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Economic Performance and Progressive Jackpots: A Better Analysis

Erik M. Jensen

letters to the editor

ECONOMIC PERFORMANCE AND PROGRESSIVE JACKPOTS: A BETTER ANALYSIS

To the Editor:

The timing of deductions associated with progressive slot machines is an issue that obviously won't disappear, although worrying about casino taxation may be a peculiar way for bright people to spend their time. Lee Sheppard's news analysis on this issue (see *Tax Notes*, October 9, 1989, p. 160) is delightful, and I agree with her ultimate conclusion: in the best of all possible worlds, a casino should not be able to deduct amounts associated with progressive jackpots until they are paid out. But Ms. Sheppard purports to analyze section 461(h), not the ideal world, and she is on shaky ground in her statutory analysis.

Ms. Sheppard is also too quick to reject a perfectly plausible argument interpreting obscure statutory language.

Several years ago in this journal (see *Tax Notes*, September 1, 1986, p. 911) I concluded that, had section 461(h) been in effect for the tax years involved, it would have changed the result in *United States v. Hughes Properties*, 476 U.S. 593 (1986). I came to regret that position, not because I thought it was necessarily wrong, but because I had given insufficient weight to the argument that economic performance occurs as gamblers play the machines, rather than when the jackpots are paid.[1] I think that Ms. Sheppard is also too quick to reject a perfectly plausible argument interpreting obscure statutory language.

Here's how the argument runs. *Hughes Properties* tells us that the all events test is met at the end of the casino's taxable year (assuming the amount of the liability can then be determined). Had there been no statutory change, casinos could therefore have deducted each year's increase in the aggregate progressive jackpot liabilities. However, section 461(h), added to the Code in 1984, attached a further requirement: a liability meeting the all events test can be deducted no earlier than the time of economic performance. What constitutes economic performance in the case of progressive jackpots?

Section 461(h)(2) lists a number of ways in which economic performance is deemed to occur, and somehow or other we need to fit the casino situation into statutory language not designed to it. Ms. Sheppard does not tell us how she concludes *under the statute* what economic performance is. Ms. Sheppard uses the word "clearly" often in her analysis, but the conclusion that economic performance occurs upon payment of the jackpot is not at all clear. Ms. Sheppard notes that "taxpayers cannot write their own exceptions"; similarly, she cannot write her own statute. In most cases under section 461(h)(2), economic performance is *not* payment, but some other event or series of events.

What else could economic performance be? Section 461(h)(2)(B) states that, in the case of services and property provided by the taxpayer, "economic performance occurs as the taxpayer provides such property or services." One of Ms. Sheppard's interviewees asked, "What does entertainment have to do with timing of deductions?" The answer to that question is obvious—*under the statute.* If providing entertainment constitutes the provision of services and gamblers are entertained by merely playing slot machines provided by a casino, economic performance occurs as the machines are played. That analysis is not mandated by the statutory language—there are a lot of ifs involved—but neither is it an off-the-wall argument. For better or for worse, statutes do not always lead to the conceptually best results.

Ms. Sheppard uses the recurring items exception of section 461(h)(3) to bolster her case that economic performance occurs at the time of payment, but her presentation is misleading at best. That exception permits treating a liability associated with certain "recurring items" as incurred in a particular taxable year even though economic performance has not yet occurred. For the exception to apply, a number of tests must be met, including a requirement that economic performance in fact occurs within the shorter of a reasonable period or 8.5 months after the close of the taxable year. Ms. Sheppard concludes that "there is a reason for the 8.5 month rule. Congress clearly [that word again!] did not want deductions accelerated more than that limit."

Saying something is clear doesn't make it so. If Congress had wanted Ms. Sheppard's "8.5 month rule," it could have written the rule into the basic definition of economic performance, rather than into an exception—an exception that comes into play only when the economic performance requirement has not otherwise been met. Indeed, for nonrecurring items, it is conceivable that, even with section 461(h) on the books, deductions

[1] I pulled back a bit from my initial position in "The Supreme Court and the Timing of Deductions for Accrual-Basis Taxpayers," 22 *Ga. L. Rev.* 229, 255 n. 119 (1988).

can be accelerated far beyond 8.5 months (e.g., if the all events test and economic performance are met long before the taxpayer must make payment on the liability).

