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JUST ENOUGH: SUBSTANTIAL PERFORMANCE, MINISTERIAL ACTS AND THE ALL EVENTS TESTS FOR INCOME AND EXPENSE ACCRUALS

by

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JUST ENOUGH: SUBSTANTIAL PERFORMANCE, MINISTERIAL ACTS, AND THE ALL EVENTS TESTS FOR INCOME AND EXPENSE ACCRUALS

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I. INTRODUCTION

The tax law sets unrealistic expectations for accruing many income and expense items arising out of bilateral contracts. Under an accrual method, a taxpayer generally takes an income item into account when the taxpayer has a fixed right to receive it and takes an expense item into account when the taxpayer has a fixed liability to pay it.[1] The tax law thus expects the taxpayer to determine when all events have occurred to make the right or liability unconditional.[2] The taxpayer might find this determination easy if it were to exchange only one promise for one promise (e.g., seller only promises to perform services and buyer only promises to pay), use words establishing conditional relationships (e.g., the buyer promises to pay if and only if the seller performs the services), and experience nothing short of complete performance (e.g., the seller never provides nonconforming services). But the taxpayer probably doesn't engage in those transactions very often.

For most transactions, the taxpayer will find it difficult to determine whether all events have occurred to fix rights and liabilities from bilateral contracts. For example, consider a contract that contains a typical explicit requirement that a service provider submit an invoice to a client to receive payment for rendered services. Once the services have been performed, the accrual method rules contemplate that the parties will determine whether the submission of the invoice represents an event that must occur to fix the service provider's right to income and the client's liability to pay under the contract. That determination might prove difficult because some authorities and guidance have disregarded requirements to submit documentation[3]

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1. See Reg. § 1.446-1(c)(1)(ii)(A) (as amended in 2006).

2. See id.

3. See, e.g., Dally v. Commissioner, 227 F.2d 724, 726 (9th Cir. 1955) ("This mere mechanical act of making out the necessary voucher did not operate to postpone the accrual of the sum which had been earned.") (citing Commissioner v. Dumari Textile Co., 142 F.2d 897, 899-900 (2d Cir. 1944)); Frank's Casing Crew & Rental Tools, Inc. v. Commissioner, T.C. Memo 1996-413, 72 T.C.M. (CCH) 611, 612-13 (1996) ("Petitioner must accrue income from the goods and services in the taxable year in which performance occurs, and it cannot wait until the year in which

whereas others have treated the satisfaction of such requirements as a prerequisite to any finding of fixed rights and liabilities.[4] Aside from raising questions about how to reconcile the authorities and guidance, the differences in treatment highlight a larger issue that tax accounting rules occasionally require, but do not always permit—accruals prior to the full performance of all promises contained in bilateral contracts. As a consequence, taxpayers need to consider whether the occurrence of substantial performance, rather than full performance, represents the last event that must occur to fix rights and liabilities for tax purposes.

This Article explores the role of substantial performance under the all events tests of sections 451 and 461 by placing particular emphasis on its application to ministerial acts. Because these Code sections focus on unconditional rights and liabilities, Part II starts with a discussion of conditions constructed by courts to preserve expectations and avoid forfeitures in accordance with promises contained in bilateral contracts. This discussion of contract law then describes why, in response to additional concerns about fairness, courts treat the substantial performance of certain promises as satisfying the conditions that the courts construct. The discussion illustrates how a party's substantial performance, rather than full performance, can establish unconditional rights and obligations under a contract.

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it invoices its customer."); Rev. Rul. 98-39, 1998-2 C.B. 198 ("Y's submission of a claim form and proofs of performance . . . 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[, and] . . . not a condition precedent that is necessary to establish X's liability for § 461 purposes.").

4. See, e.g., United States v. General Dynamics Corp., 481 U.S. 239, 244 (1987) ("[The taxpayer was] liable to pay for covered medical services only if properly documented claims forms were filed . . . . Such filing is not a mere technicality. It is crucial to the establishment of liability on the part of the taxpayer."); Challenge Publ'ns, Inc. v. Commissioner, 845 F.2d 1541, 1544 (9th Cir. 1988) ("It seems plain that under the agreement, Challenge was under no obligation to reimburse PDC without these evidences of unsold copies. Therefore, it cannot be said its liability to PDC was fixed, absolute, and unconditional at the time of shipment, but only at the time of the returned documents."); Tech. Adv. Mem. 94-16-004 (Dec. 23, 1993) ("Thus, the contract term is controlling in determining what events fix the dealer's right to income and Taxpayer's obligation to reimburse for advertising expenses. The contract . . . provides that a dealer association will be reimbursed if its expenditures are properly substantiated and it fulfills certain other requirements. Since this requirement appears to delineate the performance required by the contract, it is no less an element of performance than any other requirement . . . . The parties determined the provisions of the contract and there is no indication that the parties did not intend for all terms and conditions to be met.").

The remainder of the Article discusses substantial performance in the context of the tax law. Part III considers how substantial performance, as developed under contract law, might and should impact income and expense accruals under the all events tests. This consideration begins by examining a poorly-explained anomaly under the all events tests that disregards unfulfilled requirements to perform ministerial acts in determining when to accrue income and expense items. That Part then explains that the all events tests could better justify such accruals, despite the unfulfilled requirements, by treating a party's substantial performance under the contract as being sufficient to fix certain rights and liabilities. Finally, that Part of the Article suggests that the all events tests cannot confine considerations of substantial performance to ministerial acts. Accordingly, that Part argues that a party's substantial performance—rather than full performance—of primary contractual obligations would similarly require accruals for those obligations. Finally, Part IV describes the desirability of taking substantial performance into account in applying the all events tests, despite the difficulty of the resulting analyses, to the extent such applications also reflect any constructive conditions to the parties' contractual obligations.

II. CONSTRUCTIVE CONDITIONS AND THEIR SATISFACTION THROUGH SUBSTANTIAL PERFORMANCE

Although parties exchange promises as their requisite consideration in forming a bilateral contract,[5] the valid formation of the contract does not assure that the parties will or must perform as promised. Instead, conditions can affect a party's obligation to perform. A condition precedent makes the maturity of a performance obligation depend on the occurrence of an event, which is not guaranteed to occur.[6] In other words, a promisor might lack an obligation to do *X* as promised unless and until the condition of *Y* occurs. Prior to the occurrence of *Y*, the unexcused condition precedent would foreclose both a definite obligation to perform *X* as promised[7] and any allegation of breach attributable to the promisor's nonperformance.[8]

5. See Johnson Enters. of Jacksonville, Inc. v. FPL Group, Inc., 162 F.3d 1290, 1311 (11th Cir. 1998) (noting that a contractual promise is not enforceable unless supported by consideration and, in a bilateral contract, "the exchange of promises by both parties constitutes consideration").

6. See Restatement (Second) of Contracts § 224 (1981). An event certain to occur, such as a mere passage of time, cannot serve as a condition because the certainty establishes a definite performance obligation. See id. § 224 cmt. b.

7. See id. § 225(1).

8. See id. § 235 cmt. b ("Non-performance is not a breach unless performance is due.").

A. Constructive Conditions to Performance Obligations

Conditions precedent originate from several sources. Express and implied conditions originate from the intentions of contracting parties to make an obligation to perform contingent on the occurrence of a specific event.[9] Express conditions appear in the oral and written language used to describe an agreement in terms of a conditional obligation.[10] Implied conditions (occasionally called implied in fact conditions) reflect the parties' understandings of a conditional obligation as evidenced, for example, by prior course of dealings, trade usage, or the general nature of the agreement.[11] Express and implied conditions, therefore, regulate the maturity of a performance obligation in accordance with the contracting parties' intentions.

In contrast, courts use their equitable powers to fashion constructive conditions for otherwise unconditional promises of future performance. A court would read a constructive condition (occasionally called an implied in law condition) into a contract where the parties have omitted a term that the court considers essential for determining their rights and obligations.[12] Rather than interpreting the parties' intentions as reflected in express and implied conditions, a court might impose a constructive condition on a promise where necessary to address circumstances beyond those originally contemplated by the parties.[13] For example, a court might make the performance of promised work, in accordance with industry standards, a condition to a promise to make progress payments for such work. Such a condition would permit the payor to stop making payments if the work quality were to become unacceptable.[14] A construction would thus condition the payment obligation on the rendering of acceptable work to meet a need identified by the court irrespective of the seemingly unconditional relationship established by the parties.

