1-1-1989

The All Events Test Proves Taxing to Magazine Publishers

Nelson James Handy

Recommended Citation
Available at: http://digitalcommons.lmu.edu/elr/vol9/iss1/10

This Notes and Comments is brought to you for free and open access by the Law Reviews at Digital Commons @ Loyola Marymount University and Loyola Law School. It has been accepted for inclusion in Loyola of Los Angeles Entertainment Law Review by an authorized administrator of Digital Commons@Loyola Marymount University and Loyola Law School. For more information, please contact digitalcommons@lmu.edu.
THE ALL EVENTS TEST PROVES TAXING TO MAGAZINE PUBLISHERS

A frequently disputed issue between the Internal Revenue Service ("IRS") and business taxpayers is the timing of the inclusion of revenues and expenses in income. Generally, it is to the taxpayer's advantage to delay the recognition of income to later years and to include expenses in the current tax year. This practice reduces the taxable income and defers the payment of taxes to later years, allowing the taxpayer to earn interest on the amount of taxes deferred. In resolution of one of these timing disputes, the tax court and the Ninth Circuit Court of Appeals were called on to decide whether the Commissioner of the IRS ("Commissioner") has the authority to tax as income the full invoice amount of the magazines shipped when the contract right to be paid depends upon the actual net sales of the magazines at the retail level. This question was answered in the affirmative in Challenge Publications, Inc. v. Commissioner Internal Revenue1 ("Challenge"), by the tax court and upheld by the Ninth Circuit on appeal.

I. HISTORICAL BACKGROUND

Challenge Publications is a California corporation engaged in the business of publishing a variety of magazines. For the tax years between 1972 and 1976, the majority of these magazines were sold to Publishers Distribution Corporation ("PDC") who in turn consigned2 the magazines to retail outlets. During these years the contracts between Challenge Publications and PDC required Challenge Publications to send an invoice to PDC for all magazines sent. However, PDC was only obligated to pay for the magazines which were actually sold. The contract required PDC to make a twenty-five percent deposit within ten days after shipment and to begin making additional payments thirty days after the magazines were taken "off sale."3 These payments were based upon the total amount of magazines PDC estimated to have been sold. The

---

1. 51 T.C.M. (CCH) 342 (1986), aff'd 845 F.2d 1541 (9th Cir. 1988).
2. When goods are consigned, an agency relationship is created between the owner of the goods and the party accepting the goods for purposes of sale to an ultimate party. When goods are consigned the owner of the goods does not realize a sale until goods are sold by the agent. Frank Handfield v. Commissioner, 23 T.C. 633, 637 (1955).
3. The "off sale" date is the day the magazines are to be taken out of circulation by removing them from the shelves and replacing them with the new issue. Challenge, 51 T.C.M. (CCH) 344.
result of this method of payment effectively limited Challenge Publications' right to payment to the estimate of amount sold, even though the invoice amount was much higher.\(^4\)

A common practice in the publishing industry is to ship substantially more magazines than are expected to be sold to enable the retailers to keep their shelves stocked.\(^5\) Keeping the retailers' shelves stocked promotes visibility of the magazines and insures that there will be an adequate stock of undamaged magazines on hand for sale. The contract between PDC and Challenge Publications provided that the unsold magazines after the off sale date were to be credited to PDC.\(^6\) This crediting procedure was accomplished either through sending back the unsold magazines or by PDC delivering an affidavit from the retail stores stating the amount of unsold magazines.\(^7\) This return procedure resulted in the reconciliation of the amount of magazines sold to PDC and the amount of magazines sold at the retail level.

Challenge Publications maintained its books and records and filed its tax returns using the accrual method of accounting. Income Tax Regulation section 1.446-1(c)(1)(ii) defines the accrual method as follows:

Generally, under an accrual method, income is to be included

\[\text{\textsuperscript{4}}\] Pertinent portions of a representative contract are as follows:

1. **PUBLISHER AGREES:**

   (d) to bill Distributor for copies delivered . . . and to credit Distributor for returns of all unsold copies evidenced by full copies, or front covers, or headings, or wholesaler affidavits, at the same price. . . .

2. **DISTRIBUTOR AGREES:**

   (b) to pay Publisher on the basis of net sales of each issue, less Distributor's credits as follows . . . .

   1. An advance of 25\% within 10 days after receipt of completion of shipping card.

   2. Settlement 70 days after off sale subject to additional returns which will be charged to succeeding issues.

   3. Thirty (30) days after off-sale date of each issue, an amount not to exceed 80\% of the balance remaining from the Distributor's estimate of net sale, less all previous advances.

3. **THE PARTIES AGREE:**

   (i) The loss, damage, or destruction to copies of said publication, or evidence of returns of unsold copies, while in transit, or in Distributor's possession, shall be at the risk of the Publisher.

   (j) This contract shall be construed to effect a consummated sale to Distributor of copies shipped F.O.B. to Distributor's consignees . . . .

*Challenge*, 51 T.C.M. (CCH) at 343.

5. *Challenge*, 845 F.2d at 1542.

6. *Id.*

7. *Id.*
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. Under such a method, deductions are allowable for the taxable year in which all the events have occurred which establish the fact of the liability giving rise to such deduction and the amount thereof can be determined with reasonable accuracy. The method used by the taxpayer in determining when income is to be accounted for will be acceptable if it accords with generally accepted accounting principles, is consistently used by the taxpayer from year to year, and is consistent with Income Tax Regulations.8

The Ninth Circuit summarized Challenge Publications’ method of accruing income stating: “Challenge consistently reported on its federal income tax returns its net revenues derived from newsstand sales by recording as income the aggregate sales price of all copies of magazines printed and shipped through its distributor, reduced by the aggregate sales price of estimated unsold copies.”9

The IRS objected to this method of determining income and assessed a deficiency for tax due relating to amounts invoiced but not included in income in the current year. The Commissioner reasoned that Challenge Publications was not entitled to a reduction in income for magazines anticipated to be returned in a subsequent year.10 In response to the Commissioner’s assessment, Challenge Publications petitioned the tax court for a determination as to the proper treatment of magazines expected to be returned.

