DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, DC 20224

OFFICE OF
CHIEF COUNSEL

September 20, 2001

Number: **200203004**
Release Date: 1/18/2002
CC:ITA:B02
TL-N-6800-00
UILC: 461.00-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR Associate Area Counsel (LMSB) – Philadelphia
Attn: Linda S. Bednarz, Air Transportation Industry Counsel

FROM: Associate Chief Counsel (Income Tax & Accounting)
CC:ITA

SUBJECT: Air Transportation Industry – Travel Voucher Expenses

This Field Service Advice responds to your memorandum dated June 21, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

ISSUE

May a commercial airline deduct the estimated incremental cost of transporting passengers in the taxable year a travel voucher is issued and reduce earned revenue by the voucher's face value less this previously deducted amount in the taxable year the voucher is redeemed for a ticket, or must the airline wait to deduct the actual costs incurred in providing the flight service in the taxable year the flight service is provided?

CONCLUSION

The flight service expenses allocable to flights purchased by customers who redeem taxpayer-issued vouchers may not be deducted prior to the time 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. Based on the facts presented, these requirements are not met before the flight services are performed.

FACTS

The taxpayer is an accrual basis commercial airline in the business of providing passenger and cargo flight services within the United States. To maintain customer goodwill, airlines routinely issue travel vouchers when a customer's experience has been unsatisfactory. For example, vouchers may be issued when customers are voluntarily or involuntarily denied boarding or when luggage is lost or damaged.

Vouchers are not tickets but are similar to discount coupons, issued in a customer's name usually for a stated dollar amount. The customer may redeem the voucher in a subsequent transaction with the airline to obtain a free ticket or to reduce the purchase price of a ticket. However, there are certain restrictions on the use of a voucher. The vouchers:

- are valid for 1 year from the date of issuance,
- have no cash surrender value,
- are not transferrable,
- are not replaceable if lost or stolen,
- must be redeemed for a ticket,
- must be redeemed at the airline's ticket office (and not with a travel agent),
- may not be redeemed for tickets on certain "blackout" dates.

The use (or non-use) of a voucher lies totally within the receiving customer's discretion, and a significant percentage of vouchers expire without being redeemed.

In the taxpayer's accounting for its voucher system, there are three significant events:

1. Issuance of the voucher. Upon issuance, the taxpayer, in its financial books and records, debits the appropriate expense account (for example, the "denied boarding" expense account) an amount equal to percent of the voucher face value, at it credits its "travel voucher liability" expense account in the same amount.

   For federal income tax purposes, taxpayer claims a deduction, equal to the percent of face value, for the estimated incremental cost of providing the flight that will be obtained when the customer uses the voucher.

2. Redemption of voucher for a ticket. Upon redemption, the taxpayer debits the "travel voucher liability" account by the percent face value previously credited and credits its "air traffic liability" account in the same amount. The taxpayer also credits its "air traffic liability" account by the remaining percent of voucher face value, matched with a percent face value debit in its "passenger revenue" account.

   Based on this accounting model, for federal income tax purposes the taxpayer, in effect, deducts from gross income the remaining percent face value of the voucher when the voucher is redeemed for a ticket.

3. Exchange of ticket for boarding pass. Upon the exchange of a ticket for a boarding pass (or when the ticket ages beyond 12 months), the taxpayer recognizes the entire face value of the voucher as earned revenue.

The taxpayer includes the face value in income, presumably based on Rev. Proc. 71-21, 1971-2 C.B. 549, at this time.

For example, for a $100 voucher issued for “bumping” an air traveler:

Events	Accounts								Federal Income Tax Treatment
	Denied Boarding		Voucher Liability		Air Traffic Liability		Passenger Revenue		
Issuance of Voucher	$			$					$ deduction
Redemption of Voucher for Ticket			$			$	$		$ deduction
Exchange of Ticket for Boarding Pass					$			$	$100 inclusion

If the customer does not use the voucher, the taxpayer recognizes an amount as earned revenue equal to the previously deducted estimated incremental cost (e.g., percent of the face value) upon expiration of the voucher (1 year from issuance), and includes that amount in gross income for federal income tax purposes.

