INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

Third Party Communication: None
Date of Communication: Not Applicable

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CASE-MIS No.: TAM-119229-20

LB:EC:SE:TT2:T1606

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

Taxpayer =
A =
B =
C =
D =
E =
F =
Date1 =
Date2 =
Year 1 =
Year 2 =

ISSUE:

Is an accrual method taxpayer's liability to pay sales incentives to third party distributors incurred under the all events test of § 461 of the Internal Revenue Code in the taxable year when distributors earn the incentives, or is the liability accelerated by the taxpayer's promise in writing to pay a guaranteed minimum of sales incentives to distributors in the following year?

CONCLUSION:

The taxpayer's liability to pay sales incentives to third party distributors is incurred under the all events test of § 461 in the taxable year the distributors earn the sales incentive, and is not accelerated by the taxpayer's promise to pay a guaranteed minimum sales incentive because its liability to pay guaranteed minimum is contingent on distributors selling at least one unit in Year 2, and also on not selling sufficient units to earn incentives that exceeded the guaranteed minimum.

FACTS:

Taxpayer is on an accrual method with taxable and fiscal years ending on Date1. Taxpayer manufactures and distributes A to independently owned and operated B for resale to retail customers.

To encourage sales of A to retail customers, Taxpayer offers a sales incentive program to B and to retail customers. This advice concerns the sale incentives offered to B. Under its sales incentives program, Taxpayers offers a variety of retail sales incentives to B and retail customers (e.g., bonuses, rebates, etc.). The rules and guidelines of these programs are outlined in a document called the C. The rules require that B must satisfy certain conditions before Taxpayer is obligated to make an incentive payment. The sales incentive program is communicated in the form of E and are offered throughout the year. However, it is only those sales incentives earned by B that was in B's ending inventory as of Date1 of Year 1 and sold by B between Date2 of Year 2 ("the qualifying period") that is relevant for this discussion.

In Year 1, Taxpayer introduced the D in order to encourage additional purchases of A. Under the D, Taxpayer makes an irrevocable promise, to pay participating B an allocated share of a guaranteed minimum sales incentive payment if B sell A during the qualifying period, which is sales of A that was in B's ending inventory as of Date1 of Year 1 between Date2 of Year 2. Moreover, the promise to make the guaranteed minimum sales incentive payment under the D takes effect only if the participating B, in the aggregate, do not earn sales incentive payments during the qualifying period equaling at least the guaranteed minimum amount promised under the D.

To earn the incentive B must sell A during the qualifying period, and to be eligible to share in the D, B must sell A during the qualifying period.

Taxpayer effectuates the D by posting two short announcement letters—one addressed to each of the respective B divisions—to a B portal website that guarantees that participating B will have the opportunity to earn a minimum sales incentive payment in the following year. Taxpayer usually posts the letters for the D near the end of the fiscal year-end. Although the letters indicate that Taxpayer will provide additional details about the D, which include how the individual incentives will be calculated and a mechanism to allocate the guaranteed minimum payment among the B at a later date,

Taxpayer has never published any additional details or information about the D other than the letters issued a few days before year-end.

For every taxable year of the D, Taxpayer set the guaranteed minimum payment amount to be "somewhat below" the total incentive payments Taxpayer expected to pay B pursuant to C for the qualifying period. In effect, Taxpayer did not develop a mechanism to allocate the guaranteed minimum payment among the B for any of the taxable years at issue because the participating B always qualified to receive sales incentive payments in excess of the guaranteed amount promised under the D.

Also, for the taxable years at issue for the D, there is no evidence indicating that participating B relied upon the announcement letters to purchase any additional A prior to the fiscal year-end announcement period. Taxpayer was unable to confirm or track whether any participating B opened or viewed the D announcement letters and Taxpayer received no inquiries or communication from B regarding the D announcement letters.

For the taxable years at issue, Taxpayer has been treating the amount of the guaranteed minimum payment as a reduction to its gross receipts in the taxable year Taxpayer issues the D announcement letters. For sales incentive payments earned by B outside of the qualifying period (which is shorter than a year) and thus not covered by the D, Taxpayer deducts the sales incentive payments earned by B when Taxpayer pays or credits B.

