

July 1985

The Deduction of Future Liabilities by Accrual-Basis Taxpayers: Premature Accruals, the All Events Test, and Economic Performance

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University of Florida Law Review

VOLUME XXXVII

TAX 1985

NUMBER 3

THE DEDUCTION OF FUTURE LIABILITIES BY ACCRUAL-BASIS TAXPAYERS: PREMATURE ACCRUALS, THE ALL EVENTS TEST, AND ECONOMIC PERFORMANCE*

ERIK M. JENSEN**

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** Assistant Professor of Law, Case Western Reserve University School of Law. S.B., Massachusetts Institute of Technology (1967); M.A., University of Chicago (1972); J.D., Cornell Law School (1979).

The author will be forever indebted to Robert O. Bucklew, Jr., Case Western Reserve University School of Law class of 1986, for his superlative efforts in the preparation of this article. As discussant, researcher, and editor, he was an invaluable colleague. The author also wishes to thank Professors Leon Gabinet and Peter D. Junger, who both made many helpful comments on an earlier draft, and Ms. Elizabeth Ann Kaye, who kept the manuscript and those working on it in order.

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I. INTRODUCTION

The Internal Revenue Code requires that "the amount of any deduction . . . shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income."¹ Despite its importance to the tax system, determination of the "proper taxable year," under either an accrual method or the cash receipts and disbursements method of accounting,² has been an uncertain exercise. Inconsistent judicial decisions³ and conflicting positions of the Internal Revenue Service⁴ have failed to produce clear guidelines for taxpayers to follow. Prompted by the perception that taxpayers had been successful in accelerating the timing⁵ or overstating the amount⁶ of deductions, Congress passed the Tax Reform Act of 1984,⁷ which substantially modified the principles governing the determination of the "proper taxable year."

This article examines the tax treatment of future liabilities by accrual-basis taxpayers. Prior to the Tax Reform Act of 1984, future liabilities often generated

1. I.R.C. § 461(a) (1982).

2. Section 446 of the Internal Revenue Code generally requires a taxpayer to compute taxable income under the same method of accounting that he regularly uses for financial accounting purposes. "Method of accounting," for this purpose, includes overall methods of accounting such as the cash receipts and disbursements method, an accrual method, some combination of the two, or the other methods permitted by Treas. Reg. § 1.446-1(c) (CCH 1985). It also includes the accounting treatment of particular items, such as research and experimental expenditures or depreciation. I.R.C. § 446(c) (1982); Treas. Reg. § 1.446-1(a)(1) (CCH 1985).

3. See 4 B. BITTKER, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS* ¶¶ 105.2.5, 105.3.5, 105.3.6 (1981); Aidinoff & Lopata, *Section 461 and Accrual-Method Taxpayers. The Treatment of Liabilities Arising from Obligations to be Performed in the Future*, 33 TAX LAW. 789, 790-95 (1980).

4. The Service's positions conflicted with judicial authority. See, e.g., *Ohio River Collieries Co. v. Commissioner*, 77 T.C. 1369 (1981) (rejecting Service's view on accrual of mining reclamation obligation); Aidinoff & Lopata, *supra* note 3, at 796. Sometimes the positions were internally inconsistent. See *infra* notes 33-34 and accompanying text.

5. See H.R. REP. NO. 432, 98th Cong., 2d Sess. 1254 (1984); STAFF OF SENATE FINANCE COMM., 98TH CONG., 2D SESS., DEFICIT REDUCTION TAX BILL OF 1984 EXPLANATION OF PROVISIONS APPROVED BY THE COMMITTEE ON MARCH 21, 1984, at 271, 274 (Comm. Print) [hereinafter cited as SENATE COMMITTEE REPORT]; STAFF OF JOINT COMMITTEE ON TAXATION, 98TH CONG., 2D SESS., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 260 (Comm. Print) [hereinafter cited as JOINT COMMITTEE REPORT].

6. H.R. REP. NO. 432, *supra* note 5, at 1254; SENATE COMMITTEE REPORT, *supra* note 5, at 271; JOINT COMMITTEE REPORT, *supra* note 5, at 260.

7. The Tax Reform Act of 1984 and the Spending Reduction Act of 1984 make up the Deficit Reduction Act of 1984. Pub. L. 98-369, 98 Stat. 494.

“premature accruals.”⁸ Deductions were sometimes allowed when liabilities were accrued rather than when they were satisfied. Premature accruals provided enormous economic benefits to a taxpayer⁹ because, under the governing “all events” test,¹⁰ the time value of money¹¹ was not a factor in determining the timing and the amount of any deductions. To remedy this abuse, the Tax Reform Act provided, in general, that liabilities are deductible¹² no earlier than “economic performance,” the time when activities are performed that satisfy the liability.¹³

8. The term “premature accrual” is used throughout the legislative history of the Tax Reform Act but without explicit definition. See H.R. CONF. REP. No. 861, 98th Cong., 2d Sess. 871, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS 1445, 1559 [hereinafter cited as CONFERENCE COMMITTEE REPORT]; H.R. REP. No. 432, *supra* note 5, at 1252; SENATE COMMITTEE REPORT, *supra* note 5, at 264; JOINT COMMITTEE REPORT, *supra* note 5, at 258.

9. See *infra* notes 26-40 and accompanying text.

10. See *infra* notes 49-138 and accompanying text.

11. The tax literature on the “time value of money” has become voluminous. For a sample of recent discussions of potential abuses arising from failure to take the time value of money into account, see Aidinoff & Lopata, *supra* note 3; Canellos & Kleinbard, *The Miracle of Compound Interest: Interest Deferral and Discount after 1982*, 38 TAX L. REV. 565 (1982); Cliff & Levine, *Interest Accrual and the Time Value of Money*, 34 AM. U.L. REV. 107, 109-10 (1984); Committee on Taxation of the Association of the Bar of the City of New York, *Transactions Involving Deferred Payment of Accrued Liabilities: Federal Income Tax and the Time Value of Money*, 38 REC. A.B. CITY N.Y. 555 (1983), *reprinted in* 20 TAX NOTES (TAX ANALYSTS) 699, 711 (Aug. 29, 1983) [hereinafter cited as New York City Bar Report, with page citations to the reprint in TAX NOTES]; Ferencz, *A Review of Tax Planning Techniques for Mismatching Income and Expenses*, 61 TAXES 829 (1983); Gunn, *Matching of Costs and Revenues as a Goal of Tax Accounting*, 4 VA. TAX REV. 1 (1984); Halperin, *The Time Value of Money — 1984*, 23 TAX NOTES (TAX ANALYSTS) 751 (May 14, 1984); Note, *Protecting the Public Fisc: Fighting Accrual Abuse with Section 446 Discretion*, 83 COLUM. L. REV. 378, 382-87 (1983). See also J. EUSTICE, *THE TAX REFORM ACT OF 1984: A SELECTIVE ANALYSIS*, ch. 2 (1984).

12. For accrual-method taxpayers the changes made by the Tax Reform Act are generally effective for deductions that, under prior law, would have been allowable after July 18, 1984 (the date of enactment of Tax Reform Act of 1984). Pub. L. No. 98-369, § 91(g)(1), 98 Stat. at 608; Temp. Reg. § 1.461-3T Q&A-1, *reprinted in* [1986] 5 FED. TAXES (P-H) ¶ 20,555, at 20,590. The taxpayer may elect, however, to apply the new rules as of the first day of the taxable year that includes July 19, 1984. Tax Reform Act of 1984, Pub. L. No. 98-369, § 91(g)(2), 98 Stat. at 608; Temp. Reg. § 1.461-3T Q&A-2 (1985), *reprinted in* [1986] 5 FED. TAXES (P-H) ¶ 20,555, at 20,590.

13. I.R.C. § 461(h)(2), *as added by* Tax Reform Act of 1984, Pub. L. No. 98-369, § 91(a), 98 Stat. at 598-99. See *infra* notes 198-213 and accompanying text. This article discusses the application of the “economic performance” test to accrual-basis taxpayers. The Act also extended the “economic performance” requirement to those cash-basis taxpayers that fit the definition of “tax shelter” under the Act. A tax shelter may deduct a prepaid expense no earlier than an accrual-basis taxpayer would have been permitted to treat the expense as incurred. I.R.C. § 461(i)(1), *as added by* Tax Reform Act of 1984, Pub. L. No. 98-369, § 91(a), 98 Stat. at 600. These changes affecting cash-basis taxpayers are generally effective for deductions claimed after March 31, 1984. Tax Reform Act of 1984, Pub. L. No. 98-369, § 91(g)(1)(B), 98 Stat. at 608.

An enterprise (other than a C corporation) is a “tax shelter” if

- (1) at any time interests in the enterprise have been offered for sale in an offering required to be registered with any state or federal agency;
- (2) more than 35 percent of the losses of the enterprise are allocable to limited investors (such as limited partners) who do not actively participate in management; or

The term "economic performance" is new, but the concept is not. The Internal Revenue Service had taken the view that a performance requirement was implicit in prior law.¹⁴ Yet, partly because the Commissioner did not articulate an *economic* justification for his position, the Service's view was not universally accepted by the courts.¹⁵ Had the Commissioner stressed the time value of money, he would probably have been far more successful in his challenges of premature accruals.¹⁶

The codification of the economic performance requirement, although imperfectly based on time value of money concepts, introduces a measure of economic sophistication into the deduction guidelines. The practical effect is to delay many deductions, thereby reducing the number of premature accruals and enhancing tax revenues.¹⁷ The changes have the additional salutary theoretical effect of interring both the "matching principle"¹⁸ and, more generally, the idea of a congruence between tax and financial accounting. Conformity to financial accounting concepts, including the matching principle, has never been a controlling principle in tax law,¹⁹ but it has had an intuitive ap-

(3) the principal purpose of the enterprise is the avoidance or evasion of income tax.

I.R.C. § 461(i)(3), as added by Tax Reform Act of 1984, Pub. L. No. 98-369, § 91(a), 98 Stat. at 601; § 1256(e)(3)(B) (CCH 1985); § 6661(b)(2)(C)(ii) (CCH 1985). "Tax shelter" is so broadly defined, particularly in category (3) above, that the statute may apply to many cash-basis taxpayers not ordinarily considered to be tax shelters. See generally Treas. Reg. § 1.6661-5(b) (CCH 1985) (defining "tax shelter").

14. See *infra* notes 78-87 and accompanying text for a discussion of cases in which the Service argued that deductibility could not precede the time that the taxpayer's liability was satisfied by the performance of the obligation. The Service was not entirely consistent in imposing an economic performance requirement, however. See Rev. Rul. 69-429, 1969-2 C.B. 108 (accrual-basis taxpayer permitted to deduct, in year award determined by a commission, undiscounted amount of workers' compensation award payable over several years), superseding I.T. 1263, I-1 C.B. 123 (1922) (to same effect); McGown, *Structured Settlements: Deduct Now and Pay Later*, 60 TAXES 251, 257 (1982); *infra* notes 34-40 and accompanying text.

15. See, e.g., *Ohio River Collieries Co. v. Commissioner*, 77 T.C. 1369 (1981). See also *infra* notes 88-95 and accompanying text.

16. See Gunn, *supra* note 11, at 31-32.

17. See Helfand & MacNeil, *New Economic Performance Test Will Defer Many Deductions of Accrual-Basis Taxpayers*, 13 TAX'N FOR LAWS. 110, 113 (1984). For example, the Senate Finance Committee estimated that its version of the provisions governing premature accruals would increase fiscal year 1984 budget receipts by \$209 million. SENATE COMMITTEE REPORT, *supra* note 5, at 269.

18. The matching principle requires that revenue and the cost of earning that revenue be matched in the same taxable year. See Aidinoff & Lopata, *supra* note 3, at 796-98.

19. For example, taxpayers have generally not been permitted to deduct contingent liabilities, see *infra* notes 57-95 and accompanying text, even if generally accepted financial accounting principles, including the matching principle, would require accrual. See *infra* text accompanying notes 63-66. Accrual of contingent liabilities is required for financial reporting purposes in some cases to prevent an overly optimistic picture of the business's financial situation. See *infra* notes 181-85 and accompanying text.

The matching of income and the costs of earning that income is not even a professed goal for taxpayers using the cash receipts and disbursements method. See Malman, *Treatment of Prepaid Income — Clear Reflection of Income or Muddied Waters*, 37 TAX L. REV. 103, 105 (1981); Note, *supra* note 11, at 381. Under the cash method, see *infra* text accompanying note 41, the timing of deductions bears no necessary relationship to the timing of inclusion of income. Because of the

peal.²⁰ The Tax Reform Act ended any legitimacy that appeal once may have had.

This article will first describe the potentially absurd economic results that can arise with premature accruals.²¹ The principles that governed deductibility prior to the Tax Reform Act are evaluated with emphasis on the "all events" test,²² the further requirement that a method of accounting "clearly reflect income,"²³ and the relationship of the matching principle to the "clear reflection" standard.²⁴

This article further considers the Tax Reform Act's response to the economic inadequacies of prior law; the Act, while nominally retaining the all events test, now includes an express economic performance requirement.²⁵ As a result, deductions of accrual-basis taxpayers more closely approach, but do not always reach, the proper economic results.

II. THE PROBLEM: PREMATURE ACCRUALS AND THE TIME VALUE OF MONEY

Prior to the Tax Reform Act of 1984, taxpayers using an accrual method of accounting were able to generate deductions for future liabilities that overstated the economic costs of those liabilities.²⁶ The disparity between the deduction and the actual cost to the taxpayer arose because the applicable Internal Revenue Code provisions did not recognize the time value of money. One dollar of future costs could result in a current deduction of one dollar, even though the present value of that future obligation was less, perhaps considerably less, than one dollar.

An economically excessive deduction, a "premature accrual," is a potential problem any time an accrual precedes the payment of a future obligation and its associated costs.²⁷ The longer the time between accrual and payment, the greater the potential economic benefit to the taxpayer. When a current deduction is permitted and the amount of the future obligation is not appropriately discounted to reflect the time interval, the taxpayer will realize the economic benefit.

The Treasury Department's explanation of its 1984 tax reform proposals

cash method's inconsistency with generally accepted accounting principles and its resultant failure to measure "economic income," the Reagan administration has recommended severely restricting the use of the cash method by taxpayers. THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY 213 (May 1985) [hereinafter cited as 1985 REAGAN PROPOSALS].

20. See Schapiro, *Tax Accounting for Prepaid Income and Reserves for Future Expenses*, 2 TAX REVISION COMPENDIUM 1133 (House Comm. on Ways and Means 1959). "The commercial accounting practices appear intuitively as producing a fairer and more accurate reflection of net income." *Id.* at 1141. Schapiro did, however, reject that intuitive appeal in his article.

21. See *infra* notes 26-40 and accompanying text.

22. See *infra* notes 49-145 and accompanying text.

23. See *infra* notes 146-62 and accompanying text.

24. See *infra* notes 163-90 and accompanying text.

25. See *infra* notes 191-256 and accompanying text.

26. The Tax Reform Act was not entirely successful in attacking this problem. See *infra* notes 233-42 and accompanying text.

27. See Gunn, *supra* note 11, at 35.

provides an example of the time value of money principle in operation.²⁸ In 1983 A, an accrual-basis taxpayer, incurred a contractual obligation to pay \$100 in 1990 for services to be performed in 1990. If A invested \$58.35 in 1983 at an eight percent after-tax rate of return, in 1990 he would have exactly the \$100 needed to satisfy the liability.

Viewed from A's perspective in 1983, the obligation can be described in two ways: an obligation to pay an expense of \$100 in 1990 or an obligation to pay an expense that in 1983 has a present value of \$58.35. For the deduction to reflect the true economic cost, A should be limited to a deduction²⁹ of \$58.35 in 1983, or a deduction of \$100 in 1990. No theory grounded in economic reality would permit A's premature accrual of the entire obligation and the deduction of \$100 in 1983.³⁰

Tax accounting rules have not been grounded in economic reality, however. The deduction in 1983 was not limited to the present value of the future obligation, and even the Internal Revenue Service did not advocate such a position.³¹ Moreover, if certain requirements were met,³² A could have deducted the entire \$100 in 1983. Although the Commissioner generally insisted that the \$100 deduction be deferred until the services under the contract were performed,³³ his protestations at times went unheeded by judicial bodies.

In some cases, even though the economic benefits were conceptually identical to those in the Treasury's example, the Commissioner did not even protest. The possibilities for imaginative tax planning were particularly prevalent in cases involving structured tort or workers' compensation settlements. Curiously, contrary to its general position, the Internal Revenue Service ruled in such cases that, if the settlement was payable in fixed amounts over a number of years, the total undiscounted amount of the future liability was deductible in the year of the award.³⁴

The following example reveals the absurdity that can result from an immediately deductible, undiscounted settlement award.³⁵ Assume that business

28. Treasury Department, *General Explanations of Administration's Revenue Provisions in 1985 Budget*, 71 STAN. FED. TAX REP. (CCH) No. 10, pt. II, at 109 (extra ed. Feb. 17, 1984).

29. This article discusses the particular problems of accrual. It is assumed that the expenses at issue have a statutory basis for deduction, such as I.R.C. § 162, which generally permits deductions for ordinary and necessary expenses of carrying on a trade or business, and the expenses do not result in the creation of assets that have useful lives extending substantially beyond the end of the taxable year. Treas. Reg. § 1.461-1(a)(2) (CCH 1985). If such an asset is created, the expense must be capitalized, and it is therefore not currently deductible. See I.R.C. § 263 (1982).

30. Treasury Department, *supra* note 28, at 109. Any deduction greater than \$58.35 in 1983 would have been theoretically inappropriate, assuming that the discount rate used for determining the present value was properly selected.

31. Such a position, however, was advocated by Aidinoff & Lopata, *supra* note 3, at 811-18.

32. See *infra* notes 49-138 and accompanying text.

33. See *infra* notes 78-87 and accompanying text.

34. Rev. Rul. 69-429, 1969-2 C.B. 108. The ruling involved a self-insured partnership that was obligated to pay an injured employee in installments over several years. The amounts were fixed by the state Industrial Commission under the governing Workmen's Compensation Act. The ruling is only four sentences long and contains no reasoning whatsoever.

35. McGown, *supra* note 14, at 252-53.

taxpayer Z, subject to a fifty percent marginal tax rate, is sued in a personal injury action. Rather than settling for \$1 million, payable currently, Z offers to make a single \$3 million payment in ten years. If currently deductible, the \$3 million liability can be quite beneficial to Z as well as to the claimant.

The future payment may be attractive to the injured party because the payment's present value, under certain assumptions, is greater than \$1 million.³⁶ From Z's standpoint, the potential benefits are astonishing. Z will save \$1.5 million in taxes provided his income is sufficient to make full use of the deduction currently. If he invests the \$1.5 million tax savings in tax-free bonds with a ten percent return, Z will have \$3,890,614 in ten years, when the \$3 million obligation must be fulfilled. Thus Z will be better off, after taxes, because he was sued.³⁷ As Professor Gunn noted, "If this is the law [prior to the Tax Reform Act], well-advised accrual-method businesses should cancel their liability insurance and run down pedestrians at the rate of at least one a year."³⁸

Premature accruals do not ordinarily *increase* the after-tax income of an accrual-method taxpayer; the structured settlement example is unusual in that respect.³⁹ Nevertheless, the example accurately portrays the nature of the economic benefit attributable to premature accruals. How could a result so patently ridiculous⁴⁰ be given serious consideration by the Internal Revenue Service or by a court? The next section of the article discusses the standards that governed deductibility prior to the enactment of the Tax Reform Act of 1984.