II. THE TAX COURT’S HOLDING

The tax court first determined the nature of the contracts between Challenge Publications and PDC. If they were consignment contracts, then no sales would be recognized by Challenge Publications until the retail sale of the magazines occurred.11 The tax court found the contracts were clear and unambiguous sale or return contracts, and that Challenge Publications had treated them like sale or return contracts. Moreover, neither PDC nor PDC’s consignees were agents of Challenge Publications and therefore the contracts were properly characterized as sale or return contracts.12

9. Challenge, 845 F.2d at 1542.
10. Challenge, 51 T.C.M. (CCH) at 344.
11. Id. For explanation of consignment see supra note 2.
12. Challenge, 51 T.C.M. (CCH) at 345.
The second issue addressed by the tax court was whether Challenge Publications was required to include in income the gross sales price of magazines shipped to wholesalers in the year the magazines were shipped. The tax court found that in sale or return contracts the total price of goods shipped must be included as income in the period the goods were shipped.\(^\text{13}\)

Lastly, the tax court decided whether the Commissioner properly disallowed petitioner's claimed deductions for anticipated returns of unsold magazines when those magazines were not returned until the next year.\(^\text{14}\) The tax court upheld the judgment of the Commissioner denying Challenge Publications a deduction in the current year for magazines expected to be returned in the following year because such a deduction fails the "all events" test.\(^\text{15}\)

III. NINTH CIRCUIT HOLDING

The issues faced by the Ninth Circuit were much more restricted. The Ninth Circuit determined that review of Challenge Publications' deduction for a business expense under the "all events" test was a question of law, and therefore subject to a de novo review.\(^\text{16}\) The precedents cited on appeal were substantially different than those cited by the tax court. The primary issue was application of the "all events" test to the claimed deduction of magazines expected to be returned. The Ninth Circuit upheld the previous decisions disallowing the expense because the "all events" test was not satisfied.\(^\text{17}\) The secondary issue was whether there could be any other ground for allowing the deduction if the "all events" test has not been satisfied. The Ninth Circuit affirmed the tax court decision determining that in order for an expense to be properly deductible in the current year the expense must satisfy the "all events" test.\(^\text{18}\) The Ninth Circuit did not address either the consignment issue or the accrual of revenue issue.

\(^\text{13}\). *Id.* at 346.

\(^\text{14}\). *Id.* at 348.

\(^\text{15}\). *Id.* at 349. The "all events" test for an expense is the requirement that before a business expense is deductible, all of the events must have occurred which fix the liability and the amount must be reasonably estimable. The reason for this requirement is that it prevents taxpayers from taking deductions in the current year that may never be incurred. *Id.*

\(^\text{16}\). On appeal, questions of law may be argued de novo, and are not limited to the arguments and cases presented at the lower court. *Challenge*, 845 F.2d at 1543.

\(^\text{17}\). *Id.* at 1545.

\(^\text{18}\). *Id.* at 1545, 1546.
IV. CONGRESSIONAL RESOLUTION OF ISSUE

In response to the conflict between magazine publishers and the IRS over the determination of the proper method to account for magazine sales, Congress enacted section 458 of the Internal Revenue Code ("IRC").19 This section allows magazine publishers, book publishers, and record distributors to exclude from income in the current year certain revenues attributable to items to be returned in the following year.20 Therefore, some aspects of Challenge are moot because deductions for magazines expected to be returned may not have to satisfy the “all events” test. However, for those who use sale or return contracts and are not within protection of this statute, this case stands as a precedent that all goods invoiced and sent must be accrued as revenue at invoice amount and that there will be no expense allowed for goods expected to be returned until it is absolutely certain they will be returned. For this reason Challenge Publications, Inc. v. Commissioner must be scrutinized to determine whether the forced accrual of revenue not yet received and not expected to be received is justified.

V. ANALYSIS BY THE TAX COURT

A. Consignment Contract Versus Sale Or Return Contract

As to the characterization of the contracts between Challenge Publications and PDC, Challenge Publications argued that the contracts were consignment contracts and therefore income from magazine sales should only be recognized at the time of the actual retail sale instead of upon shipment. The tax court stated: “[t]he characterization of the contracts between petitioner and PDC is determined from the intention of the parties at the time that the respective contracts were executed.”21

The tax court cited the plain meaning of the contract as indicative of the parties’ intent. The tax court determined that the plain meaning of the contract indicated that a sale and not a consignment was intended.22 The court also heard testimony from the president of PDC that it was not the intent of PDC to be an agent of Challenge Publications. Because a consignment contract necessarily implies an agency relationship, this testimony also refuted the claim that a consignment contract existed.23

The tax court also cited Challenge Publications’ method of account-

---

20. Id.
21. Challenge, 51 T.C.M. (CCH) at 344.
22. Id.
23. Id. See supra note 2 for explanation of a consignment contract.
ing for the sale of magazines as further proof that a consignment contract was not intended. In consignment contracts, all items shipped must remain on the consignor's books as inventory until the sale is recognized by the consignor at the time of the retail sale. Challenge Publications did not follow such a method. Instead, they accrued revenue and expenses at the time of shipment. For these reasons the tax court determined that the contracts between Challenge Publications and PDC were sale or return contracts.