For the taxable years at issue, the IRS field office has proposed disallowing Taxpayer's reduction to its gross receipts for Year 1 for the amount of the guaranteed minimum payment promised under the D announcement letters because all events have not occurred to establish the fact of this liability in Year 1.

LAW AND ANALYSIS:

Section 461(a) provides that the amount of any deduction or credit must be taken for the taxable year that is the proper taxable year under the method of accounting used in computing taxable income.

Section 461(h) and § 1.461-1(a)(2)(i) of the Income Tax Regulations provide that, under an accrual method of accounting, a liability is incurred, and is generally taken into account for federal income tax purposes, in the taxable year in which all the events have occurred that (1) establish the fact of the liability, (2) the amount of the liability can be determined with reasonable accuracy, and (3) economic performance has occurred with respect to the liability (collectively, the "all events test"). See also § 1.446-1(c)(1)(ii)(A). Section 461(h)(1) provides that the all events test is not met any earlier than when economic performance occurs.
Section 1.461-4(g)(3) provides that if the liability of the taxpayer is to pay a rebate, refund, or similar payment to another person (whether paid in property, money, or as a

reduction in the price of goods to be provided in the future by the taxpayer), economic performance occurs as payment is made to the person to which the liability is owed. This provision applies to all rebates, refunds, and payments or transfers in the nature of a rebate or refund regardless of whether they are characterized as a deduction from gross income, an adjustment to gross receipts or total sales, or an adjustment or addition to cost of goods sold.

Section 1.461-5(b)(1) provides a recurring item exception to the general rule of economic performance. Under the recurring item exception, a liability is treated as incurred for a taxable year if: (i) at the end of the taxable year, all events have occurred that establish the fact of the liability and the amount can be determined with reasonable accuracy; (ii) economic performance occurs on or before the earlier of (a) the date that the taxpayer files a return (including extensions) for the taxable year, or (b) the 15th day of the 9th calendar month after the close of the taxable year; (iii) the liability is recurring in nature; (iv) either the amount of the liability is not material or accrual of the liability in the taxable year results in better matching of the liability against the income to which it relates than would result from accrual of the liability in the taxable year in which economic performance occurs. Section 1.461-5(b)(5)(ii) provides that, in the case of a liability for rebates, the matching requirement of the recurring item exception is deemed satisfied.

The first prong of the all events test requires that all events have occurred that establish the fact of the liability. Generally, all events occur to establish the fact of the liability when (1) the event fixing the liability, whether that be the required performance or other event, occurs, or (2) payment is unconditionally due. Rev. Rul. 2007-3, 2007-1 C.B. 350; Rev. Rul. 80-230, 1980-2 C.B. 169; Rev. Rul. 79-410, 1979-2 C.B. 213, *amplified* by Rev. Rul. 2003-90, 2003-2 C.B. 353.

A taxpayer may not deduct a liability that is contingent, nor may a taxpayer deduct an estimate of an anticipated expense, no matter how statistically certain, if it is based on events that have not occurred by the close of the taxable year. Brown v. Helvering, 291 U.S. 193, 201 (1934). "The all events test is based on the existence or nonexistence of legal rights or obligations at the close of a particular accounting period, not on the probability—or even absolute certainty—that such right or obligation will arise at some point in the future." Hallmark Cards, Inc. v. Commissioner, 90 T.C. 26, 34 (1988). Even if that event is merely the arrival of a certain date. Central Investment Corp. v. Commissioner, 9 T.C. 128, 133 (1947), affd. per curiam 167 F.2d 1000 (9th Cir. 1948), cert. denied 335 U.S. 826 (1948).

Taxpayer's liability is to pay a sales incentive to B which is in effect a rebate. Taxpayer pays the incentives during the first 8½ months of Year 2. Therefore, the economic performance requirement would be met if the liability were fixed at the end of Year 1. However, in order to apply the recurring item exception, all events must have occurred that establish the fact of the liability at issue, the guaranteed minimum amount promised under the D, in Year 1.