Ms. Sheppard's recurring items analysis is flawed because it assumes its conclusion. She is right that "not all casino operators can guarantee that the progressive jackpots will be paid within 8.5 months after the close of the taxable year in which they would be deducted," but that fact is important only if payment constitutes economic performance. If economic performance occurs as the machines are played, we have no reason to be concerned about the recurring items exception.

When doubt remains about the time of economic performance after legitimate attempts have been made to apply those definitions, the deduction should be deferred until payment.

One passage in Ms. Sheppard's analysis can be interpreted to mean that "recurring items," as that term would be understood in a common sense way, must always be examined under section 461(h)(3). I'm not sure she meant to say that. In any case, it's not true. Many "recurring items" easily meet one of the definitions of economic performance in section 461(h)(2), without regard to the recurring items exception, and that is the argument of the casino lawyers and accountants.

None of this is to say that Ms. Sheppard's result is wrong, only that the issue is not nearly so clear as she makes it out to be. (An aside: Is this clearly a section 461(h) issue? Maybe we should be considering timing-of-income principles rather than those governing timing of deductions.) I prefer an analysis as follows: The progressive jackpot situation does not fit easily within any of the statutory definitions of economic performance. When doubt remains about the time of economic performance after legitimate attempts have been made to apply those definitions, the deduction should be deferred until payment. In other words, when in doubt, defer. That governing principle has several virtues, including its closer relationship to the language of section 461(h) than anything in Ms. Sheppard's analysis.

Very truly yours,

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MORE THOUGHTS ON A CAPITAL GAINS TAX CUT

Tax Notes has published two letters over the past month on justifications for cutting the capital gains tax rate (see Tax Notes, October 9, 1989, p. 244, and October 16, 1989, p. 350). This week, a third writer (or is it a second writer?) joins the fray. While Tax Notes' crack investigative reporting staff has been stymied by the fax technology that transmitted the letter, the ideas conveyed should be food for thought for our congressional taxwriters.

To the Editor:

I was deeply inspired by the letter to an unidentified senator by Mr. Ike N. O'Clast that explained why a capital gains cut is good for the country. (See *Tax Notes*, October 9, 1989, p. 244.) Indeed, I was so inspired that I wanted to add my own, of course humble, contribution. (One cannot but be humble in the face of such preceding eloquence.)

In my view, the House bill lowering the capital gains rate for two years was a brilliant piece of legislation that has taken a lot of unfair criticism. It should have a place in our hearts for years to come whether or not it passes. Unfortunately, people simply don't seem to understand its massively positive effects on efficiency.

As we learned in 1986, differential tax rates are inefficient. But given the short-term nature of the rate reduction in the House bill, it is unlikely to harm efficiency. Two years is simply too short a period for people to plan on capital gains from new investments. Thus, the provision is simply a windfall to a handful of lucky taxpayers, without negative efficiency consequences. This, in turn, is wonderful for the most important type of efficiency: efficient fund-raising by members of Congress who realize that their constituents are too lazy or ungrateful to make appropriate campaign contributions in the absence of tax incentives.

Moreover, the House bill maximizes revenue-raising efficiency. It is widely believed that changing the capital gains rate raises revenue whether the rate goes up or down. When the rate goes down, pent-up demand is released. When the rate goes up, the increase is preceded by a rush to market.

The House bill is wonderful in that it both lowers *and* raises the rate. But it is here, alas, that the bill does not go quite far enough. The ideal proposal would be one in which rates were raised and lowered again and again. For example, Congress could establish a capital gains rate lottery. Every two years, a new capital gains rate would be picked by random drawing. The rate could be any integer between, say, five and fifty percent (although there is admittedly a certain elegance to picking non-integers such as 19.6 percent). The new rate would be effective six months after it was announced, giving plenty of time for the rush to market in the event of a rate increase.

I estimate that this proposal would raise literally billions of tax dollars. On the other hand, perhaps it is not that far from the system we already have.

Mack A. Damia
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October 16, 1989