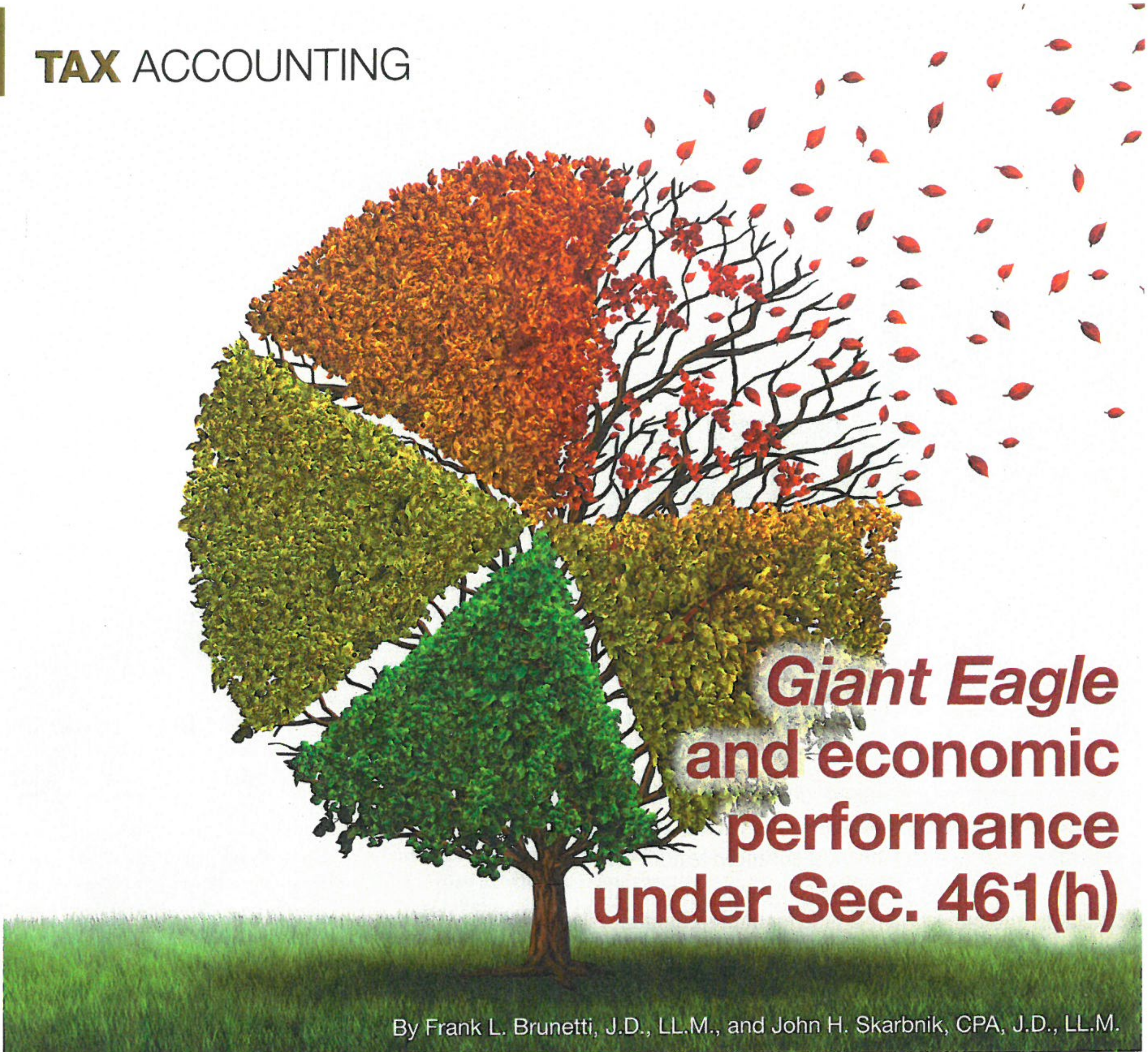

Giant Eagle and economic performance under Sec. 461(h)

By Frank L. Brunetti, J.D., LL.M., and John H. Skarbnik, CPA, J.D., LL.M.

PREVIEW

- Review the rules for determining when an accrual-method taxpayer can deduct an expense under Sec. 461(h).
- Learn how the recurring-item exception to the economic performance requirement can allow an accrual taxpayer to deduct in the current tax year certain expenses of a recurring nature that the taxpayer pays in the subsequent year.
- Find out the approach taken by the Third Circuit in determining whether a retailer qualified for the recurring-item exception where the retailer issued discount rewards with purchases that its customers could redeem only by making another purchase from the retailer within three months.

