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HUGHES PROPERTIES AND GENERAL DYNAMICS: THE SUPREME COURT, THE ALL EVENTS TEST, AND THE 1984 TAX ACT

by Erik M. Jensen

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In this article, Jensen discusses the Hughes Properties case in which the Supreme Court allowed a deduction for amounts guaranteed as payoffs for progressive slot machines but for which no winner had been determined. He notes that under section 461(h) as it was amended by the 1984 Tax Reform Act, the deductions would not be allowed. He speculates about the Supreme Court's willingness to decide an issue rendered moot by subsequent legislation. He finds that the decision in Hughes Properties will bear on the General Dynamics case which the Supreme Court has decided to hear. In General Dynamics the issue is whether accruals for medical services which had been performed were proper. Jensen concludes that Hughes Properties largely forecloses this issue, but that the amount of the deduction is still open since the government declined to have that issue submitted to the Supreme Court.

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C. Economic Performance and Hughes Properties	917
D. A Brief Digression	917
IV. Hughes Properties and Noncasino Cases	918
V. General Dynamics	918
A. Facts	918
B. The 1984 Act and General Dynamics	920
C. Hughes Properties and General Dynamics ..	920
VI. The Correct Result in General Dynamics	920
VII. Conclusion	921

I. Introduction

In *United States v. Hughes Properties, Inc.*,¹ decided on June 3, 1986, the United States Supreme Court resolved a conflict between the Ninth and Federal Circuits over the application of the "all events" test to particular future liabilities of gambling casinos. By rendering a decision in this case, the Court was apparently fulfilling its usual, and crucial, role as final arbiter of the nation's laws. Resolving circuit conflicts is a regular component of the Court's discretionary jurisdiction, and the all events test, as applied in determining the timing of deductions of accrual-basis taxpayers, has been of great practical importance.

It is not at all clear, however, that *Hughes Properties* represents a valuable use of scarce Supreme Court time. As tax lawyers know only too well, the law is constantly changing. Issues that were once important can disappear with the enactment of a new statute. And, at least at first glance, *Hughes Properties* deals with precisely such a disappearing issue. The case involved deductions in taxable years 1973-1977, and the Tax Reform Act of 1984² made substantial revisions in the rules governing the timing of deductions.

For most deductions subject to the Tax Reform Act,³ the critical consideration in determining timing will no longer be whether the requirements of the all events test are met—the issue in *Hughes Properties*—but rather

¹54 U.S.L.W. 4572 (U.S. June 3, 1986).

²Pub. L. No. 98-369, section 91(a), 98 Stat. 494, 598 (adding I.R.C. section 461(h)).

³For accrual-basis taxpayers, the changes made by the Act are generally effective for deductions that, under prior law, would have been allowable after July 18, 1984. Tax Reform Act of 1984, section 91(g)(1), 98 Stat. at 608.

Table of Contents

I. Introduction	911
II. Hughes Properties	913
A. Facts	913
B. All Events Test	913
C. Supreme Court Decision	914
1. Statutory Liabilities	914
2. Unknown Payee	914
3. Uncertain Time for Payment	914
4. Possibility That Payment Will Not Be Made	915
III. The Tax Reform Act of 1984 and Hughes Properties	915
A. Background	915
B. Economic Performance Requirement	916

provide something more than a rough estimate, although absolute precision is not necessary.²⁴

It was conceded that the amount of the liability had been shown in *Hughes Properties*; the payoff indicator amounts were stipulated.²⁵ The Commissioner argued, however, that the fact of liability would not be fixed for any particular slot machine until a winner pulled the machine handle.²⁶ Only then would all contingencies, including the identity of the winner and the time of payment, have disappeared.

Both the Claims Court²⁷ and the Federal Circuit²⁸ held for Hughes, viewing the liability as fixed by Nevada law at midnight on the last day of the fiscal year. The all events test was met on the final play of the machine before year's end, "that is, the last change in the jackpot amount before the amount is recorded for accounting purposes."²⁹ In *Nightingale v. United States*,³⁰ however, the Ninth Circuit had come to a different conclusion on similar facts involving another Nevada casino:

The one, indispensable... event is the winning of the progressive jackpot by some fortunate gambler.... Gambling being what it is, and gambling odds being what they are, it is entirely possible that no actual liability will ever occur.... [T]here is no way of knowing when any particular progressive "one armed bandit" will pay off, nor what the amount of that payoff will then be.³¹

Hughes Properties and *Nightingale*, neither of which implicated new section 461(h) of the Code, thus produced the conflict for Supreme Court review.