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9. See id. § 226 cmt. a.

10. See id. § 226 cmt. c.

11. See id.

12. See id. § 226 cmts. a, c.

13. See Edwin W. Patterson, Constructive Conditions in Contracts, 42 Colum. L. Rev. 903, 913 (1942) (describing constructive conditions as "gap fillers").

14. See K & G Constr. Co. v. Harris, 164 A.2d 451, 455-56 (Md. App. 1960) ("It would, indeed, present an unusual situation if we were to hold that a building contractor, who has obtained someone to do work for him and has agreed to pay each month for the work performed in the previous month, has to continue the monthly payments, irrespective of the degree of skill and care displayed in the performance of work, and his only recourse is by way of suit for ill-performance.").

Constructive conditions of exchange[15] often become necessary to avoid hardship and achieve justice[16] where parties to a bilateral contract fail to specify whether the promised performance of one party depends on performance by the other party.[17] Early court decisions had routinely found the absence of express and implied conditions indicative of independent relationships between promises.[18] In dealing with independent promises, a court would have held a defendant to its facially unconditional promises in a contract even if the plaintiff had neither fulfilled nor offered to fulfill its promises in that contract.[19] Courts simply enforced each promise as made by contracting parties.

The judicial approach changed by the landmark decision *Kingston v. Preston*,[20] which used constructive conditions to establish dependent relationships between promises of performance.[21] *Kingston* involved a contract wherein a buyer promised to put up adequate security for the buyer's obligation to make installment payments for property acquired from a seller.[22] The court found that the receipt of security for future payments was so fundamental to the contemplated installment sale that the court made the buyer's delivery of (or offer to deliver) adequate security a necessary condition precedent to the seller's promise to convey the underlying property.[23] In short, despite the absence of express and implied conditions, the court refused to compel a conveyance of the property because the court

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15. This Article focuses on constructive conditions of exchange, which reflect a "mutual dependency of promises," Patterson, supra note 13, at 907, without addressing other possible constructive conditions, such as conditions of cooperation and frustration. See generally id. at 928-54 (describing various constructive conditions).

16. See Dorn v. Stanhope Steel, Inc., 534 A.2d 798, 805 (Pa. Super. Ct. 1987).

17. See Restatement (Second) of Contracts § 232 (1981).

18. See, e.g., Nichols v. Raynbred, 80 Eng. Rep. 238 (K.B. 1615).

19. See Damien Nyer, Withholding Performance for Breach in International Transactions: An Exercise in Equations, Proportions or Coercion?, 18 Pace Int'l L. Rev. 29, 53 (2006) ("[I]t was thought that a party confronted with the other party's non-performance remained obligated to perform his part of the deal.").

20. 98 Eng. Rep. 606 (K.B. 1773), *discussed in* Jones v. Barkley, 99 Eng. Rep. 434, 436-37 (1781). Courts arguably recognized dependent relationships between promises prior to *Kingston*. See generally William M. McGovern, Jr., Dependent Promises in the History of Leases and Other Contracts, 52 Tul. L. Rev. 659 (1978) (arguing against a commonly-held notion that the law developed from treating promises as independent to treating them as dependent).

21. See Kingston v. Preston, 98 Eng. Rep. 606 (K.B. 1773), *discussed in* Jones v. Barkley, 99 Eng. Rep. 434, 436-37 (1781).

22. See id.

23. See id.; see also Restatement (Second) of Contracts § 234 cmt. b (1981).

could not construe the seller's promise to convey as being wholly independent of the buyer's willingness to provide security for the future payments.[24] *Kingston* thus began a trend of finding dependent relationships between promises of performance in recognition of the fact that, although parties exchange promises in forming bilateral contracts, they ultimately expect to exchange performances.[25] Today, absent a clear showing of contrary intention, a presumption exists that parties expect to exchange all performances as promised in a contract.[26] Constructive conditions help protect these expectations by allowing a party to defer performance—thereby minimizing a risk of forfeiture—until receiving some assurance that the other party will also perform as promised.[27]

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24. See Kingston v. Preston, 98 Eng. Rep. 606 (K.B. 1773), *discussed in* Jones v. Barkley, 99 Eng. Rep. 434, 436-37 (1781).

25. See Restatement (Second) of Contracts § 232 cmt. a (1981); see also id. § 231 cmt. a ("Ordinarily when parties make such an agreement [by exchanging promises], they not only regard the promises themselves as the subject of an exchange, but they also intend that the performances of those promises shall subsequently be exchanged for each other.") (citation omitted).

26. See id. § 232; see also id. § 232 cmt. a ("When the parties have exchanged promises, there is ordinarily every reason to suppose that they contracted on the basis of such an expectation since the exchange of promises would otherwise have little purpose."). The presumption avoids the task of deciding what relationships exist between various contractual promises, including those of purportedly minor importance, due to the expectation that each party will exchange all of its promised performances for all of the promised performances of the other party. See id. § 232 cmt. b. Instead, the relative importance of any failure of promised performance comes into question in determining the materiality of such failure. See infra notes 58-64 and accompanying text.

27. See id. § 234 cmt. a. Professor Andersen aptly explained the holding in *Kingston v. Preston*:

> The buyer was correct, of course, that the seller might have brought a separate action seeking damages for breach. But that remedy would have fallen far short of protecting the seller's position under the contract. It probably was precisely because the seller doubted the likelihood of collecting damages in the event of default in payment of the purchase price that the buyer's promise to provide security had been included in the agreement in the first place. The only safe way to protect the seller's interest was to permit him to withhold his own performance if the security were not forthcoming. It was exactly that remedy that was made available by the "dependency" or constructive condition relationship declared by Lord Mansfield.

Eric G. Andersen, A New Look at Material Breach in the Law of Contracts, 21 U.C. Davis L. Rev. 1073, 1079 (1988) (footnote omitted).

However, the resulting doctrine of constructive conditions does not purport to establish dependent relationships between all promises in bilateral contracts. Instead, it anticipates that courts will supply constructive conditions only as needed to avoid hardship and achieve justice in enforcing the orderings of performance as determined from supplemental timing rules and contracting parties' agreements/intentions. The supplemental timing rules generally presume that promised acts capable of simultaneous performance will become due concurrently.[28] For example, promises to convey and to pay for property in a sale would generally become due at the same time. In contrast, the timing rules treat promised acts requiring time to complete, like a promise to render personal services, as becoming due before promised acts that do not, like a promise to pay for such services.[29] The timing rules thereby set a default ordering for promised performances, which the parties may modify as they deem appropriate.[30] A sense of fairness then suggests that a party should not be asked to perform as promised unless any performance due earlier has already occurred or any performance due simultaneously will occur.[31]

Constructive conditions achieve this desired fairness by establishing dependent relationships among promises consistent with the ordering of performances. With respect to concurrently due obligations, constructive conditions generally make each obligation to perform depend on the other party's simultaneous performance or offer to perform.[32] Consequently, neither party would need to perform without reasonable assurance of simultaneous performance by the other party.[33] With respect to sequentially due obligations, performance of the earlier due obligation (e.g., rendering services) generally serves as a constructive condition for the later due obligation (e.g., a promise to pay for the services) whereas the earlier due obligation exists without any constructive conditions (i.e., an independent promise).[34] Fairness keeps a party from having to perform if an earlier due obligation has not been fulfilled. But no injustice occurs by treating the earlier due obligation as unconditional because the parties would have

28. See Restatement (Second) of Contracts § 234(1) (1981).

29. See id. § 234(2); see also id. § 234 cmt. f (noting the typical application of the timing rule to contracts involving services).

30. See id. §§ 234, 234 cmt. a ("Even absent an express provision, a contrary intention may be shown by circumstances including usage of trade and course of dealing.") (citations omitted). For example, parties might explicitly state a date on which promised performances become due.