For an accrual-method taxpayer to deduct an expense, it must meet the all-events test. This requirement did not originate in Congress. It was first articulated by the Supreme Court in *Anderson*,[1] where the Court said, with respect to a deduction for taxes, "In a technical legal sense it may be argued that a tax does not accrue until it has been assessed and becomes due; but it is also true that in advance of the assessment of a tax all the events may occur which fix the amount of the tax and determine the liability of the taxpayer to pay it."[2]

Under the all-events test the taxpayer has to demonstrate that both (1) all events have occurred to ensure that the taxpayer actually has had an obligation (the fact of the liability), and (2) the amount of the liability (while not necessarily precisely fixed) can be fixed with reasonably certainty.[3]

Among the changes to the determination of whether and when a taxpayer has a right to accrue a deduction made by the Deficit Reduction Act of 1984[4] was the enactment of Sec. 461(h), which added to existing requirements for accrual tax accounting a provision that, for an amount to be incurred with respect to any item during a tax year, economic performance must have occurred with respect to that item.

Since the enactment of Sec. 461(h), the IRS has consistently held the view that accrual-basis taxpayers have not met the economic performance requirement if all events that fix the liability for income tax purposes have not yet occurred, and that the events that fix liability include any act that must be performed by a person to whom the liability is owed. Occasionally, this has led to controversy over, for example, gift cards and discount coupons that require a further purchase by the person to whom the taxpayer issues the card or coupon. In such instances, the Service has maintained, economic performance as required under Sec. 461(h) has not occurred. In one notable recent court case, however, *Giant Eagle*,[5] the Third Circuit rejected the IRS's argument with respect to certain customer discounts.

This article analyzes the Third Circuit's holding and reasoning, while examining the origins and development of the IRS's position and supporting court decisions, which are nearly as old as the modern U.S. income tax itself.

Treasury regulations adopted the all-events test for accrual taxpayers subject to the economic performance test.

In *Anderson*,[6] the government asserted that the taxpayer, a munitions manufacturer, should have deducted a munitions tax in 1916, when it recorded a reserve for the tax, not 1917, when it paid the tax (and the deduction was more valuable because tax rates had increased). The Supreme Court agreed, stating:

> In this respect, for purposes of accounting and of ascertaining true income for a given accounting period, the munitions tax here in question did not stand on any different footing than other accrued expenses appearing on appellee's books. In the economic and bookkeeping sense with which the statute and Treasury decision were concerned, the taxes had accrued. It should be noted that section 13(d) [which authorized, subject to regulation, returns reflecting a basis of accounting other than actual receipts and disbursements] makes no use of the words "accrue" or "accrual" but merely provides for a return upon the basis upon which the taxpayer's accounts are kept, if it reflects income—which is precisely the return insisted upon by the government. We do not think that the Treasury Decision [providing guidance on then-Sec. 13(d)] contemplated a return on any other basis when it used the terms "accrued" and "accrual" and provided for the deduction by the taxpayer of items "accrued on their books."[7]

Once the all-events test was satisfied, the taxpayer could deduct the full face amount of the liability.

Fact of the liability

In a number of cases prior to the Deficit Reduction Act, courts held that expenditures were deductible only when the activities that the taxpayer was obligated to perform *were in fact performed*, not when the "fact" of the obligation to perform was determined (see, e.g., *Spencer, White and Prentis, Inc.*).[8] In *Spencer*, a contractor constructing a subway system was required under contract to restore certain property damage. The IRS denied the company's deductions for the accrued estimated future cost of restoration. The court held that the company had not incurred the liability for work done after the end of the tax year because it had not performed the work.

Subsequently, before the enactment of Sec. 461(h), courts reached inconsistent conclusions, allowing taxpayers to deduct the amount of a liability if all the events that fixed the liability had occurred and the amount could be determined with reasonable accuracy, even if the taxpayer did not actually perform the activities it was obligated to perform until a later year.[9]

The "Blue Book" explanation of the changes made by Congress in 1984[10]

1. *Anderson*, 269 U.S. 422 (1926).
2. Id. at 441.
3. See Sec. 461(h)(4); Regs. Sec. 1.461-1(a)(2)(ii).
4. Deficit Reduction Act of 1984, P.L. 98-369.
5. *Giant Eagle, Inc.*, 822 F.3d 666 (3d Cir. 2016), rev'g T.C. Memo. 2014-146.
6. *Anderson*, 269 U.S. 422 (1926).
7. Id. at 441.
8. *Spencer, White and Prentis, Inc.*, 144 F.2d 45 (2d Cir. 1944).
9. See, e.g., *Harrold*, 192 F.2d 1002 (4th Cir. 1951).
10. Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), pp. 258–64 (Dec. 31, 1984).