C. Supreme Court Decision

The Court ruled for Hughes: the obligation imposed by the Nevada statute and regulations fixed a liability in fact at the end of the casino's taxable year. The casino had therefore properly deducted each year's increase in the payoff indicator total. In arriving at that conclusion, the Court resolved a number of issues that had puzzled lower courts and commentators in cases like *Hughes Properties* prior to the 1984 Act:

1. Statutory Liabilities. An obligation under state law can fix a liability prior to the performance that satisfies the liability: "[A]s a matter of state law, [Hughes] had a fixed liability for the jackpot which it could not escape."³² This issue had been important, for example, in cases involving statutorily mandated reclamation obligations associated with strip mining.³³ The Internal Revenue Service's position, rejected by the Court, had consistently been that a statute is irrelevant in determining the fact of a liability. A statute, the government argued, does not fix

an obligation by itself, and it does not even strengthen the case for deducting a liability arising under a bilateral contract.³⁴ In either case, a liability remains contingent, in the government's view, until performance.³⁵

2. Unknown Payee. A liability can be fixed even though the identity of the ultimate payee is not known: "The obligation is there, and whether it turns out that the winner is one patron or another makes no conceivable difference as to basic liability."³⁶ Prior to *Hughes Properties*, the Service, in a number of cases involving worker's compensation and similar obligations, had argued that such a liability is necessarily contingent.³⁷ In the government's view, a liability cannot be fixed until some person exists who can assert a claim against the taxpayer.³⁸

3. Uncertain Time for Payment. A liability can be fixed even though the time of the future payment is unknown. As the Court stated, "[O]nly the exact time of payment and the identity of the winner remained for the future."³⁹ The Court noted, almost as an aside, that the government's brief "speaks of the time value of money,"⁴⁰ but it rejected that as a serious issue.⁴¹

³⁴The Service's view has also consistently been that a bilateral contract standing alone does not fix a liability prior to performance because no obligation to make payment solidifies until that time. See LTR 7831003 (Apr. 13, 1978) (technical advice memorandum considering timing of deduction for strip miner's statutory reclamation obligation); Jensen, *supra* note 11, at 457-58 (describing LTR 7831003).

³⁵See LTR 7831003 (Apr. 13, 1978); Jensen, *supra* note 11, at 457-60.

³⁶54 U.S.L.W. at 4575.

³⁷The Service had generally been unsuccessful in its argument. See, e.g., *Kaiser Steel Corp. v. United States*, 717 F.2d 1304, 83-2 U.S. Tax Cas. (CCH) paragraph 9621 (9th Cir. 1983) (permitting current deduction to cover uncontested liabilities, under worker's compensation laws, arising from injuries to employees); *Washington Post Co. v. United States*, 405 F.2d 1279, 69-1 U.S. Tax Cas. (CCH) paragraph 9192 (Ct. Cl. 1969) (permitting current deduction of accrued, but unpaid, contributions to newspaper dealer profit-sharing plan); *Ohio River Collieries Co. v. Commissioner*, 77 T.C. 1369 (1981) (permitting current deduction for future strip mining reclamation obligation even though identity of party to perform reclamation was unknown); *Reynolds Metals Co. v. Commissioner*, 68 T.C. 943 (1977) (permitting current deduction for future payments to trusts under supplemental unemployment benefit (SUB) plans); *Lukens Steel Co. v. Commissioner*, 52 T.C. 764 (1969), *aff'd*, 442 F.2d 1131, 71-1 U.S. Tax Cas. (CCH) paragraph 9374 (3d Cir. 1971) (to same effect as *Reynolds Metals*).

³⁸See Brief for the United States at 13, *Hughes Properties*. In its reply brief, the government hinted that its position in some of the earlier cases involving "group liabilities," cited in *supra* note 37, may have changed. However, even if those cases were rightly decided, the government argued, they were distinguishable from *Hughes Properties*. In *Lukens Steel*, for example, the taxpayer had an obligation to make payments, on behalf of its employees, to a supplemental unemployment benefit plan trust. The government had at the time argued that such a liability was contingent because, among other reasons, the identities of the ultimate payees were unknown. 52 T.C. at 786-87. While the government now suggests that the obligation to the entity, the trust, may itself have constituted a fixed liability, no such entity or other group obligee existed in *Hughes Properties*: "The obligee may be an individual or an entity; the obligee may be identifiable or unknown; but there must be an obligee." Reply Brief for the United States at 8-10, *Hughes Properties*.

³⁹54 U.S.L.W. at 4575 (emphasis added).

⁴⁰*Id.*

⁴¹See *infra* notes 51-65 and accompanying text (discussing time value of money and how 1984 Act deals with that issue).

²⁴See Jensen, *supra* note 11, at 462-67.

²⁵54 U.S.L.W. at 4574.

²⁶*Id.*; Brief for the United States at 13, *Hughes Properties*.

²⁷5 Cls. Ct. 641, 645, 84-2 U.S. Tax Cas. (CCH) paragraph 9616, at 84,778 (1984).

²⁸760 F.2d 1292, 1293, 85-1 U.S. Tax Cas. (CCH) paragraph 9359, at 87,943 (Fed. Cir. 1985).

²⁹5 Cls. Ct. at 645, 84-2 U.S. Tax Cas. (CCH), at 84,778.

³⁰684 F.2d 611, 82-2 U.S. Tax Cas. (CCH) paragraph 9533 (9th Cir. 1982).