III. STANDARDS FOR DEDUCTIBILITY BEFORE THE TAX REFORM ACT OF 1984: THE ALL EVENTS TEST AND THE CLEAR REFLECTION OF INCOME

Premature accruals resulted from the application of tax principles that had no economic basis. Indeed, it is striking how limited a role economic analysis played in the development of standards for deducting future liabilities. Prior to

36. McGown assumes that the claimant could secure an after-tax return of 10.8% (an 18% investment return reduced by an effective tax rate of 40%) on his \$1 million, leaving him with \$2,788,673 after 10 years. *Id.*

The desirability of the structured settlement to the claimant in a personal injury action is enhanced by the Code's treatment of amounts received "on account of personal injuries or sickness." No portion of such an award will be included in the claimant's income whether received as a lump sum or as periodic payments. I.R.C. § 104(a)(2) (1982). Thus, even though part of any payment made in a later taxable year consists of economic interest, the Code does not require breaking out the interest component and taxing it separately. *See Cane, How to Use and Benefit from Structured Settlements in Personal Injury Suits*, 59 J. TAX'N 330, 331 (1983); McGown, *supra* note 14, at 252. *See also* Ferencz, *supra* note 11, at 834 (arguing that structured settlements should be analyzed as having two elements: (i) the damage liability and (ii) interest for the privilege of paying the liability over time); Frolik, *The Convergence of I.R.C. § 104(a)(2)*, *Norfolk & Western Railway Co. v. Liepelt and Structured Tort Settlements: Tax Policy "Derailed"*, 51 *FORDHAM L. REV.* 565 (1983) (criticizing exemption of "interest" component from income).

37. McGown, *supra* note 14, at 253.

38. Gunn, *supra* note 11, at 26.

39. *See id.* at 27 n.116.

40. Gunn suggested:

[T]he absurdity of a rule that can make the tax benefit of a deduction exceed its cost is so clear, once it has been noted, that the Government should have a fair chance of winning future deferred-payment cases if it makes the right argument: that an immediate deduction

1984, no direct attempt was made to correlate the amount and timing of a deduction with the true cost of the liability to the taxpayer.

A. *Accrual Methods of Accounting: Introduction*

For taxpayers using the cash receipts and disbursements method of accounting, amounts are included in income when received, and expenses are not deductible before payment.⁴¹ In contrast, expenses may be reflected as early as the time of incurrence⁴² for a taxpayer using an accrual method of accounting;⁴³ the time an expense is paid does not control the time of the corresponding

for expenses paid in the distant future distorts income. That the law should not be "a ass, a idiot" is a principle of some persuasive force.

Id. at 31-32 (footnote omitted).

41. See Treas. Reg. § 1.451-1(a) (CCH 1985) (gains, profits, and income includible for taxable year in which cash-basis taxpayer actually or constructively receives such amounts); Treas. Reg. § 1.461-1(a)(1), T.D. 6520, 1961-1 C.B. 52, 62-63 (amounts of allowable deductions taken into account for taxable year in which paid); Treas. Reg. § 1.446-1(c)(1)(i) (CCH 1985) (to same effect).

42. "[T]he basic idea under [an] accrual system of accounting is that the books shall immediately reflect obligations and expenses *definitely incurred* and income definitely earned without regard to whether payment has [yet] been made or whether payment is due." H.H. Brown Co. v. Commissioner, 8 B.T.A. 112, 117 (1927) (emphasis added), *acq.* VII-1 C.B. 5.

Accrual principles have been described as follows:

- (1) Revenues are recognized as entering into the determination of income when sales are made or services are rendered.
- (2) The mere receipt of money or the promise of another person to pay money for goods or services does not represent revenue which should be recognized in the period of receipt if it is burdened with an obligation to deliver goods or render services in the future. Items of this nature are treated as resulting in liabilities or deferred credits until they are earned through the fulfillment of the required performances.
- (3) Costs and expenses directly identifiable with revenues are chargeable against the income of the period in which the revenues are recognized. Expenses, such as insurance, rent, property taxes and interest, which are for particular periods of time are chargeable over such periods. Other expenses incurred in the general conduct of the business are chargeable against the income of the period in which they are incurred unless it is clearly evident that they are for the benefit of future periods and there is a reasonable basis, both as to amount and time, for allocating them to future periods, in which event they should be deferred and charged to such periods.
- (4) If the precise amount of any costs or expenses is not determinable at the time they are chargeable against income, they should be recognized on the basis of reasonable estimates.
- (5) Accounting recognition of costs and expenses which cannot be determined with a reasonable degree of accuracy at the time they would otherwise be charged against income of a particular period should be deferred until such determination is possible.

Stanger, Vander Kam, & Polifka, *Prepaid Income and Estimated Expenses: Financial Accounting Versus Tax Accounting Dichotomy*, 33 TAX LAW. 403, 405 (1980).

43. The Code specifically permits use of "an" accrual method of accounting, while it refers to "the" cash receipts and disbursements method. I.R.C. §§ 446(c)(1), 446(c)(2) (1982). The choice of "an" has been interpreted as "a conscious effort on the part of Congress to permit considerable latitude within the realm of permissibility for taxpayers using the accrual approach." Diamond & Holman, *Accounting Methods — Definitions, Permissibility*, TAX MGMT. (BNA) No. 46-4th, at A-19 (1979).

In general, taxpayers that are required to use inventories for a particular trade or business

deduction. In addition, the time a payment is received does not determine the time of inclusion in income.⁴⁴

The general principles behind accrual accounting do not, of course, define the precise timing of a deduction for future liabilities. When is a deductible expense⁴⁵ definitely incurred for this purpose? Prior to the Tax Reform Act, application of the "all events test" provided a tentative answer. An additional requirement,⁴⁶ that the current deduction "clearly reflect income,"⁴⁷ was also available to the Commissioner to challenge the timing of deductions. The following subsections discuss the "all events test" and the "clear reflection" requirement. Although their importance has declined, both standards survived the changes made by the Tax Reform Act of 1984.⁴⁸

B. The All Events Test

The all events test did not originate in Congress. It was first articulated by the United States Supreme Court in *United States v. Anderson*,⁴⁹ and was later

must use an accrual method of accounting for their purchases and sales. Treas. Reg. § 1.446-1(c)(2)(i) (CCH 1985). Inventories are required in all cases in which the production, purchase, or sale of merchandise is an income producing factor. Treas. Reg. § 1.471-1 (1958). Service businesses have generally not been required to use an accrual method of accounting, but President Reagan's 1985 tax reform proposals would require service businesses with annual gross receipts greater than \$5 million to use an accrual method. 1985 REAGAN PROPOSALS, *supra* note 19, at 213.

44. Although the time of receipt is ordinarily not controlling, payments received by an accrual-basis taxpayer before the amounts have, in fact, been earned generally must be included in income at the time of receipt. This result follows even though it is inconsistent with generally accepted financial accounting principles. *See Schlude v. Commissioner*, 372 U.S. 128 (1963) (prepayments for dancing lessons); *American Auto. Ass'n v. United States*, 367 U.S. 687 (1961) (prepayments of membership dues); *Automobile Club v. Commissioner*, 353 U.S. 180 (1957) (prepayments of membership dues). The results in this Supreme Court trilogy have been justified as reflecting "tax income," which, a commentator suggests, "is intended to be an index of a taxpayer's current ability to pay tax," rather than a measure of economic income. Note, *supra* note 11, at 403.

Some relief from the effects of the trilogy has been provided in the Code, the regulations, and the Internal Revenue Service's own procedures. *See* I.R.C. § 455 (1982) (special rules for prepaid subscription income); I.R.C. § 456 (1982) (special rules for prepaid dues of certain membership organizations); Treas. Reg. § 1.451-5(b), T.D. 7397, 1976-1 C.B. 115, 121-22 (generally permitting income from sale of goods to be deferred until year of accrual under financial accounting method if consistent method used for tax purposes); Rev. Proc. 71-21, 1971-2 C.B. 549 (one-year deferral of inclusion permitted under certain circumstances). For a discussion of the prepayment issue, see Malman, *supra* note 19.

45. *See supra* note 29.

46. Thus, "accrual analysis can be easily summarized: a taxpayer accounts for income and expenses according to the all-events test unless special considerations, raised by the notion of 'clear reflection of income,' require a different result." Gunn, *supra* note 11, at 4.

47. If the method of accounting used by a taxpayer (*see supra* note 2) "does not clearly reflect income," the Secretary of the Treasury is empowered to require the reporting of taxable income under a method that does clearly reflect income. I.R.C. § 446(b) (1982); Treas. Reg. § 1.446-1(b)(1) (1957). *See infra* notes 146-90 and accompanying text.

48. *See infra* notes 249-51 and accompanying text, which discuss what remains of the two requirements after the Tax Reform Act.

49. 269 U.S. 422 (1926). *Anderson* considered the timing of the deduction of a munitions tax that was imposed on 1916 profits but was actually paid in 1917. The taxpayer kept its books using

incorporated, in a somewhat liberalized version, into the Income Tax Regulations:

Under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy. . . . [T]he fact that the exact amount of the liability which has been incurred cannot be determined will not prevent the accrual within the taxable year of such part thereof as can be computed with reasonable accuracy.⁵⁰

Thus, for pre-Tax Reform Act accruals,⁵¹ a taxpayer had to demonstrate both (i) that all events had occurred to insure that the taxpayer actually had an obligation (the *fact* of the liability), and (ii) that the *amount* of the liability, while not necessarily precisely fixed, had been reasonably computed.⁵² The failure to satisfy either requirement of the two-part test was "fatal" to a taxpayer's claim for a current deduction.⁵³

The two-part test was not easily applied.⁵⁴ Neither of the parts generated controlling principles acceptable to both the Internal Revenue Service and the

an accrual method and established reserves for such reasonably expected expenses. The test for deductibility, as stated by Justice Stone, was whether "all the events [have occurred] which fix the amount of the tax and determine the liability of the taxpayer to pay it." *Id.* at 441. Since the 1916 munitions tax was fixed by events occurring in 1916, the Supreme Court held that the tax was properly deductible from gross income in 1916. *Id.*

Before enactment of the 1954 Code and the adoption of the regulations thereunder, the income tax regulations did not expressly incorporate the all events test: an accrual-basis taxpayer was entitled to a deduction for the taxable year in which a liability was "accrued" or "incurred," and the *Anderson* principles were applied to determine the time of accrual or incurrence. *See* LTR 7831003, IRS LETTER RUL. REPS. (CCH) No. 75, at 4 (Apr. 13, 1978) (technical advice memorandum).

50. Treas. Reg. § 1.461-1(a)(2) (1957). *See also* Treas. Reg. § 1.446-1(c)(1)(ii), T.D. 7285, 1973-2 C.B. 163, 164.

A rule nearly identical to that in Treas. Reg. § 1.461-1(a)(2) applies to the accrual of revenue: "income is to be included for the taxable year when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy." Treas. Reg. § 1.446-1(c)(1)(ii) (CCH 1985). *See also* Treas. Reg. § 1.451-1(a) (1957). This test too can be traced to a Supreme Court decision:

Keeping accounts and making returns on the accrual basis, as distinguished from the cash basis, import that it is the *right* to receive and not the actual receipt that determines the inclusion of the amount in gross income. When the right to receive an amount becomes fixed, the right accrues.

Spring City Foundry Co. v. Commissioner, 292 U.S. 182, 184-85 (1934) (emphasis in original).

The Internal Revenue Service applies a similar test in determining whether a transferee of property, who assumes liabilities of the transferor in the transaction, may include the estimated cost of the unsatisfied liabilities in the basis of the property: "[N]o amount is to be included in cost with respect to those obligations which are so contingent and indefinite that they are not susceptible to present valuation, until such time as they become fixed and absolute and capable of determination with reasonable accuracy." Rev. Rul. 55-675, 1955-2 C.B. 567, 568.

51. *See supra* note 12 (effective date of accrual provisions of Tax Reform Act of 1984).

52. *See* *Ohio River Collieries Co. v. Commissioner*, 77 T.C. 1369, 1372-73 (1981).

53. *See id.* at 1373; *Southern Pac. Trans. Co. v. Commissioner*, 75 T.C. 497, 634 (1980).

54. Although taxpayers are often granted considerable leeway for purposes of income inclusion,

judiciary. Indeed, the disagreement over the Treasury regulations was fundamental, involving potentially radical differences in the timing of deductions.⁵⁵

The proper timing of deductions is an economic issue. Because of the time value of money, taxpayers usually seek to accelerate deductions⁵⁶ and, in time-honored fashion, the Commissioner resists. Despite the economic motivation, however, timing disputes between taxpayers and the Commissioner were not resolved by the economic reasonableness of deferral or acceleration. The disputes centered instead on formalistic analyses of the contingency and the accuracy of the liability, factors that have little bearing on the economic wisdom of a deduction's timing.

1. All Events Test Requirement I: Fact of the Liability

As a general proposition, a liability in fact exists if no contingencies are present that could defeat the liability.⁵⁷ For example, in *Lucas v. American Code Co.*,⁵⁸ the taxpayer was not permitted to deduct the estimated amount of its "strenuously contested" liability in a breach of contract suit. By its contest, the taxpayer made the fact of the liability uncertain.⁵⁹

Similarly, in *Brown v. Helvering*,⁶⁰ an insurance agent's "obligation" to refund a portion of his commissions upon the cancellation of any policies was held to be contingent. Because it was not definite that any policy would be cancelled,

see Treas. Reg. § 1.446-1(c)(1)(ii), T.D. 7285, 1973-2 C.B. 163, 164, application of the all events test is not necessarily simple. Cf. Gunn, *supra* note 11, at 8-9, 28-30. In many areas involving significant dollar amounts, application of the all events test to future liabilities has been crucial to deductibility — for example, structured settlements, mining reclamation obligations, employer obligations under workers' compensation agreements, and employer contributions under supplemental unemployment benefit plans. See New York City Bar Report, *supra* note 11, at 701-06.

55. See *infra* notes 140-41 and accompanying text.

56. A deduction of one dollar in the current taxable year is generally preferable to a deduction of one dollar in a subsequent year, but there are exceptions to this general rule. For example, deferring a deduction may be desirable if the taxpayer expects to be subject to a higher marginal tax rate in later years.

57. Under the rulings of the Internal Revenue Service, the only contingency that may exist if the all events test is to be satisfied is the obligor's ability to pay. See *infra* note 78 and accompanying text.

58. 280 U.S. 445 (1930).

59. *Id.* at 450-51. In addition, the amount of the damages was "wholly unpredictable," depending on such factors as the extent of the plaintiff's mitigation of damages. *Id.* at 451. See also *Consolidated Indus., Inc. v. Commissioner*, 82 T.C. 477 (1984), *aff'd per curiam*, 767 F.2d 41 (2d Cir. 1985) (where state law uses federal taxable income as the tax base and taxpayer contests federal liability, state tax liability is treated as contested and therefore not deductible until dispute resolved); *Webb Constr. Co. v. Commissioner*, 43 T.C.M. (CCH) 241 (1981) (liability contingent where no admission of loss).

The Code itself now provides limited relief for contested liabilities. A contested liability may be deducted by an accrual-method taxpayer prior to resolution if the liability would otherwise be deductible and the taxpayer has actually paid the liability. I.R.C. § 461(f), as amended by Tax Reform Act of 1984, Pub. L. No. 98-369, 91(e), 98 Stat. at 607. If the liability has been paid, there is no interval between accrual and payment and hence no premature accrual. But see *infra* notes 237-40 and accompanying text (prepayment under TRA).

60. 291 U.S. 193 (1934).

a refund obligation might never arise. Therefore the agent was not permitted to deduct an estimate of future refunds.⁶¹

The holding in *Brown* was predicated on the uncertainty of the future liability, not on the future nature of the obligation. Presumably, the result would have been different if the agent had sought to deduct a future refund obligation arising from a policy already cancelled. Assume, for example, that Brown became contractually obligated to refund a portion of the commissions for a policy cancelled in 1984, but was not required to make the refund until 1986. Under these circumstances, the fact of the obligation would have been fixed in 1984, the year of the cancellation.⁶² If the agent also demonstrated the amount of the obligation, both prongs of the all events test would have been met, and thus a deduction permitted, in 1984.

The proper role of generally accepted accounting principles in determining the timing of deductions is a subject of controversy, but it is clear those principles are not ultimately controlling. Unless the Code expressly provides otherwise,⁶³ contingent liabilities cannot be deducted for tax purposes, even though they must often be reflected in a taxpayer's financial accounts. In order for potential investors and creditors to receive an accurate picture of a business's financial health,⁶⁴ generally accepted accounting principles require that contingent obligations be reflected as expenses on the enterprise's financial statements.⁶⁵ Mandatory financial accounting treatment, however, does not necessarily translate into required, or even permitted, tax accounting treatment.

61. *Id.* at 200-01. The Supreme Court stated:

[N]o liability accrues during the taxable year on account of cancellations which it is expected may occur in future years, since the events necessary to create the liability do not occur during the taxable year. Except as otherwise specifically provided by statute, a liability does not accrue as long as it remains contingent.

Id. at 200. *Brown* continues to be cited. *E.g.*, Rev. Rul. 80-191, 1980-2 C.B. 168, 169. The apparent reasonableness of viewing a liability as fixed if statistically accurate predictions of future cancellations are made "must yield to the countervailing rule of law that no deduction is permitted if an expense is merely contingent." Aidinoff & Lopata, *supra* note 3, at 798. See *Ertegun v. Commissioner*, 531 F.2d 1156 (2d Cir. 1976) (credit for unsold, returned phonograph records deductible by wholesaler only upon return of records); Rev. Rul. 81-93, 1981-1 C.B. 322 (denial of deductions for additions to reserve for uninsured losses).

62. *Cf.* Rev. Rul. 78-116, 1978-1 C.B. 143 (employer permitted current deduction for sick leave accrued during year under plan where employees must use sick leave in following year or be paid for unused leave, even if their employment is terminated).

63. For example, the Code does so provide for reasonable additions to reserves for future bad debts. I.R.C. § 166(c) (1982). *But see* 1985 REAGAN PROPOSALS, *supra* note 19, at 215-17 (recommending repeal of reserve method for bad debt deductions).

64. See *infra* notes 181-85 and accompanying text.

65. Generally accepted accounting principles require that a contingent obligation to make payments at some time in the future . . . be recorded as an expense in the profit and loss statement if it is probable that a liability has been incurred as of the date of the financial statement and if the amount of the liability may then be reasonably estimated. This treatment is mandatory, even if the identity of the payee is unknown.

New York City Bar Report, *supra* note 11, at 711. The amount of the recorded expense will depend on whether the time of payment is known as of the date of the financial statement. If the time

Reserves created to cover future estimated expenses may also be treated differently for tax and financial accounting purposes. Reserves for future liabilities are consistent with, and at times required by, financial accounting standards to protect third parties who rely upon a business's financial statements. However, a taxpayer has never been permitted a deduction for "reasonable additions" to reserves merely because of this financial accounting doctrine.⁶⁶ Demonstrating the fact of a liability requires more than demonstrating accounting conformity.

2. The Strip Mining Paradigm: *Ohio River Collieries Co.*

However the cases have phrased the issue, the real question has not been whether contingencies other than the obligor's liability to pay exist — some

of payment is unknown, accrual of the undiscounted amount of the future payment is required. If the time of payment is known, however, accrual of only the discounted present value of the future payment is required. *Id.* See FINANCIAL ACCOUNTING STANDARDS BOARD, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 5: ACCOUNTING FOR CONTINGENCIES (1975); FINANCIAL ACCOUNTING STANDARDS BOARD, STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS NO. 5: RECOGNITION AND MEASUREMENT IN FINANCIAL STATEMENTS OF BUSINESS ENTERPRISES ¶ 67(d)-(e), at 23-24 (1984).