The taxpayer’s financial accounting and tax treatment of travel vouchers differs from its treatment with respect to tickets that are actually sold. The taxpayer does not establish and deduct a reserve for the future expenses to be incurred in the provision of the future flight service when a customer purchases a ticket. Instead, the taxpayer incurs and deducts the actual expenses for the flight service when the flight service is actually performed and the related revenue is earned and recognized.

LAW AND ANALYSIS

In General

Section 162(a) provides that there shall be allowed as a deduction all the ordinary and necessary expenses *paid or incurred* during the taxable year in carrying on any trade or business. Section 461(a) provides that the amount of any deduction or credit allowed under subtitle A shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

Under an accrual method of accounting, a liability is incurred, and generally is taken into account for federal income tax purposes, 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)(2); see § 461(h); see also United States v. Anderson, 269 U.S. 422 (1926).

Fact of Liability

A taxpayer may not deduct an estimate of an anticipated expense no matter how statistically certain, if the fact of the liability is based on conditional events that have not occurred by the close of the taxable year. United States v. General Dynamics Corporation, 481 U.S. 239 (1987), is the controlling case in this area. In General Dynamics, the taxpayer established a medical plan for its employees under which employees would file claims for reimbursement of medical care expenses. The Court noted there existed various reasons that some employees would not timely file reimbursement forms, and therefore the last event fixing the taxpayer's liability was not the provision of the medical services, but rather the independent action of the claimant in submitting proper reimbursement forms which fixed the liability. Hence the Supreme Court found that the liability was not fixed until the claim forms had been submitted.

Similarly, in Spitzer Columbus, Inc. v. Commissioner, T.C.M. 1995-397, the taxpayer issued coupons to customers, in settlement of consumer fraud claims, valid for either $100 for parts or service, $150 towards the purchase of a new item, or $97.50 cash (if approved by the attorney general). The court held that the taxpayer’s liability was not fixed until a customer presented a coupon, or if the coupon was returned for cash, until the payment was approved; “Where further events must occur before a liability is fixed, an accrual amounts to nothing more than a reserve, and it is well established that in the absence of specific statutory provisions providing otherwise, reserves are not deductible.”

Also, in Artnell Company v. Commissioner, 48 T.C. 411 (1967), reversed on other grounds, 400 F.2d 981 (7th Cir. 1968), the court held that the owner of a baseball team could not deduct anticipated payments to visiting teams when advance tickets were sold; the liability did not become fixed until after the games were played (in accordance with American Baseball League rules).

Conversely, courts have found that the fact of liability is fixed even if a condition subsequent exists that could later reduce or eliminate the payment obligation. See Cooper Communities v. United States, 678 F. Supp. 1412 (W.D. Ark. 1987) (liability for sales commissions was fixed, even though, in the event of a default, no further commissions would be paid on future installment payments); Lawyer's Guaranty Fund v. United States, 508 F.2d 1 (5th Cir. 1975) (an attorney's right to commissions for writing insurance policies was fixed at the time accrued, though subject to reduction due to negligence or other operating losses); Central Cuba Sugar Co. v. Commissioner, 198 F.2d 214 (2d Cir. 1952) (liability for brokerage commissions was fixed although the sales contracts might not finally be executed or the amount of the commissions may later be adjusted).

Courts have found a fixed liability in situations where an expense is certain to be incurred under relevant law. In United States v. Hughes Properties, Inc., 476 U.S. 593 (1986), the taxpayer, a casino, was allowed a deduction for its slot machines' accrued jackpot payoff amounts as the amount increased, rather than when paid out, as the taxpayer was absolutely liable, under local gaming regulations, to award the accrued amount. Similarly, in Gold Coast Hotel & Casino v. United States, 158 F.3d 484 (9th Cir. 1998), a Nevada partnership set up a "slot club," and members received "points" when they gambled at the taxpayer's casino that could be redeemed for merchandise. Once a member accrued 1,200 points (the minimum number of points required for redemption), the taxpayer's liability to the member was fixed under local gaming regulations; the court allowed a deduction for the value of those points. Also, in Harrold v. Commissioner, 192 F.2d 1002 (4th Cir. 1951), the court found that the taxpayer's liability for strip mining reclamation costs was fixed in the taxable year the land was stripped because of laws requiring such reclamation.