³¹684 F.2d at 614, 82-2 U.S. Tax Cas. (CCH), at 84,907.

³²54 U.S.L.W. at 4575.

³³E.g., *Ohio River Collieries Co. v. Commissioner*, 77 T.C. 1369 (1981) (holding that state statute fixed, in year land was disturbed, strip miner's obligation to reclaim mined land).

The Court's opinion does not make clear whether time value issues were unimportant primarily because of the particular facts of *Hughes Properties*. Where jackpots are paid on the average every 4½ months, the benefits of accelerated deductions would generally be small.⁴² However, the opinion can also be read to suggest that the time value of money is always an irrelevant consideration under the all events test. This latter reading is consistent with the implication of prior cases: that the time value of money, if it is an issue at all under pre-Act law, is properly taken into account under other doctrines such as "clear reflection of income."⁴³ In any event, while the boundaries of the opinion in *Hughes Properties* may be fuzzy on this point, the Court clearly rejected the Service's long-time contention that a liability is necessarily contingent under the all events test if the precise time of payment is unknown.⁴⁴

4. Possibility That Payment Will Not be Made. The fact that a taxpayer may go out of business prior to satisfaction of a liability does not necessarily make the liability contingent.⁴⁵ Thus, although Hughes could have avoided

the jackpot obligations through its own voluntary acts—surrendering its license or filing for bankruptcy, for example—the liability remained fixed as long as those possibilities were remote: "The existence of an absolute liability is necessary; absolute certainty that it will be discharged by payment is not."⁴⁶ If a legitimately deducted liability is not ultimately satisfied, proper tax accounting, the Court suggested, requires making a later adjustment under the tax benefit rule.⁴⁷ This conclusion, which also ignored the time value of money,⁴⁸ elicited a strong dissent by Justice Stevens. Stevens argued that the Court's opinion implicitly rejected the valid distinction between (i) the nonpayment of an existing fixed (and therefore potentially deductible) obligation and (ii) the nonexistence of an obligation.⁴⁹ The progressive jackpot guaranty, Stevens maintained, belonged in the latter category until a winning pull of the handle.⁵⁰

Each of these four issues had been important prior to the Tax Reform Act of 1984. *Hughes Properties* thus would have been instructive had there been no 1984 Act. The next question for consideration, however, is whether the Court's opinion is any help in analyzing similar cases that are governed by new section 461(h) of the Code.

III. The Tax Reform Act of 1984 and Hughes Properties

A. Background

The 1984 Act, by adding section 461(h) to the Internal Revenue Code, significantly changed the rules governing the timing of deductions by accrual-basis taxpayers. The Congress was concerned that the all events test, as judicially construed in some cases, permitted the deduc-

⁴²In the opinion, the recital of the machine payoff records, see *supra* text accompanying notes 16-19, was not directly tied to the limited discussion of the time value of money issues. Instead, the Court merely noted that, "since the casino of course must pay taxes on the income it earns from the use of as-yet-unwon jackpots, the Government vastly overestimates the time value of [Hughes's] deductions." 54 U.S.L.W. at 4576.

⁴³I.R.C. section 446(b) provides that "if the method [of accounting] 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." The best-known instance in which the Service successfully attacked a premature accrual on the basis of the "clear reflection" standard is *Mooney Aircraft, Inc. v. United States*, 420 F.2d 400, 69-2 U.S. Tax Cas. (CCH) paragraph 9714 (5th Cir. 1969). In *Mooney Aircraft*, the taxpayer had sought to deduct a liability that might not be satisfied for as long as 30 years. Although the technical requirements of the all events test had been met in the case, the court concluded that the possible time between accrual and satisfaction was "too long," and that a current deduction therefore would "not clearly reflect income." 420 F.2d at 409-10, 69-2 U.S. Tax Cas. (CCH), at 85,982. See 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, 800-06 (1980); Jensen, *supra* note 11, at 469-72.

The trial judge and the Supreme Court in *Hughes Properties* both suggested that the government has the power under I.R.C. section 446(b) to correct abusive situations that nevertheless meet the requirements of the all events test. The clear reflection doctrine might apply, for example, (i) if a casino were to place additional machines with very high jackpots on the floor near the end of a taxable year solely in order to boost its deduction for the year; (ii) if a casino were to set extremely high odds on some machines to lessen the probability of payout in the near future; or (iii) if a casino were to transfer guaranteed amounts from machines with favorable payout probabilities to machines with relatively unfavorable probabilities in order to defer indefinitely the payout obligation. 5 Cls. Ct. at 646, 84-2 U.S. Tax Cas. (CCH), at 84,779; 54 U.S.L.W. at 4575-76.

⁴⁴See, e.g., *Denise Coal v. Commissioner*, 271 F.2d 930, 935, 59-2 U.S. Tax Cas. (CCH) paragraph 9769, at 74,035 (3d Cir. 1959) (permitting current deduction for future strip mining reclamation obligation); *Lukens Steel Co. v. Commissioner*, 52 T.C. 764, 784-85 (1969), *aff'd*, 442 F.2d 1131, 71-1 U.S. Tax Cas. (CCH) section 9374 (3d Cir. 1971) (permitting current deduction for future payments to trust under supplemental unemployment benefit plans).

