Part I

Section 461.--General Rule for Taxable Year of Deduction

26 CFR 1.461-1: General rule for taxable year of deduction. (Also Section 451; 1.451-1.)

Rev. Rul. 98-39

ISSUE

Under the all events test of § 461 of the Internal Revenue Code, is an accrual method manufacturer's liability to pay a retailer for cooperative advertising services incurred in Year 1 when those services are provided by the retailer, or in Year 2 when the retailer submits the required claim form for those services?

FACTS

X, an accrual method taxpayer using a calendar year as its taxable year, manufactures various consumer products, including product M. Retailers engaged in the business of selling merchandise to consumers purchase product M from X for resale. In August of Year 1, X made a written offer to pay each of these retailers $1 for each case of product M that the retailer purchased from X during September, October, and November of Year 1, provided that the retailer advertised X's product M during October or November of Year 1. To qualify for X's payment, the advertising provided by the retailer had to satisfy the requirements set forth in X's offer regarding the format and content of the advertising (including the offering of a discount

on product M), and the time for performance of the advertising. X's offer further required that, to obtain payment, the retailer had to submit a claim form and proofs of performance within 90 days after the date that the advertising was performed, verifying that the advertising was performed in accordance with the terms of X's offer.

Y, a retailer that accepted X's offer, ordered 1,000 cases of product M from X during September, October, and November of Year 1, and advertised product M in November of Year 1 in a manner that satisfied the requirements of its agreement with X. To obtain payment for that advertising, Y submitted its claim form and proofs of performance to X in January of Year 2.

X is able to make a reasonable estimate of the amount that it is liable to pay Y for the cooperative advertising services performed by Y in Year 1.

LAW AND ANALYSIS

Section 451 provides rules for determining the taxable year of inclusion for items of gross income.

Section 1.451-1(a) of the Income Tax Regulations provides that under an accrual method of accounting, income is includible in gross income when all the events have occurred that fix the right to receive such income and the amount thereof can be determined with reasonable accuracy.

Section 461(a) provides that the amount of any deduction or credit is 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) provide that, under the 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 (1) all the events have occurred that 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.

Section 461(h)(2)(A)(i) provides that, if the liability of the taxpayer arises out of the providing of services to the taxpayer by another person, economic performance occurs as that person provides the services.

Generally, in a transaction where one taxpayer is accruing a liability to pay another taxpayer, the last event necessary to establish the fact of liability under the all events test of § 1.461-1(a)(2)(i) is the same event that fixes the right to receive income under the all events test of § 1.451-1(a). See Capital Investments of Hawaii, Inc. v. Commissioner, T.C. Memo. 1982-80, n. 9 (the reasoning of cases analyzing § 451 is applicable to an analysis under § 461); Schneer v. Commissioner, 97 T.C. 643 at 650 (1991) ("the prerequisite of performance of the services prior to any liability on the part of the obligor is an essential to satisfying the all-events test. The right to receive income cannot become fixed before the obligor has an obligation to pay"); see also Rev. Rul. 79-266, 1979-2 C.B. 203, and Rev. Rul. 79-410, 1979-2 C.B. 213.

Where a taxpayer's obligations are set forth in a written agreement, the terms of the agreement are relevant in determining the events that fix the taxpayer's obligation to pay. See, e.g., Decision, Inc. v. Commissioner, 47 T.C. 58 (1966), acq., 1967-2 C.B. 2.

In general, the event fixing the fact of liability pursuant to an agreement for the provision of services is performance of the services. See, e.g., National Bread Wrapping Machine Co. v. Commissioner, 30 T.C. 550 (1958) (performance of services pursuant to a contract was necessary to establish the taxpayer's liability); Charles Schwab v. Commissioner, 107 T.C. 282 (1996) (execution of a trade pursuant to a customer order fixes the broker's right to receive the commission income).