B. Recognition of Revenue

The tax court next addressed the proper timing for the accrual of revenue in a sale or return contract. Citing Spring City Foundry Co. v. Commissioner, and Income Tax Regulations sections 1.446-1(c)(1)(ii) and 1.451-1(a), the tax court set forth the principle that "[g]enerally, under the accrual method of accounting, income is included in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy." The tax court, however, did not apply this principle to the facts present. Instead the tax court relied on Record Wide Distributors, Inc. v. Commissioner for authority that "[u]nder a sale or return contract, petitioner is required to report the income from the sale of merchandise upon delivery of such merchandise to its customers."

In Record Wide, the taxpayer sold records on a sale or return basis. Similar to the contracts at issue in Challenge, the record contracts did not require payments until the goods were sold at the retail level. However, Record Wide Distributors accounted for the transaction by accruing an expense for the cost of goods sold at the time of shipment and accruing revenue at the time payment was received. The tax court and the Eighth Circuit upheld the discretion of the Commissioner in disallowing this method of accounting because the taxpayer was using a hybrid of cash and accrual accounting which did not clearly reflect income.
Lastly, the tax court considered whether Challenge Publications could properly take a deduction in the current year for the estimated cost of goods to be returned in the following year. The tax court began its analysis with the general requirement, from IRC section 446(a), that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books. The tax court noted the exception to this general rule is that if the method used by the taxpayer does not reflect income in the opinion of the Commissioner, then the Commissioner can prescribe a method of computing taxable income which does clearly reflect income.

The tax court cited Thor Power Tool Co. v. Commissioner for the proposition that the Commissioner has broad power in determining whether a method of accounting clearly reflects income. The tax court went on to state that just because a taxpayer follows generally accepted accounting principles in keeping his books does not prove that the taxpayer's method of computing income results in such a clear reflection of income that it should be binding on the Commissioner. This is shown to be particularly true when the taxpayer seeks to deduct an estimated reserve because of the differing goals of financial accounting and tax law.

The tax court then looked to IRC section 461 and Income Tax Regulations section 1.461-1(a)(2) as the applicable statutes for determining the proper time to recognize an expense. The regulation recognizes the

33. Challenge, 51 T.C.M. (CCH) at 346.
34. Id. (citing I.R.C. §§ 446 and 461 (1978)).
35. Challenge, 51 T.C.M. (CCH) at 346.
37. Challenge, 51 T.C.M. (CCH) at 346 (citing Thor, 439 U.S. at 533).
38. Challenge, 51 T.C.M. (CCH) at 347. The differing goals between financial accounting and tax accounting were recognized in Thor Power Tool Co. v. Commissioner, 439 U.S. 522 (1979), wherein the Supreme Court stated:

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. The primary goal of the income tax system, in contrast, is the equitable collection of revenue; the major responsibility of the Internal Revenue Service is to protect the public fisc. Consistently with its goals and responsibilities, financial accounting has as its foundation the principle of conservatism, with its corollary that 'possible errors in measurement [should] be in the direction of understatement rather than overstatement of net income and net assets.' In view of the Treasury's markedly different goals and responsibilities, understatement of incomes is not destined to be its guiding light.

Thor, 439 U.S. at 542 (citing AICPA ACCOUNTING PRINCIPLES BOARD, STATEMENT NO.4, BASIC CONCEPTS AND ACCOUNTING PRINCIPLES UNDERLYING FINANCIAL STATEMENTS OF BUSINESS ENTERPRISES ¶ 171 (1970), REPRINTED IN 2 APB ACCOUNTING PRINCIPLES 9089 (1973)).
39. Challenge, 51 T.C.M. (CCH) at 347.
"all events" test as the applicable standard and sets forth two requirements before an expense may be deducted in the current taxable year: 1) all the events which determine the fact of the liability must have occurred, 2) and the amount must be determinable with reasonable accuracy.40

Challenge Publications argued that the first requirement fixing liability was satisfied because, "under its distribution agreements, its liability to accept, and allow credits for, refunds of unsold magazines was fixed and unconditional as of the time it shipped magazines to PDC's wholesalers."41 The tax court dismissed this argument stating that the liability was not fixed because the contract required PDC to send notification to Challenge Publications stating the amount of magazines unsold before Challenge Publications was obligated to credit PDC's account for returned magazines.42 Further, the court reasoned that this notification was not just a formality, but a condition precedent to the obligation by Challenge Publications to issue credit to PDC. Thus, even though in the past this notification was typically given, in the absence of such notification Challenge Publications was under no obligation to extend the credit. Therefore, the obligation to grant credit for unsold magazines was contingent on notification by PDC of the amount of magazines unsold by sending back actual magazines, portions of magazines, or affidavits stating the amount unsold.43

For authority that such an obligation was contingent, the tax court cited Ertegun v. Commissioner.44 In Ertegun, the taxpayer was a record wholesaler who guaranteed to some of their distributors that they could return for full credit an amount up to ten percent of goods shipped if returned within a specified time. The actual merchandise had to be returned to receive credit. Ertegun accounted for the transaction by recognizing income for the amount of goods shipped, less a ten percent reduction for the goods expected to be returned.45 The Second Circuit, according to the tax court in Challenge, determined in Ertegun that: "the agreement between the taxpayer and its distributors was a sales contract with an option to return unsold merchandise, and that the taxpayer's . . . [liability to credit retailers for merchandise expected to be returned] was

40. Id. (citing Treas. Reg. § 1.461-1(a)(2)).
41. Challenge, 51 T.C.M. (CCH) at 347.
42. Id.
43. Id.
44. 531 F.2d 1156 (2d Cir. 1976).
45. Challenge, 51 T.C.M. (CCH) at 347, 348.
not incurred until the time the unsold merchandise was actually returned."\(^{46}\)