⁴⁵54 U.S.L.W. at 4576.

⁴⁶*Id.* (quoting *Helvering v. Russian Finance & Constr. Corp.*, 77 F.2d 324, 327, 35-1 U.S. Tax Cas. (CCH) section 9367, at 9981 (2d Cir. 1935)). If bankruptcy had been more than an extremely remote possibility for Hughes, the result in the case would presumably have been different.

⁴⁷54 U.S.L.W. at 4576 (citing Treas. Reg. section 1.461-1(a)(2)).

⁴⁸The tax benefit rule merely requires later inclusion of a dollar amount equal to the amount of the deduction previously taken. For example, if a one dollar deduction is taken in 1986 for a 1991 liability, and the liability is not satisfied, the taxpayer must include the one dollar in income in 1991. Viewed from the perspective of 1986, the taxpayer thus received a one dollar deduction with an inclusion obligation having a present value of considerably less than one dollar. See *infra* note 51.

⁴⁹Justice Stevens, joined in dissent by Chief Justice Burger, cited *World Airways, Inc. v. Commissioner*, 62 T.C. 786 (1974), *aff'd*, 564 F.2d 886, 78-1 U.S. Tax Cas. (CCH) paragraph 9149 (9th Cir. 1977), in which an airline's statutory obligation to overhaul engines and airframes used for a certain number of hours was held to be contingent because certain events, such as bankruptcy or the crash or other disposition of an airplane, could prevent the obligation from ripening. 54 U.S.L.W. at 4576 (citing *World Airways*, 62 T.C. at 804). An airline subject to the statute would have an obligation to overhaul the aircraft only if the airline was going to proceed with business as usual.

⁵⁰Stevens suggested that a relevant consideration in determining whether a liability in fact exists is whether the claim is one that would be discharged in bankruptcy, and a jackpot guaranty clearly would not. 54 U.S.L.W. at 4576. The government, however, had not advanced such a position:

The point [in discussing bankruptcy] is not that [Hughes] has creditors whose claims might be discharged in bankruptcy. The point is that no slot machine player could even assert a claim against [Hughes] in bankruptcy unless and until he had won a jackpot.

Reply Memorandum for the United States at 3, *Hughes Properties*. (Emphasis in original.)

tion of amounts that exceeded the true cost of the liabilities. For example, consider a taxpayer which could demonstrate that it had a fixed, definite liability to pay \$100 in five years for an otherwise deductible expense. With both the fact and the amount of the liability set, and if no other statutory or judicial barrier intervened, the taxpayer could deduct the full \$100 currently, without any discounting to reflect the time value of money. Therefore, a liability with a present value of less than \$100 could generate a current deduction equal to the full \$100—a "premature accrual."⁵¹

The taxpayer could deduct the full [amount] without any discounting to reflect the time value of money.

The Internal Revenue Service has never been happy with premature accruals, but the reason for its concern was not clearly articulated in the older cases and rulings. The Commissioner did not speak in terms of the time value of money until recently.⁵² Although he provided no underlying theory for his position, the Commissioner generally fought any deduction taken prior to the time that services were performed or property was provided.⁵³ In the above example, if the \$100 liability is for services to be performed in five years, the Commissioner would have insisted, even without benefit of the modifications made by the 1984 Act, that the deduction also be delayed for five years. In the language of the all events test, the Commissioner would have argued that the fact of the liability is not fixed until the services are performed. If successful in such an argument, and if the \$100 is in fact paid in five years, the Commissioner would have brought the cost of the liability (\$100 in five years) and the deduction for the liability (\$100 in five years) into alignment.⁵⁴

⁵¹The present value of that future obligation, using a discount rate of five percent compounded semiannually, is \$78.12. That is, if the taxpayer invested \$78.12 today at a five percent after-tax rate of return, it would have the \$100 in five years necessary to satisfy the liability.

⁵²See Jensen, *supra* note 11, at 477. In one sense, it is unfair to the Commissioner to suggest that the time value of money was not an articulated concern; attacks on accelerated deductions of course have been motivated by the knowledge that, all other things being equal, a deduction today is worth more than a deduction next year. The point here, however, is that no full theory was developed by the Commissioner to justify his challenges to premature accruals.

⁵³The Service was not entirely consistent in this posture. See, e.g., Rev. Rul. 69-429, 1969-2 C.B. 108 (self-insured partnership obligated to pay injured employees in installments, with the payments fixed by the state Industrial Commission under worker's compensation statute, permitted to deduct full undiscounted amount in year of award); see also Gunn, *Matching of Costs and Revenues as a Goal of Tax Accounting*, 4 Va. Tax Rev. 1, 26 (1984) (discussing potentially absurd applications of Rev. Rul. 69-429); McGown, *Structured Settlements: Deduct Now and Pay Later*, 60 Taxes 251, 257 (1982) (discussing planning potential of Rev. Rul. 69-429).