31. See id. § 237 cmt. a.

32. See id. § 238.

33. See id. § 238 cmt. a.

34. See id. § 237.

anticipated its fulfillment prior to the performance of other promised acts.[35] Constructive conditions thus help secure expectations about exchanges of performance and minimize risks of forfeiture[36] where contracting parties have not addressed those concerns themselves.[37]

Constructive conditions become particularly relevant upon a material failure of promised performance, including any defective performance or an absence of performance.[38] The nonoccurrence of performance prevents any obligation, which was constructively conditioned on that performance, from falling due.[39] A party with an obligation subject to such an unsatisfied condition could accordingly withhold performance of that party's own promise without breaching the contract.[40] Therefore, in a lawsuit, a court must evaluate constructive conditions to determine which party, if any, to charge with the first material failure of performance.[41] That initial failure would then justify the nonperformance of all remaining promises that never became due as a result of unsatisfied constructive conditions.[42] Accordingly, in frequent contractual disputes where both parties fail to complete their promised performances, the identification of a first material failure of

35. See id. § 234 cmt. e ("Since one of the parties must perform first, he must forego the security that a requirement of simultaneous performance affords against disappointment of his expectation of an exchange of performances, and he must bear the burden of financing the other party before the latter has performed."); see also Patterson, supra note 13, at 918 (noting that students extend credit by paying tuition in advance of receiving instruction).

36. See Restatement (Second) of Contracts § 234 cmt. a (1981); see also Robert H. Jerry, II, Insurance, Contract, and the Doctrine of Reasonable Expectations, 5 Conn. Ins. L.J. 21, 45 (1998) ("This doctrine rewrites text in the sense that it adds terms to the contract that are simply not there; but no one seriously argues that courts, at least with respect to the doctrine of constructive conditions, should abstain from rewriting text to enable the reasonable expectations of the parties to be protected.").

37. See Restatement (Second) of Contracts § 234(1) (1981) (prescribing an order for performances "unless the language or the circumstances indicate the contrary"); id. § 234(2) (same); id. § 239(2) (describing an assumed risk of having to perform a promised obligation despite the absence of a forthcoming exchange due to the nonoccurrence of a condition).

38. See id. § 237 cmt. a.

39. See id. §§ 225(1), 237.

40. See id. § 235 cmt. b.

41. See id. § 237 cmt. b.

42. See id. §§ 225(2), 237. The failure would initially justify a suspension of any obligation for future performance before resulting in a discharge of the obligation. See id. § 242.

performance helps resolve whether one party's failure to perform justified the other party's nonperformance.[43]

B. The Satisfaction of Constructive Conditions Through Substantial Performance

The use of a materiality standard in assessing failures of performance has meant that something less than full performance can satisfy constructive conditions. Full performance generally must occur before an obligation becomes due under an agreement that makes such performance an express or implied condition of the obligation.[44] If a court were to otherwise accept less than full performance of an express or implied condition, then the court would frustrate the contracting parties' clear intentions to have such condition applied strictly. So contracting parties can expect that a court will demand full performance of any promised acts that function as triggering events for conditional obligations, even if such demand produces harsh consequences, where the parties intended that result.[45] Conversely, contracting parties might reasonably expect less exacting standards for satisfying judicially constructed conditions, which were designed to meet needs identified by a court rather than outcomes intended by the parties.[46]

Consistent with that expectation, the less demanding standard of substantial performance has been applied to constructive conditions. Under that standard, no material failure of performance occurs as long as a party has substantially performed or offered to perform as promised.[47] Accordingly, any remaining obligation constructively conditioned on the performance of a promised act becomes due upon substantial performance of that act even though a claim for damages might arise from the failure to perform fully as promised.[48]

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43. See id. § 237 cmt. b.

44. See id. § 226 cmt. c.

45. See id.; id. § 237 cmt. d ("If . . . the parties have made an event a condition of their agreement, there is no mitigating standard of materiality or substantiality applicable to the nonoccurrence of that event. If, therefore, the agreement makes full performance a condition, substantial performance is not sufficient . . . .").

46. See id. § 226 cmt. c.

47. See id. §§ 237 cmt b, 238 cmt. a.

48. See id. §§ 235(2), 235 cmt. b ("When performance is due, . . . anything short of full performance is a breach, even if the party who does not fully perform was not at fault and even if the defect in his performance was not substantial."), 236 cmt. a ("Every breach gives rise to a claim for damages . . . ."), 241 cmt. a ("Even if not material, the failure may be a breach and give rise to a claim for damages for partial breach.").

The willingness of courts to accept substantial performance as satisfying constructive conditions seems compelled by the same notion of fairness used to justify the construction of those conditions. In supporting mutual expectations about an exchange of performances, constructive conditions avoid hardship and achieve justice by shielding a party from demands that it fulfill its later-due obligations where an earlier due performance has not occurred.[49] As a shield, these conditions minimize the risk that the party would forfeit its later-due performance if the benefit of return performance were not forthcoming. For example, a constructive condition minimizes the risk of having to pay for work that will never be performed by generally permitting an employer to avoid paying an employee until after the employee has provided services.[50]

These concerns about a risk of forfeiture shift once a party has substantially performed. Fairness then suggests that the performing party should expect to receive the benefit of return performance rather than to forfeit its own performance (albeit deficient).[51] So fairness suggests that the employee in the above example should receive payment, less any damages, for providing services even if the employee's work were to deviate somewhat from the original promise of performance. Courts achieve such fairness by accepting substantial performance as the satisfaction of a constructive condition to other performance obligations. This acceptance thereby prevents the defensive shield provided by a constructive condition from morphing into a weapon that a party might otherwise use to threaten nonperformance of its promises as a result of immaterial nonconforming performance of other requirements in a contract.[52]

Substantial performance thus significantly affects performance obligations. As a long-standing complement to constructive conditions,[52] substantial performance mitigates the harshness that demands for full

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49. See supra text accompanying notes 20-27.

50. See Restatement (Second) of Contracts § 234 cmt. e (1981) ("Centuries ago, the principle became settled that where work is to be done by one party and payment is to be made by the other, the performance of the work must precede payment, in the absence of a showing of contrary intention . . . . [M]ost parties today contract with reference to the principle . . . .").

51. See id. § 241 cmt. d. The performing party should also expect to be held accountable for damages attributable to the failure to perform fully. See supra note 48 and accompanying text.

52. See Patterson, supra note 13, at 925-26 (describing how a constructive condition gives a party with a conditional obligation "a method of coercing performance" from the other party).

52. See Boone v. Eyre, 126 Eng. Rep. 160 (K.B. 1777) (recognizing the need for substantial performance four years after Kingston v. Preston established constructive conditions).

performance might otherwise inflict.[53] For example, in its classic application to construction contracts,[54] the doctrine of substantial performance permits a contractor to receive compensation (less an allowance for damages) for building a house despite having installed the wrong brand of pipe during construction.[55] Although the obligation to pay for the house would normally depend on completion of its promised construction, the obligation would become due even with the deviation. Such a trivial and insignificant deviation from the promised act—arguably within a margin of error expected for sizable projects—simply cannot defeat the contractor's expectation to receive *some* compensation under notions of equity and fairness.[56] Thus one party's promise, which was otherwise considered dependent under a judicial construction, becomes equivalent to an unconditional promise to perform upon the occurrence of substantial performance.[57]

Considerations of substantial performance and its corollary of a material failure of performance[58] impose a considerable burden in assessing when performances become due under a contract. The burden results from the need to decide whether a particular instance of deficient performance is sufficient to satisfy a constructive condition.[59] The decision, reflecting considerations of justice and relative hardships, necessarily must occur

53. See Celia R. Taylor, Self-help in Contract Law: An Exploration and Proposal, 33 Wake Forest L. Rev. 839, 862 (1998).

54. The substantial performance doctrine applies to contracts of all types, even though the doctrine is most frequently described in the context of construction contracts. See Restatement (Second) of Contracts § 241 cmt. a (1981); Patterson, supra note 13, at 927 n.116.

55. See Jacob & Youngs, Inc. v. Kent, 129 N.E. 889, 891 (N.Y. 1921); see also Restatement (Second) of Contracts § 237 cmt. d (1981) (describing a typical application of the substantial performance doctrine to construction contracts).

56. See *Jacob & Youngs*, 129 N.E. at 890-91.

57. See id. at 890; see also id. at 891 ("This is not to say that the parties are not free by apt and certain words to effectuate a purpose that performance of every term shall be a condition of recovery . . . . This is merely to say that the law will be slow to impute the purpose, in the silence of the parties, where the significance of the default is grievously out of proportion to the oppression of the failure.").

58. See Restatement (Second) of Contracts § 237 cmt. d (1981) (noting that the substance of an issue remains the same regardless if one asks whether a material failure of performance has occurred or whether substantial performance as occurred); Amy B. Cohen, *Reviving* Jacob and Youngs, Inc. v. Kent*:* Material Breach Doctrine Reconsidered, 42 Vill. L. Rev. 65, 79 n.51 (1997) (characterizing the substantial performance doctrine as a parallel doctrine to the material breach doctrine).