Challenge Publications argued that *Ertegun* was distinguishable because the return of records was required so that the taxpayer could destroy the unused copies and reduce its royalty obligations to the performers. Since there was an economic benefit conferred by the return of the records, the return requirement was not a "ministerial" act. In contrast, no such economic benefit was incurred by the taxpayer in *Challenge* when the notification of unsold magazines was received.\(^{47}\) The tax court rejected this argument stating that the requirement of notification of unsold magazines in *Challenge* "served a substantial function because it enabled the petitioner to insure that it was giving PDC credit only for unsold magazines. Thus, petitioner clearly derived an economic benefit from its receipt of notification of unsold magazines before giving PDC credit."\(^{48}\) The tax court concluded that because the first hurdle of the "all events" test had not been satisfied that the second requirement was immaterial.\(^{49}\)

Challenge Publications relied on two cases as authority that the liability for magazines expected to be returned was fixed and not contingent. The tax court dismissed reliance on these two cases as misplaced. The first was *Gillis v. United States*.\(^{50}\) In *Gillis*, the taxpayer was involved in the exportation of cotton. Upon shipping the cotton and accruing revenue for the goods shipped, the taxpayer would accrue an expense for cotton which did not conform to contract requirements. The basis for the expense was that the taxpayer when shipping the cotton knew that some cotton did not meet contract requirements and therefore a refund would eventually have to be issued to the purchaser. Because the obligation to issue the refund was enforceable by binding arbitration, the court in *Gillis* found that the obligation was fixed and not contingent, and therefore properly expensed at the time of shipping.\(^{51}\)

The tax court in *Challenge* distinguished *Gillis* on the ground that the cotton merchant knew at the time of shipping that he was shipping non-conforming goods. Therefore, the liability was fixed because the cotton merchant knew which goods would be returned. "By contrast, there was no absolute certainty that any of the magazines shipped by petitioner

\(^{46}\) Id. at 348.
\(^{47}\) Id.
\(^{48}\) Id.
\(^{49}\) Id.
\(^{50}\) 402 F.2d 501 (5th Cir. 1968).
\(^{51}\) *Challenge*, 51 T.C.M. (CCH) at 349.
to wholesalers would ultimately be returned as unsold for credit.”

The tax court then reiterated that the test is absolute certainty of obligation. Therefore, the court reasoned, even accepting Challenge Publications’ argument that it is virtually certain that some magazines are going to be returned, virtual certainty still falls short of absolute certainty.

The second case on which Challenge Publications relied was *Pacific Grape Products Co. v. Commissioner.* In *Pacific*, the taxpayer was a canner of fruit who contracted with brokers to find buyers for the fruit. In determining taxable income, the taxpayer would deduct broker commissions not yet paid that were attributable to revenue already accrued. The Ninth Circuit upheld the deduction of the commissions before payment as proper because the obligation to pay the commissions was fixed. The tax court in *Challenge* distinguished *Pacific* because the liability to pay commissions was completely fixed unlike the liability in *Challenge* which was contingent upon notification from PDC.

Challenge Publications' final argument was that recognizing revenue for magazines not expected to be sold would have the effect of mismatching revenue and expense, and therefore income would not be clearly reflected. This argument was dismissed on the ground that “[t]he ‘matching’ principle does not overcome the requirements of the ‘all events’ test for the recognition of income and deductions.”

The tax court cited two cases to demonstrate the point. The first, *American Automobile Association v. United States,* was cited to show that prepaid income, for an insurance company, had to be accrued immediately and not spread over the time in which expenses related to that income accrued. The second was *World Airways, Inc. v. Commissioner,* wherein the taxpayer was by law required to perform a certain amount of maintenance to the planes based on the number of flight hours. The taxpayer was not allowed to accrue expenses for repairs required to be performed in the future, but only allowed the expense when the repairs were actually made.

---

52. *Id.*
53. *Id.*
54. 219 F.2d 862 (9th Cir. 1955).
55. *Id.* at 869.
56. *Challenge,* 51 T.C.M. (CCH) at 349.
57. *Id.*
58. *Id.* at 349, 350.
60. *Challenge,* 51 T.C.M. (CCH) at 350.
61. 564 F.2d 886 (9th Cir. 1977).
62. *Challenge,* 51 T.C.M. (CCH) at 350.
VI. ANALYSIS BY THE NINTH CIRCUIT

A. The "All Events" Test

The Ninth Circuit began their analysis with the application of the "all events" test to the accrual of an expense for magazines expected to be returned. The court cited IRC section 461(a) and Income Tax Regulation section 1.461-1(a)(2), which provide the general rules for determining the proper year in which a deduction should be taken. The Ninth Circuit quoted the following Income Tax Regulation:

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. . . . While no accrual shall be made in any case in which all the events have not occurred which fix the liability, the 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.

The Ninth Circuit cited the origins of the "all events" test, its confirmation as the touchstone for the year an expense accrues, and its acceptance as a fundamental principal of tax accounting. Because the Ninth Circuit found that Challenge Publications had not met the first hurdle of the "all events" test, the analysis, similar to the tax court's opinion, was limited to the first requirement.

