INTERNAL REVENUE SERVICE

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Deborah A. Butler
Assistant Chief Counsel CC:DOM:FS

SUBJECT: Proper Royalty Expense Accrual

This Field Service Advice responds to your memorandum dated May 18, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

A =

ISSUE:

Whether A's royalty expense deduction for royalties paid to authors under book contracts should be computed on the basis of sales less actual returns and a reasonable reserve for returns.

CONCLUSION:

Pursuant to the all events test of section 461(h), A's royalty expense deduction for royalties paid to authors under book contracts must be computed on the basis of sales less actual returns and a reasonable reserve for returns.

FACTS:

A is an accrual basis taxpayer, and its subsidiaries entered into royalty contracts with various authors. Each contract contains the following language regarding the amount of royalty payable to the respective author:

> The Publisher shall pay to the Author a royalty on the retail price of every copy sold by the Publisher, less actual returns and a reasonable reserve for returns.

Typically, authors are paid semi-annually, and subsequent adjustments are made to the extent the estimated reserve for returns differs from actual experience.

For financial accounting purposes, A's accounting conforms to the terms of each contract regarding royalties; that is, A expenses royalties on the basis of sales less actual returns and a reasonable reserve for returns. For tax purposes, A accrues royalty expenses on the basis of books sold less actual returns, which, of course, results in a higher expense figure than the method used for financial reporting.

Using A's Schedule M-1, all royalties expensed on sales of books expected to be returned pursuant to "reasonable reserves" have been disallowed in the statutory notice.

LAW:

Under section 461, deductions are to be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income. Section 461 also requires that a taxpayer's method of accounting clearly reflect income.

Treas. Reg. § 1.461-1(a)(2) provides that under an accrual method of accounting, a liability is taken into account in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability.

Treas. Reg. § 1.461-1(a)(3) provides that if a liability if properly taken into account in an amount based on a computation made with reasonable accuracy and the exact amount of the liability is subsequently determined in a later taxable year, the difference, if any, between such amounts shall be taken into account for the later taxable year.

ANALYSIS:

1. The Contract defines the royalty expense liability

The contract at issue provides that A must pay a royalty on the retail price less actual returns and a reasonable reserve for returns. A argues that the return of sold books is a condition subsequent which should have no effect on the computation of a royalty deduction.

We disagree with A's argument, but, more importantly, the argument is irrelevant. The reserve for estimated returns is not a condition subsequent, but rather is an aspect of the fact of liability of the all events test; that is, the reserve, according to the contract, is part of the equation defining the liability (sales minus (returns and estimated returns)).

The fundamental question involving the "fact of liability" is always whether all operative facts have occurred that establish the liability. Such facts are those that make it clear that a taxpayer has incurred an obligation to take some action, and the action, though not yet taken, is nonetheless fixed. If the existence of the liability is subject to a condition precedent, the obligation is not fixed until the condition has occurred or is satisfied. A classic example may be found in United States v. General Dynamics Corp., 481 U.S. 239 (1987). In that case, the issue was whether an accrual basis taxpayer, providing medical benefits to its employees, may deduct at the close of the taxable year an estimate of its obligation to pay for medical care obtained by employees or their qualified dependents during the final quarter of the year, claims for which have not been reported to the employer. Taxpayer's position was that the liability for medical benefit payments accrued at the time the medical services were received, whether or not a claim for reimbursement had been filed or approved. Thus, taxpayer sought to deduct a reserve for estimates of liabilities which had been incurred but not reported.

The Supreme Court stated that the case involved a mere estimate of liability based on events that had not occurred before the close of the taxable year, and the all events test was not met. The missing event in order to fix the liability (condition precedent) was the filing of properly documented claims forms. 481 U.S. at 244. To receive reimbursement for covered medical services, employees had to submit claim forms to employee benefits personnel. Similarly, in this case, it is unequivocal that the royalty expense owed is less a "reasonable reserve for returns." The specific contract provision defines the royalty owed as the book price, less actual returns and a reasonable reserve for returns. The reserve is a fundamental part of the liability.

