacturer is permitted a deduction.

[redacted]

[redacted]

[redacted] Thus, the slotting allowance argument should only be made as an alternative to those outlined in the TAM. We concur with your plan to argue the payments are in consideration for exclusivity over the periods of the agreement, rather than as trade discounts for goods purchased, as discussed in the TAM.

If you have any further questions, please call the branch telephone number.

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