⁵⁴If payment is not made in five years but the taxpayer is permitted a deduction at that time, a premature accrual will still result, although it would obviously be less beneficial than a deduction in the same amount taken five years earlier.

In challenging premature accruals prior to the 1984 Act, the Internal Revenue Service thus in effect added a "performance" requirement to the all events test. An alternative attack was available under section 446(b) of the Code: a deduction much earlier than performance should be denied because it would "not clearly reflect income."⁵⁵ The Service, however, seldom made such an argument.⁵⁶ Instead, by formalistically concentrating on the all events test, the Service burdened the language of the regulation with more than it could carry. The regulation made no reference to performance, or anything like that, and the Service's litigation record was accordingly less than perfect.⁵⁷ Frustrated by the courts, the Service took its grievances to Congress.

B. Economic Performance Requirement

Congress, newly sophisticated in 1984 about the time value of money, was receptive to the Commissioner's pleas. To impose some rationality on the deduction scheme, Congress in the Tax Reform Act required that a deduction be taken no earlier than "economic performance," thereby generally codifying the Commissioner's prior position. The all events test was retained—indeed, elevated from the regulations into the Code⁵⁸—but the economic performance requirement was grafted on to that test.⁵⁹ As a result, to be entitled to deduct a future liability in the current taxable year, a taxpayer must now⁶⁰ demonstrate not only the fact and the amount of the liability, but also that economic performance has occurred or is occurring.

New section 461(h) in general operates to defer deductions . . .

Economic performance in general occurs as activities are performed that are necessary to satisfy the liability. What constitutes economic performance depends on the nature of the subject transaction. Economic performance attributable to an obligation to provide or pay for property or services occurs only as the property or services

⁵⁵See *supra* note 43.

⁵⁶*Mooney Aircraft* is an unusual example in which the Commissioner successfully argued the clear reflection standard with respect to a premature accrual. See *supra* note 43; Jensen, *supra* note 11, at 470-72 (discussing possible reason why Service generally did not press clear reflection argument).

⁵⁷See, e.g., *Denise Coal v. Commissioner*, 271 F.2d 930, 935, 59-2 U.S. Tax Cas. (CCH) paragraph 9769, at 74,035 (3d Cir. 1959) (strip mining reclamation obligation under Pennsylvania law held currently deductible); *Harrold v. Commissioner*, 192 F.2d 1002, 52-1 U.S. Tax Cas. (CCH) paragraph 9107, at 45,138 (4th Cir. 1951) (strip mining reclamation obligation under West Virginia law held currently deductible); *Ohio River Collieries Co. v. Commissioner*, 77 T.C. 1369 (1981) (strip mining reclamation obligation under Ohio law held currently deductible).

⁵⁸Following the language of the regulations, I.R.C. section 461(h)(4) provides that "the all events test is met with respect to any item if all events have occurred which determine the fact of liability and the amount of such liability can be determined with reasonable accuracy."

⁵⁹See *supra* note 4.

⁶⁰See *supra* note 3 (effective date of section 461(h)).

are provided.⁶¹ For liabilities arising from tort or worker's compensation claims, economic performance occurs as required payments are made to another person.⁶² The statute also provides that economic performance with respect to a liability arising from the use of property (an obligation under a lease, for example) occurs as the property is used.⁶³ In all other cases, the Secretary of the Treasury is directed to issue regulations governing the determination of economic performance.⁶⁴

New section 461(h) in general operates to defer deductions; that, of course, is why the provision was added to the Code. Economic performance will usually be later than, or will coincide with, the time at which the unmodified all events test is met. In most cases, economic performance fixes the fact of a liability; prior to the Tax Reform Act, even the Commissioner conceded that result.⁶⁵ The first part of the all events test is therefore generally redundant. In addition, the amount of a liability will usually be reasonably certain, if not fixed, at the time of economic performance. Hence, in most cases, the critical consideration will be the time of economic performance; the requirements for deductibility will be met no earlier than, but also no later than, that time.

C. Economic Performance and Hughes Properties

The facts of *Hughes Properties*, if governed by section 461(h), would easily fit within the terms of the statute. A careful analyst can discover many conceptual difficulties with the application of the economic performance requirement,⁶⁶ but none of those difficulties would be involved in a progressive jackpot case. Economic performance under the statute would be deemed to occur at the time that the machine's arm is pulled and the machine disgorges its promise of riches,⁶⁷ the time that Hughes provides services or property.⁶⁸ The fact of the liability and the amount of the liability would also then be set.

⁶¹1.R.C. sections 461(h)(2)(A), 461(h)(2)(B).

⁶²1.R.C. section 461(h)(2)(C).

⁶³1.R.C. section 461(h)(2)(A)(iii).

⁶⁴1.R.C. section 461(h)(2)(D).