66. "The prudent business man often sets up reserves to cover contingent liabilities. But they are not allowable as deductions." *Lucas v. American Code Co.*, 280 U.S. 445, 452 (1930) (Brandeis, J.) (footnote omitted).

The Internal Revenue Code of 1954, in its original form, included a provision, § 462, that permitted an accrual-method taxpayer to deduct "reasonable additions" to reserves for estimated expenses related to a trade or business. Within less than a year of enactment, however, § 462 and § 452, another new provision permitting deferral of prepayments received by accrual-basis taxpayers, were repealed retroactively. Ch. 143, §§ 1(a)-(b), 69 Stat. 134, 134 (1955).

Does the repeal of § 462 mean that additions to reserves are necessarily not deductible? Answers to that question vary. The Tax Court has concluded that there are few occasions in which such additions should be deductible:

The repeal of section 462 removed the only provision providing, in general, for the deduction of estimates of expenses to be incurred in the future. While prudent accounting or financial practices may dictate the establishment of reserves for liabilities to be incurred in the future, these reserves are not ordinarily deductible.

World Airways, Inc. v. Commissioner, 62 T.C. 786, 801 (1974). See *Simplified Tax Records, Inc. v. Commissioner*, 41 T.C. 75, 81 n.4 (1963) (repeal of § 462 indicates that Commissioner's discretion in disallowing deduction will be disturbed only if "clear abuse"). *Cf. American Auto. Ass'n v. United States*, 367 U.S. 687, 695-96 (1961) (repeal of § 452 demonstrates congressional disapproval of deferral of prepayments). The Tax Court has expressed its concern that excessively loose construction of the all events test would result in the judicial "reenactment" of the repealed § 462. *Ohio River Collieries Co. v. Commissioner*, 77 T.C. 1369, 1377-78 (1981).

On the other hand, § 462 expressly applied only to items for which there was no other statutory basis for deduction. I.R.C. § 462(d)(1)(A) (1954). Additions to reserves that would have been deductible under other principles should have remained deductible after the repeal. See *Kaiser Steel Corp. v. United States*, 717 F.2d 1304, 1308 (9th Cir. 1983) (rejecting government's argument that estimates reflected in additions to reserve should never be deductible); S. REP. NO. 372, 84th Cong., 1st Sess., reprinted in 1955-2 C.B. 858, 861; Aidinoff & Lopata, *supra* note 3, at 810; Gunn, *supra* note 11, at 29; McGown, *supra* note 14, at 260; Stanger, Vander Kam, & Polifka, *supra* note 42, at 421. See also *Schlude v. Commissioner*, 372 U.S. 128, 139-40 (1963) (Stewart, J., dissenting) (no inference of disapproval of accrual accounting principles to be drawn from repeal of sections 452 and 462).

contingencies *always* exist⁶⁷— but how contingent a liability can be and nevertheless qualify for current deductibility. *Ohio River Collieries Co. v. Commissioner*⁶⁸ illustrates the factors involved in making that determination. The contingent obligation at issue was an archetypical “premature accrual” obligation, the statutorily required reclamation of land disturbed by strip mining.⁶⁹

Before a state license for strip mining would be issued, Ohio River Collieries Company was required by Ohio law to submit a reclamation plan and post a bond to ensure reclamation would be completed.⁷⁰ The state had other enforcement mechanisms as well at its disposal, and it had strictly enforced compliance with the statute in the past.⁷¹

At the end of each tax year the company estimated the cost of the required reclamation on land that had been mined during the year, and deducted the undiscounted amounts on its federal income tax return.⁷² The company and the Internal Revenue Service agreed that the amount of future reclamation costs had been estimated with “reasonable accuracy,” thus meeting the second part of the all events test,⁷³ but the parties differed on whether the company had demonstrated the *fact* of the liability.⁷⁴

Not unreasonably, Ohio River Collieries Company argued that the fact of its reclamation liability was fixed since, once ground was broken, no further event was necessary to solidify the obligation to restore the land.⁷⁵ The precise timing of the reclamation⁷⁶ and the party that would perform the services⁷⁷ were uncertain; nevertheless, unless the state modified its statute or lost its zest for enforcement, someone at some time was required to complete the reclamation at the company’s expense.

67. Professor Gunn notes that, if the all events test were taken at face value, “accrual accounting would be an administrative horror.” Gunn, *supra* note 11, at 7. At least in the cases of routine business receipts and outlays, however, it is not read literally. For example, reporting of routine sales income need not await detailed analysis of the effects of the Uniform Commercial Code on the buyer’s obligation under a sales contract. *Id.* at 7-8; 4 B. BITTKER, *supra* note 3, at ¶ 105.3.2.

68. 77 T.C. 1369 (1981).

69. See New York City Bar Report, *supra* note 11, at 705-06.

70. OHIO REV. CODE ANN. § 1513 (Page 1978).

71. *Ohio River Collieries Co.*, 77 T.C. at 1370-71.

72. *Id.* at 1371.

73. See *infra* notes 96-138 and accompanying text. The government had also agreed that the reclamation costs were deductible as a business expense. 77 T.C. at 1371 n.3. See *supra* note 29. The government’s concession on this point must have been based on the premise that the expense, when paid, would provide no benefit to the company other than the relief of its statutory obligations. If the company owned the mined land and the reclamation increased the land’s value, the expenditures would have been nondeductible capital expenditures. See N.Y. City Bar Report, *supra* note 11, at 706.

74. 77 T.C. at 1372-73.

75. *Id.* at 1371.

76. Ohio law specified only that all reclamation activities except planting be completed within 12 months of the cessation of mining. *Id.* at 1370.

77. The reclamation might be done by the company, a third party under contract, or, if the company forfeited its bond, the state of Ohio. *Id.* at 1375-76. See New York City Bar Report, *supra* note 11, at 706.

The Internal Revenue Service took its traditionally conservative position that any contingency (other than the obligor's ability to pay) is sufficient to prevent deductibility.⁷⁸ Despite the company's obligation under the Ohio statute, the Commissioner disagreed that the company proved the fact of the liability and urged the Tax Court to adopt a standard that looks to economic performance. The Commissioner argued the deduction could not be taken until the company became "obligated to pay cash immediately to an identified person,"⁷⁹ and, as a matter of contract law, this obligation would arise only as the reclamation activities proceeded.⁸⁰

The Internal Revenue Service's position is only briefly described in *Ohio River Collieries Co.* It is better developed in a widely noted 1978 technical advice memorandum involving similar facts.⁸¹ First, the memorandum cited cases hold-

78. See JOINT COMMITTEE REPORT, *supra* note 5, at 259; Rev. Rul. 72-34, 1972-1 C.B. 132; see also Rev. Rul. 77-266, 1977-2 C.B. 236, following *Lawyers' Title Guar. Fund v. United States*, 508 F.2d 1 (5th Cir. 1975) (allowing immediate deduction of commission accounts, payable in seven years, with only contingency the ability to pay). Compare Rev. Rul. 79-338, 1979-2 C.B. 212, in which the Service refused a deduction of a company's estimated liabilities for medical services already rendered for its employees through its medical benefits program. Before a deduction was allowed, the program's independent administrator had to certify the claim as eligible for payment. The possibility of noncertification was sufficient to make the liability contingent. *Id.* at 213; see also *Fred Nesbit Distrib. Co. v. United States*, 85-2 U.S. Tax Cas. (CCH) ¶ 9609 (S.D. Iowa 1985) (no deduction for refundable deposits on bottles until empty containers actually returned); Rev. Rul. 78-273, 1978-2 C.B. 163 (to same effect as *Nesbit*); Rev. Rul. 70-78, 1970-1 C.B. 120 (no deduction for addition to reserves for customers' cash discounts, based on customers' outstanding accounts receivable, in anticipation of discounts in following year); Rev. Rul. 54-608, 1954-2 C.B. 8, modified by Rev. Rul. 55-426, 1955-1 C.B. 68 (employer permitted no deduction for vacation pay for following year unless an absolute liability to pay existed regardless of termination of employment).

The Code provides relief from the strict Service position in certain special areas. See I.R.C. § 463, as amended by Tax Reform Act of 1984, Pub. L. No. 98-369, § 561(a), 98 Stat. at 901 (permitting deduction of advance accruals of vacation pay if vested vacation pay plan exists); I.R.C. § 466 (1982) (permitting deduction of advance redemption costs of qualified discount coupons that are in fact redeemed within certain period).

79. 77 T.C. at 1375. This position was consistent with the Service's published rulings. See Rev. Rul. 76-345, 1976-2 C.B. 134, where the Service rejected deductions for a newspaper publisher's obligation to make contributions to a dealer profit-sharing plan:

Since the group [of dealers] is subject to constant change, neither the ultimate recipients nor the time of distribution can be ascertained in the year of accrual. The "all events test" can be met only when the fact of the liability to a specified individual participant has been clearly established and the amount of liability to each individual can be determined with reasonable accuracy.

Id. at 135. The Service thereby repudiated a contrary decision of the Court of Claims. See *infra* notes 89-90; see also Rev. Rul. 72-34, 1972-1 C.B. 132, 133 ("no deduction will be allowed until that time when the taxpayer becomes currently obligated to make an actual cash payment").

80. 77 T.C. at 1374.

81. LTR 7831003, I.R.S. LETTER RUL. REPS. (CCH) No. 75, at 4 (Apr. 13, 1978); H.R. REP. NO. 432, *supra* note 5, at 1253; JOINT COMMITTEE REPORT, *supra* note 5, at 260; SENATE COMMITTEE REPORT, *supra* note 5, at 274; see *Aidinoff & Lopata*, *supra* note 3, at 795, 797; *Collings & Finley, Controversy Concerning the Accrual of Reclamation Costs*, 28 OIL & GAS TAX Q. 521 (1980); *McGown*, *supra* note 14, at 255.

The rationale is also described, in more summary fashion, in Rev. Rul. 80-182, 1980-2 C.B. 167. This ruling denied deduction, prior to the year of removal, for an obligation to remove

ing that an accrual-basis taxpayer may not deduct a liability attributable to a bilateral contract prior to the rendition of the contracted services.⁸² Thus, although the *amount* of some obligation may have been proven,⁸³ contracting in advance for the reclamation does not establish the *fact* of any deductible liability. When the taxpayers entered into such a contract, "the [taxpayers] incurred no liability but merely agreed to become liable to pay in the event future services were performed."⁸⁴

offshore drilling platforms and well fixtures installed pursuant to a long-term oil and gas lease with the federal government. See A. BRUEN & W. TAYLOR, *FEDERAL INCOME TAXATION OF OIL AND GAS INVESTMENTS* ¶ 6.04, at 6-9, 6-10 (1983 & 1985 Supp.); F. BURKE & R. BOWHAY, *INCOME TAXATION OF NATURAL RESOURCES* ¶ 15.61, at 1565 (1984).

82. LTR 7831003, I.R.S. LETTER RUL. REPS. (CCH) No. 75, at 2 (Apr. 13, 1978). *E.g.*, Levin v. Commissioner, 21 T.C. 996, 998-99 (1954) (no fixed liability for costs of contracted advertising services until services performed), *aff'd*, 219 F.2d 588 (3d Cir. 1955) Amalgamated Hous. Corp. v. Commissioner, 37 B.T.A. 817, 829 (1938) (no fixed liability for costs of renovating rental housing until renovation occurs), *aff'd per curiam*, 108 F.2d 1010 (2d Cir. 1940). See Rev. Rul. 80-182, 1980-2 C.B. 167 (citing same cases).

83. Even the amount of the liability might not be so clear. In Levin v. Commissioner, 21 T.C. 996 (1954), *aff'd*, 219 F.2d 588 (3d Cir. 1955), the taxpayer contracted to have otherwise deductible advertising services performed, and the Tax Court determined that no fixed liability existed until the services were performed. But the Levin court also questioned the *amount* of the liability deducted in advance of performance: "The measure of [the obligation in the event future services are performed] is not the contract price which the [taxpayers] here seek to deduct but a contingent response in damages for its breach." 21 T.C. at 998-99 (citing Hallack & Howard Lumber Co. v. Commissioner, 18 B.T.A. 954, 958 (1930)). If this view is correct — and the Levin suggestion is dictum — showing the amount of a liability arising from a bilateral contract with reasonable accuracy is presumably impossible: the amount of damages to which the advertiser may be entitled in the event of breach would be dependent on many variables outside the control of the taxpayer (extent of consequential damages, advertiser's mitigation of damages, and so on).

84. Levin v. Commissioner, 21 T.C. 996, 998 (1954), *aff'd*, 219 F.2d 588 (3d Cir. 1955).

In Amalgamated Hous. Corp. v. Commissioner, 37 B.T.A. 817, 829 (1938), *aff'd per curiam*, 108 F.2d 1010 (2d Cir. 1940), the Board of Tax Appeals stated:

[Taxpayers] did not have to wait until they had actually paid for the renovating before they could accrue their liabilities to pay for that renovating, but, on the other hand, they could not properly accrue as an expense the estimated cost of the renovating prior to the . . . time that the painter rendered some services.

37 B.T.A. at 829.

In support of its position, the Service also noted its symmetrical policy relating to accrual of income from a bilateral contract. A taxpayer on the accrual method is not required to include amounts in income until the earlier of payment, the due date for payment, or economic performance. LTR 7831003, I.R.S. LETTER RUL. REPS. (CCH) No. 75, at 3 (Apr. 13, 1978). The Service had at one time argued that accrual and inclusion were required at the time a contract became effective, but it abandoned that position in Schlude v. Commissioner, 372 U.S. 128, 132-33, 133 n.6 (1963).

On the fact of liability issue in the technical advice memorandum, the Service also cited two cases involving contracts to provide services rather than to secure services, Capital Warehouse Co. v. Commissioner, 171 F.2d 395 (8th Cir. 1948), *aff'g* 9 T.C. 966 (1947), and Spencer, White & Prentis, Inc. v. Commissioner, 144 F.2d 45, 47 (2d Cir.), *cert. denied*, 323 U.S. 780 (1944). These cases, however, are properly interpreted as failures to demonstrate the *amount* of the liability. For example, in *Spencer, White*, the court noted that "the *only* thing which had accrued was the obligation to do the work which might result in the estimated indebtedness after the work was performed." 144 F.2d at 47 (emphasis added). That "only" thing is the fact of a liability, although its amount may be indeterminate. See also Capital Warehouse Co. v. Commissioner, 171 F.2d at 398 ("the amount of the liability or cost of handling out was not definite or fixed").

Second, the Service did not see a pertinent distinction between a contractual obligation and a statutory obligation: "In both situations the fact of the liability to incur or pay the service expense does not become fixed, and hence deductible, . . . until the taxable year [the] services are rendered."⁸⁵ Indeed, under the Service's position, a statutory obligation is irrelevant. A statutory obligation standing alone is indistinguishable from an obligation under a bilateral contract, and it is therefore insufficient to fix the liability. When coupled with a contractual obligation, the statutory obligation does not strengthen the case for deductibility. If a taxpayer required by statute to reclaim stripped land contracts to fulfill the obligation, the statutory requirement is "a reason or motivation for the entering into the reclamation contract," nothing more.⁸⁶

Finally, the Commissioner saw no decisive difference between the situation where the strip miner contracts with another party to do the reclamation and the situation where the miner itself does the reclamation.⁸⁷ Accordingly, since

85. LTR 7831003, I.R.S. LETTER RUL. REPS. (CCH) No. 75, at 3 (Apr. 13, 1978).

The Service cited *Atlas Mixed Mortar Co. v. Commissioner*, 23 B.T.A. 245 (1931), in which the taxpayer was denied a deduction for a credit to a reserve to cover the cost of refilling a proposed sand and gravel pit excavation. A city ordinance required a permit and bond to cover the cost of refilling the excavation, *id.* at 245-46, but the Board of Tax Appeals held that no liability had been incurred in the year prior to the actual refilling. *Id.* The precedential value of *Atlas Mixed Mortar* on the fact of liability issue is suspect. The Board concluded that the taxpayer had not demonstrated the reasonable accuracy of its claimed deductions, *id.* at 248, rendering its conclusion on the fact of liability issue unnecessary. In addition, for authority on the fact of liability issue, the Board relied almost entirely on *Ostheimer v. Commissioner*, 1 B.T.A. 18 (1924), where the claimed liability arose entirely from an obligation under a lease rather than under a statute. *See* 23 B.T.A. at 247. *Cf.* Rev. Rul. 80-182, 1980-2 C.B. 167, 168 (no fact of liability arises from restoration obligation under lease with federal government).

86. LTR 7831003, I.R.S. LETTER RUL. REPS. (CCH) No. 75, at 4 (Apr. 13, 1978). "Why a taxpayer incurs an expense is of no consequence in determining when such expense was incurred." *Id.* The Service was concerned about a general acceleration of accruals if expenses related to statutory obligations were to be routinely considered fixed in fact, such as expenses for legal and accounting services required to fulfill statutory filing obligations. *Id.*

The Service's position on structured settlements prior to the Tax Reform Act of 1984, *see supra* notes 34-40 and accompanying text, is not consistent with its usual performance requirement. In Rev. Rul. 69-429, 1969-2 C.B. 108, a deduction of the undiscounted amount of a workers' compensation award was permitted in the year of the award. *See supra* note 34. No obvious reason justifies the Service's treating this scenario differently from other contingent liability deductions. Perhaps, as McGown suggests, a liability ordered by a quasi-judicial authority like a state industrial commission is less contingent than a liability arising from a statute, which is subject to change by the legislature. It is certainly more fixed than an obligation arising from a contract, which is subject to modification by the parties or differing interpretations by a court. *See McGown, supra* note 14, at 257.

87. LTR 7831003, I.R.S. LETTER RUL. REPS. (CCH) No. 75, at 2-4 (Apr. 13, 1978). "Just as [an] expense is not incurred for Federal income tax purposes until the taxable year the contracted for reclamation services have been performed, a taxpayer, who takes it upon itself to reclaim the land, does not incur an expense until the taxable year it renders the reclamation work." *Id.* at 4. The Service cited *National Bread Wrapping Mach. Co. v. Commissioner*, 30 T.C. 550, 556 (1958) (no current deduction for installation expenses on already sold but as yet uninstalled machines); and *Spencer, White & Prentiss, Inc. v. Commissioner*, 144 F.2d 45 (2d Cir.) (no deduction for future restoration work to be performed under contract), *cert. denied*, 323 U.S. 780 (1944). *See also* Rev. Rul. 80-182, 1980-2 C.B. 167 (citing same cases to same effect).

the bilateral contract does not fix the liability, whether or not coupled with a statutory obligation, the miner's decision to undertake the reclamation would not give rise to a fixed liability in advance of performance.