59. See Taylor, supra note 53, at 879 (commenting that the circumstances used to determine whether a material failure has occurred "place[ ] the burden on the 'innocent' (presently non-breaching party) to make a critical determination about contractual status").

without the assistance of well-defined guidance.[60] Imprecise, yet flexible, standards remain vital in assessing the substantiality of performance or the materiality of failure under notions of fairness.[61] In that regard, circumstances impacting the decision might include: (1) the extent to which a breach denies an expected benefit, (2) the extent to which adequate compensation exists for the denied benefit, (3) the extent to which the breaching party will suffer forfeiture, (4) the likelihood of cure, and (5) the extent to which the breaching party acted in accordance with expectations of good faith and fair dealing.[62] Unfortunately, courts inconsistently account for these circumstances in their decisions and occasionally abandon them in favor of other vague approaches, such as making determinations based on the mere "essence" of agreements.[63] Considerations of substantial performance thereby theoretically advance the objective of achieving fairness. But these considerations also impose uncertainty on the practical process of identifying unconditional performance obligations in bilateral contracts.[64]

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60. See Restatement (Second) of Contracts § 241 cmt. a (1981) ("[C]ircumstances, not rules, . . . are to be considered in determining whether a particular failure is material.").

61. See id.; *Jacob & Youngs*, 129 N.E. at 891 ("We must weigh the purpose to be served, the desire to be gratified, the excuse for deviation from the letter, the cruelty of enforced adherence. Then only can we tell whether literal fulfillment is to be implied by law as a condition.").

62. See Restatement (Second) of Contracts § 241 (1981).

63. Andersen, supra note 27, at 1089-92; see also Cohen, supra note 58, at 83-90 (highlighting "the arbitrariness and uncertainty of the material breach doctrine" as applied by courts).

64. See Cohen, supra note 58, at 67 (describing a determination about whether a material breach has occurred as "often seem[ingly] either completely without logic or precision, or self-evident and conclusory"); Taylor, supra note 53, at 863 ("What then is 'substantial' performance? This is clearly a critical question as it determines the life or death of the contract . . . . Although the concept of substantial performance is simple to state in general terms, it is difficult to nail down."); Andersen, supra note 27, at 1083-84 ("Fairness and justice are not empty concepts, but unaided by a more specific theory of materiality they cannot provide anything close to the sense of certainty or predictably that is important to both the formation of agreements and the resolution of contract disputes."); Stewart Macaulay, The Reliance Interest and the World Outside the Law School's Doors, 1991 Wis. L. Rev. 247, 251 (mentioning material failures of performance and substantial performance in observing that "[t]he law often states contracts doctrine in hard-to-apply qualitative standards"); see also Arthur I. Rosett, Contract Performances: Promises, Conditions and the Obligation to Communicate, 22 UCLA L. Rev. 1083, 1087 (1975) ("[The traditional approach for analyzing contracts] assumes that the crucial need is to advise judges and lawyers how to dispose of litigation. This assumption is misguided, for at the time of litigation courts are engaged in salvage operations at best, seeking to raise the hulk or to apportion blame for the sinking. At worst, courts

III. THE ROLE FOR SUBSTANTIAL PERFORMANCE IN DETERMINING TAXABLE INCOME

Under an accrual method of accounting, a taxpayer must identify unconditional performance obligations to determine taxable income. Similar "all events" tests focus on a taxpayer's unconditional rights to receive income and unconditional liabilities to pay expenses in taking such items into account.[65] One all events test generally requires that a taxpayer include an item of income in gross income when all the events have occurred that fix the right to receive such item and its amount is determinable with reasonable accuracy.[66] The other test generally treats a taxpayer as having incurred a liability for an expense item when all of the events have occurred that establish the fact of liability and its amount is determinable with reasonable accuracy.[67] Both tests accordingly call for inquiries into whether every necessary event has happened, including the occurrence of any prerequisite performance, to establish a fixed right or liability.[68] The existence of the right or liability thus establishes the time to account for the item rather than the date when a taxpayer receives income or pays an expense.[69] In the context of a bilateral contract, these tests naturally suggest a need to examine when a taxpayer has an unconditional right to receive another party's promised performances and when the taxpayer becomes unconditional obligated to perform as promised.

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serve a function analogous to that of the men with brooms who follow the passage of the circus parade.").

65. See Reg. § 1.446-1(c)(1)(ii)(A) (as amended in 2006). The all events test applicable to liabilities extends to any items allowable as a deduction, cost, or expense. See Reg. § 1.446-1(c)(1)(ii)(B). For clarity, the text discusses the all events test in the context of a liability to pay an expense.

66. See Reg. § 1.451-1(a) (as amended in 1999).

67. See Reg. § 1.461-1(a)(2)(i) (as amended in 1999). A taxpayer cannot treat the all events test as being satisfied for any liability prior to the taxable year during which economic performance occurs with respect to the liability. See IRC § 461(h)(1). This Article focuses on how performance under a contract might fix a liability for purposes of the all events test without addressing the impact of the economic performance requirement in taking the liability into account.

68. See United States v. Anderson, 269 U.S. 422, 441 (1926).

69. See Spring City Foundry Co. v. Commissioner, 292 U.S. 182, 184-85 (1934) ("Keeping accounts and making returns on the accrual 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."); United States v. Hughes Properties, Inc., 476 U.S. 593, 604 (1986) ("[T]he accrual method itself makes irrelevant the timing factor [of payment] that controls when a taxpayer uses the cash receipts and disbursements method.").

A. The "All Events" Anomaly for Ministerial Acts

As fundamental tax principles,[70] the all events tests put forth exacting requirements to have a definite, unconditional right or established liability to justify an accrual.[71] As a result, a taxpayer cannot accrue an item without having a fixed right to receive or liability to pay irrespective of the probability of receipt or payment.[72] An unsatisfied condition precedent to a right or liability simply precludes the accrual.[73] Each test seeks a seemingly clear-cut answer to a simple question: Does an unconditional right or liability exist or not?[74]

But, while the all events tests ascended to touchstone status,[75] an anomaly developed to account for rights and liabilities conditioned on ostensibly insubstantial events. The anomaly permits a finding of fixed rights to income or fixed liabilities to pay under the all events tests despite the nonoccurrence of ministerial, procedural, or mechanical acts required by contracts (collectively, "ministerial acts").[76] Courts still regarded the

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70. See United States v. Consolidated Edison Co., 366 U.S. 380, 385 (1961).

71. See Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 543 (1979) ("[T]he tax law, with its mandate to preserve the revenue, can give no quarter to uncertainty. This is as it should be.").

72. See Brown v. Helvering, 291 U.S. 193, 201 (1934).

73. See *Hughes Properties*, 476 U.S. at 600-01. With respect to accruing a deduction for a liability, the Court noted:

> The Court's cases have emphasized that "a liability does not accrue as long as it remains contingent." Brown v. Helvering, 291 U.S. 193, 200 (1934); *accord*, Dixie Pine Products Co. v. Commissioner, 320 U.S. 516, 519 (1944). Thus, to satisfy the all-events test, a liability must be "final and definite in amount," Security Flour Mills Co. v. Commissioner, 321 U.S. 281, 287 (1944), must be "fixed and absolute," Brown v. Helvering, 291 U.S., at 201, and must be "unconditional," Lucas v. North Texas Lumber Co., 281 U.S. 11, 13 (1930). And one may say that "the tax law requires that a deduction be deferred until 'all the events' have occurred that will make it fixed and certain." Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 543 (1979).
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> Id.

74. See Hallmark Cards, Inc. v. Commissioner, 90 T.C. 26, 34 (1988) ("The all-events test is based on the existence or nonexistence of legal rights or obligations at the close of a particular accounting period, not on the probability—or even absolute certainty—that such right or obligation will arise at some point in the future.") (citing United States v. General Dynamics Corp., 481 U.S. 239 (1987), and Brown v. Helvering, 291 U.S. 193 (1934)).

75. See *Consolidated Edison*, 366 U.S. at 385.

76. See Exxon Mobile Corp. v. Commissioner, 114 T.C. 293, 314 (2000).

ministerial acts, such as certain required approvals or computations, as conditions.[77] However the courts have considered the nonperformance of the required acts too insubstantial to prevent the fixing of rights or liabilities under the all events tests.[78] The reference to "all events" in the tests thus essentially became understood to mean all events other than the performance of ministerial acts.