The IRS field office argues that Taxpayer's commitment to make the guaranteed minimum payment promised under the D is not required to be fulfilled unless and until B sells A that was in B's ending inventory as of Date 1 of Year 1 between Date2 of Year 2. Also, the IRS field office argues that Taxpayer's commitment to make the guaranteed minimum payment promised under the D is contingent upon participating B, in the aggregate, not earning sales incentives during the qualifying period in the following year equaling at least the guaranteed minimum amount promised under the D.

We agree with the field that these are conditions precedent that are necessary to establish Taxpayer's liability for purposes of § 461. Since the last event necessary to establish Taxpayer's liability occurs in Year 2, Taxpayer cannot establish the fact of its liability in Year 1. Thus, since Taxpayer may not treat the liability as incurred in tax Year 1 when it issues the commitment letter to make the guaranteed minimum payment under the D, the liability does not meet the requirements of the recurring item exception at that point.

Taxpayer argues that its liability to pay the guaranteed minimum payment under the D is fixed and determinable for purposes of § 461 in Year 1 when it issues the D announcement letters because its situation is indistinguishable from United States v. Hughes Properties, Inc., 476 U.S. 593 (1986). In Hughes Properties, the Supreme Court allowed a Nevada casino operator to deduct amounts guaranteed for payment of progressive slot machine jackpots that had not yet been won by casino patrons. The Court found that the last event that created the casino's liability was the last play of a slot machine before the end of the fiscal year. At that point, Nevada law made the amount shown on the jackpot payoff indicators incapable of being reduced and, moreover, the Court found "[t]he effect of Nevada's law was the equivalent to the situation where state law requires the amounts of the jackpot indicators to be set aside in escrow pending the ascertainment or the identity of the winners." Hughes Properties, 476 U.S. at 602. Further, the Court noted that "[t]he obligation is there, and whether it turns out that the winner is one patron, or another makes no conceivable difference as to basic liability." Id.

According to Taxpayer, Taxpayer was under a fixed obligation to pay the guaranteed minimum payment under the D at the end of its Year 1, even though it is based on when B sells A during the qualifying period, which occurs in Year 2. Taxpayer argues that the event triggering Taxpayer's obligation pay the guaranteed minimum payment under the D, which is when B sells A during the qualifying period in tax Year 2, was no different than when a patron wins a jackpot in the year following the taxable year in which the casino was allowed a deduction for the jackpot amount in Hughes Properties. Taxpayer adds that the event triggering Taxpayer's obligation to pay the guaranteed minimum payment under the D, which is when B sells A during the qualifying period in tax Year 2, was inevitable and that the Court in Hughes Properties held that a liability incurred by a taxpayer at the end of a taxable year is deductible in that taxable year if payment of the

liability was inevitable even though some act remained to be completed in the following taxable year.

We disagree with Taxpayer's interpretation of Hughes Properties that its situation is analogous to Hughes Properties. In Hughes Properties, the last event necessary to establish the liability was the last play of the slot machine at year end because, even if the jackpot was not won with that play, Nevada law had the effect of irrevocably setting aside the amount of the jackpot by that play, which the casino eventually was required to pay. In Taxpayer's case, one of the two last events necessary to establish the liability was when B sells A during the qualifying period in Year 2. In short, in Taxpayer's case, the contingencies determine the existence of the liability as of the end of tax Year 1, whereas in Hughes Properties the only contingencies relate to the identity of the winners of the jackpot.