The Tax Court in *Ohio River Collieries Co.* found that the statutory and contractual obligations did establish a liability in fact. The court looked to the requirements of local law: once a strip miner estimates reclamation costs, posts a surety bond, and mines the land, his liability is certain. If he does not reclaim the land, he forfeits the bond under Ohio law.⁸⁸ Relying on cases involving liabilities to trust funds under unemployment benefit plans,⁸⁹ the court rejected the notion that a deduction is necessarily improper when the identity of the recipient and the precise timing of the payment are unknown.⁹⁰

This decision in favor of the taxpayer aligned the Tax Court with the more lenient approach of the courts of appeals. *Ohio River Collieries Co.* was consistent with two earlier circuit court opinions involving statutory reclamation obligations, *Harold v. Commissioner*⁹¹ and *Denise Coal v. Commissioner*,⁹² decisions that

88. 77 T.C. at 1374. The record contained nothing to support an argument that any further option was available to the company. *Id.*

89. *Id.* at 1375; *Reynolds Metals Co. v. Commissioner*, 68 T.C. 943 (1977); *Lukens Steel Co. v. Commissioner*, 52 T.C. 764 (1969), *aff'd*, 442 F.2d 1131 (3d Cir. 1971). In *Lukens Steel* and *Reynolds Metals*, the taxpayers agreed to make certain future payments to trusts under supplemental unemployment benefit plans in accordance with collective bargaining agreements. Although the amounts in *Lukens Steel* were reflected on the books in an account entitled "Contingent Liabilities Account," the liability was subject to no contingency except the passage of time. 52 T.C. at 784-85. The annual liability to the trusts in both *Reynolds Metals* and *Lukens Steel* was fixed by events occurring within the taxable year, and only the identity of the ultimate beneficiaries and the timing of the payments from company to trust and from trust to beneficiaries were uncertain. 68 T.C. at 960; 52 T.C. at 784-85. See also *Washington Post Co. v. United States*, 405 F.2d 1279 (Ct. Cl. 1969) (deduction of accrued, but unpaid contributions to newspaper dealer profit-sharing plan approved); *Cyclops Corp. v. United States*, 408 F. Supp. 1287 (W.D. Pa. 1976) (following *Lukens Steel*); *Inland Steel Co. v. United States*, 76-2 U.S. Tax Cas. (CCH) ¶ 9791 (Ct. Cl. 1976) (following *Lukens Steel*).

90. 77 T.C. at 1375. The Internal Revenue Service rejected the decisions in *Reynolds Metals*, *Lukens Steel*, and *Washington Post* described in *supra* note 89. *E.g.*, Rev. Rul. 76-345, 1976-2 C.B. 134 (rejecting *Washington Post*); Rev. Rul. 72-34, 1972-1 C.B. 132 (rejecting *Lukens Steel*). The specific result in *Washington Post* was subsequently changed by legislation. Under I.R.C. § 404(d) (1982), no deduction may be taken for deferred compensation provided to an independent contractor, such as the dealers in *Washington Post*, until the taxable year in which the contractor includes the compensation in gross income.

91. 192 F.2d 1002 (4th Cir. 1951) (strip mining reclamation obligation under West Virginia law), *rev'g* 16 T.C. 134. In two additional coal mining cases, *Commissioner v. Gregory Run Coal Co.*, 212 F.2d 52 (4th Cir.), *cert. denied*, 348 U.S. 828 (1954), and *Patsch v. Commissioner*, 208 F.2d 532 (3d Cir. 1953), the respective courts had come to the same conclusion as the Fourth Circuit in *Harold* with respect to the fact of the reclamation liability. However, in neither case had the taxpayer demonstrated that its estimate of the liability was "reasonably accurate," and the deductions were accordingly disallowed. 212 F.2d at 58; 208 F.2d at 535.

92. 271 F.2d 930 (3d Cir. 1959) (strip mining reclamation obligation under Pennsylvania law), *rev'g in pertinent part* 29 T.C. 528 (1957). The Internal Revenue Service refused to follow the decisions in *Harold* and *Denise Coal*. See LTR 7831003, I.R.S. LETTER RUL. REPS. (CCH) No. 75 (Apr. 13, 1978), where the Service did not even cite *Harold* and *Denise Coal* on the fact of liability issue, although it did discuss their treatment of the amount of liability question. *Id.* at 5-6.

In some respects, *Denise Coal* was a much harder case than *Ohio River Collieries Co.* from the

the Tax Court had previously refused to follow.⁹³

In *Harold and Denise Coal*, the courts found statutory obligations to reclaim strip mined land sufficient to establish the fact of the liabilities. Similar analysis has been applied, and arguably extended, in a group of cases where employers established reserves, pursuant to state workers' compensation laws, to cover uncontested liabilities arising from injuries to employees. Additions to the reserves for injuries within the current taxable year were held to be deductible if the reasonable accuracy of the estimates of future liability was shown. The fact of the liability was demonstrated by the injury and the obligation under state law.⁹⁴

The workers' compensation cases do not stand for the proposition that the fact of a liability can be established by probability analysis or by the employer's historical accident records. Cases have not permitted an employer to deduct in the current year amounts it will be obligated to pay arising from accidents that might occur in the future. A large employer can predict those future obligations with great accuracy, but the Internal Revenue Service and all courts have agreed that no deductible liability exists under those circumstances. The principles of *Brown v. Helvering*⁹⁵ stand firm. The fact of a liability is demonstrated in the current taxable year only with respect to accidents that have occurred in that year.

taxpayer's perspective. Pennsylvania authorities in the 1940s and 1950s were apparently much more lax than Ohio authorities in the 1970s in enforcing the state reclamation statutes. *Denise Coal*, 271 F.2d at 935. The Third Circuit in *Denise Coal* nevertheless concluded that laxity in enforcement did not affect the fact of the reclamation obligation; it merely affected timing. See *id.*

93. For example, the Tax Court in *Denise Coal* specifically rejected the Fourth Circuit's decision in *Harold*. 29 T.C. at 549. See *Ohio River Collieries Co.*, 77 T.C. at 1377; see also *Kaiser Steel Corp. v. United States*, 717 F.2d 1304, 1307 (9th Cir. 1983) (noting Tax Court's adoption of *Harold* standard in *Ohio River Collieries Co.*).

94. See, e.g., *Kaiser Steel Corp. v. United States*, 717 F.2d 1304, 1306-07 (9th Cir. 1983); *Crescent Wharf & Warehouse Co. v. Commissioner*, 518 F.2d 772, 774 (9th Cir. 1975). Cf. *Imperial Colliery Co. v. United States*, 599 F. Supp. 653 (S.D.W. Va. 1984) (deduction, pursuant to West Virginia law, of present value of projected uncontested total disability claim).

The United States Court of Appeals for the Ninth Circuit has been the leader in allowing deductions in uncontested workers' compensation cases. The court has refused to distinguish the strip mining cases and has rejected the possibly fatal contingencies advanced by the Internal Revenue Service. The Service has unsuccessfully argued that an employee might recover from his disability so quickly that he would miss no work, see *Kaiser Steel Corp.*, 717 F.2d at 1306 n.3, or that an employee might not survive into subsequent taxable years. See *Wien Consol. Airlines, Inc. v. Commissioner*, 528 F.2d 735, 737 (9th Cir. 1976), *aff'g* 60 T.C. 13 (1973), *nonacq.* 1978-2 C.B. 4; *Crescent Wharf & Warehouse Co. v. Commissioner*, 518 F.2d 772, 774 (9th Cir. 1975). The Internal Revenue Service announced that it would not follow the decisions in *Crescent Wharf* and *Wien*. Rev. Rul. 80-191, 1980-2 C.B. 168. See also *Gunn*, *supra* note 11, at 28 n.131.

As applied to the payments in these cases, the all-events test is ambiguous. Looking at each month's (or year's) payment individually, the test seems not to be satisfied before the date of payment arrives. The taxpayer will be liable to make any particular payment only if the recipient remains alive. If, however, one applies the test to the taxpayer's entire obligation to the injured worker the test is satisfied. The taxpayer has become liable to pay something and the amount of the liability can be estimated accurately with the use of actuarial tables.

95. 291 U.S. 193 (1934) (denying deductions for refunds on future cancellations of insurance policies). See *supra* notes 60-62 and accompanying text.

3. All Events Test Requirement II: Amount of the Liability

The second prong of the all events test requires the taxpayer to demonstrate the amount of the liability, "computed with reasonable accuracy."⁹⁶ Disputes regarding the necessary level of precision have mirrored those that have occurred over the first prong of the all events test; indeed, the two issues in some cases were not kept analytically distinct.⁹⁷ The Commissioner has argued for a high level of precision, which generally results in a deferral of deductions. Courts, on the other hand, have been more sympathetic to taxpayers' arguments that the requirements for deductibility have been met.

The Supreme Court's original statement of the all events test in *United States v. Anderson*⁹⁸ required that the amount as well as the fact of the liability be fixed,⁹⁹ and, prior to 1951, mere estimates of the amounts of liabilities were held insufficient to meet the all events test.¹⁰⁰ In 1951, the Fourth Circuit, in *Harold v. Commissioner*,¹⁰¹ held that the amount of liability need only be "susceptible of estimate with reasonable accuracy in the tax year," not definitely ascertainable.¹⁰² *Harold* now represents the unanimous view of the courts of appeals.¹⁰³

96. Treas. Reg. §§ 1.461-1(a)(2) (CCH 1985); 1.446-1(c)(1)(ii), T.D. 7285, 1973-2 C.B. 163, 164.

97. See *supra* note 84.

98. 269 U.S. 422 (1926).

99. *Id.* at 441. See *supra* note 49. Eighteen years later, in *Dixie Pine Prods. Co. v. Commissioner*, 320 U.S. 516 (1944), the Court restated the test in similar language: "[A]ll the events must occur in that year which fix the amount and the fact of the taxpayer's liability . . ." *Id.* at 519.

100. See, e.g., *Capital Warehouse Co. v. Commissioner*, 171 F.2d 395 (8th Cir. 1948):

Certainly the amount of the taxpayer's liability to its customers for the expense of loading out their merchandise in future years was not "fixed" in the taxable year nor did the particular event upon which the amount depended occur in the taxable year. That event was the determination of the actual cost of loading out at the time the merchandise was ordered out by the customer. Here the petitioner has only estimated such cost.

Id. at 398. See also *Spencer, White & Prentis, Inc. v. Commissioner*, 144 F.2d 45, 47 (2d Cir.), *cert. denied*, 323 U.S. 780 (1944).

101. 192 F.2d 1002 (4th Cir. 1951). See *supra* notes 91-93 and accompanying text.

102. 192 F.2d at 1006. To justify its conclusion, the Fourth Circuit picked up on apparently more lenient language in *Brown v. Helvering*, 291 U.S. 193 (1934). In *Brown*, the Supreme Court stated that *Anderson* permitted deductibility even though the amount of the liability had not been "definitely ascertained." *Id.* at 200. In light of the Supreme Court's rigid language in *Dixie Pine Products Co.* (quoted *supra* note 99), decided 10 years after *Brown*, the Fourth Circuit probably overestimated the significance of the phrase in *Brown*. Indeed, the result in *Brown* reflects no obvious softening of *Anderson*: deductibility was denied because of the taxpayer's failure to show that the fact of the liability was "fixed and absolute." 291 U.S. at 201. See *supra* notes 60-62 and accompanying text.

103. See, e.g., *Hughes Properties, Inc. v. United States*, 760 F.2d 1292, 1293 (Fed. Cir.) (additions to reserve for jackpot obligations of gambling casino guaranteed under state law held deductible), *cert. granted*, 106 S. Ct. 522 (1985); *ESCO Corp. v. United States*, 750 F.2d 1466, 1468-69 (9th Cir. 1985) (workers' compensation liability deductible); *Kaiser Steel Corp. v. United States*, 717 F.2d 1304, 1308 (9th Cir. 1983) (workers' compensation liability deductible); *Wien Consol. Airlines, Inc. v. Commissioner*, 528 F.2d 735, 737-38 (9th Cir. 1976) (workers' compensation liability to minor children of employees killed in employment deductible); *Crescent Wharf & Warehouse Co. v. Commissioner*, 518 F.2d 772, 775 (9th Cir. 1975) (workers' compensation

The Tax Court, however, accepted *Harold* grudgingly,¹⁰⁴ and the Internal Revenue Service has consistently demanded greater precision.¹⁰⁵

Although the 1957 Treasury regulations setting out the all events test¹⁰⁶ appear to have liberalized the standards for demonstrating the amount of a liability, the Commissioner viewed the regulatory language as “merely a . . . paraphrasing of a Supreme Court mandate [in *Anderson*].”¹⁰⁷ The proper standard, the government continues to argue, is that, at the end of the taxable year, the exact amount of the liability should be “determinable by a mere computation based on presently known or knowable factors.”¹⁰⁸

Liabilities that are not definitely *ascertained* at the end of the taxable year in question but which are definitely *ascertainable*, based on known or knowable facts, are potentially deductible in the government’s view.¹⁰⁹ However, the gov-

liability deductible); *Gillis v. United States*, 402 F.2d 501, 507 (5th Cir. 1968) (estimated loss from export sales deductible); *Denise Coal Co. v. Commissioner*, 271 F.2d 930, 936-37 (3d Cir. 1959) (reclamation liability deductible); *Hilinski v. Commissioner*, 237 F.2d 703, 705 (6th Cir. 1956) (assumed cost of contract completion deductible); *Patsch v. Commissioner*, 208 F.2d 532, 534-35 (3rd Cir. 1953) (*Harold* principles approved, but reclamation obligation not deductible because no attempt made to estimate probable cost of reclamation of area actually mined). *See also* Aidinoff & Lopata, *supra* note 3, at 795-96.

104. The Tax Court has come to accept the “reasonably estimable” language. *See* *Ohio River Collieries Co. v. Commissioner*, 77 T.C. 1369, 1373 (1981) (citing *Harold*); *Southern Pac. Trans. Co. v. Commissioner*, 75 T.C. 497, 634 (1980) (citing *Harold*); *World Airways, Inc. v. Commissioner*, 62 T.C. 786, 797 (1974); *Peoples Bank & Trust Co. v. Commissioner*, 50 T.C. 750, 755 (1968) (citing *Harold*). Although the precise amount of the liability need not be ascertained, the Tax Court does note that the *amount* requirement “provides an element of certainty,” and the Tax Court’s view of what is reasonably estimable differs from that of the Fourth Circuit. *See* *Ohio River Collieries Co.*, 77 T.C. at 1373; LTR 7831003, I.R.S. LETTER RUL. REPS. (CCH) No. 75, at 4-6 (Apr. 13, 1978); *infra* note 121 and accompanying text.

105. *See, e.g.*, *Kaiser Steel Corp. v. United States*, 717 F.2d 1304, 1308 (9th Cir. 1983) (rejecting government’s contention “that to meet the all-events test, the *amount* of liability must be fixed, definite and determinable by objective facts existing at the end of the year for which deduction is sought”).

106. *See supra* text accompanying note 50.

107. LTR 7831003, I.R.S. LETTER RUL. REPS. (CCH) No. 75, at 4 (Apr. 13, 1978). Treas. Reg. § 1.461-1(c)(1)(ii), T.D. 7285, 1973-2 C.B. 163, 164, requires that the amount of liability be determined only with “reasonable accuracy,” not that the amount be fixed, a standard that appears to be considerably more liberal than the *Anderson* standard. *See supra* note 49. If the draftsmen of the regulations intended simply to paraphrase *Anderson*, they did a poor job of it.

From the Commissioner’s perspective, the *Harold* court dramatically extended well-settled law. The Service said the Fourth Circuit had misconstrued older cases to support its position. LTR 7831003, I.R.S. LETTER RUL. REPS. (CCH) No. 75, at 6 (Apr. 13, 1978). *See supra* note 102. Indeed, the Fourth Circuit acknowledged, but rejected, the contrary prior authority:

In any event, we think that the ability to make an approximate estimate should be the determining factor in each case, rather than the literal application of the formula that an asset or a liability may not be accrued in any taxable year prior to its liquidation, unless both the existence and the amount thereof is fixed and certain.

192 F.2d at 1004.

108. LTR 7831003, I.R.S. LETTER RUL. REPS. (CCH) No. 75, at 4 (Apr. 13, 1978). *See supra* note 105.

109. LTR 7831003, I.R.S. LETTER RUL. REPS. (CCH) No. 75, at 6 (Apr. 13, 1978). The Service’s reading of the pre-*Harold* case law, although narrow, is defensible. The language of *Brown*

ernment considers liabilities that are not ascertainable at that time, because all facts on which the calculations depend are not fixed,¹¹⁰ not to be deductible.¹¹¹

The government has drawn support for its position from the trilogy of Supreme Court cases involving prepayments received by accrual-basis taxpayers for services to be provided on demand in the future.¹¹² Taxpayers argued unsuccessfully that, under basic accrual principles,¹¹³ the amounts should not be considered earned until the services were performed. The extent of the deferral asked by the taxpayers was uncertain, however, because the taxpayers were not able to predict precisely the amount of net income to be earned from the contracts.¹¹⁴ The government has contended that the trilogy demonstrates that estimates are unacceptable for tax accounting purposes.¹¹⁵ The government has pointed as well to the Supreme Court's hostility to estimates in *Thor Power Tool Co. v. Commissioner*,¹¹⁶ where the Court stated that, while financial accounting

v. Helvering relied upon by the Fourth Circuit, see *supra* note 102, was (1) dictum since the fact of the liability had not been shown and that failure was sufficient to defeat deductibility, and (2) consistent with the distinction made in the text between those liabilities whose amounts are definitely ascertainable and those whose amounts are definitely ascertained.

The result in *Anderson* fits the Service's analysis. The munitions tax liability at issue, which the taxpayer was required to deduct in 1916 because the all events test had been met in that year, had not then been definitely ascertained, although all events had occurred to make it ascertainable. See *supra* note 49.

110. Deduction would depend on other requirements for deductibility. See *supra* note 29.

111. In strip mining cases, the Commissioner has usually viewed the amount of reclamation expenses as non-ascertainable until the reclamation occurs, and, accordingly, no deduction should be permitted until that time. LTR 7831003, I.R.S. LETTER RUL. REPS. (CCH) No. 75, at 6 (Apr. 13, 1978). The Commissioner's stipulation to the reasonable accuracy of the estimates in *Ohio River Collieries Co.* was an anomaly. See *Gunn*, *supra* note 11, at 30; *infra* note 121.

112. See Levey, Cameron & Sciortino, *Kaiser Steel Case Makes New Strides Toward the Deductibility of Self-insurance Reserves*, 60 J. TAX'n 74, 75 (1984). The trilogy is *Schlude v. Commissioner*, 372 U.S. 128 (1963); *American Auto. Ass'n v. United States*, 367 U.S. 687 (1961); *Automobile Club v. Commissioner*, 353 U.S. 180 (1957). See *supra* note 44.

113. See *supra* notes 42-44 and accompanying text.

114. The boundaries of the trilogy have not been well-defined. See *Gunn*, *supra* note 11, at 15-17. The cases are generally interpreted as requiring immediate inclusion in income of any prepayments. However, some commentators and courts have argued that the holdings are limited to cases in which the income cannot be ascertained because the time and extent of future services cannot be predicted. If the time and extent of future services can be ascertained, however, deferral may be appropriate. See, e.g., *Artnell Co. v. Commissioner*, 400 F.2d 981 (7th Cir. 1967) (deferral permitted of prepayments for tickets, parking, and broadcasting rights attributable to baseball games to be played in next taxable year); *Morgan Guar. Trust Co. v. United States*, 585 F.2d 988 (Ct. Cl. 1978) (portion of prepaid interest deferred until "earned"); *Boise Cascade Corp. v. United States*, 530 F.2d 1367 (Ct. Cl.) (per curiam) (prepayment for services not dependent on customer demand deferred until services performed), *cert. denied*, 429 U.S. 867 (1976).

115. See Levey, Cameron & Sciortino, *supra* note 112, at 75 & 75 n.10 (citing government's reply brief in *Kaiser Steel Corp. v. United States*, 717 F.2d 1304 (9th Cir. 1983)).