Courts have accommodated the nonperformance of ministerial acts in applying the all events tests with little explanation. Their opinions occasionally mentioned that the ministerial acts did not go to the substance of the agreements and, as such, their nonperformance apparently could not preclude a finding of fixed rights or liabilities.[79] In some instances, courts summarily concluded that the acts were associated with collection procedures rather than events that fixed the rights or liabilities for the amounts subject to collection.[80] But the courts did not disclose why the otherwise exacting tests accepted something less than the occurrence of all events.

Dally v. Commissioner[81] provides a good example of this unexplained accommodation for ministerial acts. The *Dally* court considered a seller's right to income under a single contract clause that provided for payment of 90 percent of a purchase price "upon submission of properly

77. See Dally v. Commissioner, 227 F.2d 724, 727 (9th Cir. 1955) (describing acts as "necessary in order to make the collection"); Charles Schwab Corp. v. Commissioner, 107 T.C. 282, 293-94 (1996) (indicating that ministerial acts might function as conditions subsequent), *aff'd without opinion*, 161 F.3d 1231 (9th Cir. 1998); cf. H.J. Heinz Co. v. Granger, 147 F. Supp. 664, 670 (W.D. Penn. 1956) ("Payment was expressly made 'subject to the terms and conditions' applicable to the contracts and it is evident that those terms and conditions included more than the making of eligible sales."); IRS Priv. Ltr. Rul. 81-29-114 (Apr. 27, 1981) (noting that "[m]inisterial functions are not substantial conditions").

78. See, e.g., Charles Baloian Co. v. Commissioner, 68 T.C. 620, 627 (1977) (distinguishing the subsequent approval of a claim from the prior "primary substantive considerations and decisions" that fixed a right to payment), *nonacq.*, 1978-2 C.B. 3.

79. See *Hallmark Cards*, 90 T.C. at 33 ("Far from being a ministerial act, the passage of title and risk of loss to the buyer constitutes the very heart of the transaction and is the sine qua non to petitioner's right to receive payment."); see also *Charles Schwab*, 107 T.C. at 295 ("[W]e cannot agree that ministerial acts . . . are converted to conditions precedent merely because they may comprise a significant percentage of the overall activities conducted by the broker.").

80. See Continental Tie & Lumber Co. v. United States, 286 U.S. 290, 295 (1932) (characterizing an award by a government agency as a "mere administrative procedure to ascertain the amount to be paid," which did not delay the fixing of the right to payment, despite acknowledging that the taxpayer had no vested right to any amount and could not compel payment prior to the award).

81. 227 F.2d 724 (9th Cir. 1955).

certified invoices" for delivered articles and 10 percent of the purchase price upon final acceptance of all articles by the buyer.[82] Although the court did not question that the seller lacked a fixed right to 10 percent of the purchase price before final acceptance, the court found that the seller had a fixed right to 90 percent of the purchase price in the year of delivery despite the fact that the required certification was not submitted before year end.[83] The opinion summarily concluded that the seller must accrue 90 percent of the payment as income because it was earned, even if the amount was uncollectible due to the nonoccurrence of the mechanical act of certifying performance.[84] Neither the *Dally* opinion nor other court decisions following *Dally* gave any meaningful explanation about why the certification, as required by the contract, was not a condition precedent to the right to receive 90 percent of the purchase price whereas the required final approval was a condition precedent to the right to receive the remaining amount.

Because courts have readily accepted this anomaly without explanation, the only real insight about it comes from discussions about whether to characterize certain acts as ministerial in applying the all events tests. For example, the Supreme Court found the submissions of medical claim forms to represent nonministerial acts in *United States v. General Dynamics Corp.*[85] The taxpayer in *General Dynamics* self insured its medical plans for employees and attempted to deduct the cost of covered medical services provided to its employees by year end but for which the employees had not filed the required forms by year end.[86] Such costs are frequently described as being incurred but not reported ("IBNR") by year end. The taxpayer asserted that the provision of covered medical services was the final event that established the taxpayer's unconditional liability for the IBNR costs.[87] But the Court disagreed and noted that the filing of a claim was "not a mere technicality" but a condition precedent to the taxpayer's liability.[88] Because the medical plans stated that payment would occur only after the filing of a claim form, the Court concluded that, "as a matter of law, the filing of a claim was necessary to create liability."[89] The Court expressed concern that, as a result of oversight, procrastination, confusion, or fear of disclosure, employees might not file claims for covered costs; therefore, the

82. Id. at 725.
83. See id. at 726-27.
84. See id. at 727.
85. 481 U.S. 239 (1987).
86. See id. 241-42.
87. See id.
88. Id. at 244-45.
89. Id. at 244 n.4.

Court refused to treat the requirement to file claims as an ignorable ministerial act in applying the all events test.[90]

In contrast to *General Dynamics*, the submission of claim forms and documentation has constituted ministerial acts in other situations. For instance, the Internal Revenue Service ("Service") concluded that a medical practice, conducted in a professional corporation, had a fixed liability for IBNR costs subject to direct billing by outside physicians.[91] Under a contract with a health maintenance organization, the corporation agreed to pay for services rendered by outside physicians for the benefit of the corporation's patients.[92] The corporation then required the physicians to submit claims directly to the corporation in order to receive payment for the rendered services.[93] The Service could not find a reason why a physician might render services without making a claim.[94] Because the physicians were commercially motivated to file claims, the Service found this situation distinguishable from *General Dynamics* insofar as the submission of a claim represented a mere technical obligation to verify that the services were rendered and therefore constituted a ministerial act.[95] The Service thus concluded that the liability for the IBNR costs became fixed when the physicians rendered the services irrespective of when the claims were filed.[96] Accordingly, one might surmise that an economic interest in filing claims or a fiduciary duty to file claims would minimize concerns that claims could go unfiled, as had so troubled the Court in *General Dynamics*.[97] Those diminished concerns suggest the insignificance of filing a claim and

90. See id. at 244-45.

91. See IRS Field Serv. Adv. 2001-04-011 (Oct. 19, 2000).

92. See id.

93. See id.

94. See id.

95. See id.

96. See id.; see also IRS Field Serv. Adv. 2000-36-009 (May 4, 2000) (concluding that IBNR costs of a taxpayer engaged in network management becomes fixed when an affiliated physician renders services because the physician's submission of a claim form to the taxpayer constitutes a ministerial act).

97. See IRS Priv. Ltr. Rul. 2004-09-010 (Nov. 13, 2003); IRS Field Serv. Adv. 2001-04-011 (Oct. 19, 2000) ("In general, we believe that the rule of law of *General Dynamics* should be confined to analogous facts involving consumers or patients. Where a claim for payment in which processing is ministerial is required from a business in a commercial transaction, the fixing of the liability is not delayed until the claim is filed.") (footnote omitted). But see Coordinated Issue Pharmaceutical Industry Medicaid Rebates (Apr. 17, 1997) (concluding that a pharmacist might not submit a claim to a state for dispensing a drug to a Medicaid beneficiary, which would prevent the drug manufacturer from having a fixed obligation to pay the state under the Medicaid program), *reprinted in* IRS Releases ISP Paper On Medicaid Rebates, 97 Tax Notes Today 75-19 (Apr. 18, 1997).

apparently support characterizing the filing as a ministerial act. The ministerial nature of an act therefore occasionally seems to depend on factors external to the contract, such as the parties' interests in having the act performed.

In other situations, the relative importance of an act in comparison to other required performances appears to determine whether the nonoccurrence of the act has any impact under the all events tests. For example, the Tax Court held that the preparation and sending of invoices constituted a ministerial act under a contract that required a taxpayer to send customers invoices with all supporting documentation.[98] Although the taxpayer had delayed its invoicing because it had not yet received documentation for third-party charges, the court concluded that the taxpayer nevertheless had a fixed right to income because it had performed the sales and services, for which it would send the invoices, for its customers.[99] Pursuant to the court's rationale, the performance of the primary objectives of a contract would appear to establish a fixed right or liability, whereas any required billing would operate merely as a secondary administrative function.[100] Accordingly, acts of billing or sending invoices to customers[101] as well as acts of having customers accept invoices,[102] even where such acts are required by contract, would often be considered ministerial acts. So ministerial acts also seem to consist of required performances of secondary importance in contracts.