points toward the significant revenue loss to the government by taxpayers who took accrued deductions not yet paid or performed. It noted that a deduction for a contingent liability generally was not allowed because all of the events necessary to fix the liability had not yet occurred. The Blue Book pointed out, however, that in *Lukens Steel Co.*,[11] the court allowed the taxpayer to deduct amounts paid to a trust to fund benefits under a negotiated supplemental unemployment benefit plan, including amounts accrued in a "contingent liability account" until a targeted fund amount was reached.

Prior to the Deficit Reduction Act, the IRS took the position that for an amount to be deductible, there must be a current liability to pay that amount, and there must not be a contingency as to payment (other than the ability of the obligor to pay).[12]

The Blue Book noted that the 1984 Congress believed that the prior accounting rules relating to the *time* for a deduction by a taxpayer using the accrual method of accounting should be changed to take into account the time value of money and when the deduction was economically incurred. Congress was concerned about the revenue loss from taxpayers taking overstated deductions. It noted that in many everyday business transactions, taxpayers had incurred (deducted) liabilities to pay expenses in the future. Congress believed that because of the large number of transactions in which deductions might be overstated and because of the then high interest rate, the magnitude of the revenue loss was significant.[13]

Congress noted that the prior law, i.e., the all-events test, failed to take into account the time value of money and had become the cornerstone for a variety of tax abuses and shelters. In some instances, deductions were taken in a current year but economic performance would not occur until later. A good example illustrating the difficulty with the all-events test before the addition of Sec. 461(h) is *Mooney Aircraft, Inc.*,[14] where, for each sale of an airplane, the taxpayer issued a "Mooney Bond" in the face amount of $1,000. The bond was redeemable when the airplane was retired, which could be 30 years after the plane was sold. The Fifth Circuit denied deductions for the bonds in the years they were issued under the all-events test because, in its view, the time between when the bond was issued and when, if ever, it might be redeemed was too long and contingent.

To correct and limit these abuses, Congress added the economic performance requirement to the statute so that accrual-method taxpayers could not

11. *Lukens Steel Co.*, 442 F.2d 1131 (3d Cir. 1971).
12. Rev. Rul. 72-34.
13. Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), p. 260 (Dec. 31, 1984).
14. *Mooney Aircraft, Inc.*, 420 F.2d 400 (5th Cir. 1969).

EXECUTIVE SUMMARY

- Sec. 461(h) requires that accrual-method taxpayers cannot take a deduction, even if the all-events test is met, before economic performance with respect to the item has occurred. For certain enumerated liabilities, payment—generally, to the person to whom the liability is owed—constitutes economic performance.

- Under the recurring-item exception to the economic performance requirement, taxpayers may deduct an item in the tax year before economic performance occurs if (1) the all-events test is otherwise fulfilled in the tax year of deduction, (2) the item is recurring in nature and the taxpayer consistently treats such items as incurred in the year before economic performance occurs, (3) economic performance occurs within 8½ months after the end of the tax year of deduction, and (4) either (a) the item is not material, or (b) its accrual in the tax year of deduction results in a more proper match against income than in the year of economic performance.

- In the *Giant Eagle* case, a supermarket chain issued loyalty discounts for its gasoline to its customers when they made a certain amount of grocery purchases. The customers could use the discounts, which expired three months after issuance, only when they purchased gasoline.

- The taxpayer, using the recurring-item exception, took a deduction for discounts issued during the year but not redeemed at year end that it estimated it would redeem in the following year. The Tax Court agreed with the IRS that the amount of the expense for the discounts was not fixed at year end, since it was contingent upon the customers' redemption in a further purchase. Thus, the Tax Court held that the all-events test was not met with respect to the unredeemed discounts, and the taxpayer could not deduct them currently.

- On appeal, the Third Circuit overturned the Tax Court's decision, based on a theory of unilateral contract and held that the taxpayer had met the all-events test and could deduct an estimate of the amount of unredeemed discounts that would be redeemed in the subsequent year.

take a deduction, even if the all-events test was satisfied, until the taxpayer economically performed: "[I]n determining whether an amount has been incurred with respect to any item during any taxable year, the all events test shall not be treated as met any earlier than when economic performance with respect to such item occurs."[15]

The principle provided by the act encompasses the two most common categories of liabilities: first, cases where the liability arose as a result of another person's providing goods and services to the taxpayer and, second, cases where the liability required the taxpayer to provide goods and services to another person or undertake some activity as a result of its income-producing activities.