To define the general parameters of the "all events" test the Ninth Circuit related the following principles from four United States Supreme Court cases applying the "all events" test to the accrual of an expense:

"A liability does not accrue as long as it remains contingent." "To satisfy the 'all events' test, a liability must be 'fixed and absolute' and 'unconditional.' " "A taxpayer may not 'deduct an estimate of an anticipated expense, no matter how statistically certain, if it is based on

---

63. The Internal Revenue Code is the group of laws enacted by Congress pertaining to taxation. Internal Revenue Code § 7805 gives authority to the Secretary of the Treasury Department to prescribe regulations needed to carry out the IRC.
64. Challenge, 845 F.2d at 1543 (citing Treas. Reg. § 1.461-1(a)(2) (1987)).
65. Challenge, 845 F.2d at 1543.
66. Id. at 1543, 1544.
67. Id. at 1543 (quoting Brown v. Helvering, 291 U.S. 193, 200 (1934)).
events that have not occurred by the close of the taxable year.'” 70 Finally, “a liability need not [sic] be ‘final and definite in amount’ in order to satisfy the first prong of the test.” 71

The Ninth Circuit found the primary issue to be “whether Challenge’s estimate of returned magazines represents a sufficiently fixed, absolute, and unconditional liability.” 72 Each party cited a Supreme Court case to show the proper treatment of expected returns of magazines under the “all events” test. Challenge Publications cited United States v. Hughes Properties, Inc., 73 where the taxpayer was a casino operator who was allowed to deduct an accrued expense for jackpots guaranteed to be won based on past play, but not yet won at the end of the fiscal year. 74 The Commissioner relied on United States v. General Dynamics Corp., 75 where the Court held that a company providing medical benefits to its employees could not accrue the expenses at the time the employees received treatment, but had to wait for the employee to actually submit the claim forms. The Ninth Circuit determined General Dynamics to be the controlling precedent in Challenge. 76

The Supreme Court in General Dynamics did not allow the accrual of the expense because the obligation to pay the medical claims was contingent on the employees submitting the claim forms. Thus, the claimed expense was just a “mere estimate of liability based on events that had not occurred before the close of the taxable year.” 77 In contrast, in Hughes the Supreme Court found that the event establishing liability was the last play of the slot machine which increased the amount of the eventual payout that was irrevocably guaranteed by the casino. 78 In Challenge, the Ninth Circuit agreed with the Commissioner that the event establishing liability for Challenge Publications was the delivery of the notice of unsold magazines from PDC to Challenge Publications, as required in the sales contracts for the issuance of any credit. The Ninth Circuit found this to be adequate ground to distinguish Hughes and to affirm the Commissioner’s deferral of the expense based on General

71. Challenge, 845 F.2d at 1544 (quoting United States v. Hughes Properties, 476 U.S. 593, 600 (1986)).
72. Challenge, 845 F.2d at 1544.
73. 476 U.S. 593 (1986).
74. Challenge, 845 F.2d at 1544.
76. Challenge, 845 F.2d at 1544.
77. Id. (quoting General Dynamics, 107 S. Ct. at 1736).
78. Challenge, 845 F.2d at 1544.
Dynamics.\textsuperscript{79}

To support this decision, the Ninth Circuit cited Readers’ Publishing Corp. v. United States.\textsuperscript{80} Readers’ Publishing involved a magazine publisher who was not allowed to accrue an expense for magazines expected to be returned.\textsuperscript{81} Challenge Publications argued that Readers’ Publishing was distinguishable on the ground that the taxpayer there was not an accrual taxpayer and did not attempt to match income and expenses. This distinction was rejected because matching of income is not an additional requirement of the “all events” test.\textsuperscript{82}

B. Alternative Ground For Deduction

Challenge Publications also argued that the unfairness of the “all events” test when applied to their situation was recognized by the legislature when they enacted IRC section 458.\textsuperscript{83} This provision allows magazine publishers to exclude from gross income the revenue attributable to magazines expected to be returned within seventy-five days of the close of the taxable year. The Ninth Circuit did not apply the principles recognized by Congress in the passage of this provision. Instead, the Ninth Circuit drew support for their decision from the legislative history of IRC section 458. The Ninth Circuit stated that the legislative history confirmed that prior to the passage of IRC section 458, Challenge Publications was required to recognize the full invoice amount of goods shipped irregardless of anticipated returns.\textsuperscript{84}

Finally, Challenge Publications argued that IRC section 446(a) requires taxable income to be computed on the taxpayer’s regular method of accounting. Because their method of accounting conforms to standard industry practice, they argued, that this demonstrates that Challenge Publications’ method is the one required by the Internal Revenue Code.\textsuperscript{85} The Ninth Circuit rejected this assertion without analysis of the code on the ground that the “all events” test entirely governs the issue.\textsuperscript{86} The

\textsuperscript{79} Id.

\textsuperscript{80} Id. (citing Readers’ Publishing Corp. v. United States, 40 F.2d 145 (Ct. Cl. 1930)).

\textsuperscript{81} Challenge, 845 F.2d at 1544, 1545.

\textsuperscript{82} Id. at 1545. For this point the Ninth Circuit cited the three cases earlier cited by the tax court for disposition of the matching argument. For American Automobile Association, see supra note 59 and accompanying text; for World Airways, see supra note 61 and accompanying text; and for Ertegun, see supra note 44 and accompanying text.

\textsuperscript{83} I.R.C. § 458 (1978).


\textsuperscript{85} I.R.C. § 446(a) (1982).

\textsuperscript{86} Challenge, 845 F.2d at 1545 (citing Hughes, 106 S. Ct. at 2096 and General Dynamics, 107 S. Ct. at 1735).
Ninth Circuit went on to state that many generally accepted accounting methods, which clearly reflect income for accounting purposes, do not clearly reflect income for tax purposes. Further, this divergence between tax accounting and financial accounting is especially common when a taxpayer seeks a current deduction for a future expense.  

VII. CRITIQUE OF THE COURTS’ ANALYSIS

A. “All Events” Test

Though the reasoning of the tax court and the Ninth Circuit seem sound it is hard to escape the unfairness of imposing a tax on revenue not yet received, for which there is no right to receive, and which is never expected to be received.