Moreover, once the services are performed, the establishment of the fact of liability under the all events test is not delayed by an additional requirement in the agreement that a claim or documentation be submitted to obtain payment, if such act is ministerial. See Dally v. Commissioner, 227 F.2d 724 (9th Cir. 1955), cert. denied, 351 U.S. 908 (1956) (contractor's right to income was fixed in year it delivered houses, not in later year when a properly certified invoice was submitted, even though the contract specifically provided for payment upon the submission of a properly certified invoice); Frank's Casing Crew & Rental Tools, Inc. v. Commissioner, T.C. Memo. 1996-413 (contractor's preparation and sending of the invoices were ministerial acts

that did not postpone accrual of income otherwise earned). See also Continental Tie & Lumber Co. v. United States, 286 U.S. 290 (1932).

However, in some cases, the requirement that a claim for payment be filed is a condition precedent that delays satisfaction of the all events test for § 461 purposes. In United States v. General Dynamics Corp., 481 U.S. 239 (1987), the Court held that employees must file claims with the employer to establish the fact of the liability to reimburse employees for medical expenses under the all events test. The Court noted that some covered employees fail to file claims with their employer for various reasons, such that an employee's receipt of covered medical services was not sufficient to fix the employer's liability. Thus, the filing of the claim was not a mere technicality.

In the cooperative advertising agreement between X and Y, the performance required under the agreement is the provision of advertising services. Y's submission of a claim form and proofs of performance substantiating that it has performed the advertising according to X's specifications is merely the mechanism by which Y requests payment for advertising services already performed. Thus, similar to Dally and Frank's Casing, Y's submission of the claim form and proofs of performance is a ministerial act, much like the submission of an invoice. These facts distinguish the cooperative advertising agreement between X

and Y from General Dynamics and demonstrate that Y's submission to X of the claim form and proofs of performance is a mere technicality, not a condition precedent that is necessary to establish X's liability for § 461 purposes.

The last event necessary to establish the fact of X's liability under the all events test occurred when Y performed the cooperative advertising services in Year 1 in accordance with the terms of the contract. X can reasonably estimate the amount of its Year 1 liability for the cooperative advertising services performed by Y. Economic performance with respect to X's liability occurred in Year 1 when Y performed the cooperative advertising services. Accordingly, X may deduct on its Year 1 federal income tax return its liability for Y's cooperative advertising services.

HOLDING

Under the all events test of § 461, an accrual method manufacturer's liability to pay a retailer for cooperative advertising services is incurred in Year 1, the year in which the services are performed, provided the manufacturer is able to reasonably estimate this liability, and even though the retailer does not submit the required claim form until Year 2.

APPLICATION

Any change in a taxpayer's method of accounting to conform with this revenue ruling is a change in method of accounting to which the provisions of §§ 446 and 481 and the regulations thereunder apply. A taxpayer wanting to change its method of accounting for its payments for cooperative advertising services

provided by a retailer to conform with this revenue ruling must follow the automatic change in accounting method provisions of Rev. Proc. 97-37, 1997-33 I.R.B. 18, except that the scope limitations in section 4.02, as well as the application procedures in sections 6.03, 6.04, and 6.05, of Rev. Proc. 97-37 do not apply. However, if the taxpayer is under examination, before an appeals office, or before a federal court with respect to any income tax issue, the taxpayer must provide a copy of the Form 3115, Application for Change in Accounting Method, to the examining agent(s), appeals officer, or counsel for the government, as appropriate, at the same time that it files the copy of the Form 3115 with the national office. The Form 3115 must contain the name(s) and telephone number(s) of the examining agent(s), appeals officer, or counsel for the government, as appropriate.

EFFECT ON OTHER DOCUMENTS

Rev. Proc. 97-37 is modified and amplified to include this accounting method change in the APPENDIX.

DRAFTING INFORMATION

The principal author of this revenue ruling is John P. Moriarty of the Office of Assistant Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, contact Mr. Moriarty on (202) 622-4950 (not a toll-free call).