Also, Taxpayer's situation is distinguishable from Rev. Rul. 2011-29, 2011-49 I.R.B. 824. In Rev. Rul. 2011-29, the Service concluded that a taxpayer had established the fact of its liability, by the end of a taxable year, for a minimum amount of bonuses payable to a group of eligible employees in the following year even though the identity of the particular employees to which the bonuses will be paid was unknown until after the end of the taxable year. The Service noted the fact of the taxpayer's liability for the minimum amount of bonuses is established by the end of the year in which the services are rendered by the employees. See Rev. Rul. 54-446, 1955-2 C.B. 531, as modified by Rev. Rul. 61-127, 1961-2 C.B. 36 (holding that bonuses payable to ascertainable employees under an incentive compensation plan that has been communicated to the employees, the exact amounts of which are determinable through a formula in effect prior to the end of the taxable year, are properly accruable for Federal income tax purposes for the year to which they relate). Unlike Rev. Rul. 2011-29, in Taxpayer's case, Taxpayer promise to pay the guaranteed minimum payment under the D is not unconditionally fixed by the end of tax Year 1 because participating B have not rendered any services or provided any other consideration to Taxpayer by the end of tax Year 1 which would unconditionally require Taxpayer to pay the guaranteed minimum payment under the D. Taxpayer's promise to pay the guaranteed minimum payment under the D becomes unconditionally fixed when participating B sells A during the qualifying period in Year 2 and when participating B do not earn sales incentives during the qualifying period equaling at least the guaranteed minimum amount promised under the D, which can only be determined in Year 2.

Similarly, Taxpayer's situation is distinguishable from Willoughby Camera Stores, Inc. v. Commissioner, 125 F.2d 607 (2d Cir. 1942). In Willoughby, the Second Circuit held that where the taxpayer's employees were informed at the time of hiring that they would participate in a general bonus distribution and in December of each year the taxpayer's board of directors determined an amount to be paid as bonuses during the next year, which was setup on the taxpayer's books at the end of the year as a reserve for bonus compensation, the taxpayer was allowed a deduction for the taxable year in which this determination was made, notwithstanding the fact that the amounts were not paid until

the following year. The Second Circuit noted that the action of the taxpayer's board of directors must be regarded as definitely fixing a minimum for the amount to be paid and that it was apparent that the action was intended by the company and accepted by the employees as more than a statement that so much would be paid if the company did not change its mind. Unlike in Willoughby, the facts do not indicate that in Taxpayer's case, the participating B had already earned the incentives or expected to receive the guaranteed minimum payment under the D, unless and until participating B sells A during the qualifying period in Year 2, even then the guarantee only arises if participating B do not earn sales incentives during the qualifying period equaling at least the guaranteed minimum amount promised under the D, which can only be determined in Year 2. Further, there are no facts indicating that participating B were induced or otherwise relied upon the offer provided by the D announcement letters to purchase any additional A from Taxpayer.

In United States v. General Dynamics Corp., 481 U.S. 239 (1987), the Supreme Court held that the estimated liability represented by a self-insured medical plan reserve account did not satisfy the all events test because the last event necessary to fix that liability, no matter how statistically certain to occur, had not occurred by the end of the taxable year. Even though the employees had received medical treatment and the amount of the employee's liability was determinable with reasonable accuracy, the employees had not filed claims for reimbursement. The Court held that, as a matter of law, General Dynamics' liability to reimburse its employees was conditioned on the employees submitting a properly documented claim. The filing of the claim was the last event necessary to create the liability and therefore absolutely fix the taxpayer's liability under the first prong of the all events test. General Dynamics, 481 U.S. at 244. See also Chrysler Corporation v. Commissioner, 436 F.3d 644 (6th Cir. 2006), aff'g T.C. Memo. 2000-283 (the Sixth Circuit held that Chrysler could not deduct its anticipated warranty expense deductions, no matter how statistically certain the expense, because its liability was not fixed until a customer submitted a valid warranty claim).

New York Life Insurance Company v. U.S, 724 F.3d 256 (2nd Cir., 2013), and Mass. Mutual Life Ins. Co. v. U. S., 782 F.3d 1354 (Fed. Cir. 2015), both apply the all events test to policyholder dividends on life insurance contracts and reach conflicting results. In New York Life, the taxpayer paid two types of dividends, policyholder dividends and termination dividends and it was possible for the dividends to overlap and both be paid. The policyholder dividends were only paid on policies in force on the payment date in the next year. One of the taxpayer's arguments was that at the end of each year a minimum liability was fixed with respect to the dividends to be paid in the next year because it was inevitable that either the policy would be in force at the time of the payment of the policyholder dividend, or the policy would have terminated resulting in the termination dividend. The Third Circuit held that neither dividend was a fixed liability of the taxpayer at the end of the year- that each was contingent on the occurrence of events in the following year. In Mass. Mutual, the Federal Circuit held that the taxpayer's liability to pay policyholder dividends was fixed in the year prior to payment of the dividends. The Federal Circuit distinguished New York Life, based on the

taxpayer's board of directors' resolution to pay an aggregated amount of policyholder dividends to the policy holders as a class, applying reasoning similar to the employee bonus cases such as Willoughby.