The main issue identified by the courts was the application of the “all events” test to the accrued expense for magazines expected to be returned. The “all events” test originated in a 1920s Supreme Court case and has had a long history of interpretation and change. The courts came to a valid conclusion that Challenge Publications’ obligation to credit PDC for unsold magazines was contingent upon an event which would not occur in the same fiscal year that the deduction was claimed. The obligation was contingent because the contract required notification of unsold magazines before credit was issued. Both the tax court and the Ninth Circuit cited precedent establishing that the obligation to credit PDC in the future failed the “all events” test.

87. Challenge, 845 F.2d at 1545, 1546 (citing Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 541 (1979)).

88. The “all events” test was first introduced in United States v. Anderson, 269 U.S. 422 (1926). The test originally was used to explain when it is proper to accrue an expense. The “all events” test was then incorporated into Income Tax Regulation § 1.446 in 1954, where its use was extended to accrual of revenue. There have been many controversies concerning the application of the “all events” test. The part of the test that was hard to apply was the requirement of proof of liability. The courts adopted a contingency test to help in the application of the “all events” test. If the liability is contingent on almost anything the court may find that it is improper to accrue the liability. Though consistency in application of the “all events” test in the past may have been lacking, the decision of the Supreme Court in General Dynamics, 481 U.S. 239, 107 S. Ct. 1732 (1987), which was decided after Challenge’s tax court case, should add consistency. General Dynamics established that statistical certainty does not satisfy the no contingency requirement, and therefore the court could find any contingency short of the possibility of going out of business as failing the “all events” test. The “all events” test was also incorporated into the IRC in the 1986 revisions under § 461(h).

89. For application of the “all events” test, General Dynamics, supra notes 75 & 76, was cited by the Ninth Circuit in Challenge, 845 F.2d. at 1544, and Thor Power Tool, supra note 36, was cited by the tax court in Challenge, 51 T.C.M. (CCH) at 347.
However, the tax court’s dismissal of *Gillis v. United States*\(^90\) as distinguishable is not justified. An estimate by a cotton exporter of refunds he is bound by contract to pay is just as contingent as an estimate, by a publisher, of credit to be given for magazines expected to be returned. The deduction for cotton expected to be returned is contingent on the purchaser actually claiming the credit. A purchaser of cotton may not notice the inferior cotton or may not claim the credit for other reasons. Nonetheless, the tax court was justified in not relying on *Gillis* for a different reason. In 1987, the Supreme Court in *United States v. General Dynamics*,\(^91\) held that an obligation to pay medical claims is not accruable before the actual vouchers are submitted because the obligation to pay the medical expenses is contingent on the submission of the vouchers.\(^92\) Consequently, the decision by the Fifth Circuit in *Gillis*, holding that an obligation to pay buyers for non-conforming cotton was accruable before such credit was claimed,\(^93\) is now questionable precedent.

In light of the precedents cited by the courts it can be concluded that the description for the “all events” test given by both the tax court and the Ninth Circuit is today an accurate statement of the “all events” test.

**B. Accrual of Revenue**

The tax court disposed of the accrual of revenue issue by citing *Record Wide Distributors, Inc. v. Commissioner*\(^94\) for the proposition that in a sale or return contract the invoice amount must be accrued as revenue at the time of shipment. The Ninth Circuit did not address this issue. The tax court’s reliance on *Record Wide* is inadequate for disposal of the accrual of revenue issue. In *Record Wide*, the taxpayer was selling records on a sale or return basis. The taxpayer’s method of accounting consisted of recognizing the cost of goods sold upon shipment and delaying the recognition of revenue until he actually received payment, which was usually 120 days later.\(^95\) The Eighth Circuit disallowed the taxpayer’s method of determining income because it was a hybrid of cash and accrual accounting which violated the requirement of Income Tax Regulation section 1.446-1(c)(2).\(^96\) This regulation requires businesses

---

\(^90\) 402 F.2d 501 (5th Cir. 1978). *See supra* note 50 and accompanying text for the tax court’s reasoning.


\(^92\) *Id.* at 1737.

\(^93\) *Gillis*, 402 F.2d at 509.

\(^94\) 682 F.2d 204 (8th Cir. 1982).

\(^95\) *Record Wide Distr., Inc. v. Commissioner*, 41 T.C.M. (CCH) 704, 705 (1981).

\(^96\) *Record Wide*, 682 F.2d at 206.
that maintain inventories to use the accrual method of accounting. However, the issue was completely different in Challenge, because Challenge Publications was already using an accrual method of accounting.

It is important to make clear in arguing the issue of exclusion of revenue from income that it is an entirely different issue than accrual of an expense even though each may have the same net effect on taxable income. An expense is an offset against gross income for the purpose of establishing taxable income. It usually represents the cost of producing the income. However, an exclusion from income can imply one of two things. It can imply a statutory exception for an item that is constitutionally income, as in section 458 of the Internal Revenue Code, which today allows magazine publishers an exclusion from income.\footnote{I.R.C. § 458 (1978).} Or, it can refer to an amount of potential income for which the probability of gaining a right to the income is too low to merit inclusion of the amount in gross income. For this reason, the argument that Challenge Publications did not comply with regulations because the “all events” test has not been satisfied for the expense misses the whole point that Challenge Publications had two possible ways to reduce taxable income. Challenge Publications could accrue an expense or defer the recognition of revenue. Because the accrual of the expense was not allowable does not mean the deferral of the revenue was not allowable.

In Conner v. United States,\footnote{439 F.2d 974 (5th Cir. 1971).} the Fifth Circuit recognized that analysis of taxable income is done from both a revenue and expense perspective. This was shown in the court’s statement: “[w]e further agree that the receipt of these funds for the reasons and uses indicated represented no gain to these taxpayers and did not have to be reported as gross income for which there was no corresponding deduction.”\footnote{Id. at 980.} It is this approach that was required in Challenge to determine whether invoice amounts will eventually be included in taxable income. Even though failing the requirements of a deduction, the ability to reduce the taxable income for an amount for which no gain was derived may be proper by excluding the amount in question from gross income.