116. 439 U.S. 522 (1979). In *Thor Power Tool*, consistent with generally accepted financial accounting principles, the taxpayer wrote down its excess inventory of spare parts to net realizable value (generally scrap value), although the parts continued to be held for sale at original prices. No realization event had occurred, but the taxpayer also deducted the amount of the write-down. *Id.* at 527-30. The Commissioner successfully challenged the deduction on the ground that the write-down did "not clearly reflect income." *Id.* at 533, 537-38.

"is hospitable to estimates," tax accounting principles "can give no quarter to uncertainty."¹¹⁷

The Tax Court took a position between the Commissioner and the courts of appeals on the amount of liability issue. It accepted the "reasonably estimable" language from *Harrold*,¹¹⁸ yet demanded greater precision than that required by the courts of appeals. For example, in *Ohio River Collieries Co.*, the Tax Court, consistent with its earlier holdings in *Harrold*¹¹⁹ and *Denise Coal*,¹²⁰ expressed serious doubt that reclamation costs could ever be estimated with reasonable accuracy.¹²¹

The courts of appeals, by permitting the deduction of reasonable estimates under the *Harrold* principle, opened the door to a large number of estimation issues. For example, when should the accuracy of estimates be evaluated? What is the role to be played by statistical analysis? The debate has been most vigorous before the Ninth Circuit, a court which significantly liberalized the requirements a taxpayer must meet to demonstrate the amount of a liability. The Ninth Circuit stated in *ESCO Corp. v. United States*¹²² that, in general, the reasonable accuracy of estimates is determined based upon the facts available to the taxpayer at the end of the taxable year.¹²³

117. *Id.* at 543. See *RCA Corp. v. United States*, 664 F.2d 881 (2d Cir. 1981) (following the trilogy and *Thor Power Tool*), cert. denied, 457 U.S. 1133 (1982).

The government's argument that estimates are not permitted appears inconsistent with the regulation that sets out the all events test, which provides for the possibility of future adjustments to correct for inaccuracies in the amount deducted. See Treas. Reg. § 1.461-1(a)(2) (CCH 1985); *infra* note 129 and accompanying text.

118. See *supra* note 104.

119. 16 T.C. 134, 139, *rev'd*, 192 F.2d 1002, 1006 (4th Cir. 1951).

120. 29 T.C. 528, 549 (1957), *rev'd in pertinent part*, 271 F.2d 930 (3d Cir. 1959).

121. *Ohio River Collieries Co.*, 77 T.C. at 1373-74. "We will continue to adhere to our decision in *Denise Coal* . . . in those cases where we find that accrued costs are not susceptible of reasonable estimation." *Id.* at 1377. Apparently the Commissioner was unsuccessful in this case, not because of a change in position by the Tax Court, but because the Commissioner had conceded this critical issue, thereby "substantially circumscrib[ing] his area of maneuverability." *Id.* at 1374.

In addition to *Harrold* and *Denise Coal*, the Tax Court cited its earlier decisions in *Vincent v. Commissioner*, 19 T.C. 501 (1952), *aff'd sub nom. Commissioner v. Gregory Run Coal Co.*, 212 F.2d 52 (4th Cir. 1954), and *Patsch v. Commissioner*, 19 T.C. 189 (1952), *aff'd*, 208 F.2d 532 (3d Cir. 1953). In both cases the court found that, although a noncontingent reclamation liability existed, the taxpayer had not established the amount of the liability. See *supra* note 91.

Congressional committees drafting the Tax Reform Act of 1984 viewed *Ohio River Collieries Co.* as holding that "surface mining reclamation costs that could be estimated with reasonable accuracy were properly accrued when the overburden was removed." CONFERENCE COMMITTEE REPORT, *supra* note 8, at 879; SENATE COMMITTEE REPORT, *supra* note 5, at 274. See also JOINT COMMITTEE REPORT, *supra* note 5, at 273. The statement is accurate, but misleading given the Tax Court's reservations about a taxpayer's ability generally to make reasonable estimates.

122. 750 F.2d 1466 (9th Cir. 1985).

123. The inquiry is

[w]hether the estimate of expenses was made with reasonable accuracy on the basis of facts and procedures available to the taxpayer at the end of the tax year in question.... This is tested by examining the reasonableness, reliability, and acceptance of the taxpayer's methodology, as well as evaluating the estimates on the basis of actual experience in hindsight.

Id. at 1468 (emphasis added) (citing *Kaiser Steel Corp. v. United States*, 717 F.2d at 1308-09).

Subsequent events do not make previously inaccurate estimates reasonable, but the amount of actual future liability is obviously one indicator of the accuracy of a past estimate.¹²⁴ The Ninth Circuit concluded, however, that hindsight should be given only limited significance in evaluating accuracy because the primary concern is the accuracy of the estimate when made.¹²⁵ Accordingly, the court approved estimates that were determined with appropriate methodology,¹²⁶ but that differed from actual liability by as much as 18.5 percent in a particular year.¹²⁷

When the taxpayer overestimates the amount of future liabilities, a particularly acute premature accrual problem arises.¹²⁸ The Treasury regulations provide for the possibility of overestimates: once the exact amount of the liability is determined, the amount of the excess estimate is taken into income.¹²⁹ Yet a correction only lessens, rather than eliminates, the economic effect of the premature accrual: a future liability with a present value of one dollar in these circumstances may generate a current deduction of more than one dollar.¹³⁰

Despite the economic deficiencies, several courts have approved the deduction of significant overestimates. The Claims Court, for example, in *General Dynamics v. United States*,¹³¹ permitted the deduction of reasonable estimates of future

See generally Levey, Cameron & Sciortino, *supra* note 112. Commercial and scientific reasonableness as well as industry acceptance are important factors in testing accuracy. *ESCO Corp.*, 750 F.2d at 1468; *Kaiser Steel Corp.*, 717 F.2d at 1308-10.

124. See, e.g., *Denise Coal Co. v. Commissioner*, 29 T.C. 528, 549 (1957), *rev'd in pertinent part*, 271 F.2d 930 (3d Cir. 1959); *Patsch v. Commissioner*, 19 T.C. 189, 198 (1952), *aff'd*, 208 F.2d 532 (3d Cir. 1953).

125. 750 F.2d at 1468-69. The Court stated: "Our refusal to rely on actual experience in [*Wien Consolidated Airlines, Inc. v. Commissioner*, 528 F.2d 735, 738 (9th Cir. 1976)] illustrates that the key consideration is whether the estimates could have been expected to be reasonably accurate when made." 750 F.2d at 1469.

126. *Id.* at 1468-69.

127. The estimates were, however, found to be better than industry norms. *Id.* at 1469. Even if hindsight should be given more weight than the Ninth Circuit professed to accord it, deviation in *ESCO Corp.* was relatively easy to accept. The amounts deducted were less than the liabilities ultimately incurred, thereby incorporating a rough discounting process into the deduction computations. *Id.*

The Tax Reform Act of 1984 had been enacted when the Ninth Circuit decided *ESCO Corp.*, but the Act was not yet effective. Although the court therefore did not rely on the Act, it noted that the "conservative underestimates" roughly incorporated time value of money concepts into the deduction scheme, and the decision was consistent with the theory of the Act. *Id.*; see *infra* notes 191-216 and accompanying text.

128. See *supra* note 127 (conservative underestimates present such difficulties to lesser extent). This is not to say that underestimates create no premature accruals. If currently deductible, an underestimate that exceeds the present value of a future liability overstates the economic cost of the obligation.

129. Treas. Reg. § 1.461-1(a)(2) (CCH 1985).

130. Consider a \$200 deduction taken in 1983 for a 1990 liability that in fact is only \$100. A \$100 deduction taken in 1983 would have been economically excessive, since the present value of the future obligation was only \$58.35. See *supra* notes 28-30 and accompanying text. A \$200 deduction in 1983 would have compounded the economic error. Even if the taxpayer includes \$100 in income in 1990 — leaving a net deduction of \$100 — he has received the benefit of seven years' use of the tax savings attributable to the additional \$100 deduction in 1983.

131. 6 Cls. Ct. 250, 84-2 U.S. Tax Cas. (CCH) ¶ 9783 (1984), *aff'd*, 773 F.2d 1224 (Fed.

claims although only 82.2 percent of the amount put aside was subsequently paid.¹³² In Judge Seto's view, the circuit court opinions in *Harrold*¹³³ and *Denise Coal*¹³⁴ stand for the proposition that an estimate may be deemed reasonably accurate even if actual costs are as low as 48 percent of the estimate.¹³⁵

Aggregate analysis has never been permissible to determine whether a liability in fact exists.¹³⁶ However, the Ninth Circuit, in *Kaiser Steel Corp. v. United States*,¹³⁷ did permit the amount of the liability to be determined by an aggregate claim analysis, rather than claim-by-claim. Thus, although actual injuries were necessary to establish the fact of the liability, the court permitted the use of statistical analysis of the aggregate claims to establish the reasonable accuracy of the amount of the liability.¹³⁸

4. Fixed Liabilities and the Time Value of Money

The controversy between the Commissioner and the courts on the application of the all events test was, in many respects, misdirected. The ultimate issue was the timing of deductions, a factor of clear economic significance. However, the debates have turned not on economics but on the nature of contractual and statutory obligations and on the necessary level of statistical precision.

With the issues so framed, courts that rejected the Commissioner's position had the better of the arguments. The Commissioner grossly underestimated the obligatory nature of statutes and bilateral contracts.¹³⁹ For example, it made

Cir. 1985). *General Dynamics* involved the deductibility of amounts accrued under a medical self-insurance plan.

132. 6 Cls. Ct. at 256, 84-2 U.S. Tax Cas. (CCH) ¶ 9783, at 85,324.

133. 192 F.2d 1002 (4th Cir. 1951).

134. 271 F.2d 930 (3d Cir. 1959).

135. 6 Cls. Ct. at 256, 84-2 U.S. Tax Cas. (CCH) ¶ 9783, at 85,324. Judge Seto's reading of the two cases is suspect. The judge viewed *Harrold* as permitting the deduction of the entire estimated amount where actual costs were only 81% of that amount. However, the taxpayer in *Harrold* had amended its return and was seeking to deduct only the lesser, actual figure. Viewed as an estimate, the amended figure was 100% accurate. See 192 F.2d at 1003. The Third Circuit in *Denise Coal* clearly permitted less than precise estimation, but at no point did the court hold that 48% was sufficient. Indeed, it did not quantify the measure of accuracy. 271 F.2d at 936.

136. Future obligations under a state worker's compensation law, for example, will be a statistical near certainty for a large employer. However, the fact of the liability is demonstrated only with respect to injuries incurred in the current taxable year. See *supra* notes 94-95 and accompanying text.

137. 717 F.2d 1304 (9th Cir. 1983).

138. *Id.* at 1309-10. See H.R. REP. NO. 432, *supra* note 5, at 1253; JOINT COMMITTEE REPORT, *supra* note 5, at 259; SENATE COMMITTEE REPORT, *supra* note 5, at 265; see generally Levey, Cameron & Sciortino, *supra* note 112.

139. Bilateral contracts are not obligation free; certainly parties entering into such contracts view themselves as incurring liabilities. Rules have been developed to deal with the situation in which one party to a bilateral contract fails to perform, but those rules do not affect the existence of a contract. See E. FARNSWORTH, CONTRACTS §§ 8.1-2 (1982). Professor Farnsworth explains:

To the extent practicable, a court will supply terms under which a party's duties are conditioned on the performance to be given in return. A party whose duty is in this way impliedly conditional on the other party's performance is afforded the security of not having to perform unless the other party has performed. Suppose that a house painter promises to paint a house in return for the homeowner's promise to pay \$1,000. Even though the

little sense in *Ohio River Collieries Co.* to view the company as having no liability in fact to reclaim the strip mined land. Contingencies could be imagined, but they were for all practical purposes imaginary. Moreover, the Commissioner's argument regarding the necessity of absolute precision in determining the amount of a liability was not only unrealistic, but also contrary to the Treasury's own regulations.

The Commissioner's position would have been strengthened by an economic analysis. The Commissioner's strict interpretation of the all events test had the effect, when accepted, of delaying deductions, thereby bringing the time of deduction and the time of payment more closely into alignment. This result would have lessened the benefit of a premature accrual. Nevertheless, the Commissioner did not inject the economic issue into the analysis under the all events test.

Perhaps the Commissioner felt it improper to introduce economic concepts into a test which makes no reference to those concepts. Yet he had nothing to lose and a great deal to gain by raising the economic argument. By limiting himself to formalistic attacks under the all events test, the Commissioner was often unsuccessful, and the revenue losses to the Treasury were dramatic. Although, in *Ohio River Collieries Co.*, Ohio law required reclamation to occur within twelve months of the cessation of mining, and thus the time value benefits of the accelerated deduction may not have been great,¹⁴⁰ the time between deduction and payment in other cases has been extremely long.¹⁴¹ In the latter cases the opportunity existed to argue that the excessive time interval made the fact of the liability contingent and the amount of the liability uncertain. The

language of the contract does not make the homeowner's promise to pay conditional on the painter's performance, it is impliedly conditional on his performance. If the painter paints the house, payment becomes due; if he does not paint it, payment does not become due.

Id. at 536-37. Should one party to a contract with such an implied condition of exchange not perform, that event may serve to "terminate [the other party's] duty of immediate performance or one to pay damages for breach." RESTATEMENT (SECOND) OF CONTRACTS § 230 (1981).

The Commissioner's position on the fact of liability issue is that no liability exists until any implied conditions of exchange have been fulfilled. Perhaps viewed from the homeowner's perspective in Farnsworth's example, there is something to be said for this. But, from the standpoint of the painter, can it really be said that he has no liability under the contract until he performs? He must either paint the house and incur costs associated with that painting, enter into yet another contract with a third party to paint the house, or respond in a suit for damages. The dollar amount may be unclear, but the painter has a fixed obligation.

A statutory requirement would strengthen the obligation. With respect to a statutory reclamation obligation, see New York City Bar Report, *supra* note 11, at 706:

[I]t seems clear that if the mandated payments were simply an obligation to make a lump sum payment to the state upon the completion of mining . . . , the "all events" test would be met. In that case, the liability would be . . . a fixed obligation to make a fixed payment in the future, with the payer receiving nothing in return. This is similar to a fixed tax obligation payable in the future, or an obligation to pay accrued rent at a future date.

140. The full benefit, however, is impossible to determine from the facts as presented by the Tax Court. For example, the time of *payment* for the reclamation may have been delayed beyond the time of reclamation. See *infra* notes 233-42 and accompanying text.

141. See *infra* note 145.

Commissioner could have pointed to the bizarre economic results that would follow if the deduction were permitted in the year of accrual.

Because the Service did not make the potentially powerful argument, however, the cases are clear: if length of time between accrual and payment is a factor in determining when a future obligation may be deducted, it is not because of the all events test. For example, in the widely noted *Mooney Aircraft, Inc. v. United States*,¹⁴² the taxpayer, with each aircraft it sold, issued a "Mooney bond," a promise to pay \$1,000 when the aircraft was permanently retired from service. Although the date of retirement could have been more than thirty years from the date of sale,¹⁴³ Mooney deducted \$1,000 in the year of issue of each of the bonds. The Commissioner's challenge to the deductions was successful, but not because of the all events test. On the issues under the all events test, the taxpayer prevailed: the fact of liability was fixed in the year of issue because it was certain that the aircraft would be retired from service,¹⁴⁴ and the amount of the liability, \$1,000, was subject to no uncertainty. Nevertheless, the Commissioner prevailed because he convinced the court that the time interval between accrual and retirement was "too long," and thus the deduction did "not clearly reflect income."¹⁴⁵

142. 420 F.2d 400 (5th Cir. 1969). See, e.g., Aidinoff & Lopata, *supra* note 3, at 800-06; Ferencz, *supra* note 11, at 839; Gunn, *supra* note 11, at 3-4; New York City Bar Report, *supra* note 11, at 712.

143. 420 F.2d at 409.

144. There is no contingency in this case as to the *fact* of liability itself; the only contingency relates to *when* the liability will arise. . . . [H]ere there is no doubt at all that the liability will occur since airplanes, like human beings, regrettably must cease to function.

420 F.2d at 406 (footnotes omitted).

145. *Id.* at 409-10. See *infra* notes 150-52 and accompanying text. Perhaps in peculiar situations length of time could affect the fact of a liability. For example, *Mooney Aircraft* contains a suggestion that in some circumstances length of time might make it unlikely that a liability would in fact ever be satisfied. 420 F.2d at 410. That uncertainty sounds suspiciously like a contingency fatal to deductibility, unless the uncertainty relates only to the obligor's ability to pay. See also *Reynolds Metals Co. v. Commissioner*, 68 T.C. 943, 960 (1977) (result permitting deduction might be different if time period sufficiently long that liability is "practical nullity"). Judge Hastie's concurrence in *Lukens Steel Co. v. Commissioner*, 442 F.2d 1131, 1135 (3d Cir. 1971), addresses the same issue:

That finding [that amounts would have to be paid out within a short time] makes it unnecessary to decide whether sums committed to such a fund as this are then immediately deductible as an accrued business expense if the time of future disbursement is entirely speculative and is as likely to occur decades hence as in the near future. Yet the opinion of the Court seems broad enough to cover that situation.

Generally, however, uncertainty as to time of payment, regardless of the potential time period involved, has not been deemed to make a liability contingent, and has not adversely affected a taxpayer's ability to demonstrate the amount of the liability. E.g., *Crescent Wharf & Warehouse Co. v. Commissioner*, 518 F.2d 772, 774 (9th Cir. 1975) (all events test met although disability under workers' compensation plan might not occur until future time); *Washington Post Co. v. United States*, 405 F.2d 1279 (Ct. Cl. 1969) (liabilities with respect to dealer profit-sharing plans deductible although date of obligation uncertain); *Denise Coal Co. v. Commissioner*, 271 F.2d 930, 935 (1959) (fixed reclamation obligation deductible even though timing of fulfillment of obligation not of the essence). In *Washington Post Co.*, it was conceivable that the period between deduction

C. Clear Reflection of Income

1. Clear Reflections: Introduction

If a deduction survived scrutiny under the all events test prior to the Tax Reform Act of 1984, it was subject to further challenge on the ground that it did "not clearly reflect income."¹⁴⁶ Unlike the all events test, whose language did not offer the Commissioner a clear opportunity to make an economic attack on deductibility, the clear reflection standard was inviting. An accrual that overstates the economic cost of a deduction could certainly be construed as a distortion of income.

The Commissioner had a basis for anticipating success in such a challenge. Recent cases, although not involving premature accruals, have increasingly deferred to the Commissioner's evaluation of a taxpayer's accounting methods.¹⁴⁷ For example, the Supreme Court has stated that "Congress . . . granted the Commissioner broad discretion in shepherding the accounting methods used by taxpayers 'It is not the province of the court to weigh and determine the relative merits of systems of accounting.'"¹⁴⁸ When the Commissioner challenges a taxpayer's method, the taxpayer is therefore left with the difficult burden of showing that the Commissioner has abused his discretion.¹⁴⁹

The Commissioner has nevertheless seldom attacked premature accruals on the basis of the clear reflection standard, and he has at no time presented economic concepts to justify a challenge. His only notable success was *Mooney Aircraft*,¹⁵⁰ where the Fifth Circuit upheld the Commissioner's denial of deductions in the year of issue for the \$1,000 "Mooney bonds." Provided with no economic guidance by the Commissioner, however, the court did not develop a persuasive rationale. It simply noted that the expected period before redemption, "15, 20 or even 30 years," was "too long."¹⁵¹ Because of the length

and payment could exceed 30 years. See Aidinoff & Lopata, *supra* note 3, at 802 & n.80. In *Denise Coal*, the Third Circuit did not even mention the fact that the period between accrual and economic performance could be as long as 11 years, although the time periods involved are clear from the Tax Court's opinion. See 29 T.C. at 540, 549; Aidinoff & Lopata, *supra* note 3, at 803.