But the ministerial nature of an act could also be derived from its purpose in a contract. For example, after having issued a series of rulings with conflicting conclusions,[103] the Service generally addressed the

98. See Frank's Casing Crew & Rental Tools, Inc. v. Commissioner, T.C. Memo 1996-413, 72 T.C.M. (CCH) 611 (1996).

99. See id. at 613; cf. Cox v. Commissioner, 43 T.C. 448, 458 (1965) (noting that a billing delay attributable to independent auditors did not affect the taxpayer's right to income), *acq*., 1965-2 C.B. 4, *nonacq*., 1965-2 C.B. 7.

100. See IRS Field Serv. Adv. 1999 FSA LEXIS 382 (June 25, 1999).

101. See Jerry Lipps, Inc. v. Commissioner, T.C. Memo 1990-293, 59 T.C.M. (CCH) 849, 866 (1990).

102. See IRS Tech. Adv. Mem. 2009-03-079 (Oct. 8, 2008) (noting that a buyer's acceptance of an invoice might act as a condition precedent to the seller's right to payment but not to the seller's right to bill); *cf.* IRS Tech. Adv. Mem. 2003-10-003 (Oct. 30, 2002) ("Even if the terms of the sales agreement made acceptance of the system a condition precedent to the right to receive income, … [t]he return of an acceptance form by the customer is merely a ministerial act, and is not required to establish Taxpayer's right to the income under the all-events test.").

103. See IRS Field Serv. Adv. 1997 FSA LEXIS 350 (Feb. 10, 1997) (noting that, by "dictating the form and documentary requirements for reimbursement" in a cooperative advertising agreement, the taxpayer "made the submission of certain documents a condition precedent to its own" liability to pay

ministerial nature of submission requirements under a cooperative advertising agreement.[104] The agreement obligated a manufacturer to pay a retailer a promotional allowance for products purchased from the manufacturer and advertised by the retailer in a prescribed time and manner, provided the retailer submitted a claim form and proof of the advertising.[105] Drawing a comparison to submitting an invoice, the Service found that the retailer's claim and proof submission only functioned as the means to request payment insofar as it merely evidenced that the advertising services were performed as required under the agreement.[106] The comparison led the Service to conclude that the filing constituted a ministerial act that would not serve as a condition precedent to the manufacturer's liability to make the payments.[107] Thus, the Service derived the submission's ministerial nature from its purpose to substantiate the other performances required by the contract.

The unpredictable approaches taken in these cases and rulings show that ministerial acts lack readily identifiable characteristics and any willingness to disregard the nonoccurrence of required performance depends largely on context. Cases and rulings broadly suggest that a nonministerial act, which can preclude a taxpayer from having a fixed right or liability, often signifies more than just a technical requirement,[108] provides some

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the cooperative advertising expenses); IRS Tech. Adv. Mem. 94-16-004 (Dec. 23, 1993) (concluding that a liability for cooperative advertising expenses did not become fixed prior to the submission of a claim form, absent proof that substantial performance would establish liability under state law); IRS Tech. Adv. Mem. 93-43-006 (July 13, 1993) (holding, in reconsideration of IRS Tech. Adv. Mem. 92-04-003, that a liability did not become fixed prior to compliance with a contractual requirement to submit a claim); IRS Tech. Adv. Mem. 93-20-001 (Dec. 17, 1992) (holding that a liability became fixed only upon compliance with a claim submission requirement in a contract); IRS Tech. Adv. Mem. 92-04-003 (Oct. 2, 1991) (finding that a liability for cooperative advertising expenses became fixed upon the performance of the required advertising); IRS Tech. Adv. Mem. 91-43-083 (Aug. 1, 1991) (concluding that a right to receive payment for cooperative advertising services became fixed upon the placement of advertising despite the requirement to submit a claim form). The Service apparently faced an internal disagreement between the field, which thought satisfaction of the all events tests depended on compliance with all contractual terms, and the National Office, which believed performance of the services (for which the parties had contracted) satisfied the all events tests. See IRS Field Ser. Adv. 1999-1134 (undated).

104. See Rev. Rul. 98-39, 1998-2 C.B. 198.

105. See id.

106. See id. at 199.

107. See id.

108. See United States v. General Dynamics Corp., 481 U.S. 239, 244 (1987); Challenge Publ'ns, Inc. v. Commissioner, 845 F.2d 1541, 1544 (9th Cir. 1988) (characterizing compliance with a requirement to submit suitable

significant benefit to contracting parties,[109] represents consideration exchanged for something else,[110] calls for performance of a complex nature or in a manner subject to interpretation or judgment,[111] or constitutes something crucial in a contract.[112] On the other hand, they also suggest that a ministerial act often functions as a mere mechanism to substantiate other performances,[113] appears minor or insubstantial in comparison to other

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documentation under the terms of an agreement as a "legally significant moment" for a taxpayer's obligation); IRS Chief Couns. Adv. 2008-34-019 (May 7, 2008) (finding that the mailing of a rebate form is "necessary" to fix the liability to pay a rebate, whereas the processing and issuing of a rebate cannot be "anything other than a ministerial act"); *compare* Orange & Rockland Utils., Inc. v. Commissioner, 86 T.C. 199, 214 (1986) (finding a utility company's inability to bill customers prior to a meter reading date, pursuant to industry regulations, distinguishable from a ministerial act of billing) *with* Announcement 86-65, 1986-19 I.R.B. 19 (concluding that a right to income becomes fixed when earned "irrespective of the time when billing is permitted").

109. See IRS Tech. Adv. Mem. 77-42-002 (June 27, 1977) (manufacturer benefits when customers return defective products).

110. See Ertegun v. Commissioner, 531 F.2d 1156, 1159 (2d Cir. 1976) (remarking that the finding of a *quid pro quo* precludes a ministerial act characterization); L.E. Thompson v. Commissioner, 489 F.2d 288, 292 (4th Cir. 1974) ("[I]t is doubtful that delivery of three rocket launcher track assemblies, each 3,000 feet in length, from Parkersburg, West Virginia, to Dahlgren, Virginia, could be construed as an insignificant part of the consideration bargained for and a mere ministerial duty.").

111. See H.J. Heinz Co. v. Granger, 147 F. Supp. 664, 672 (W.D. Penn. 1956) ("[T]he receipt of subsidies was subject to the making of a factual determination by the party controlling the payment of satisfactory performance of applicable conditions."); IRS Field Serv. Adv. 2000-36-009 (May 4, 2000); IRS Field Ser. Adv. 1999-1134 (undated); IRS Field Serv. Adv. 992 (Apr. 30, 1992) ("triggers a substantive verification process"); *cf.* Yapp Corp. v. Commissioner, T.C. Memo 1992-348, 63 T.C.M. (CCH) 3155, 3157 (1992) (rejecting an argument that an examination of a refund claim by a state tax commissioner constitutes a ministerial act); Rev. Rul. 2003-3, 2003-1 CB 252 (concluding that approvals of tax refunds by state tax authorities "involves substantive review").

112. See Hallmark Cards, Inc. v. Commissioner, 90 T.C. 26, 33 (1988) (a nonministerial act is "the sine qua non to petitioner's right to receive payment"); IRS Field Serv. Adv. 1994 FSA LEXIS 283 (Mar. 23, 1994) ("a necessary identifying event in taxpayer's … procedures"); IRS Field Ser. Adv. 1999-1134 (undated) ("contracts with its providers still must be evaluated to determine whether the claim represents a crucial element of taxpayer's liability or is merely a bill").

113. See Rev. Rul. 98-39, 1998-2 C.B. 198, 199 ("substantiating that it has performed"); Rev. Rul. 74-372, 1974-2 C.B. 147, 147 (trade confirmation); IRS Tech. Adv. Mem. 2000-37-004 (May 11, 2000) ("merely verification"); *In re* Doyle, Dane, Bernbach, Inc. v. Commissioner, *action on decision* 1988-014 (June 27, 1988) (used to ascertain accuracy).

contractual requirements,[114] contemplates mere steps necessary to effectuate a transaction,[115] or denotes something nonessential to a contract.[116] Unfortunately, these suggestions are not particularly helpful. They might seem like obvious ways to distinguish between nonministerial and ministerial acts in hindsight. But they hold little predictive value. Where a taxpayer encounters a contractual requirement to submit paperwork, for example, these suggestions to consider aspects such as contractual technicalities, significance, and essence provide poor guidance for determining whether the submission is critical like the requirement in *General Dynamics* or ministerial like the requirement in the cooperative advertising guidance.