Travel vouchers are subject to several conditions precedent upon issuance. Applying the cases discussed above to the facts at hand, it is clear that until these conditions are met, there is no fixed liability. Similarly, a traveler's redemption of a voucher for a ticket does not establish the fact of liability, as the ticket must be redeemed for a boarding pass before the traveler can receive the flight services. This is similar to the situation in the Spitzer Columbus case, where the fact of liability with respect to a coupon was not fixed until the coupon was presented for goods or services.

Amount of Liability

Even if the taxpayer can establish that the liability was fixed upon issuance of the voucher, the taxpayer would still be prevented from accruing any expenses unless it could be shown that the amount of the liability could be determined with reasonable accuracy.

In United States v. General Dynamics Corp., 481 U.S. 239, 243 (1987), the Supreme Court reiterated the long established rule that a taxpayer may not deduct an estimate of an anticipated expense, no matter how statistically certain, if it is based on events that have not occurred by the close of the taxable year. See Brown v. Helvering, 291 U.S. 193, 201 (1934); cf. American Automobile Assn. v. United States, 367 U.S. 687, 693 (1961). In Simplified Tax Records, Inc. v. Commissioner, 41 T.C. 75, 82 (1963), the court stated: "Where the operative facts giving rise to the future expenses have not occurred in the year of accrual, the estimated expenses cannot be deducted even though they can be estimated with reasonable certainty and even though prudent business requires that a reserve be set up."

In Spitzer Columbus, Inc. v. Commissioner, supra, the Court found that the taxpayer’s liability could not be determined with reasonable accuracy; the taxpayer had the burden of proving the amount of its liability and had failed to do so.

Even if the taxpayer can statistically forecast the number of vouchers that would be used and the applicable expenses in honoring them, this is not sufficient to satisfy the second prong of the "all events" test.

The taxpayer treats percent of the face value of a voucher as an estimate of its anticipated incremental flight-related costs (meals, fuel, baggage handling, etc.). The taxpayer’s methodology, however, fails to tie this figure to any actual costs (including costs that will not be incurred with respect to vouchers that are not redeemed for tickets).

Economic Performance

Section 461(h)(1) provides that in determining whether an amount has been incurred with respect to any item during any taxable year, the all events test shall not be treated as met any earlier than when economic performance with respect to such item occurs. Section 461(h)(2)(B) provides that if the liability of the taxpayer requires the taxpayer to provide property or services, economic performance occurs as the taxpayer provides such property or services. See also § 1.461- 4(d)(4)(i).

When a travel voucher is issued to a customer, economic performance does not occur until the flight service is performed for the customer. It is only when the customer actually flies using the ticket acquired with the voucher that the airline incurs the incremental costs in performance of the flight service. Prior to this time, the only cost incurred by the airlines would be the actual administrative cost of the issuance of the travel voucher, e.g. paper, ink, ticket agent payroll. These costs are deductible as incurred and are not at question.

Section 461(h)(3) provides a "recurring item” exception to the economic performance requirement; see also § 1.461-5(b)(1)(ii). This exception applies if: (1) the "all events" test is otherwise satisfied with respect to economic performance; (2) economic performance occurs on or before the earlier of the date the taxpayer files a timely return or within eight and one half months after the end of the taxable year; (3) the item is recurring in nature; and (4) either the item is not a material item or the accrual of the item results in a more proper match against income than if the item were accrued in the year of economic performance.

Since the taxpayer in the present case has failed to meet the "all events" test, the taxpayer fails the first part of the recurring item exception. Turning to the second part, it is clear that there will be numerous instances that the economic performance will occur after the applicable time period (because the vouchers are valid for 1 year, and the flight services will be provided subsequent to that). Presumably the incremental expenses are, in fact, recurring in nature, thus satisfying the third part. As to materiality, § 1.461-5(b)(4)(i) indicates that the size of the item must be considered in absolute terms and in relation to the taxpayer's income and other expenses. In the present case, the issue involves tax adjustments of more than $1 million.

Finally, the taxpayer would not meet the final requirement of the economic performance test which provides that even if the item is material, the recurring item exception would be applicable if deduction of the expense in the tax year prior to economic performance results in a better matching of the expense with the income to which it relates. However, this is clearly not met, as the taxpayer does not take into account any income related to these expenses until the flight services are performed.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Please call (202) 622-7900 if you have any further questions.

Sincerely,
HEATHER C. MALOY
By: CLIFFORD M. HARBOURT
Senior Technician Reviewer
Branch 2