Third Circuit addresses when certain accrued liabilities become fixed under all-events test (Giant Eagle)

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In brief

The U.S. Court of Appeals for the Third Circuit on May 6 held in *Giant Eagle, Inc. v. Commissioner*, WL 2609572 (2016), that the accrued liabilities relating to the taxpayer's 'fuelperks!' reward program were 'fixed' for purposes of Section 461 when earned by its customers, and not (as the IRS argued) when redeemed. Businesses with reward programs or rebate accruals should consider whether the court's decision could affect when their liabilities would be deemed fixed under the all-events test.

In detail

Background

Giant Eagle, Inc. is a Pennsylvania corporation that operates supermarkets, pharmacies, gas stations, and convenience stores. To promote customer loyalty throughout its business, Giant Eagle instituted a discounted gasoline and diesel fuel (collectively, 'fuel') promotion called the 'fuelperks!' program. Customers would earn 'fuelperks!' by purchasing qualifying goods or services that were redeemable for reductions in the price of future purchases of fuel. However, 'fuelperks!' rewards expired after three months and could not be redeemed for cash.

On its federal income tax return, Giant Eagle claimed deductions for 'fuelperks!' rewards awarded to customers by year-end and estimated to be paid before the filing of Giant Eagle's tax return. The IRS disallowed the deduction of the accrued 'fuelperks!' liabilities based on the definition of a 'fixed liability' established by the US Supreme Court in *United States v. General Dynamics Corp.*, 481 U.S. 239 (1987). The taxpayer then litigated in the U.S. Tax Court.

In *General Dynamics*, the Supreme Court considered whether an accrual-basis taxpayer's self-insured employee medical plan liabilities represented a 'fixed' liability. For an employee to be reimbursed under such a plan, the employee first must properly submit a claim form to the employer. The Court viewed the act of submitting a claim form to the employer as a condition precedent, rather than as a ministerial technicality. As a result, it determined that the accrual did not meet the 'fixed' prong of the all-events test because no reimbursement was due to the employee if the claim form never was submitted.

Court decisions

The Tax Court in *Giant Eagle* found in favor of the IRS, viewing Giant Eagle's fact pattern as similar to that in *General Dynamics*. The Tax Court ruled that Giant Eagle's liability was not fixed because the right to redeem the rewards was contingent on the customer using a 'fuelperks!' card to make an actual fuel purchase. Giant Eagle appealed to the Third Circuit.

On May 6, the Third Circuit, in a 2-1 decision citing *United States v. Hughes Properties, Inc.*, 476 U.S. 593 (1986), reversed the Tax Court, holding that the rewards were fixed when earned by the customer. The Third Circuit concluded that the Tax Court had misapplied the all-events test as it pertains to recurring expenses by deferring deductions for rewards until customer redemption.

Observation: *Giant Eagle* may be followed by courts in other Circuits, but is binding only in the Third Circuit, which covers Delaware, New Jersey, Pennsylvania, and the Virgin Islands.

The decision in *Hughes Properties* highlighted the importance of state and local law in establishing whether a liability is 'fixed.' In that case, the Supreme Court considered whether a slot machine with progressive jackpots — jackpots that increase with each use until the jackpot is won — resulted in a 'fixed' liability at the end of the tax year. Under Nevada gaming regulations, the slot machine operator could not legally reduce the jackpot prior to payout. Accordingly, the jackpot accrued at the end of the tax year was determined to be 'fixed' because it represented the legally required minimum payout.

In the instant case, the Third Circuit found that the customers had a valid unilateral contract with Giant Eagle. Under Pennsylvania contract law, a unilateral contract legally would obligate Giant Eagle to provide the fuel price reduction as promised. In light of *Hughes Properties*, the liability was fixed — even though the exact amount that would be ultimately redeemed was unknown — because it was based on a legal obligation to perform. The IRS conceded that Giant Eagle met all parts of the all-events test — when applying the recurring-item exception for economic performance — with respect to these accrued liabilities except for the 'fixed liability' prong. Because the Third Circuit determined that the liability was 'fixed' and the IRS conceded that they met all other prongs of the all events test, Giant Eagle was allowed to deduct the liability in the year it became fixed.

Observation: Depending on a taxpayer's facts and circumstances, *Giant Eagle* may be applied more broadly than only to reward programs similar to 'fuelperks!' Taxpayers with loyalty reward programs, such as frequent flyer miles or credit card points, or other rebate accruals, such as Medicaid rebates or merchandise coupons, may benefit from application of the definition of 'fixed' in *Giant Eagle*.

Observation: One key factor in the court's decision was the nature of Pennsylvania law. The Third Circuit focused on how contract law supports the fact that the liability ultimately will be paid and therefore is 'fixed.' Taxpayers seeking to rely on *Giant Eagle* should consider whether state or local law establishes a legal obligation for the taxpayer to pay or perform.

The judge who authored the dissenting opinion noted that he was troubled by the fact that 'fuelperks!' rewards expired after three months. He reasoned that the legal liability for the 'fuelperks!' reward program was not indefinite because it could be extinguished via the reward's expiration provisions and therefore, in his opinion, the requirements of a 'fixed' liability established by *Hughes Properties* were not met.

Observation: When not bound by the Third Circuit, the IRS may choose to challenge positions similar to that taken by the taxpayer in *Giant Eagle*. Accordingly, taxpayers outside the Third Circuit considering accounting method opportunities based on *Giant Eagle* should take note of the dissenting opinion as well as the Tax Court's decision as possible support for IRS challenges.

The takeaway

Taxpayers wishing to apply the Third Circuit's holding in *Giant Eagle* to their own accrued reward program's liabilities now may be able to accelerate these accrued liabilities by filing Form 3115, *Change in Method of Accounting*, if their current method of accounting is to deduct such liabilities when paid. However, before doing so, they should give careful consideration to the specific terms of the reward programs, the impact of state and local law, and other relevant authorities.

Let's talk

For a deeper discussion of how this might affect your business, please contact:

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