As a result, accrual-method taxpayers lack both a solid justification for disregarding ministerial acts and a reasonable means for identifying them. Perhaps the ministerial acts anomaly under the all events tests represents a practical accommodation for insignificant events. But the anomaly seems hard to reconcile with the notion that, with respect to assessing fixed rights and liabilities, "the tax law … can give no quarter to uncertainty."[117] Moreover, the anomaly provides little guidance but awkwardly forces taxpayers to decide what contractual requirements, which were important enough to include in the contract, are too insubstantial to take into account in applying the all events tests.

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114. See Exxon Mobile Corp. v. Commissioner, 114 T.C. 293, 319 (2000) ("perfunctory"); Charles Baloian Co. v. Commissioner, 68 T.C. 620, 627 (1977) (distinguishing the remaining ministerial acts from the prior "primary substantive considerations and decisions"), *nonacq*., 1978-2 C.B. 3; Schneider v. Commissioner, 65 T.C. 18, 28 (1975) ("only the ministerial act of computation remained to be done"), *acq*., 1976-2 C.B. 2; IRS Tech. Adv. Mem. 2009-03-079 (Oct. 8, 2008); IRS Priv. Ltr. Rul. 81-29-114 (Apr. 27, 1981) ("not substantial conditions"); IRS Field Serv. Adv. 1992 FSA LEXIS 69 (Mar. 14, 1992) ("no substantive contingency remains"); *cf.* Dumari Textile Co. v. Commissioner, 47 B.T.A. 639, 645 (1942) (finding a ministerial act where the remaining required function was "purely a matter of computation under the express direction of the statute"), *aff'd*, 142 F.2d 897 (2d Cir. 1944).

115. See Charles Schwab Corp. v. Commissioner, 107 T.C. 282, 293-94 (1996) (functions that "effectuate the mechanics of the [securities] transfer and confirm the trade executed"), *aff'd without opinion*, 161 F.3d 1231 (9th Cir. 1998); Rev. Rul. 74-372, 1974-2 C.B. 147, 147 (same); *cf*. Gold Coast Hotel & Casino v. United States, 158 F.3d 484, 490 (9th Cir. 1998) ("Here, a slot club member's demand for payment (redemption of points) is a technicality. It is nothing more than making a demand for payment of an uncontested liability.").

116. See IRS Field Serv. Adv. 2001-04-011 (Oct. 19, 2000); IRS Field Serv. Adv. 992 (Apr. 30, 1992).

117. Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 543 (1979).

B. Substantial Performance as a Justification for the Ministerial Acts Anomaly

The substantial performance doctrine, as established under contract law, can explain and provide structure for the accommodation of ministerial acts under the all events tests. The general willingness of courts to ignore ministerial acts, based on aspects like contractual technicalities and significance, in accruing items of income and expense resembles the willingness of courts to accept substantial performance in determining which party, if any, to charge with the first material breach of performance under a contract. In each instance, promised performance under a contract can become due despite the nonperformance of other required acts. Under the tax law, a right to receive or liability to pay is deemed fixed and its accrual is not delayed where the unfulfilled acts appear ministerial in nature.[118] Under contract law, a right to receive or obligation to pay is deemed unconditional where fairness dictates that a party should not have to forfeit its performance due to immaterial noncompliance with a contractual requirement.[119] Both approaches basically ask whether the performances occurring to date have sufficiently met the parties' expectations, in accordance with the "essence" of their agreement, such that one could justify holding the parties to their remaining promises.[120]

The recognition of constructive conditions and their satisfaction through substantial performance would accord with current applications of the all events tests to items not otherwise subject to express or implied conditions. The Service, for example, asserts that a right to income becomes fixed upon the earliest of when performance occurs, payment becomes due, or payment is made.[121] Similarly, the Service takes a position that a liability becomes fixed upon the earliest of when certain events occur, such as a rendering of performance, or payment becomes due.[122] Under these standards, where a corporation promises to render services and a customer promises to pay for those services under a bilateral contract, the corporation generally would have a fixed right to income only after performing the services and the customer would not have a fixed liability to pay for the services prior to such performance.[123] The Service would focus on when the

118. See supra Part III.A.

119. See supra Part II.B.

120. See supra notes 63, 116 and accompanying text.

121. See Rev. Rul. 74-607, 1974-2 C.B. 149, 149-50.

122. See Rev. Rul. 2007-3, 2007-1 C.B. 350, 350.

123. See, e.g., *Charles Schwab*, 107 T.C. at 282, 292-96 (reciting that a right to income becomes fixed upon the earliest of being due, paid, or earned and determining when the taxpayer earned its income by performing services), *aff'd without opinion*, 161 F.3d 1231 (9th Cir. 1998); IRS Priv. Ltr. Rul. 2008-28-011

corporation performed the services because it generally believes the performance constitutes an event that must occur to fix the right and liability despite the absence of express and implied conditions to the promise to pay.

Although the Service has not articulated this reason for its standards, the performance of the services plays such a critical role under the all events tests because a court, following a well-accepted principle that work precedes payment,[124] would treat the performance as a constructive condition to the promise to pay.[125] Notions of fairness and justice would simply preclude a finding that the corporation has a right to demand and the customer has an obligation to make payment before the services are rendered.[126] Consistent with this judicial approach and as discussed elsewhere, the all events tests accordingly must account for constructive conditions in determining fixed rights and liabilities for seemingly unconditional promises in bilateral contracts.[127]

In accounting for these and other conditional obligations, the all events tests must address the impact of unfulfilled requirements to perform ministerial acts. Ministerial acts only become relevant under the all events tests where their completion functions as a condition to a right or obligation; if no such condition exists, the right or obligation is fixed. Where parties to a contract make purportedly ministerial acts express or implied conditions to other promises, only the full performance of the ministerial acts could fix a right or liability.[128] In that situation, the all events tests would appropriately deny any related accruals prior to such performance.

(Apr. 15, 2008) ("With regard to services, the event fixing the liability generally is the performance of services, unless payment is due prior to the services being performed."). Although the corporation and customer could agree to have the payment due in advance, most service contracts reflect a principle that the performance of services should occur before payment becomes due. See Restatement (Second) of Contracts § 234 cmt. e (1981) ("It is sometimes supposed, that this principle grew out of employment contracts, and reflects a conviction that employers as a class are more likely to be responsible than are workmen paid in advance. Whether or not the explanation is correct, most parties today contract with reference to the principle, and unless they have evidenced a contrary intention it is at least as fair as the opposite rule would be.").

124. See Restatement (Second) of Contracts § 234 cmt. e (1981) ("Centuries ago, the principle became settled that where work is to be done by one party and payment is to be made by the other, the performance of the work must precede payment, in the absence of a showing of contrary intention.").

125. See supra text accompanying note 34.

126. See supra notes 31-37 and accompanying text.

127. See Glenn Walberg, Constructive Conditions and the All Events Test, 62 Tax Law. 433, 463-68 (2009) (describing the implications of constructive conditions for the standards applied by the Service under sections 451 and 461).

128. See supra notes 44-45 and accompanying text.

But where parties exchange a promise to perform a ministerial act along with other promises of future performance without an intention to establish a conditional relationship, a court might treat the ministerial act as a constructive condition to another promise. The constructive condition would thereby reflect the basic presumption that contracting parties expect to exchange all promised performances.[129] So, in the example above, assuming the corporation promised to provide services and send an invoice, and the customer agreed to pay for those services, the promise to pay might be conditioned on the performance of the services and the sending of an invoice. One must then ask if the all events tests, which otherwise would treat the corporation's right and customer's liability as becoming fixed upon the performance of the services, should require a different result if the corporation were to perform the services without sending an invoice by year end.

The doctrine of substantial performance could help answer that question by showing how to account for the nonperformance of certain requirements, such as ministerial acts, under the all events tests. The doctrine would recognize that the desires to achieve justice and avoid forfeitures, which motivated the construction of the condition for the customer's promise to pay,[130] would not let the customer avoid paying for its receipt of services if the corporation failed to send an invoice.[131] The corporation's substantial compliance with its promises would result in the deemed satisfaction of the condition to the customer's promise to pay. Accordingly, the payment would become unconditionally due. Irrespective of whether the act of sending an invoice appears "ministerial" in nature,[132] the all events tests would justifiably treat the rendering of services as fixing the corporation's right and the customer's liability because the occurrence of substantial performance satisfied the condition to such right and liability.