The other cases cited by the tax court dealing with the accrual of revenue issue can be distinguished on the ground that in those cases the taxpayers gained the contract right to full payment upon delivery of the magazines or records.\footnote{See Ertegun v. Commissioner, 531 F.2d 1156 (2d Cir. 1976). The court did not explicitly state that the taxpayer received the right to payment upon shipment, however in the two}
merchandise did not exist in Challenge Publications' contract. The contract provided Challenge Publications with the right to a twenty-five percent deposit within ten days of delivery and did not grant any further right to payment until thirty days after the off sale date of the magazines. This distinction over right to the payment has been found critical in determining in which year an item of revenue will be included in taxable income. In *Spring City Foundry Co. v. Commissioner,* the Supreme Court stated: "[k]eeping 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." Because the contract did not give Challenge Publications the right to full payment, the obligation to accrue the entire invoice amount cannot be supported under an argument that the accrual method requires recognition of the entire invoice amount.

VIII. Determining the Time to Accrue Revenue

A. Income Tax Regulations

One source of authority for timing the accrual of revenue is the Income Tax Regulations. The Regulations state that for the accrual method "[t]he method used by the taxpayer in determining when income is to be accounted for will be acceptable if it accords with generally accepted accounting principles, is consistently used by the taxpayer from year to year, and is consistent with the Income Tax Regulations." For satisfaction of the requirement of conformance with generally accepted accounting principles, Challenge Publications offered the testimony of two expert witnesses on proper accounting practices to establish that Challenge Publications’ methods were in conformance with the required principles. None of this testimony was contradicted by the Commissioner. The second requirement of the Regulation is consistency in appli-

---

101. See supra note 4 section 2, for contract right to payment. The description the Ninth Circuit gave of Challenge’s right to payment is as follows: "[u]nder the terms of the 1971, 1973, and 1976 agreements, PDC was obligated to pay Challenge only for the net sales of each of Challenge’s magazines, that is, the number of copies shipped less the number of copies unsold." *Challenge,* 845 F.2d. at 1542.

102. 292 U.S. 182 (1934).

103. Id. at 184 (emphasis in the original).


cation of method. There was no indication from the briefs or court opinions that Challenge Publications ever used any method besides the one here in dispute. The last requirement is the compliance with Income Tax Regulations.

Two regulations are of special concern on the issue of proper accounting method for accrual of revenue. Under section 1.446-1(a)(2): "no method of accounting is acceptable, unless, in the opinion of the Commissioner, it clearly reflects income. Under section 1.446-1(c)(1)(ii): "income [under the accrual method] 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."106

B. Clear Reflection of Income

The tax court in Challenge recognized the broad power of the Commissioner in determining whether the accounting method used by a taxpayer clearly reflects income.107 But there are limits. The Seventh Circuit recognized that the Commissioner abuses his discretion when he denies the use of an accounting method that clearly reflects income.108 To be a clear reflection of income an accounting method should match revenue recognized to the period it was economically earned. Accordingly, the expenses of creating that revenue should also be recognized at that time.109 Challenge Publications' method of accounting had that result. At the time the sales were made, Challenge Publications accrued an estimate of the actual revenue that was expected to be received in the future. Accruing estimated revenue is proper under Income Tax Regulation section 1.451-1(a) which states, "[w]here an amount of income is properly accrued on the basis of a reasonable estimate and the exact amount is subsequently determined, the difference, if any, shall be taken into account for the taxable year in which the determination is made."110 This amount, Challenge Publications estimated to have been earned, was sixty percent of the invoice price of the magazines shipped because the other forty percent were not sent with the expectation that they would be

107. Challenge, 51 T.C.M. (CCH) at 346.
108. Artnell v. Commissioner, 400 F.2d 981, 985 (7th Cir. 1968).
109. An alternate theory for a clear reflection of income is one which reflects the actual receipt and distributions of funds. However, such a theory is just simply the cash method of accounting and for the regulations to state that it is acceptable to use an accrual method of accounting for tax purposes only if it results in a cash method is contradictory and therefore such a theory could not be an explanation of clear reflection of income.
sold. They were sent for the purpose of facilitating the sale of the other sixty percent. The invoice amount for the magazines was for all one hundred percent of the magazines sent, but this should not have tax consequences as it is only a bookkeeping entry to keep track of movement of magazines and not a reflection of expected revenue.

Normally when revenue is recognized for only a portion of goods sent, the expense should also be limited to the cost of producing the goods expected to be sold. However, in this case it was proper to expense one hundred percent of the magazines even though only sixty percent were expected to be sold because the cost of producing the other forty percent was a cost associated with the sale of the sixty percent. At the off sale date for the magazines, the inventory value of the unsold magazines is zero, as they have served their purpose and are then disposed of by the retailers, distributor, or the publisher.

The method prescribed by the Commissioner, on the other hand, clearly distorts income. The Commissioner's requirement that Challenge Publications recognize revenue for the magazines that were sent out to facilitate the sale of other magazines clearly did not reflect the economic reality of the transaction nor reflect the actual flow of revenue that occurred. There is no precedent that the sending of an invoice constitutes an economic event deserving of tax consequences. Such a requirement is not present in any method of accounting. The economic reality of the transaction was that Challenge Publications earned the wholesale price for sixty magazines by incurring an expense for the cost of creating one hundred magazines.