⁶⁵See *supra* notes 52-57 and accompanying text. Whether it should have satisfied a Commissioner attuned to the time value of money is another matter. If both economic performance and fulfillment of the all events test precede *payment* or other satisfaction of a liability, the benefit of a premature accrual still exists under the new law. In that situation, section 461(h) may defer a deduction, but not long enough. See Jensen, *supra* note 11, at 483-84.

⁶⁶For example, until the issuance of clarifying regulations, there may be difficulty in determining when economic performance has in fact occurred. When does economic performance occur in a two-party, nonsimultaneous barter transaction, when both parties to the transaction are providing property or services? Does economic performance occur as party A provides property or services or as party B provides property or services? And how should economic performance be deemed to occur when property or services are provided over more than one year? See Bowers & Stone, *Some Items Still Deductible Under All-Events Test Despite New Economic Performance Rules*, 64 J. Tax'n 354, 355 (1986).

⁶⁷Perhaps the arm could be pulled a fraction of a second before midnight on the last day of the taxable year, and the winning combination could appear in the next taxable year. Another theorist can determine in which year economic performance is deemed to occur in such a case.

⁶⁸It should not matter whether the casino is deemed to be providing services or whether it is deemed to be providing property.

Indeed, at that time, given the Nevada statutory and regulatory scheme,⁶⁹ no uncertainty whatsoever would remain: the obligation would be unquestionably fixed, and the identity of the payee and the time of payment would be unquestionably known.⁷⁰

Nothing in the Supreme Court's opinion is . . . helpful . . . in deciding casino cases under the 1984 Act.

For future progressive jackpot cases, unless a statutory exception to the economic performance requirement applies, section 461(h) provides exactly the result that the government sought, and that the Court rejected, in *Hughes Properties*: deferring the casino's deduction until the jackpot is won. Only one exception to the economic performance requirement can even arguably apply to such jackpot obligations, and the application of that exception appears to have a fatal flaw, as described below. Accordingly, nothing in the Supreme Court's opinion is necessary, or even helpful, in deciding casino cases under the 1984 Act. The Court in *Hughes Properties* answered a number of questions that have disappeared from the consideration of similar fact situations.⁷¹

D. A Brief Digression

The conclusion that section 461(h) easily resolves future progressive jackpot cases assumes that no exception to the economic performance requirement applies. For "certain recurring items,"⁷² however, the Code in effect relies on the unmodified all events test to determine the timing of deductions. Since this exception, if it did apply, would leave the authority of *Hughes Properties* unimpaired, a brief digression is necessary to explain why the exception appears not to be available.⁷³

The progressive jackpot obligations meet three of the four requirements for application of the exception: (1) As *Hughes Properties* decides, the unmodified all events test is met in a year prior to the year of economic performance;⁷⁴ (2) the obligations are recurring in nature and are consistently accounted for by the casinos;⁷⁵ and (3) the accrual of a jackpot obligation in an earlier taxable year gives a better matching of income and expense than would accruing the liability in the year of economic

⁶⁹See *supra* notes 12-15 and accompanying text.

⁷⁰The time of payment would be known unless the casino contests, and does not pay, the liability. In that case, no deduction would be permitted until the contingency disappears. See *infra* note 82 and accompanying text.

⁷¹The issues have not disappeared, of course, from those casino cases in the litigation pipeline that are not governed by the Tax Reform Act. See *supra* note 5.

⁷²1.R.C. section 461(h)(3).

⁷³"Appears" is the appropriate word because, "in many if not most of the cases, it will be difficult to determine if the exception is available." Bowers & Stone, *supra* note 66, at 356.

⁷⁴1.R.C. section 461(h)(3)(A)(i).

⁷⁵1.R.C. section 461(h)(3)(A)(iii).

performance.⁷⁶ On the third point, too, the opinion in *Hughes Properties* is helpful: the Court gives surprisingly great weight to the matching principle and the determination of "true income" in concluding that a deduction prior to performance must be permitted.⁷⁷

The final requirement for application of the recurring items exception is more problematic, however: economic performance must occur no later than 8½ months after the close of the taxable year in which the all events test is met.⁷⁸ No regulations have yet specified the workings of this (or any other) requirement of the exception, but the requirement can apply to progressive jackpots only if it is very generously interpreted.

The exception for recurring items was intended to "avoid disrupting normal business and accounting practices" when the benefit of a premature accrual for an item would be slight.⁷⁹ Progressive jackpots are, by their nature, not routine; the precise timing for any particular machine cannot be predicted in advance. Moreover, the time value benefit of accruing future liabilities for some of the machines in any particular year may be substantial. On the average, Hughes' progressive jackpots were paid every 4½ months, clearly within the prescribed period. But not all jackpots were so paid. One machine had not been forthcoming with its prize for 35 months.⁸⁰ Nor can it be said that the payment of any particular jackpot more than 8½ months after the end of a taxable year was aberrational; it was statistically to be expected that some jackpots would be delayed to such an extent.