146. I.R.C. § 446(b) (1982). Early cases interpreted "clear reflection of income" to require only that books be kept "fairly and honestly." See, e.g., *Osterloh v. Lucas*, 37 F.2d 277, 278 (9th Cir. 1930). The now governing general — very general — principle is that income must be computed "with as much accuracy as standard methods of accounting practice permit." *Caldwell v. Commissioner*, 202 F.2d 112, 115 (2d Cir. 1953).

147. See Ferencz, *supra* note 11, at 838. This deference is limited by consistency with prior case law and the duty not to apply the accounting rules arbitrarily. New York City Bar Report, *supra* note 11, at 712.

148. *United States v. Catto*, 384 U.S. 102, 114 (1966) (citing *Brown v. Helvering*, 291 U.S. 193, 204-05 (1930)). See also *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, 540 (1979).

149. See *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, 532 (1979); *RCA Corp. v. United States*, 664 F.2d 881, 886 (2d Cir. 1981), *cert. denied*, 457 U.S. 1133 (1982).

150. *Mooney Aircraft, Inc. v. United States*, 420 F.2d 400 (5th Cir. 1969). See *supra* text accompanying notes 142-45. *Mooney Aircraft* was followed in *Hodge v. Commissioner*, 32 T.C.M. (CCH) 277, 281 (1973), with respect to "Mooney bonds" issued by a regional distributor of the taxpayer in *Mooney Aircraft*.

151. 420 F.2d at 409-10.

of time, the court reasoned, it was unrealistic to view the obligation as related to the income generated in the year of sale.¹⁵²

Mooney Aircraft stands for the proposition that a liability which in fact exists and whose amount is not subject to doubt (\$1,000) may not be deductible currently if the liability is to be fulfilled too far in the future. *Mooney Aircraft*, although lacking an economic justification, should have laid the foundation for systematic development of the clear reflection doctrine. But nothing happened. *Mooney Aircraft* generated far more commentary than jurisprudence. The Commissioner cited the case in only one published ruling¹⁵³ and later apparently abandoned the clear reflection argument: in a number of cases he conceded that a deduction which satisfies the all events test clearly reflects income.¹⁵⁴

The Commissioner's hesitation to invoke the clear reflection rule may reflect the ambiguity in the controlling statute. Section 446(b) of the Internal Revenue Code provides that, "if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income."¹⁵⁵ By its terms, the statute gives the Commissioner authority to challenge an accounting method only if the threshold determination¹⁵⁶ has been made that the method currently used does not clearly reflect income. Consequently, in several cases the Commissioner was prevented from requiring improvements in already acceptable methods of accounting, at least where the taxpayers had consistently used the challenged methods over long periods.¹⁵⁷

Premature accruals do not clearly reach the threshold required for invocation of the Commissioner's power to challenge an accounting method. As long as the accrual-method taxpayer is consistent in his accounting, he can plausibly argue that the deduction of a liability meeting the all events test does reflect income clearly and that the Commissioner therefore has no authority to require deferral of the deduction.

The Internal Revenue Code takes as its starting point the taxpayer's financial

152. The court stated that to regard the bond as a current expense would be "to let an accounting fiction obscure the business and fiscal realities that are the heart of this case. In exercising his discretion the Commissioner need not close his eyes to these realities." *Id.* at 410.

153. Rev. Rul. 78-212, 1978-1 C.B. 139 (accounting for store coupons).

154. See Ferencz, *supra* note 11, at 839. In *Ohio River Collieries Co.*, for example, the Commissioner did not even make the "clear reflection" argument. 77 T.C. at 1371 n.4. See also *W.S. Badcock Corp. v. Commissioner*, 491 F.2d 1226, 1228 (5th Cir. 1974) (deductibility of future liability challenged under all events test, with stipulation that accrual method clearly reflects income); G.C.M. 30242 (Jan. 10, 1980) ("The accrual method of accounting clearly reflects income when the 'all events' test is satisfied.").

155. I.R.C. § 446(b) (1982).

156. It is not intuitively obvious who should make the threshold determination. See Note, *supra* note 11, at 394-98.

157. E.g., *Peninsula Steel Prods. & Equip. Co. v. Commissioner*, 78 T.C. 1029, 1042-52 (1982); *Bay State Gas Co. v. Commissioner*, 75 T.C. 410, 423-24 (1980); *Madison Gas & Elec. Co. v. Commissioner*, 72 T.C. 521, 555-57 (1979); *Auburn Packing Co. v. Commissioner*, 60 T.C. 794, 797-98 (1973); *Garth v. Commissioner*, 56 T.C. 610, 622-23 (1971); *Fort Howard Paper Co. v. Commissioner*, 49 T.C. 275, 286-87 (1967).

accounting method,¹⁵⁸ and the Code specifically designates an accrual method as an acceptable over-all method of accounting.¹⁵⁹ The regulations provide that a taxpayer must in general compute his taxable income by utilizing the same method of accounting employed in computing his regular business income.¹⁶⁰ The key to meeting the clear reflection of income standard is a consistent application of accounting principles and a consistent treatment of items of income or expense in different taxable years.¹⁶¹ Thus, if a strip miner consistently deducts future reclamation expenses in conformity with general industry practice and generally accepted accounting principles,¹⁶² his method of accounting should ordinarily be deemed to reflect income clearly. Once this determination has been made, analysis under section 446(b) should end.

2. The Matching Principle and Clear Reflection of Income

A factor complicating the Commissioner's use of section 446(b) is that, in many cases, premature accruals are fully consistent with generally accepted accounting principles.¹⁶³ To a financial accountant, "clear reflection of income" means matching revenue and related costs in the same taxable year.¹⁶⁴ Permitting accrual prior to economic performance may be necessary to satisfy the matching principle. In *Ohio River Collieries Co.*, for example, the result of accruing the future liability was to allocate a legitimate expense of strip mining, the reclamation obligation, to a taxable year in which the ground was disturbed and revenue was generated.¹⁶⁵

158. I.R.C. § 446(a) (1982). See *supra* note 2. More precisely, the statute refers to the method used by the taxpayer in "keeping his books." "Books" refers to records, ledgers, and journals rather than to financial statements. See *Patchen v. Commissioner*, 258 F.2d 544, 550 (5th Cir. 1958).

159. I.R.C. § 446(c)(2) (1982); Treas. Reg. § 1.446-1(c)(1)(ii), T.D. 7285, 1973-2 C.B. 163, 164.

160. "Except for deviations permitted or required by . . . special accounting treatment [such as for research and experimental expenditures], taxable income shall be computed . . . on the basis of which the taxpayer regularly computes his income in keeping his books." Treas. Reg. § 1.446-1(a)(1) (CCH 1985).

161. A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year.

Treas. Reg. § 1.446-1(a)(2) (CCH 1985).

162. See *infra* note 165.

163. See *supra* notes 64-65 and accompanying text.

164. See *Gunn*, *supra* note 11, at 1.

165. The American Institute of Certified Public Accountants, in an Accounting Research Study, explained proper financial accounting for restoration costs:

The undertaking to restore or improve property upon completion of mining operations is an unavoidable cost of producing minerals. If matching is to be obtained, revenue should bear a ratable portion of these costs. . . .

Failure to record substantial accumulations of restoration costs to which the mining company is committed by its operations understates current expense and overstates expense

In many instances, tax law has uncritically adopted the matching principle as its own. The principle has been understood to reflect the statutory mandate that a taxpayer's method of accounting "clearly reflect income."¹⁶⁶ As explained by the Supreme Court in *United States v. Anderson*,¹⁶⁷ the accrual method and matching are synonymous. The accrual method is intended to enable taxpayers "to make their returns . . . by charging against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income during that period."¹⁶⁸ The all events test, applied to fix the inclusion of income and the deductibility of expenses, facilitates this result;

of some future period when restoration must be made.

ACPA, *Financial Reporting in the Extractive Industries*, ACCOUNTING RESEARCH STUDY 11, at 74 (1969). See also text accompanying note 64.

The result in *Ohio River Collieries Co.*, consistent with the matching principle, is usefully contrasted to *World Airways, Inc. v. Commissioner*, 62 T.C. 786 (1974), where an airline company sought to deduct future overhaul costs for its airframes and engines. The periodic overhauls were necessary to meet requirements set by the Federal Aviation Administration, and the company had entered into a maintenance contract with another major air carrier. *Id.* at 789-90. For a number of reasons, the Tax Court denied deductibility. The company was unsuccessful in demonstrating the fact of the liability because of the existence of several contingencies, including the possibility that the airplanes might be sold or permanently grounded. *Id.* at 804-05. Most important, the estimated future overhaul expenses

were not part of the *operative* expenses incurred in the *process of earning* the income received during the taxable years. The expenses accrued were estimates of expenses expected to be incurred in future years which would enable or permit petitioner to earn similar income in the future.

Id. at 805 (emphasis in original). In contrast, the restoration expenses in *Ohio River Collieries Co.* indisputably related to the income generated by the strip mining itself and not to a potential future use of the land.

166. The requirements of § 446(b) apply to all methods of accounting, not just accrual methods. Nonetheless, even though it makes no attempt to match income and revenue, see *supra* note 19, the over-all cash method of accounting has always been deemed to meet the mandate of § 446(b) that a method of accounting "clearly reflect income." See Gunn, *supra* note 11, at 6 n.22. Particular characteristics of the cash method may, however, be abused, and in some cases the results of an unmodified cash method may therefore "not clearly reflect income." For example, a great deal of litigation has developed regarding the proper treatment of prepaid expenses by cash-method taxpayers, see Cliff & Levine, *supra* note 11, at 113-14; Note, *supra* note 11, at 380-82, and the Tax Reform Act of 1984 limited the deductibility of such prepaid expenses. See *supra* note 13.

167. 269 U.S. 422 (1926). See *supra* note 49.

168. 269 U.S. at 440. A noted commentator explains *Anderson* in this way: "*Anderson* . . . is chiefly interested in *matching* expenses with the particular revenues with which those expenses happen to be associated; the Court's aim was to assure that the taxpayer's gross income and related expenses would be reported in the *same* taxable period." M. CHIRELSTEIN, *FEDERAL INCOME TAXATION* 220 (4th ed. 1985) (emphasis in original).

Following *Anderson*, many judicial decisions have treated the accrual method as synonymous with the accounting process of matching. See, e.g., *Mooney Aircraft, Inc. v. United States*, 420 F.2d 400, 403 (5th Cir. 1969); *Citizens Hotel Co. v. Commissioner*, 127 F.2d 229, 230 (5th Cir. 1942); *Lichtenberger-Ferguson Co. v. Welch*, 54 F.2d 570, 572 (9th Cir. 1931); *Galatoire Bros. v. Lines*, 23 F.2d 676, 676-77 (5th Cir. 1928); *American Express Co. v. Commissioner*, 2 B.T.A. 498, 504 (1925). See also Hahn, *Methods of Accounting: Their Role in the Federal Income Tax Law*, 1960 WASH. U.L.Q. 1, 51.

it is necessary to achieve the "objective of matching the taxpayer's expenses with the income to which they are allocable."¹⁶⁹

A significant body of case law permitting premature accruals has relied on the matching principle. In fact, one court of appeals, in *Denise Coal*, suggested that accrual of a reclamation obligation prior to economic performance may be necessary for the clear reflection of income.¹⁷⁰

Many other examples can be cited. In *Pacific Grape Products Co. v. Commissioner*,¹⁷¹ the court considered the proper treatment of a fruit canner's estimated future shipping expenses. The deductions, based on past shipping experience, were intended to match the accrued income for the taxable years in which goods were ordered by customers.¹⁷² The Commissioner successfully argued to the Tax Court that the deductions did not clearly reflect income,¹⁷³ but the appellate court reversed. In so doing, the Ninth Circuit noted that the taxpayer's accounting system was used by the entire industry and had a substantial intuitive appeal. Furthermore, in the court's opinion, the Commissioner's suggested approach would have grossly distorted the taxpayer's true income.¹⁷⁴ Similarly, in *Schuessler v. Commissioner*,¹⁷⁵ the Fifth Circuit concluded that the deduction of future expenses associated with obligations under a service guarantee contract more accurately reflected income than the method urged by the Commissioner.¹⁷⁶ The Commissioner had argued for reporting total receipts in the year of sale and reporting the expenses only as the guarantee's services were provided.

Given the apparently impressive history of the matching principle, it is

169. 4 B. BITTKER, *supra* note 3, ¶ 105.3.1, at 105-48.

170. "The taxpayer on an accrual system of accounting will not have his books 'clearly reflect' the state of his income if he does not make such a reserve [for reclamation obligations]." *Denise Coal*, 271 F.2d at 936.

171. 219 F.2d 862 (9th Cir. 1955).

172. *Id.* at 863-64.

173. 17 T.C. 1097, 1104-05 (1952).

174. Not only do we have here a system of accounting which for years has been adopted and carried into effect by substantially all members of a large industry, but the system is one which appeals to us as so much in line with plain common sense that we are at a loss to understand what could have prompted the Commissioner to disapprove it. Contrary to his suggestion that petitioner's method did not reflect its true income it seems to us that the alterations demanded by the Commissioner would wholly distort that income.

219 F.2d at 869. See Stanger, Vander Kam, & Polifka, *supra* note 42, at 419-20. See also *Hughes Properties, Inc. v. United States*, 760 F.2d 1292 (Fed. Cir.), *cert. granted*, 106 S. Ct. 522 (1985).

The taxpayer's method of accounting accurately reflects the casino's income and expenses.

If we were to require that the deduction of a jackpot liability be deferred until the year of actual payment, rather than the year in which the liability accrued, it would distort taxable income for the year of payment. Here, the accounting method used by the taxpayer results in allocation of the expense to the year in which the revenues were earned.

Id. at 1293.

175. 230 F.2d 722 (5th Cir. 1956), *rev'd* 24 T.C. 247 (1955).

176. *Id.* at 723. *Schuessler* illustrates the sometimes fine line between the treatment of prepaid income of an accrual-basis taxpayer, see *supra* note 44 and accompanying text, and the treatment of estimated future expenses of such a taxpayer:

[I]f a taxpayer sells an article with a warranty of future repair service, it is possible to say on the one hand that some portion of the net income to be derived from the transaction

understandable why the Commissioner's attacks on premature accruals under the clear reflection doctrine have been at best sporadic. Nevertheless, the Commissioner has been unduly timid. The history of the matching principle has not been so straightforward, and, on closer inspection, the matching principle lacks a coherent theoretical basis for tax purposes.

The deficiencies in the *Anderson* Court's reading of the history and the purposes of accrual accounting and the matching principle were recently detailed by Gunn.¹⁷⁷ Accrual accounting for tax purposes originated not as an attempt to measure "true income" but from "considerations of convenience": it was easier for taxpayers to make tax returns on the basis on which they kept their books.¹⁷⁸ A review of tax accounting history demonstrates that, when administrative convenience would be served by a departure from the standards of financial accounting, convenience has generally prevailed. For example, taxpayers must include in income amounts received under a "claim of right" even though, because of a dispute, all the events that have fixed the right to the income have not occurred.¹⁷⁹ Additionally, the tax law has never permitted the deduction of contingent liabilities, although reflection in financial accounts is often required by generally accepted accounting principles, including the matching principle.¹⁸⁰

The goals of financial and tax accounting do not coincide, and therefore the case for incorporation of the matching principle into tax law is theoretically suspect. As the Supreme Court recently explained in *Thor Power Tool Co. v. Commissioner*,¹⁸¹ "The primary goal of financial accounting is to provide useful information to management, shareholders, creditors, and others properly interested; the major responsibility of the accountant is to protect these parties from being misled."¹⁸² If matching of income and expenses does not occur, potential

will be earned at the time the warranty is fulfilled (prepaid income) or, on the other hand, that the entire net income to be derived from the transaction is attributable to the year of the sale, but in computing this net income estimated future expenses properly attributable to servicing the warranty should be deducted.

Schapiro, *supra* note 20, at 1134. "[T]he courts have recognized that since the underlying purpose for deferring income and for accruing expenses is the same, *i.e.*, the matching of revenues against the expenses that produced the revenues, the two concepts should be governed by the same legal principles." Stanger, Vander Kam, & Polifka, *supra* note 42, at 406. See, *e.g.*, *Commissioner v. Milwaukee & Suburban Transp. Corp.*, 367 U.S. 906 (1961) (remanding case involving accrued future expenses for reconsideration in light of *American Automobile Association*); *Villafranca v. Commissioner*, 359 F.2d 849 (6th Cir.) (same principles apply in evaluating prepaid income and estimated future expenses), *cert. denied*, 385 U.S. 840 (1966); *Simplified Tax Records, Inc. v. Commissioner*, 41 T.C. 75 (1963) (to same effect).

177. Gunn, *supra* note 11.

178. *Id.* at 4-6. The Court in *Anderson* had cited no authority in support of its understanding of accrual accounting and the matching principle. In *Brown v. Helvering*, 291 U.S. 193 (1934), the Court, when forced to choose between the all events test and the matching principle, deferred to the all events test. See *supra* notes 60-62 and accompanying text.

179. Gunn, *supra* note 11, at 9. See *supra* note 44.

180. See *supra* notes 57-66 and accompanying text.

181. 439 U.S. 522 (1979).

182. *Id.* at 542. The Court stated that its "cases demonstrate that divergence between tax

investors and creditors are given misleading views of the financial status of the company.¹⁸³ Consequently, generally accepted accounting principles are conservative, tending to depress rather than inflate reported profits. In contrast, the interests of the Commissioner in protecting the revenue and collecting taxes equitably are not well-served by conservative principles.¹⁸⁴ With such a fundamental conflict in the purposes of the two accounting regimes, the Court in *Thor Power* properly concluded that no presumptive equivalency exists between the two.¹⁸⁵

The Supreme Court's repudiation of the proposition that financial accounting concepts should necessarily govern tax issues has reached the lower courts. Relying on *Thor Power*, the Second Circuit in *RCA Corp. v. United States*,¹⁸⁶ a prepaid income case, expressly refused to follow the dictates of the matching principle.¹⁸⁷

If the matching principle is "irrelevant" to tax accounting concerns,¹⁸⁸ a "clear reflection of income" standard for tax purposes should be distinct from matching.¹⁸⁹ By forgoing the opportunity to inject economic principles into the analysis of the premature accrual cases, the Commissioner lost his opportunity to participate in the redefinition of "clear reflection of income."¹⁹⁰

and financial accounting is especially common when a taxpayer seeks a current deduction for estimated future expenses or losses." *Id.* at 541 (citing *Commissioner v. Hansen*, 360 U.S. 446 (1959) (reserve to cover contingent liability if guaranty not performed); *Brown v. Helvering*, 291 U.S. 193 (1934) (reserve to cover expected insurance commission refunds arising from cancelled policies); and *Lucas v. American Code Co.*, 280 U.S. 445 (1930) (reserve to cover expected liability for contested lawsuit)).

183. See *Gunn*, *supra* note 11, at 12:

Financial accountants devise their rules to achieve matching because the failure to do so would generate financial statements misleading to prospective investors and creditors. . . . [The purposes of financial accounting] derive from the supposition that investors and creditors will use this year's "income" as an estimate of future performance

See also FINANCIAL ACCOUNTING STANDARDS BOARD, STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS No. 3, at 41-43 (1980).