With respect to the second category, in which a taxpayer was required to provide property or perform services, economic performance occurred as a taxpayer provided the property or performance of the services. The Blue Book states that if a contractor were engaged by a highway construction company to repair damaged properties, economic performance occurred as the contractor made the repairs, i.e., economically performed.[16]

Treasury regulations adopted the all-events test for accrual taxpayers subject to the economic performance test. The regulation states:

> Generally, under an accrual method, income is to be included for the taxable year when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy. Under such a method, a liability is incurred, and generally is taken into account for Federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability.[17]

The recurring-item exception

Noting that the economic performance test might hamper businesses, Congress created the recurring-item exception to the economic performance requirement (Sec. 461(h)(3)). Under the recurring-item exception, taxpayers may treat an expense item as incurred in the tax year before economic performance occurs if, and only if, the following four conditions are satisfied:

1. The all-events test, without regard to economic performance, is satisfied with respect to the item during the tax year;
2. Economic performance occurs with respect to the item within a reasonable period (but in no event more than 8½ months) after the close of the tax year;
3. The item is recurring in nature, and the taxpayer, from year to year, consistently treats items of this type as incurred in the tax year in which the all-events test (without regard to economic performance) is satisfied; and
4. Either (a) the item is not material, or (b) the accrual of the item in the tax year in which the all-events test (without regard to economic performance) is satisfied results in a better matching of the item with the income to which it relates than would result from accruing the item in the tax year in which economic performance occurs.[18]

Time and manner of adopting the recurring-item exception

The recurring-item exception is a method of accounting that must be consistently applied with respect to a type of item, or for all items, from one tax year to the next to clearly reflect income. A taxpayer may adopt the recurring-item exception as part of its method of accounting for any type of item for the first tax year in which that type of item is incurred. Except as otherwise provided, the rules of Sec. 446(e) and Regs. Sec. 1.446-1(e) apply to changes to or from the recurring-item exception as a method of accounting.[19]

Payment

A principal component of economic performance often is payment, but what constitutes payment for this purpose? The regulations allow a deduction only when payment has occurred under the principles *applicable to a taxpayer using the cash method of accounting*. The regulations provide that payment has not been made to another person unless a cash-basis taxpayer in the position of that person would be treated as having actually or constructively received the amount of the payment under the principles of Sec. 451.[20]

Certain liabilities for which payment is economic performance

The regulations identify six types of liabilities for which payment constitutes economic performance:

1. Liabilities arising out of a breach of contract;
2. Liabilities arising under a workers' compensation act or from a tort or violation of law;
3. Rebates and refunds;

15. Sec. 461(h)(1).
16. Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), p. 262 (Dec. 31, 1984).
17. Regs. Sec. 1.446-1(c)(1)(ii). See also Regs. Sec. 1.461-1(a)(2).
18. Regs. Sec. 1.461-5(b)(4) provides rules for determining materiality for purposes of the recurring-item exception.
19. Regs. Sec. 1.461-5(d)(1).
20. Regs. Sec. 1.461-4(g)(1)(ii).

4. Awards, prizes, and jackpots;
5. Amounts paid under insurance, warranty, and service contracts; and
6. Taxes (other than creditable foreign taxes and real property taxes for which the taxpayer has made a valid election under Sec. 461(c)).[21]

In the case of a taxpayer's liability for which economic performance rules are not provided elsewhere in any other internal revenue regulation, revenue ruling, or revenue procedure, economic performance occurs as the taxpayer makes payments in satisfaction of the liability to the person to which the liability is owed.[22]

Accordingly, the purchase of an annuity contract or other asset does not constitute payment to the person to which a liability is owned unless the ownership of the annuity contract or other asset is transferred to that person.[23] Moreover, the furnishing of a note or other evidence of indebtedness by a taxpayer, or a promise by a taxpayer to provide property or services in the future, is not payment for purposes of Sec. 461(h). In addition, a payment is not an amount transferred as a loan, deposit, or contingent payment with respect to which the taxpayer may receive a refund or credit.[24]

Person to whom payment is made

In general, economic performance occurs when payment is made to the person to whom the liability is owed.[25] For example, in the case of a liability arising under a workers' compensation act, economic performance occurs when payment is made to the person entitled to payment. On the other hand, a payment to a trust, escrow account, fund, or any person other than the person to whom a liability is owed does not constitute performance.[26]