C. The “All Events” Test For Revenue

The “all events” test for the accrual of revenue and the “all events” test for the accrual of an expense are both required in Income Tax Regulation section 1.446-1(c)(ii). Assuming that the authors of the regulation intended that the test for accrual of revenue be applied in a method similar to the test for the accrual of an expense, then the description of the “all events” test set forth by the Ninth Circuit should be equally applicable to revenue. The “all events” test as set forth by the Ninth Circuit requires that any accrual that is contingent on an event that has not occurred does not satisfy the “all events” test. Under this rule,

111. Challenge, 51 T.C.M. (CCH) at 343.
113. For a recent tax court case applying the “all events” test to the accrual of revenue see Hallmark Cards, Inc. v. Commissioner of Internal Revenue, 90 T.C. 26 (1988).
114. Challenge, 845 F.2d at 1543.
Challenge Publications would not have to recognize the income from magazine sales until the sale at the retail level, which is the event that establishes Challenge Publications' right to income under the contract.\textsuperscript{115} However, this does not mean that Challenge Publications can defer the recognition of the revenue until the actual retail sale, because this would violate the regulation requiring the use of the taxpayers normal method of accounting. However, in the event the taxpayer's method of accounting does not clearly reflect income and is therefore not accepted by the Commissioner, then the "all events" test should be applied by the Commissioner in determining an appropriate method.

\textit{Schlude v. Commissioner of Internal Revenue,}\textsuperscript{116} is an example of a case in which the Commissioner realized that some potential income was not subject to taxation because the receipt of the revenue was contingent on factors that had not yet occurred. In \textit{Schlude}, the taxpayer was the owner of an Arthur Murray dance studio. The method of accounting used by the taxpayer was determined by the Commissioner to not clearly reflect income. Among other demands made by the Commissioner was the requirement that the taxpayer pay tax on revenue for contracts signed, but not paid for or secured by note. The Commissioner conceded this issue, stating: "\textsc{upon reconsideration, however, we concede the error of accruing future payments which are neither due as a matter of contract, nor matured by performance of the related services.}"\textsuperscript{117} Similarly, in \textit{Challenge}, the taxpayer was not due the funds according to the contract, and the service that was provided was the delivery of magazines that were expected to generate sales for an amount equal to sixty percent of the invoice value of the magazines sent. Therefore, the conclusion again appears that revenue recognized should have been limited to the value of Challenge Publications' performance which was to provide the magazines necessary to generate sales equal to sixty percent of magazines sent.

\textbf{D. Constitutional Limits On Taxation}

Another approach to the issue of taxation is the determination of whether the amount in question is income under the Sixteenth Amendment to the United States Constitution. Two cases where the courts determined limits on the definition of income provide guidance in the resolution of this issue.

\textsuperscript{115} See supra note 101.
\textsuperscript{116} 372 U.S. 128 (1963).
\textsuperscript{117} Id. at 133 n.6.
Eisner v. Macomber is a landmark case in the determination of taxable income. In Eisner, the Supreme Court was called upon to determine whether a stock dividend constituted income. The Supreme Court found that the net result of a stock dividend is that the shareholder still owns the same percentage of outstanding stock and therefore he has not realized any gain recognizable as income. The Supreme Court identified the following as characteristic and distinguishing attributes of income: "a gain, a profit, something of exchangeable value proceeding from the property, severed from the capital however invested or employed, and coming in, being 'derived' that is, received or drawn by the recipient (the taxpayer) for his separate use, benefit and disposal..." Acknowledging that the court was describing growth in capital as being not taxable until actually received, the same principles should be applicable to invoice amounts.

The taxpayer in Challenge never received any money nor had any expectation of receiving the money represented by forty percent of the invoice. There was no gain or profit attributable to this portion of the invoice amount which was expected to be received. If the transaction was structured such that the taxpayer was paid immediately for the entire invoice amount and he had an obligation to repay the distributor for returned magazines, then it is conceivable that funds would have been received for his separate use, benefit, and disposal to the extent necessary to constitute income.

For Challenge Publications, all the profit or gain for the shipment of one hundred magazines was represented by the revenue of sixty magazines less the cost of producing one hundred. The possible revenue for the other forty magazines need not and should not enter the calculation as income unless it is actually received or there is some rational expectation that it will be received. Challenge Publications did not receive anything of exchangeable value for the shipment of the magazines not expected to be sold in excess of the revenue from the magazines which actually sold.

Conner v. United States also dealt with the definition of income under the sixteenth amendment. In Conner, the Fifth Circuit was called upon to make a determination of what portions of insurance proceeds

118. 252 U.S. 189 (1920). The holding of this case has been modified by the requirements under IRC § 305(b) to assure that only stock dividends which are given in proportion to current ownership and are not given as a form of compensation qualify as non-taxable.
119. Id. at 219.
120. Id. at 207 (emphasis in the original).
121. 439 F.2d 974 (5th Cir. 1971).
could be considered income. The Fifth Circuit, affirming in part the district court, stated: "[w]e agree with the district court that there must be gain before there is income within the meaning of the sixteenth amendment."\footnote{122} The only real gain for Challenge Publications was the income attributable to the magazines that were expected to be sold. The gain derived by sending out the additional magazines was represented by revenue from the magazines which actually sold. Challenge Publications accurately estimated their gain upon sending out the magazines by recognizing sixty percent of the invoice amount as income. Any requirement to accrue more revenue than this is not supported by the Sixteenth Amendment to the United States Constitution.

IX. CONCLUSION

The invoice amount attributable to magazines which were not expected to be sold and from which no revenue was expected should not have been included in gross income. The codes and regulations do not require this premature accrual of revenue. Further, invoice amounts for goods not expected to sell are not income under the sixteenth amendment. This precedent taxing invoice amounts, if not overturned, will lead to unfair results if IRC section 458 is ever repealed or if the precedent is applied to similar situations not covered by IRC section 458. Therefore, Challenge Publications, Inc. v. Commissioner should either be overturned or limited to precedent for application of the "all events" test to an expense.

Nelson James Handy