On the other hand, a condition subsequent is a condition which may later arise and eliminate a previously fixed liability, and such a possibility does not preclude accrual and deduction of the total liability. For example, in United States v. Hughes Properties, 476 U.S. 593 (1986), taxpayer sought to deduct at the end of each fiscal year an accrued liability for progressive jackpot amounts shown on the payoff indicators of the jackpot machines. Although pursuant to state law and regulation, registered jackpot amounts were recorded daily and could not be turned back to a lesser amount, unless paid to a winning player or unless the change in reading was necessitated by a machine malfunction, the Commissioner's position was that the obligation to pay a jackpot was contingent until a winning handle pull by a patron. Absent a winning handle pull, there was no one who could make a claim for payment and thus no accrued deductible expense existed.

The Court held that the effect of the Nevada regulation was to fix taxpayer's liability; the event creating liability was the last play of each progressive slot machine before the end of the fiscal year, since that play fixed the jackpot amount irrevocably. The Court pointed out, that the identity of the eventual winner was irrelevant to the existence of the basic liability. Furthermore, that an extremely remote and speculative possibility existed that the jackpot might never be won, did not change the fact that, as a matter of state law, taxpayer had a fixed liability. "There is always a possibility, of course, that a casino may go out of business, or surrender or lose its license, or go into backruptcy, with the result that the amounts shown on the jackpot indicators would never be won by playing patrons. But this potential nonpayment of an incurred liability exists for every business that uses an accrual method, and it does not prevent accrual. See e.g., Wien Consolidated Airlines, Inc. v. Commissioner, 528 F.2d 735 (9th Cir. 1976)." 476 U.S. at 605-06. The various possibilities which would result in nonpayment of the liability were conditions subsequent, which did not defeat accrual of the jackpot liability.

This issue does not involve a condition subsequent. Rather, the event that A refers to as a condition subsequent is part of the definition of the liability. We concur with your analysis that the explicit contract language precludes accruing royalties on books reasonably expected to be returned.

We do wish to point out, though, that the contract clause at issue provides a method for A to more accurately estimate its royalty liabilities and to avoid requiring authors to refund in a subsequent period a portion of royalties previously received for books which end up being returned. This method of calculating royalty expenses does not violate the economic performance rules of section 461(h). That is, economic performance for a royalty liability of publishers to authors is based on the service of providing books and their sale. The sale of books creates the liability for royalties, and in this contract the parties agreed that the royalty would be reduced by estimated returns of books purchased in the current period. In contrast, if the contract calculated royalties based on an estimate of future sales of books, that would constitute advance royalties and would violate economic performance, resulting in a premature deduction.

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[redacted] [1] [redacted]

In general, it is not necessary for a taxpayer's related items of income and expense to be precisely matched. Matching is a desired goal of financial accounting rather than an overriding rule of tax accounting. See Hughes Properties, supra, 476 U.S. at 603-04. For example, in Koebig & Koebig v. Commissioner, 23 T.C.M. 170 (1964), taxpayer accrued income only those amounts which were billed during the year, but it deducted expenses actually incurred, even when the expenses were incurred after the last billing date. The Tax Court determined that income was clearly reflected, and it rejected any requirement of precise matching. Similarly, in Fidelity Assocs. Inc. v. Commissioner, T.C.M. 1992-142, the Tax Court allowed the deduction of selling commissions in the year in which the all events test was satisfied notwithstanding the

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Commissioner's assertion that the allowance of such deductions created a mismatch between related items of income and expense and thus caused the taxpayer's method of accounting to fail to clearly reflect income.

In summary, matching is a dominant principle of financial accounting, and although the matching principle may sometimes be used as a sword by the Commissioner, related items of income and expense need not be recorded in the same taxable year in order for income to be clearly reflected. The matching principle is sometimes relevant in testing whether a particular method of accounting clearly reflects income for tax purposes, but matching alone neither condones nor prevents finding a fixed liability or permitting a deduction. In this case, the contract defines the royalty expense deduction. The alleged "mismatch" is required by tax law. Income may not be reduced by estimated returns (because the returns are not deductible pursuant to section 461), and the royalty expense, by contract, must be reduced by estimated returns.

<u>CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS</u>:

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[redacted].

DEBORAH A. BUTLER

By: ________________________

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