In addition, the regulations provide that, in connection with the sale of a trade or business by a taxpayer, if the purchaser agrees to assume a liability of the taxpayer arising out of the trade or business, the taxpayer is deemed to be making payments on that liability for purposes of Sec. 461(h), since the amount of the liability is included in the amount realized by the taxpayer on the transaction. The regulations define "trade or business" using principles drawn from Sec. 355(b) and the regulations thereunder.[27]

Example 1: *Y* Corp., a calendar-year, accrual-method taxpayer, manufactures and distributes DVD recorders. *Y* offers to refund the price of the recorder to any purchaser not satisfied with it. During tax year 1, 100 purchasers request a refund of the $500 purchase price. *Y* refunds $30,000 on or before Sept. 15 of year 2 and the remaining $20,000 after this date but before the end of tax year 2.

Economic performance with respect to the $30,000 of refund liability occurs on or before Sept. 15 of year 2, because payment has been made during the 8½-month period. This illustrates the recurring-item exception.

Example 2: Alternatively, assume the refund is deductible (or allowable as an adjustment to gross receipts or cost of goods sold) when incurred. If *Y* does not or is not entitled to adopt the recurring-item exception with respect to rebates and refunds, it incurs $30,000 for tax year 2. However, if *Y* has made a proper election under Regs. Sec. 1.461-5 and, as of Dec. 31 of year 1, all events have occurred that determine the fact of the liability for the $30,000, *Y* incurs that amount for tax year 1.

Because economic performance (payment) with respect to the remaining $20,000 occurs after Sept. 15 of year 2 (more than 8½ months after the end of year 1), the amount is not eligible for recurring-item treatment under Regs. Sec. 1.461-5. Thus, the $20,000 amount is not incurred by *Y* until year 2.

Rebates and refunds

Under the regulations, if a taxpayer is obligated to pay a rebate, refund, or similar payment to another person (whether in property, money, or as a reduction in the price of goods or services to be provided in the future by the taxpayer), economic performance occurs as payment is made to the person to which the liability is owed.[28]

The following example involving rebates and refunds is quoted from the regulation:[29]

(i) X corporation, a calendar year, accrual method taxpayer, manufactures and sells hardware products. X enters into agreements that entitle each of its distributors to a rebate (or discount on future purchases) from X based on the amount of purchases made by the distributor from X during any calendar year. During the 1992 calendar year, X becomes liable

21. Regs. Sec. 1.461-4(g).
22. Regs. Sec. 1.461-4(g)(7).
23. Regs. Sec. 1.461-4(g)(1)(ii)(B).
24. Regs. Sec. 1.461-4(g)(1)(ii)(A).
25. Regs. Sec. 1.461-4(g)(1).
26. Regs. Sec. 1.461-4(g)(1)(i).
27. Regs. Sec. 1.461-4(d)(5).
28. Regs. Sec. 1.461-4(g)(3). "This paragraph (g)(3) applies to all rebates, refunds, and payments or transfers in the nature of a rebate or refund regardless of whether they are characterized as a deduction from gross income, an adjustment to gross receipts or total sales, or an adjustment or addition to cost of goods sold."
29. Regs. Sec. 1.461-4(g)(8), Example (2).

to pay a $2,000 rebate to distributor A. X pays A $1,200 of the rebate on January 15, 1993, and the remaining $800 on October 15, 1993. Assume the rebate is deductible (or allowable as an adjustment to gross receipts or cost of goods sold) when incurred. (ii) If X does not adopt the recurring item exception described in §1.461-5 with respect to rebates and refunds, then under paragraph (g)(3) of this section, economic performance with respect to the $2,000 rebate liability occurs in 1993. However, if X has made a proper election under §1.461-5, and as of December 31, 1992, all events have occurred that determine the fact of the rebate liability, X incurs $1,200 for the 1992 taxable year. Because economic performance (payment) with respect to the remaining $800 does not occur until October 15, 1993 (more than 8½ months after the end of 1992), X cannot use the recurring item exception for this portion of the liability (see §1.461-5). Thus, the $800 is not incurred by X until the 1993 taxable year. If, instead of making the cash payments to A during 1993, X adjusts the price of hardware purchased by A that is delivered to A during 1993, X's "payment" occurs as X would otherwise be required to recognize income resulting from a disposition at an unreduced price.

The same principle is found in the regulation's discussion of awards, prizes, and jackpots. If the taxpayer's liability is to provide an award, prize, jackpot, or other similar payment to another person, economic performance occurs as the taxpayer makes payment to the person to whom the taxpayer owes the liability.[30]

The Third Circuit held that Giant Eagle could currently deduct the amount of loyalty discount rewards earned by the end of the tax year even if its customers had not yet claimed the rewards.