184. See *RCA Corp. v. United States*, 664 F.2d 881, 885-86 (2d Cir. 1981) (citing *Thor Power Tool Co.*), *cert. denied*, 457 U.S. 1133 (1982); Dubroff, Cahill, & Norris, *Tax Accounting: The Relationship of Clear Reflection of Income to Generally Accepted Accounting Principles*, 47 ALB. L. REV. 354, 378-79 (1983); Oberdorfer & Michelman, *A Commentary on Tax Administration and Accrual Accounting*, 12 AM. U.L. REV. 135, 140 (1963); Raby & Richter, *Conformity of Tax and Financial Accounting*, 139 J. ACCT. No. 3, March, 1975, at 42, 44 (arguing against conformity).

185. 439 U.S. at 543.

186. 664 F.2d 881 (2d Cir. 1981), *cert. denied*, 457 U.S. 1133 (1982).

187. 664 F.2d at 885. The court held that prepaid income could not be deferred even though the taxpayer's method of accounting "matched . . . revenues and related expenses with reasonable precision" *Id.* The court left open the possibility that deferral of prepaid income would be permitted in a case in which the services were to be performed on fixed dates and the taxpayer could be sure of the profit to be earned from the services contract. *Id.* at 889. See *supra* note 114.

188. *Gunn*, *supra* note 11, at 19.

189. *Id.* at 34. Not all commentators agree that financial accounting principles should be irrelevant: "[E]ven acknowledging the bias of financial accounting towards minimizing income, reference to the financial accounting treatment of transactions may be appropriate in determining what constitutes a clear reflection of [income]." New York City Bar Report, *supra* note 11, at 701 (footnotes omitted).

190. *Gunn* suggests that, rather than setting out general accounting guidelines, "clear reflec-

IV. PREMATURE ACCRUALS AFTER THE TAX REFORM ACT: THE CODIFICATION OF A PERFORMANCE REQUIREMENT

Prior to the Tax Reform Act of 1984, the all events test was silent concerning an economic performance requirement; nothing in the test specifically required that a deduction for a future liability be deferred until activities were performed that would satisfy the liability. The Internal Revenue Service generally argued that such a requirement was implicit,¹⁹¹ but the Commissioner received mixed judicial support.¹⁹² Furthermore, the Commissioner had effectively abandoned an alternative argument that such deductions do "not clearly reflect income."¹⁹³ To end the confusion and to establish a relationship between deduction and cost, the Tax Reform Act expressly included a performance requirement that the taxpayer must meet before a liability may be deducted.

The original theoretical justification for the performance requirement is lost in the mists of antiquity. Perhaps it had to do with administrative convenience — permitting deduction at a relatively definite, predictable time — although the rule of *Ohio River Collieries Co.*,¹⁹⁴ for example, appears no less definite or predictable. The motivation for the statutory change is clear, however. Congress "[gradually realized] . . . a basic economic fact of life, well known to the financial community: money has a time value as well as an exchange value."¹⁹⁵ The unmodified all events test had not taken the time value of money into account, and the "clear reflection" principle had never been expressly applied with that concept in mind.¹⁹⁶

There is no evidence that the time value of money influenced the Commissioner and those courts which accepted an economic performance requirement prior to the Tax Reform Act. Certainly the rulings and cases did not articulate the issues in that way. Since an economic theory could only have strengthened the rulings, it is doubtful that such a rationale was consciously suppressed.¹⁹⁷ Although economic theory played no explicit role in the case law

tion" authorizes a process:

Once an income or deduction item has been received, paid, or accrued, someone must decide whether to give it tax effect at that time. Sensible decisions require asking questions about administrative convenience and economics. The Commissioner's power to determine clear reflection of income is a power to ask — and answer — those questions.

Gunn, *supra* note 11, at 34.

191. See *supra* notes 78-87 and accompanying text.

192. See *supra* notes 88-95 and accompanying text.

193. See *supra* notes 146-90 and accompanying text.

194. See *supra* notes 88-90 and accompanying text.

195. J. EUSTICE, *supra* note 11, at 2-2. See also H.R. REP. NO. 432, *supra* note 5, at 1254; JOINT COMMITTEE REPORT, *supra* note 5, at 260-61; SENATE COMMITTEE REPORT, *supra* note 5, at 266.

196. See CONFERENCE COMMITTEE REPORT, *supra* note 8, at 871: "Neither the Internal Revenue Code nor case law require[d] a taxpayer to account for future expenses on a present value basis."

197. Moreover, the performance doctrine arose in a time of relatively low interest rates, when the benefits of premature accruals were not as substantial as in recent years. The time value of money is a much less compelling concern in times of little or no inflation. See J. EUSTICE, *supra* note 11, at 2-2 to -3.

development of an economic performance standard, it is probable that economic concerns played an implicit one. An obligation to be fulfilled in the distant future may have met the technical requirements for deductibility, but *something* must have seemed amiss.

This section discusses the new statutory scheme with its economic performance requirement, the exceptions to that requirement, the deficiencies in the new statute, and the remaining scope of the old all events test. Finally, the section considers the effect of the changes on the use of financial accounting concepts in determining the timing of deductions.

A. *The Statutory Modification: Introduction*

The Tax Reform Act expressly incorporated an economic performance standard into the all events test. The all events test was made part of the Internal Revenue Code¹⁹⁸ with the two components of the test taken, nearly verbatim, from the Income Tax Regulations,¹⁹⁹ but in general the test is met²⁰⁰ no earlier than economic performance.²⁰¹ To deduct a future liability, a taxpayer must now be able to demonstrate not only the fact and the amount of the liability, but also that economic performance has occurred.²⁰²

Economic performance occurs as activities are performed that are necessary to satisfy the liability. Where the liability is attributable to the taxpayer's obligation to provide or pay for property or services, economic performance takes place only as the property or services are provided.²⁰³ This principle generally

198. I.R.C. § 461(h)(4), as added by Tax Reform Act of 1984, Pub. L. No. 98-369, § 91(a), 98 Stat. at 599.

199. See *supra* text accompanying note 50. New § 461(h)(4) (CCH 1985) reads: "[T]he 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."

200. See *infra* notes 217-32 and accompanying text (exceptions to economic performance test).

201. I.R.C. § 461(h)(1), as added by Tax Reform Act of 1984, Pub. L. No. 98-369, § 91(a), 98 Stat. at 598.

202. I.R.C. § 461(h)(4), as added by Tax Reform Act of 1984, Pub. L. No. 98-369, § 91(a), 98 Stat. at 599. See *infra* notes 249-51 and accompanying text for a discussion of what remains of the old all events test.

203. I.R.C. §§ 461(h)(2)(A)(i), 461(h)(2)(a)(ii), 461(h)(2)(B), as added by Tax Reform Act of 1984, Pub. L. No. 98-369, § 91(a), 98 Stat. at 598-99. When the property or services are provided over time, economic performance also occurs over time, and the allowable deduction must be appropriately allocated. One commentator has suggested that the percentage of completion method for allocating contract income among taxable years may provide guidance for the interpretation of "economic performance" under § 461(h). Under that method, a taxpayer recognizes income under a contract as he gives economic performance. Determination of the portion of the gross contract price included in income in a taxable year is made by use of either the cost completion method (comparing costs incurred to estimated total contract costs) or the physical completion method (comparing work performed to estimated total work). Martin, *Tax Shelter Accounting Under the New Law: An Analysis of a Dramatically-Changed Area*, 61 J. TAX'N 170, 170-71 (1984). See Treas. Reg. § 1.451-3(c), T.D. 7397, 1976-1 C.B. 115, 117.

The Senate Finance Committee intended that regulations be issued to the effect that the time at which property is provided may include the time of delivery, the time of shipment, or some other time as long as the taxpayer is consistent from year to year. SENATE COMMITTEE REPORT, *supra* note 5, at 267.

corresponds to the Internal Revenue Service's longstanding position.²⁰⁴ Thus, if A incurs an obligation to pay \$100 when services are performed in 1990,²⁰⁵ he will be permitted to deduct the \$100 no earlier than 1990.²⁰⁶

If a liability arises out of a tort or workers' compensation claim, economic performance takes place only as required payments are made to "another person."²⁰⁷ This rule obviates the particular economic problems that had been associated with structured settlements.²⁰⁸ In a lease of property for use in a trade or business, economic performance occurs as the taxpayer uses the property throughout the lease term.²⁰⁹ Economic performance with respect to interest occurs as time passes — as the lender forgoes the use of, and the borrower uses, the lender's funds — not as payments are made.²¹⁰ Thus, prepayments of interest are not fully deductible in the year made.²¹¹ Insurance expenses and rent are similarly allocated to the period to which they relate.²¹² Finally, in all other cases, the Secretary of the Treasury must issue regulations governing the determination of when economic performance has occurred.²¹³

204. See *supra* notes 78-87 and accompanying text. The rule may deviate from the historical Internal Revenue Service position in one respect. Under the pre-Tax Reform Act all events test, if a taxpayer had prepaid for property or services, and had not contested the liability, it appears that the Commissioner would have permitted a deduction in the year of the payment. See *infra* note 239 and accompanying text.

The House Ways and Means Committee report specifically deals with the strip mining situation:

[I]f a strip mining company engages a contractor to reclaim stripped land, economic performance occurs when the contractor performs the reclamation rather than when the strip mining company enters into a binding contract with the contractor. Likewise, when the strip mining company itself reclaims the land, economic performance occurs when the land is reclaimed.

H.R. REP. NO. 432, *supra* note 5, at 1255.

205. See *supra* notes 28-33 and accompanying text.

206. If, for some reason, the services were not performed until 1991, A would be required to defer his deduction until that time, apparently without regard to whether or not the \$100 was paid in 1990. See *infra* notes 239-42 and accompanying text.

207. I.R.C. § 461(h)(2)(C), as added by Tax Reform Act of 1984, Pub. L. No. 98-369, § 91(a), 98 Stat. at 598-99.

208. In McGown's striking example of a structured settlement, the \$3 million future payment would be deductible no earlier than the year made. See *supra* notes 34-40 and accompanying text. But see *infra* notes 243-48 and accompanying text (ambiguities affecting treatment of payments pursuant to structured settlements).

209. I.R.C. § 461(h)(2)(A)(iii), as added by Tax Reform Act of 1984, Pub. L. No. 98-369, § 91(a), 98 Stat. at 599.

210. CONFERENCE COMMITTEE REPORT, *supra* note 8, at 875; JOINT COMMITTEE REPORT, *supra* note 5, at 265.

211. See *infra* notes 239-42 and accompanying text. Treating economic performance as occurring over time ties § 461 into the existing rules for deducting interest, including original issue discount. An issuer of a discounted debt instrument may deduct the annual portion of the original issue discount, computed using compounding assumptions. See I.R.C. § 163(e), as amended by Tax Reform Act of 1984, Pub. L. No. 98-369, §§ 42(a)(3), 128(c), 98 Stat. at 599.

212. CONFERENCE COMMITTEE REPORT, *supra* note 8, at 875; JOINT COMMITTEE REPORT, *supra* note 5, at 264.

213. I.R.C. § 461(h)(2)(D), as added by Tax Reform Act of 1984, Pub. L. No. 98-369, § 91(a), 98 Stat. at 599. The new regulations may provide for deduction at a time determined by existing regulations or rulings when the prior law is consistent with economic performance principles.

The effect of the economic performance requirement is to base the amount and timing of a deduction on the true cost of the liability.²¹⁴ Congress had available two methods for achieving this result: allowing only the present value of the future liability to be deducted or requiring deferral of the deduction.²¹⁵ Permitting a current discounted deduction would have resulted in extraordinary administrative burdens, both in drafting the implementing rules and regulations and in administering those rules. The choice of the economic performance standard was unquestionably made for reasons for certainty and ease of administrative application.²¹⁶

B. *Exceptions To Economic Performance*

The strict economic performance requirement does not apply in a number of different situations. In some cases, prior law will control while, in others, the Tax Reform Act created new statutory rules. The statute specifically exempts those situations, such as additions to reserves for bad debts,²¹⁷ which are covered by other provisions of the Code.²¹⁸ Deductibility will be governed by prior law, with no economic performance requirement applied.

An additional statutory exception applies for a limited class of recurring

CONFERENCE COMMITTEE REPORT, *supra* note 8, at 876; JOINT COMMITTEE REPORT, *supra* note 5, at 265; SENATE COMMITTEE REPORT, *supra* note 5, at 268. For example, the legislative history of the Act indicates that economic performance for property taxes may be deemed to occur at the time of assessment rather than at the time a lien attaches. SENATE COMMITTEE REPORT, *supra* note 5, at 268.

214. *But see infra* notes 233-42 and accompanying text (deviations from time value of money concepts).

215. *See supra* notes 29-30 and accompanying text. Taxpayers should generally have been indifferent between the two methods, assuming that the rates used for discounting could be properly selected. *See Abusive Tax Shelters, Hearings Before Senate Finance Subcommittee on Oversight of the Internal Revenue Service of the Senate Comm. on Finance, 98th Cong., 1st Sess. 87 (1983)* [hereinafter cited as *Hearings*] (statement of Robert G. Woodward); Gunn, *supra* note 11, at 31 n.144. Discount rates, however, cannot, by definition, take account of unexpected inflationary changes.

216. *Hearings, supra* note 215, at 87 (statement of Robert G. Woodward). *See H. R. REP. NO. 432, supra* note 5, at 1254-55:

The committee recognizes that in the case of noncapital items, a taxpayer, theoretically, should be allowed a deduction for either the full amount of a liability when the liability is satisfied or a discounted amount at an earlier time. However, the committee also recognizes that determining the discounted values for all kinds of future expenses would be extraordinarily complex and would be extremely difficult to administer. For instance, a system that allowed current deductions for discounted future expenses would have to include a complex set of rules for recalculating overstated and understated deductions when the future liabilities are reestimated or are actually satisfied at a time, or in an amount, different from that originally projected; a complex recapture mechanism would be required. . . . Therefore, in order to prevent deductions for future expenses in excess of their true cost while avoiding the complexity of a system of discounted valuation, the committee believes that expenses should be accrued only when economic performance occurs.

See also JOINT COMMITTEE REPORT, *supra* note 5, at 261.

217. I.R.C. § 166(c) (1982). *But see* 1985 REAGAN PROPOSALS, *supra* note 19, at 215-17 (recommending repeal of reserve method for bad debt deductions).

218. *E.g.*, I.R.C. § 463 (CCH 1985) (relating to vacation pay); I.R.C. § 466 (1982) (relating to discount coupons).

items. In these instances the Act permits the accrual of a liability prior to the year of economic performance. This exception was intended to "avoid disrupting normal business and accounting practices" with respect to various routine business deductions when the economic benefit of a premature accrual is slight.²¹⁹ A liability will be considered incurred in a particular taxable year if four conditions are satisfied:

- (1) the all events test, applied without an economic performance requirement, is satisfied;
- (2) economic performance in fact occurs within a reasonable period after the close of the taxable year (and no later than 8-1/2 months after such close);
- (3) the item is recurring and the taxpayer's treatment is consistent from year to year; and
- (4) either the item is not a material item or accrual in the taxable year results in a "more proper" matching of expenses and income than would accrual in a later year.²²⁰

The exception will in no case apply to workers' compensation or tort liabilities.²²¹

The recurring item exception is not without ambiguities. For example, how is a taxpayer, when filing a timely return, to determine whether economic performance will in fact occur within 8-1/2 months after the end of the taxable year?²²² Past experience may be helpful in the determination, yet Congress intended the exception to be available to new businesses, for new types of expenses, and for expenses that, though recurring, do not recur annually.²²³ These situations, by their nature, will not have a helpful history.

The Act also departs from a strict application of the economic performance requirement for certain liabilities incurred in activities that are considered socially important. For example, taxpayers may elect to use a "more liberal" reserve method of accounting in the case of some strip mining reclamation and solid waste disposal costs.²²⁴ To qualify for the special treatment, costs must be "qualified reclamation or closing costs." In general, such costs are those associated with obligations arising under federal or state laws.²²⁵

219. CONFERENCE COMMITTEE REPORT, *supra* note 8, at 873. The exception for recurring items did not appear in either the House or Senate versions of the bill. It was added in conference, and it contains the ambiguities that last-minute additions often have.

220. I.R.C. § 461(h)(3)(A), as added by Tax Reform Act of 1984, Pub. L. No. 98-369, § 91(a), 98 Stat. at 599.

221. I.R.C. § 461(h)(3)(C), as added by Tax Reform Act of 1984, Pub. L. No. 98-369, § 91(a), 98 Stat. at 600.

222. See Horvitz & Angelini, *Restrictions of New Law on Accrual- and Cash-Basis Tax Shelters*, 2 J. TAX'N INVESTMENTS 285, 295-96 (1985).

223. JOINT COMMITTEE REPORT, *supra* note 5, at 263.

224. SENATE COMMITTEE REPORT, *supra* note 5, at 274.

225. Specifically, the obligations must arise under permits granted pursuant to the Surface Mining Control and Reclamation Act of 1977, the Solid Waste Disposal Act, or similar federal or state laws. I.R.C. § 468(d)(2), as added by Tax Reform Act of 1984, Pub. L. No. 98-369, § 91(b), 98 Stat. at 603-04. "Qualified reclamation costs" would therefore *not* include reclamation obligations arising from other mining or drilling activities, such as an obligation to restore land once an oil pipeline has gone out of service. See generally Aidinoff & Lopata, *supra* note 3.

The amount that may be deducted currently is the estimated reclamation or closing costs attributable to mining activity or production during the taxable year.²²⁶ The estimate is made on the basis of prices prevailing in the year of the estimate.²²⁷ Deductible amounts are added to a bookkeeping reserve and interest on the reserve is deemed to accrue annually at a statutory rate.²²⁸

Amounts actually expended for reclamation and closing are subtracted from the reserve.²²⁹ No further deduction is available upon reclamation unless the amount expended exceeds the year-end reserve balance, in which case the excess is deductible in the year paid.²³⁰ If the closing balance exceeds current reclamation or closing costs, however, that excess is includable in taxable income.²³¹

A modified discounting scheme is created by the use of current price levels, the accrual of interest, and the recapture of excess reserves. Consequently, the economic benefit of the current deductions is limited. The Act repudiated the rule of *Ohio River Collieries Co.*, and the special exception provided for reclamation costs was not intended to preserve the full benefits of prior law. Yet, since the exception was meant to serve as an incentive, it overstates the amount of deductions when measured against true costs. A limited premature accrual possibility therefore remains, intentionally retained to further desirable social ends.²³²

226. I.R.C. § 468(a)(1), as added by Tax Reform Act of 1984, Pub. L. No. 98-369, § 91(b), 98 Stat. at 601.

227. I.R.C. § 468(d)(1), as added by Tax Reform Act of 1984, Pub. L. No. 98-369, § 91(b), 98 Stat. at 603.

228. I.R.C. § 468(a)(2)(B), as added by Tax Reform Act of 1984, Pub. L. No. 98-369, § 91(b), 98 Stat. at 602. The rate is a specified percentage (70% for taxable years ending in 1984 or 1985, 85% for 1986, and 100% thereafter) of the "Federal short-term rate," compounded semiannually. The Federal short-term rate is the average market yield during any six-month period on outstanding obligations of the United States with maturities of three years or less. I.R.C. §§ 468(a)(2)(B), 1274(d)(1)(D), as added by Tax Reform Act of 1984, Pub. L. No. 98-369, §§ 41(a), 91(b), 98 Stat. at 602.