In sum, whether the appropriate "item" for analysis under the recurring items exception is the aggregate of the jackpot obligations for all machines or the jackpot obligations with respect to any particular machine, the 8½ month test would not be met on a recurring basis. The economic performance requirement should therefore remain applicable to progressive jackpots.

⁷⁶I.R.C. section 461(h)(3)(A)(iv). As an alternative to showing that better matching would result from an earlier accrual, the taxpayer may demonstrate that the item is not a "material item." For the evaluation of either alternative, the treatment of the item on financial accounting statements must be taken into account. I.R.C. section 461(h)(3)(B).

⁷⁷The Court stated that

one of the expenses that necessarily attends the production of income from a progressive slot machine is the commitment of a particular portion of the revenue generated to an irrevocable jackpot. [Hughes's] *true income* from its progressive slot machines is only that portion of the money gambled which it is entitled to keep.

54 U.S.L.W. at 4576 (emphasis added). The government had strenuously argued, with a great deal of support in recent Supreme Court opinions (see, e.g., *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, 542-43 (1979)), that matching is not a significant tax accounting concept even though it continues to be important for financial accounting purposes. See Brief for the United States at 26-28, *Hughes Properties*. The Court agreed that "financial accounting does not control for tax purposes" because the purposes of the two accounting regimes are different, 54 U.S.L.W. at 4575, but it nevertheless deferred to the matching principle. This resuscitation of an apparently dying concept in tax law came as a surprise to some commentators. See, e.g., Gunn, *supra* note 53; Jensen, *supra* note 11, at 472-76.

⁷⁸I.R.C. section 461(h)(3)(A)(ii). If a "reasonable period" after the close of the taxable year is less than 8½ months, that shorter period governs.

⁷⁹H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 873 (1984).

⁸⁰See *supra* text accompanying note 17.

IV. Hughes Properties and Noncasino Cases

Section III of this article concluded that, if the Tax Reform Act of 1984 had applied to the facts of *Hughes Properties*, the result would have been straightforward, and the Supreme Court's analysis would have played no role in reaching that result. *Hughes Properties* quite simply has nothing to say about the future resolution of similar cases.

This is not to say, however, that the opinion necessarily has no future effect. Although the all events test, as applied to liabilities, has been stripped of much of its importance by the Tax Reform Act, it has not disappeared altogether; the test for current deductibility under section 461(h) is not solely economic performance. In those cases in which economic performance precedes the fulfillment of the old all events test, the all events test retains vitality.

The all events test... has been stripped of much of its importance....

For example, consider a liability, for services already performed, that is contested by an accrual-basis taxpayer. Even though economic performance has occurred because of the performance of the services, the liability is not currently deductible because the all events test has not been met. The contest itself defeats the fact of the liability, at least in part,⁸¹ and the special Code provision dealing with contested liabilities will help the taxpayer only if the contested liability is first paid.⁸²

The significance of *Hughes Properties* thus depends on the scope of cases in which economic performance may occur before both the fact and the amount of a liability have been set. If there are few such cases, *Hughes Properties* is indeed an insignificant decision. But this category of cases may not be small or inherently unimportant. Indeed, *General Dynamics*, although it too will be decided under pre-Act law, is an example of the continuing significance of the all events test.

V. General Dynamics

A. Facts

General Dynamics and its affiliated corporations (collectively, GD) were required under collective bargaining agreements to maintain health insurance coverage for GD employees. In 1972 GD, which had earlier funded a plan through private insurance carriers, took over the insurance function itself. GD established reserves to meet its estimated liability and retained the two insurance firms that had earlier provided coverage to evaluate and approve benefit claims. On its 1972 tax return GD deducted its liability for medical services assumed to have

⁸¹If only part of a liability is fixed in fact and the amount thereof can be determined with reasonable accuracy, the regulations, as yet not amended to reflect the 1984 Act, permit the deduction of the fixed part. Treas. Reg. section 1.461-1(a)(2).

⁸²I.R.C. section 461(f) provides in effect that the all events test may be deemed met, despite a taxpayer's contest of a liability, if a transfer of property or services is made to satisfy the liability.

been performed during the year; that is, GD deducted not only its liability for those employees whose claims had been approved during the year, but also its estimated liability for claims during the year that had either not yet been filed, or, if filed, had not yet been approved.

The Commissioner denied the deductions for the estimates,⁸³ even though the estimates were based on the actuarial principles used by the insurance industry for determining such "incurred but not reported" (IBNR) claims.⁸⁴ The basis for the denial was the all events test. The Commissioner contended that no deduction should be permitted until an insurance company administrator had approved a claim for payment. At any earlier time, GD could establish no liability in fact: either an employee might not file a claim or, for one reason or another, the administrator might deny the claim.⁸⁵ Accordingly, in the government's view, any deduction permitted would be with respect to "expenses that [GD] may never incur at all."⁸⁶

GD prevailed at both the Claims Court⁸⁷ and Federal Circuit⁸⁸ levels. The last event necessary to fix liability was held to be the "occurrence of the insured event,"⁸⁹ that is, the provision of medical services. In taking a deduction, "[GD was] not predicting the happening of future events; rather, [it was] estimating the amount of fixed liability for events which had already occurred."⁹⁰ Not everything reflected in a reserve account would necessarily be paid to claimants, but absolute certainty is not required to establish the fact of a liability. The all events test must be applied in a "reasonable and practical matter,"⁹¹ and, so applied, the courts held, the test was met.