Like in General Dynamics, where the last act that established the liability was an employee filing a claim, which had not happened by the end of the year (and might never happen), the last event that establishes Taxpayer's liability occurs when participating B sell A during the qualifying period in Year 2 and when participating B do not earn sales incentives during the qualifying period equaling at least the guaranteed minimum amount promised under the D, which can only be determined in Year 2. Taxpayer argues that its commitment to make the guaranteed minimum payment under the D was enforceable under state of F law as a unilateral contract. According to Taxpayer, State of F law recognizes the validity of the unilateral contract, which is formed when the offeror makes a promise contained in the offer, and the offeree accepts the offer by rendering performance. Specifically, Taxpayer asserts that under state of F law, the commencement of partial performance by the offeree renders an offer irrevocable. Taxpayer argues that the promise to make the guaranteed minimum payment under the D announcement letters presented an offer, and that the ensuing partial performance by B was the purchasing of additional A by the close of the announcement period (Date1 of Year 1). According to Taxpayer, under state of F law, this partial performance rendered Taxpayer's offer irrevocable and thus Taxpayer had a binding liability to make the guaranteed minimum payment under the D upon when B completes performance which occurs when participating B sells A during the qualifying period in Year 2.

Finally, Taxpayer asks us to consider the guarantee as the primary liability, and the general incentive program as overlapping, such that the B reduce Taxpayer's guarantee liability as they earn incentives. We decline to adopt this reasoning because it is contrary of our understanding of a guarantee as a secondary liability (See guarantee/guaranty in Black's Law Dictionary (11th ed. 2019), and the facts demonstrate that Taxpayer has never had to make a payment under D, and does not have a formula to allocate such a payment between the qualifying B if the need arose.

Even if Taxpayer's assertion about state of F law is correct regarding partial performance in a unilateral contract, the facts do not indicate that participating B relied upon the offer provided by the D announcement letters to purchase any additional A from Taxpayer in Year 1. Also, the fact that Taxpayer issued the D announcement letters a few days prior to its fiscal year end, Date1 of Year 1, indicates that B would have little or no time to make an informed decision to buy any additional A prior to fiscal year end, Date 1 of Year 1. In other words, B would have little or no time or opportunity to act upon Taxpayer's offer. In fact, Taxpayer was unable to confirm or track whether any participating B opened or viewed the D announcement letters and Taxpayer received no inquiries or communication from B regarding the D announcement letters. This indicates that B did not act upon Taxpayer's offer by the end of the fiscal year end,

Date 1 of Year 1. Thus, Taxpayer's offer for a unilateral contract could only be accepted when the participating B sells A during the qualifying period in tax Year 2.

In conclusion, assuming that the D creates an unconditional obligation of Taxpayer to pay the guaranteed minimum amount stated to qualifying B, to be a qualifying B requires sales during the qualifying period during the next year. These facts are distinguishable from the bonus cases and Mass. Mutual because at the end of Year 1, the class of eligible recipients does not yet have any members, no B have earned sales incentives during the qualifying period. Also, we conclude that the guarantee is secondary to the liability to pay incentives under the C, so that the D liability could only arise if B, in the aggregate failed to attain the minimum incentive payments offered in the D, under the C during the qualifying period.

CAVEAT(S):

The memorandum addresses the technical issue raised by the IRS field office and Taxpayer regarding the application of § 461. Also, although this memorandum also addresses the argument raised by Taxpayer that its commitment to make the guaranteed minimum payment under the D was enforceable under state of F law as a unilateral contract, this memorandum does not address the interpretation of what constitutes a binding unilateral contract under state of F law; we have relied upon Taxpayer's interpretation of the applicable law for this analysis.

A copy of this technical advice memorandum is to be given to Taxpayer. Section 6110(k)(3) provides that it may not be used or cited as precedent.