229. I.R.C. § 468(a)(2)(C), as added by Tax Reform Act of 1984, Pub. L. No. 98-369, § 91(b), 98 Stat. at 602.

230. I.R.C. § 468(a)(3), as added by Tax Reform Act of 1984, Pub. L. No. 98-369, § 91(b), 98 Stat. at 602.

231. I.R.C. § 468(a)(4), as added by Tax Reform Act of 1984, Pub. L. No. 98-369, § 91(b), 98 Stat. at 602-03.

232. The interest rate used, for example (*see supra* note 228), would be inappropriately low if the purpose were to adopt an accurate discount rate. The Reagan administration has accordingly proposed to curtail the use of the reserve method in this area. *See* 1985 REAGAN PROPOSALS, *supra* note 19, at 220-21.

With another category of future liabilities, nuclear plant decommissioning expenses, the Act established a different deduction mechanism, without the same incentive effect. The Act permits deductions before economic performance, but without lowering the taxes paid in present value terms. JOINT COMMITTEE REPORT, *supra* note 5, at 270.

In general, a taxpayer may deduct contributions to a "Nuclear Decommissioning Reserve Fund," a segregated trust established by the taxpayer for the payment of decommissioning and other costs. The fund is a separate taxable entity, taxed at the maximum corporate rate (46%). I.R.C. § 468A(c)(2), as added by Tax Reform Act of 1984, Pub. L. No. 98-369, § 91(c), 98 Stat. at 605. The taxpayer must obtain an advance ruling establishing the maximum annual contribution to the fund, and the schedule of deductible amounts is subject to review by the Secretary of the Treasury.

C. Statutory Deficiencies

The changes made by the Tax Reform Act are major improvements over prior law. They generally result in equalizing deductions for future liabilities and the true costs of those liabilities. However, inconsistencies with time value of money concepts continue to exist, and the statute contains other shortcomings arising from its ambiguous language.

1. Deviations from Time Value of Money Principles

The deduction provisions of the Tax Reform Act deviate from time value of money principles in two situations. The problem in both cases arises because time of economic performance may differ from time of payment. In the first case, the rules have not eliminated the possibility of premature accruals. In the second, the rules operate to deny a deduction at the economically appropriate time.

The deduction of an undiscounted liability overstates economic cost when a substantial period separates accrual and *payment*.²³³ After the Tax Reform Act of 1984 a premature accrual is still possible if a lag time between economic performance and payment exists and economic performance occurs first. For example, if a taxpayer contracts for services to be performed in 1985, but is not required to pay for the services until 1990, and if the contract specifies a precise amount for the services, the taxpayer is entitled in 1985 to an undiscounted deduction for the future liability. Economic performance takes place in 1985, when the services are performed. The fact of the liability, established by performance, and the amount of the liability, set by the contract, would be demonstrable in that year as well.

The cost to the Treasury of the premature accrual would not necessarily be offset by increased revenues from the provider of services. If the provider is a cash-basis taxpayer, for example, income from the services would not be reported until 1990, when payment is received.²³⁴

How serious a problem is this potential for premature accruals? In most cases, there will be no substantial lag between performance and payment. Nevertheless, the statute allows for imaginative tax planning similar to that suggested for structured settlements under pre-Act law.²³⁵ Providers and consumers of

I.R.C. § 468A(d), as added by Tax Reform Act of 1984, Pub. L. No. 98-369, § 91(c), 98 Stat. at 605. The ruling is to insure that excess funds are not accumulated and that deductions will not be more rapid than level funding. I.R.C. § 468A(d)(2), as added by Tax Reform Act of 1984, Pub. L. No. 98-369, § 91(c), 98 Stat. at 605; JOINT COMMITTEE REPORT, *supra* note 5, at 270-71. Contributions will be deductible in the year made, but only to the extent the amounts are added to the taxpayer's cost of service for ratemaking purposes and charged to customers. I.R.C. § 468A(b), as added by Tax Reform Act of 1984, Pub. L. No. 98-369, § 91(c), 98 Stat. at 604-05.

233. See Gunn, *supra* note 11, at 35; *supra* notes 26-40 and accompanying text.

234. See *supra* note 41 and accompanying text. But see 1985 REAGAN PROPOSALS, *supra* note 19, at 213 (proposing to limit use of cash method). If the services-provider uses an accrual method, he will have to recognize income no later than the year of economic performance. See *supra* note 84. But the Treasury may still be the loser if the two parties are not in the same marginal tax bracket.

235. See *supra* notes 34-40 and accompanying text.

services can structure contracts that divide the tax savings from a premature accrual between the parties. In the above example, the consumer of services will deduct the 1990 contract price in 1985, offsetting income in that year and lowering his tax bill. The contract price should reflect an adequate return to the provider of services, both for the services and for the delay in payment. In addition, because he has facilitated the deferral arrangement, the services-provider can insist that the contract price provide him with a share of the consumer's benefit from the accelerated deduction.²³⁶

As long as the enhanced contract price is reasonable, it should be defensible against the Commissioner's challenge that it does not reflect market considerations. The parties can argue the higher price exists to compensate the services-provider for the risk of nonpayment. If the consumer is unable to pay in five years, the services-provider would have to carry the loss.

This loophole in the economic performance test has been partially closed by other provisions of the Code affecting high cost service contracts. As a result of the Tax Reform Act of 1984, service contracts over \$250,000 are subject to imputed interest rules if payments for the services are to be made beyond the close of the calendar year in which services are provided. This will limit the benefit of premature accruals.²³⁷ However, since deferred-payment service contracts under \$250,000 are immune from application of the imputed interest rules,²³⁸ the ability to structure transactions to benefit from premature accruals remains great.

The second deviation from time value of money principles relates to prepayments of liabilities. The Tax Reform Act denies a deduction in the year of payment to an accrual-basis taxpayer who *prepays* the costs of services or property, even though the fact and the amount of the liability are demonstrable. For example, under prior law, a strip mining company that contracted to have

236. The economics are not the same as with the tort settlement hypothetical, however, because the compensation for services would not be excludible from income. See *supra* notes 34-40 and accompanying text.

237. I.R.C. §§ 467(g), 467(d), as added by Tax Reform Act of 1984, Pub. L. No. 98-369, § 92(a), 98 Stat. at 611. When the imputed interest rules do apply, part of the contract "price" for services will be recharacterized as interest. The amount treated as interest will be subject to its own timing rules, with economic performance occurring with the passage of time. See *supra* notes 210-11 and accompanying text. If the imputed interest rate accurately reflects the market, the contract amount remaining after the interest component has been broken out and separately treated will be the true cost of the liability. Thus, even if a current deduction is permitted, the amount of the deduction will be only the present value of the future payment.

For example, suppose a services contract provides for a \$300,000 payment in 1990, but the imputed interest rules require treating \$50,000 of that amount as interest. Even if the economic performance requirement is met in 1985 by the performance of services, only \$250,000 would be deductible in that year as a payment for services. The remaining \$50,000 would be subject to the interest accrual rules.

238. For property transfers, imputed interest rules were already in place prior to 1984, and the Act extended their scope. See I.R.C. § 483, as amended by Tax Reform Act of 1984, Pub. L. No. 98-369, § 41(b), 98 Stat. at 553-55; I.R.C. §§ 1271-1275, as added by Tax Reform Act of 1984, Pub. L. No. 98-369, § 41(a), 98 Stat. at 531-43. As with the rules affecting contracts for services, however, not all transactions are subject to the imputed interest rules.

statutorily required reclamation done in a future taxable year could have met the all events test in the year of mining if the reasonable accuracy of the obligation could have been established.²³⁹ If, pursuant to the contract, the mining company prepaid the cost of the reclamation in that year, even the Commissioner would have been satisfied with the deduction. The strip miner's payment under the contract would have constituted performance.

The Tax Reform Act, however, treats economic performance as occurring when the reclamation services are provided, not when payment is made.²⁴⁰ If it were not for the special protection afforded such strip mining obligations,²⁴¹ no deduction would be allowed prior to reclamation. Since other liabilities do not have the benefit of a statutory exception, deductions for such liabilities must await economic performance even if the liability is prepaid.

Disallowing a deduction in the year of prepayment is economically indefensible since the prepayment price presumably represents the parties' determination of the present value of the future obligation. Because the taxpayer would deduct only the present value of the future cost, accrual abuse would not result from a current deduction. Moreover, requiring deferral of the deduction until the later year *understates* the economic cost of the liability to the taxpayer.²⁴² A deduction following performance of the services will be limited to the amount of prepayment, the already discounted figure set by the parties.

This defect in the statute will not be a problem for many taxpayers. The well-advised accrual-basis taxpayer will simply avoid all prepayments that result in undesirable tax consequences. But the world includes taxpayers who are not well advised. For their benefit and for theoretical consistency, the statute should be amended.

Both of the deviations from time value of money principles are attributable to the definition of "economic performance," and both can be cured by a redefinition that ties economic performance to payment. So modified, the statute would perfectly mesh a deduction and the true cost of a liability.

2. Structured Settlements

The Tax Reform Act cures many of the previously discussed problems concerning structured settlements. When a taxpayer agrees to make periodic payments to a tort victim, the amounts will be deductible only as made.²⁴³ Thus, the taxpayer will not gain the benefit of an economically excessive current deduction.

But suppose, more realistically, that the taxpayer funds its obligation by purchasing an annuity. The annuity will pay to the tort victim the same amounts

239. See *supra* notes 67-121 and accompanying text.

240. See Lovelace & Jackson, *Impact of Tax Reform Act of 1984 on Deductions for Prepaid Intangible Drilling Costs*, 33 OIL & GAS TAX Q. 212, 214-15 (1984).

241. See *supra* notes 224-32 and accompanying text.

242. This fact was recognized even in the pre-Tax Reform Act form of I.R.C. § 461(f), which permitted a current deduction for contested liabilities that otherwise met the all events test if the taxpayer had actually paid the liability. See *supra* note 59.

243. See *supra* notes 207-08 and accompanying text.

that would otherwise have come directly from the taxpayer. Can the taxpayer deduct anything in the year the annuity is purchased, or must it wait until the tort victim receives its annuity payments? Similarly, if the taxpayer makes a payment to a third party, a "qualified assignee,"²⁴⁴ who agrees to assume the periodic payment liability, will a current deduction be permissible?

Theoretical and practical arguments support granting a taxpayer a current deduction for the cost of an annuity or for the amount of any payment to a qualified assignee. The cost in either case reflects the time value of money, and no economically excessive deduction will result. In either situation, the taxpayer will be irrevocably committed to the discharge of its obligation.²⁴⁵

To be entitled to a deduction, the taxpayer must discharge his obligation to the victim. The legislative history of the Act indicates that, if a taxpayer makes a payment to a trust for the benefit of a tort victim in a contested action, the payment does not satisfy the economic performance requirement. The payment does not discharge the taxpayer's liability.²⁴⁶ Even though the case of a contested liability is distinguishable from an unqualified purchase or assignment, concern exists that the purchase of some annuities and some qualified assignments could be subject to the same rule.

If the settlement agreement requires the purchase of the annuity, or the payment to a qualified assignee, economic performance appears to occur when required payment is made to "another person."²⁴⁷ The purchase price or payment would thus be deductible at that time. If the purchase or payment is not specifically required by the settlement, however, the statute does not clearly permit the current deduction.

A statutory amendment is not necessary to remove the ambiguity; a clarifying regulation would be sufficient. A current deduction for the cost of the annuity or for the amount of the payment is entirely consistent with the economic theory of the Tax Reform Act and with past congressional practice concerning structured settlements. It is hardly plausible that Congress, which has generally sought to further such settlements, intended to put an economic roadblock in their way.²⁴⁸

244. See I.R.C. § 130 (1982). Section 130 generally excludes from the income of an assignee the amount received for agreeing to a "qualified assignment" — that is, agreeing to make periodic payments as damages on account of personal injury or sickness. The exclusion does not apply to the extent that the amount received exceeds the cost of funding the liability, by purchase of an annuity or otherwise.

245. See Letter from Richard E. May to Ronald A. Pearlman, Acting Assistant Secretary for Tax Policy (Sept. 17, 1984), reprinted in 25 TAX NOTES (TAX ANALYSTS) 69 (Oct. 1, 1984).

246. See CONFERENCE COMMITTEE REPORT, *supra* note 8, at 876; *Are Structured Settlements Still Viable Under New Law?*, 61 J. TAX'N 208 (1984).

247. I.R.C. § 461(h)(2)(C), as added by Tax Reform Act of 1984, Pub. L. No. 98-369, § 91(a), 98 Stat. at 599. See Letter from Richard E. May, *supra* note 245, at 69.

248. I.R.C. § 130, see *supra* note 244, was enacted and I.R.C. § 104(a)(2), see *supra* note 36, was amended by the Periodic Payment Settlement Act of 1982, Pub. L. No. 97-473, 96 Stat. 2605 (1982), to "facilitate structured settlements by authorizing qualified assignments of periodic payment liabilities under section 130 and by confirming the tax-free character of periodic payments to plaintiffs under section 104(a)(2)." Letter from Richard E. May, *supra* note 245, at 70. See generally Cane, *supra* note 36.

D. *The Residual All Events Test*

The Tax Reform Act retained the all events test even though the critical determination for deductibility usually will be the time of economic performance. Relatively little remains of the jurisprudence that developed with respect to determining the fact and amount of a liability. The economic performance requirement generally delays a deduction until there is little or no doubt about either the fact or the amount of the liability.

Economic performance fixed the fact of a liability prior to the Tax Reform Act to the satisfaction of all parties, including the Commissioner, and thus its inclusion in the Code renders the first part of the all events test redundant. The amount of a liability will also generally be reasonably certain, if not fixed, at the time of economic performance.

Nonetheless, the test for deductibility is not solely economic performance. Although the scope of the old all events test is reduced, it is not eliminated. In a limited number of situations, a liability may not be deductible despite the occurrence of economic performance. Consider, for example, a taxpayer for whom services have been performed but who disputes the liability and refuses to pay. Although economic performance is deemed to occur as the services are provided, the contest negates the fact of the liability, and the all events test is not met.²⁴⁹ If the taxpayer refuses to pay the liability, the special Code provision dealing with contested liabilities is not applicable.²⁵⁰

The amount of a liability may also not be reasonably estimable despite economic performance. Any contract price tied to external, unpredictable measures may be subject to the Commissioner's challenge under the all events test.²⁵¹ Consider a deferred-payment contract which provides for services in 1985 to be paid in 1990. If the contract does not fix the price, but instead provides for payment at the market price prevailing in 1990 for such services, the future liability may not be reasonably estimable in 1985.

Although the old all events test continues to have a limited scope in determining the timing of deductions, the clear reflection standard is no longer a serious factor. Prior to the Tax Reform Act, the Commissioner had effectively abandoned use of section 446(b) in this area, even when a substantial period separated accrual and payment. Now that the Internal Revenue Code includes the economic performance requirement, it is doubtful that the Commissioner will revive the clear reflection standard to attack the few remaining opportunities for accrual abuse.

249. See *supra* notes 57-59 and accompanying text.

250. See *supra* note 59. In this case, the result is the proper one: no deduction is permitted prior to payment, and no premature accrual results.

251. The result will be different if the contract provides for a fixed amount adjusted for inflation. If part of a liability was fixed in fact and the amount thereof could be determined with reasonable accuracy, the regulations prior to the Tax Reform Act permitted the deduction of the fixed part. Treas. Reg. § 1.461-1(a)(2) (CCH 1985). If economic performance has occurred, the fixed part of a liability should remain deductible under the new law. Whether the part of a liability attributable to inflation adjustments is "reasonably estimable" was not a settled question under prior law (see New York City Bar Report, *supra* note 11, at 706), and the Act did not clarify the issue.

E. *Economic Performance and Financial Accounting Principles*

With few exceptions, the Tax Reform Act did not attempt to conform to financial accounting principles. The matching principle has all but disappeared from tax accounting analysis. If the time of economic performance is the same as the time that related revenue is generated, it is by chance and not by design.²⁵² The problem of premature accruals was created by financial accounting concepts, and, to solve that problem, it was necessary to discard those concepts.²⁵³

Two of the exceptions to the economic performance requirement do, at first glance, appear to resurrect financial accounting principles in a statute that generally abandoned those principles.²⁵⁴ The special provision for reclamation and waste disposal costs, by permitting use of reserve accounting, preserves a measure of matching, and the exception for recurring items includes a condition directly dependent on financial accounting concepts. This latter exception applies only if the item is not material or if a better matching of income and expenses would occur with immediate deductibility. Materiality and matching are both to be determined by reference to the standards of financial accounting.²⁵⁵

The continued role of financial accounting is more apparent than real. Nothing in the legislative history indicates the rationale for the special exception for reclamation and waste disposal costs was the matching principle. Matching in this case is a side-effect of a scheme developed for incentive purposes.

The special exception for recurring items is at most a last gasp for financial accounting principles. It was an afterthought in the legislative process, conceived more for reasons of taxpayer convenience than principled deference to financial accounting. Moreover, the exception does not seriously limit the general attack of the Tax Reform Act on premature accruals.²⁵⁶ Since the exception can apply

252. For example, the time of reclamation of strip mined land is not necessarily, or even probably, the same time that mining income is generated from the land. *But see supra* notes 224-32 and accompanying text (special rules that preserve matching for strip mining).

The time of removal of an oil-drilling platform or of an oil pipeline will necessarily follow the time of income generation. *See* Rev. Rul. 80-182, 1980-2 C.B. 167 (denying current deduction for future platform removal obligation); *supra* notes 81-87 and accompanying text. *See also* Aidinoff & Lopata, *supra* note 3, who use the statutory obligation to restore land after an oil pipeline has ended its operations as the "base case" for their analysis.

253. "The Deficit Reduction Act . . . contains a host of provisions that dramatically alter well-established tax accounting rules." Nesi, *Tax Accounting Under the Deficit Reduction Act of 1984*, 15 TAX ADVISER 653, 653 (1984).

254. *See* Gunn, *supra* note 11, at 36 (premature accrual rules "seem to be based rather loosely on matching").

255. CONFERENCE COMMITTEE REPORT, *supra* note 8, at 873-75; Joint Committee Report, *supra* note 5, at 263. Financial accounting principles will not necessarily be dispositive, however. In some cases, items that are not considered material for financial reporting, for example, because of the use of consolidated financial statements, may nonetheless be considered material under the exception for recurring items. CONFERENCE COMMITTEE REPORT, *supra* note 8, at 874; JOINT COMMITTEE REPORT, *supra* note 5, at 263.

256. *See* Sacco & Goldberg, *Differences in Timing of Financial and Tax Deductions Widened by Deficit Reduction Act*, 34 TAX'N FOR ACCTS. 218, 222 (1985): "The section [461(h)] makes clear that the concept of matching costs and revenues is not to be used except in very limited circumstances."

only if economic performance takes place within 8-1/2 months of the close of the taxable year, any premature accrual effect is minimal.

V. CONCLUSION

The Tax Reform Act is the first attempt to introduce economic rationality into determining the timing and amount of deductions for accrual-basis taxpayers. The statute is not perfect; some deficiencies remain. Those deficiencies are easily correctable, however, and the overall effect of the Act is worthy of praise. It remains for Congress, or in some cases the Treasury Department, to take the next step.

Amendments and Treasury regulations should be made with the same understanding that Congress generally displayed in the Tax Reform Act: it is the principles of economics, and not those of financial accounting, that should govern the deduction of future liabilities by accrual-basis taxpayers.