The *Giant Eagle* case

In *Giant Eagle,*[31] the Third Circuit held that a large supermarket chain could currently deduct the amount of loyalty discount rewards earned by the end of the tax year even if its customers had not yet claimed the rewards. The taxpayer offered a loyalty program called "fuelperks!" that awarded gasoline discount rewards (fuelperks!), which if unused, expired in three months. From the inception of the fuelperks! program in 2004, Giant Eagle, under the recurring-item exception in Regs. Sec. 1.461-5, deducted the estimated amount of the issued but unexpired and unredeemed fuelperks! at year end that customers would redeem in the following year. The IRS denied the deduction, claiming that Giant Eagle's obligation to make payment with regard to those fuelperks! was not fixed, and therefore the all-events test was not met for them. The company challenged the IRS's determination in Tax Court.

The Tax Court, in a memorandum decision, sided with the IRS, holding that the amount of the discounts for fuelperks! became fixed when they were redeemed, not when they were earned, because Giant Eagle did not satisfy the all-events test with respect to the discounts at the time they were earned.[32] Giant Eagle contended in Tax Court that the fuelperks! program constituted a unilateral contract under which it became legally obligated to redeem fuelperks! as they were earned, making its liability for the outstanding fuelperks! fixed at the end of each year at issue.

The Tax Court determined, however, that under the fuelperks! program, the redemption of fuelperks! was structured as a discount against the purchase price of gas. Consequently, the purchase of gas was necessarily a condition precedent (defined below) to the redemption of fuelperks!, and whether a customer paid a reduced price for the purchase of gas or nothing (through the redemption of fuelperks!), Giant Eagle's obligation to redeem fuelperks! was subject to a condition precedent that could be satisfied only after the close of the company's tax year. Thus, the court concluded that the liability for outstanding fuelperks! became fixed upon their redemption, not when the customer earned the fuelperks!

In the alternative, the company argued that it did meet the all-events test based on the exception to the all-events test for trading stamps and premium coupons. Regs Sec. 1.451-4(a)(1) provides:

30. Regs. Sec. 1.461-4(g)(4).
31. *Giant Eagle, Inc.*, 822 F.3d 666 (3d Cir. 2016), rev'g T.C. Memo. 2014-146.
32. The Tax Court did not specify in its opinion that it had considered the all-events test requirement in Sec. 461(h)(3)(A)(i) for the recurring-item exception, as opposed to the general all-events test in Sec. 461(h)(4). Giant Eagle complained about this in its petition to the Third Circuit, claiming that the Tax Court had not addressed the recurring-item exception at all. However, consistent with the fact that both parties agreed that the recurring-item exception had been elected and applied by Giant Eagle, the Third Circuit did not take up the issue and simply assumed that the Tax Court had addressed the all-events test in the context of the recurring-item exception.

> If an accrual method taxpayer issues trading stamps or premium coupons with sales, or an accrual method taxpayer is engaged in the business of selling trading stamps or premium coupons, and such stamps or coupons are redeemable by such taxpayer in merchandise, cash, or other property, the taxpayer should, in computing the income from such sales, subtract from gross receipts with respect to sales of such stamps or coupons (or from gross receipts with respect to sales with which trading stamps or coupons are issued) an amount equal to—
>
> (i) The cost to the taxpayer of merchandise, cash, and other property used for redemptions in the taxable year.
>
> (ii) Plus the net addition to the provision for future redemptions during the taxable year (or less the net subtraction from the provision for future redemptions during the taxable year).[33]

These regulations are designed to match revenue with expenses, and under them, taxpayers are entitled to a current deduction for the portion of coupons that will eventually be redeemed. Giant Eagle argued that Regs. Sec. 1.451-4(a)(1) applied, and, therefore, it could offset its sales revenue by the estimated future cost of redeeming the outstanding fuelperks!.

The IRS relied on Rev. Rul. 78-212, in which a taxpayer using the accrual method issued, with the sale of products, coupons to customers that they could redeem for a discount on the sale price of products purchased in the future. The IRS determined in the revenue ruling that those coupons were "not redeemable in merchandise, cash, or property" because the retailer conditioned their redemption on an additional purchase of the retailer's product by the consumer. The IRS reasoned that applying Regs. Sec. 1.451-4(a)(1) to the coupons in the revenue ruling would be inconsistent with the purpose of the provision, i.e., to match sales revenues with the expenses incurred to generate them. Because the retailer had no obligation to redeem the coupon until the additional purchase, the coupon expense was attributable to the additional purchase and not to the initial purchase with which the retailer issued the coupon.