⁸³With respect to those claims already approved but not yet paid, there was no dispute about deductibility under the all events test. The 1984 Act, had it applied to these claims, should have added no further uncertainty. Economic performance would have occurred with the provision of the medical services, and the liability would therefore have been deductible no later than the year of claim approval. Since claim approval could occur in a taxable year earlier than the year of payment, see *infra* note 101, the government effectively conceded that a premature accrual could result from some approved claims. See *supra* note 65; *infra* note 102.

⁸⁴GD followed actuarial principles, but it did not claim it was an "insurance company" specially entitled for that reason to deduct additions to reserves. See I.R.C. section 807 (permitting deduction for additions to reserves by life insurance companies); I.R.C. section 832(b)(5) (permitting deduction for additions to reserves by casualty insurance companies).

⁸⁵The administrator was required to determine "whether the medical procedures were covered by the health plans, whether stipulated maximum charges had been exceeded, and whether the treatment was medically necessary." Supplemental Memorandum for the United States at 2, *United States v. General Dynamics* (No. 85-1385). About 90 percent of the amounts for which GD's employees claimed reimbursement had historically been approved for payment. *General Dynamics Corp. v. United States*, 6 Cls. Ct. 250, 254, 84-2 U.S. Tax Cas. (CCH) paragraph 9783, at 85,322 (1984).

⁸⁶Petition for Writ of Certiorari at 8, *General Dynamics*.

⁸⁷6 Cls. Ct. 250, 84-2 U.S. Tax Cas. (CCH) paragraph 9783 (1984).

⁸⁸773 F.2d 1224, 85-2 U.S. Tax Cas. (CCH) paragraph 9688 (Fed. Cir. 1985).

⁸⁹6 Cls. Ct. at 255, 84-2 U.S. Tax Cas. (CCH), at 85,323.

⁹⁰*Id.*

⁹¹*Id.*

By validating GD's actuarial principles, the lower courts approved the use of probability theory to determine the fact of a liability. It is important to understand the narrow scope of the holding. The Claims Court and the Federal Circuit did not hold that probability theory could be used to generate a current deduction for medical services to be provided to employees in future years. Based on its experience, GD presumably could have estimated such future expenses with a fair degree of accuracy. But the permitted deduction for as-yet-unpaid expenses was limited to those arising from medical services *already provided* to employees. In seeking Supreme Court review, the government suggested that the Federal Circuit's opinion, if left standing, may permit taxpayers to deduct payments to self-insurance reserves generally.⁹² However, that argument grossly overstates the holding of the case. In no way does *General Dynamics* approve a deduction for additions to reserves to cover events that have not yet occurred,⁹³ and the deductibility of such additions will, therefore, not be before the Supreme Court.⁹⁴

The lower courts approved the use of probability theory to determine the fact of a liability.

The Court in *General Dynamics* will also not consider the application of probability theory to determine the amount, as opposed to the fact, of a liability. In the courts below, the government challenged the reasonable accuracy of the estimated amounts, but it did not request Supreme Court review of that issue.⁹⁵ The government's unwillingness to press this second point at this time⁹⁶ is unfortunate because *General Dynamics* contains some interesting features. For example, a Court opinion could have provided guidance about the extent to which the Commissioner may use hindsight (that is, the actual amounts necessary to ultimately satisfy a liability) to

⁹²See Reply Memorandum the United States at 4-5, *General Dynamics*. The government cites an article in *Forbes* to show that the business community viewed the Federal Circuit decision as having far-reaching consequences. According to the article, the decision was a "light on the horizon" that would permit deductions for "[p]ayments made to self-insurance reserves" and thus properly blur the distinction for tax purposes between insurance companies and noninsurance companies. Saunders, *Light on the Horizon*, *Forbes*, Mar. 24, 1986, at 120.

⁹³Overstatement and misstatement on this subject by popular business periodicals appear to be common. See *supra* note 92; Seligman, *Playing the Slots on an Accrual Basis*, *Fortune*, July 7, 1986, at 100 (favorably discussing Court decision in *Hughes Properties*, but misstating holding in *Mooney Aircraft*, see *supra* note 43, and ignoring effect of Tax Reform Act of 1984).

⁹⁴If that issue were before the Court, there would be no doubt about the result. *Brown v. Helvering* should control, see *supra* note 23, and no current deduction should be permitted.

⁹⁵Petition for Writ of Certiorari at 13 n.2, *General Dynamics*.

⁹⁶The government did not agree that the lower courts had ruled properly on the amount of liability issue, see *id.*, and it is an issue that surely will be seen again.