The Tax Court agreed that Giant Eagle was not obligated to redeem fuelperks!, but customers could use them to partially or fully offset the cost of purchases of gas in the future.

The IRS argued, and the Tax Court agreed, that under the fuelperks! program, Giant Eagle was not obligated to redeem fuelperks!, but customers could use them to partially or fully offset the cost of purchases of gas in the future. Therefore, as was the case with the coupons discussed in Rev. Rul. 78-212, the redemption of fuelperks! was conditioned on a subsequent purchase, making them not redeemable for "merchandise, cash or other property." The purchase of gas was necessarily a condition precedent[34] to the redemption of fuelperks!. Accordingly, the Tax Court determined that the taxpayer was not entitled to offset the estimated future costs of redeeming fuelperks! against sales revenues under the exception.

In a two-to-one decision, however, the Third Circuit held that Giant Eagle could deduct the estimated amount of its liability for fuelperks! that had not been redeemed or expired at the end of the year they were earned by customers. The court reasoned that Giant Eagle entered into a binding unilateral agreement with its customers when groceries were purchased, which established the liability.

Regs. Sec. 1.451-4(a)(1) allows accrual-method taxpayers to deduct expenses before they are paid, as long as the all-events test has been met to determine the existence of the liability and the amount of the liability could be "reasonably determined."

After referring to the recurring-item exception in Sec. 461(h)(3), the Third Circuit said (quoting Sec. 461(h)(4)), "For purposes of the 'recurring item' exception, 'the all events test is met with respect to any item if all events have occurred which determine the fact of liability and the amount of such liability can be determined with reasonable accuracy.'"

In the brief filed by Giant Eagle, the company argued that in 2004 and on all later tax returns it claimed deductions (1) for fuelperks! redeemed during the tax year plus (2) the year-over-year increment in the reasonably calculated cost of the year-end balance of outstanding fuelperks! that statistics showed would be redeemed within three months after the end of the year. The IRS conceded the reasonable accuracy of Giant Eagle's cost calculations but disallowed the deduction on the grounds that the year-end balances of outstanding unredeemed fuelperks! were not fixed under the all-events test.[35]

Giant Eagle claimed it took deductions that satisfied the recurring-item

33. Regs. Sec. 1.451-4(a)(1).
34. A condition precedent is some act or event that must occur before a duty of immediate performance of a promise arises (17A Am. Jur. 2d, *Contracts*, §458 (2014)).
35. *Giant Eagle*, No. 14-3961 (5th Cir. 12/8/14), appellant's brief, p. 2.

exception and argued that the IRS offered no affirmative testimony at trial against Giant Eagle's witnesses' uncontroverted testimony that established that the recurring-item exception was adhered to from inception of the fuelperks! program.[36]

Relying on *Hughes Properties, Inc.*,[37] *Lukens Steel Co.*,[38] and contract law principles, the Third Circuit reversed the IRS and Tax Court determinations that the taxpayer's anticipated liability was fixed at year's end. Specifically, the court stated:

> As in *Lukens Steel*, here we determine whether the taxpayer's anticipated liability was fixed at year's end with reference to contract law principles. Specifically, Giant Eagle characterizes its issuance of fuelperks! rewards as a unilateral contract formed at checkout, which conferred instant liability on the supermarket chain to its customers for the rewards they accrued.

The Third Circuit further relied on a Pennsylvania state court decision that held that a car dealership, advertising a discount on a future car purchase to any golfer who made a hole-in-one on the ninth hole of a local golf course, was obligated to honor its "offer" when a golfer finally aced the hole, despite the dealership's stated intention to end the promotion two days earlier. The Third Circuit, quoting the Pennsylvania court, said, " '[i]t is the manifested intent of the offeror and not his subjective intent which determines the persons having the power to accept the offer.' Because 'the offeror's manifested intent, as it appeared from signs posted at the ninth tee, was that a hole-in-one would win the car,' the dealer was liable in accordance with such reasonable expectations."[39] In Giant Eagle's case, the court found that a customer could reasonably have concluded that he or she could redeem fuelperks! rewards based on the well-publicized fuelperks! program guide. Thus, Giant Eagle's issuance of fuelperks! at the time of a customer's checkout resulted in a unilateral contract, and, therefore, the company's liability attached at that time.

The IRS's position in this case is straightforward: Giant Eagle's liability for unredeemed fuelperks! is not fixed until the customer buys fuel.

The dissenting opinion in the case, citing *Gold Coast Hotel & Casino*,[40] concluded that for purposes of the all-events test, what is critical is the existence of an *absolute liability*. The dissent found the liabilities that accrued to Giant Eagle on account of its fuelperks! program were not absolute. The dissent noted that after three months, there was no liability to the customer and, furthermore, there was no certainty that the customer would in fact redeem the points. The dissent also noted that the majority's reasoning improperly converted Giant Eagle's liabilities to its individual customers into a single group liability, which the dissent considered critical because whether liability is fixed on an individual or collective basis is a significant fact that could lead to different outcomes in a case. For these reasons, the dissent would have denied the deduction.

In Action on Decision 2016-03, the IRS stated it will not follow the Third Circuit's decision in *Giant Eagle* in other jurisdictions, where it will continue to litigate the issue. According to the IRS, the Third Circuit misconstrued the cases it cited in support of the taxpayer's position, noting that in each of them, the only remaining contingency at the time of the deduction was the identity of the individual or individuals who would receive the payment. Further, under the Pennsylvania law relied upon by the Third Circuit, issuance of the fuelperks! only created a contractual obligation to make a payment when the fuelperks! were redeemed but did not fix the amount of Giant Eagle's payment.

A consistent IRS position

This view is consistent with previous IRS rulings on gift cards and loyalty

Contributors

Frank L. Brunetti is a professor of taxation at Fairleigh Dickinson University in Madison, N.J., of counsel to the Lyndhurst, N.J., law firm of Scarinci Hollenbeck, and author of books and articles on accounting methods and periods and other tax-related topics. He is admitted to the state bars of New Jersey and New York. *John H. Skarbnik* is a professor of taxation at Fairleigh Dickinson University in Madison, N.J., and is tax counsel to the Florham Park, N.J., law firm of McCusker, Anselmi, Rosen & Carvelli PC. Professor Skarbnik has had numerous articles published on a wide variety of tax issues. He is admitted to the state bars of New Jersey and New York and is a New Jersey CPA. For more information about this article, contact thetaxadviser@aicpa.org.

36. Id. at 53.
37. *Hughes Properties, Inc.*, 476 U.S. 593 (1986).
38. *Lukens Steel Co.*, 442 F.2d 1131 (3d Cir. 1971).
39. *Giant Eagle*, 822 F.3d 666, 673 (3d Cir. 2016), quoting *Cobaugh v. Klick-Lewis, Inc.*, 561 A.2d 1248, 1251 (Pa. Super. Ct. 1989).
40. *Gold Coast Hotel & Casino*, 158 F.3d 484 (9th Cir. 1998).

discounts. In Legal Advice Issued by Field Attorneys (LAFA) 20082801F, the IRS ruled that a subsidiary of a parent corporation had income from the sale of the parent's gift cards at the time the cards were purchased in or reloaded by certain designated stores, but it could take a deduction only when the card was ultimately redeemed by a customer at one of the stores.

The IRS's analysis was divided into three parts: whether there was gross income; the timing of any income; and the timing of deductions. With respect to the last issue, the time of deduction, the Service noted that Sec. 461(h)(1) requires economic performance to occur before the all-events test can be satisfied. Under Sec. 461(h)(2), if the liability of the taxpayer arises out of another person's providing services to the taxpayer, economic performance occurs as such person provides services.

In other words, a deduction by an accrual-method taxpayer may be taken when:

1. All events that fix the liability have occurred;
2. The amount of the liability can be determined with reasonable accuracy; and
3. Economic performance has taken place.

In LAFA 20082801F, the IRS explained the subsidiary had liability to provide gift card holders with the parent's products. The liability was satisfied by the stores at the subsidiary's direction when customers redeemed the cards. The Service said the subsidiary's liability was subject to the contingency that gift card holders must first redeem the card. Once the customer redeemed the gift card—but no sooner—the subsidiary's liability became fixed.

The IRS's position in this case is straightforward: Giant Eagle's liability for unredeemed fuelperks! is not fixed until the customer buys fuel. The Service, in its nonacquiescence, cites the Supreme Court's *General Dynamics* decision to the effect that a taxpayer cannot deduct "an estimate of an anticipated expense . . . if it is based on events that have not occurred by the close of the taxable year."[41] Based on this precedent, by allowing the deductions at year end, the Third Circuit appears to have granted Giant Eagle premature accruals. ■

41. *General Dynamics Corp.*, 481 U.S. 239, 243–44 (1987).