An acknowledgement of this role for substantial performance would appropriately recognize that the all events tests do not ask if all requirements in a contract have been fulfilled. Instead, the tests more narrowly focus on whether all events have occurred to fix a right or liability.[133] If an event of

129. See supra note 26 and accompanying text.

130. See supra notes 49-50 and accompanying text.

131. See supra notes 51-52 and accompanying text.

132. See supra note 26.

133. See Regs. §§ 1.451-1(a) ("Under an accrual method of accounting, income is includible 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."), 1.461-1(a)(2)(i) ("Under an accrual method of accounting, a liability … is incurred … 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

either full or substantial performance satisfies a condition to a right or liability, then such right or liability becomes fixed irrespective of whether the contract requires either party to complete other performances, including any ministerial acts.

Therefore, the substantial performance doctrine provides a strong justification for a new and different treatment of ministerial acts under the all events tests. Unlike cases and rulings that have essentially chosen to disregard requirements to perform ministerial acts in applying the all events tests,[134] the doctrine takes into account the ideas that: (1) parties exchange multiple promises to form bilateral contracts, (2) the performance of certain promises might act as constructive conditions to other promises, and (3) the occurrence of substantial performance can satisfy a constructive condition to establish an unconditional obligation under a contract. The doctrine thus articulates a well-reasoned approach for addressing contractual requirements to perform ministerial acts. The all events tests should accordingly embrace this approach as its principled explanation about how to account for ministerial acts under accrual methods of accounting.

Curiously, the Service brought the doctrine of substantial performance to the forefront while struggling to resolve whether it should classify submission requirements under cooperative advertising agreements as ministerial acts. In recognizing that the terms of a written cooperative advertising agreement would determine a taxpayer's obligation to pay promotional allowances, the Service had noted that documentation requirements could operate as conditions to payment.[135] However, in accordance with case law and administrative rulings dealing with documentation requirements, the Service acknowledged at one point that "the all events test was met when substantial performance required under the contract had occurred, notwithstanding the requirement for documentation."[136] The Service thereby reasoned—at least during the early part of its struggle to resolve how to treat payments under cooperative advertising agreements—that the liability became fixed for tax purposes upon substantial performance and that the submission requirements were properly disregarded as ministerial acts under the agreements.[137]

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with reasonable accuracy, and economic performance has occurred with respect to the liability.").

134. See supra Part III.A.

135. See IRS Tech. Adv. Mem. 92-04-003 (Oct. 2, 1991), *reconsidered in* IRS Tech. Adv. Mem. 93-43-006 (July 13, 1993) (finding that a liability did not become fixed prior to full compliance with documentation requirements).

136. Id. (citing Continental Tie & Lumber Co. v. United States, 286 U.S. 290 (1932), and Dally v. Commissioner, 227 F.2d 724 (9th Cir. 1955)).

137. See id; IRS Tech. Adv. Mem. 91-43-083 (Aug. 1, 1991).

The Service clearly contemplated that substantial performance, as determined under contract law, played a critical role in determining ministerial acts for tax purposes. The Service specifically acknowledged that slight nonperformance, such as noncompliance with a requirement to submit documentation, would not bar legal recovery by a person who had substantially complied with the terms of a contract.[138] For purposes of determining substantial performance in accordance with the "spirit" of a cooperative advertising agreement, the Service recognized that a taxpayer would bargain to receive the performance of promotional services rather than to receive the verification of performance.[139] Accordingly, the Service found that the performance of the services would establish the taxpayer's contractual obligation to pay despite any failure to submit the documentation that could verify such performance.[140] The Service thereby effectively equated a liability established, as a matter of law, through substantial performance to a liability considered fixed for purposes of the all events test.[141] Under that reasoning, the obligation to pay was constructively conditioned on the rendering of services and submission of documentation. Such payment then became due upon the occurrence of substantial performance—when the advertising was performed—because the lack of documentation did not represent a material failure of performance, and only a material failure could have excused noncompliance with the promise to pay.

The Service further used the substantial performance doctrine to explain and differentiate a conclusion stated in a footnote of *General Dynamics* and its impact on the all events tests. In characterizing the filing of a claim as a condition precedent, the Supreme Court had "conclude[d] that, as a matter of law, the filing of a claim was necessary to create liability."[142] The Court, however, never explained the rationale for its conclusion. Given that the Court stated its conclusion in contrast to the factual findings of the lower court[143] and in light of the undisputed fact that a claim had not been

138. See IRS Tech. Adv. Mem. 92-04-003 (Oct. 2, 1991) (citing Woodruff v. Hough, 91 U.S. 596, 602 (1875), which had accepted jury instructions that described how parties were not entitled to recover under a contract unless they "had complied substantially with [the contract's] specifications").

139. See id.

140. See id.

141. See generally IRS Tech. Adv. Mem. 94-16-004 (Dec. 23, 1993) ("[I]f the taxpayer is able to clearly demonstrate that under applicable state law a specific term of the contract which is not satisfied by year-end would be ignored by the courts and all other terms of the contract would be enforced despite noncompliance with that term, the liability under the contract will be fixed by year-end.").

142. United States v. General Dynamics Corp., 481 U.S. 239, 244 n.4 (1987).

143. See id.

filed in that case, it seems reasonable to attribute the "as a matter of law" reference to the conditional nature of the obligation arising from a judicial construction rather than from an interpretation of the parties' intentions.[144] If the Court could have relied on an express or implied condition as a reflection of their intentions, then the case would have been easily resolved by requiring nothing less than full performance to establish liability. But the Court's willingness to weigh factors, including reasons why a claim might go unfiled, suggests that the Court instead contemplated a need to construct a condition for the promise to pay. Yet the Court's consideration of those reasons also indicates how, without a filed claim, the liability remained conditional insofar as considerations of equity made the Court unwilling to find that substantial performance had occurred to satisfy the condition. In contrast, the Service found a cooperative advertising liability enforceable as a matter of law—due to substantial performance of an underlying condition as a result of the occurrence of advertising services, which fixed the liability for purposes of the all events test—and thereby distinguishable from the liability in *General Dynamics*.[145]

Unfortunately, within a few years, the Service became unwilling to accept substantial performance as being capable of fixing liabilities under cooperative advertising arrangements.[146] In reconsidering its prior guidance, the Service expressed its belief that the contract terms themselves formed the basis for the Supreme Court's holding that the filing of a claim, as a matter of law, was necessary to establish the liability in *General Dynamics*.[147] The

144. See generally Jacob & Youngs, Inc. v. Kent, 129 N.E. 889, 891 (N.Y. 1921) ("The question [of substantial performance] is one of degree, to be answered, . . . if the inferences are certain, by the judges of the law."); Verdi Constr., Inc. v. Central Ohio Cmty. Improvement Corp., No. 2:07-CV-972, 2008 U.S. Dist. LEXIS 91551, at *18 ("When the facts are undisputed, . . . whether a party's conduct constitutes substantial performance is a question of law for the court.").

145. See IRS Tech. Adv. Mem. 92-04-003 (Oct. 2, 1991), *reconsidered in* IRS Tech. Adv. Mem. 93-43-006 (July 13, 1993); *cf.* IRS Tech. Adv. Mem. 91-43-083 (Aug. 1, 1991) (recognizing that a taxpayer can satisfy the all events tests through substantial performance under a contract but concluding that, after performing advertising services and prior to the submission of documentation, a taxpayer had a right to receive "partial" payment under a cooperative advertising agreement).

146. See, e.g., IRS Field Serv. Adv. 1997 FSA LEXIS 350 (Feb. 10, 1997) ("Although substantial performance under contract law in some states may establish a legal basis for recovery . . ., it does not meet the all events test for tax purposes, as defined in *General Dynamics*. The legal theories are different.").

147. See IRS Tech. Adv. Mem. 93-43-006 (July 13, 1993); see also IRS Field Serv. Adv. 1997 FSA LEXIS 350 (Feb. 10, 1997) ("As 'a matter of law,' the Supreme Court was referring to the contract. The contract required the filing of a

Service then relied on that belief to conclude that the submission of documentation was a prerequisite to fixing a liability under a cooperative advertising agreement where the terms of a written contract require the submission.[148] The Service thus generally took the position that contract terms for required submissions impose express or implied conditions, which courts may interpret in accordance with the intentions of contracting parties, but may not deem as being satisfied with anything less than full performance.[149] Insofar as such contracts contain unambiguous documentation requirements, the Service envisioned few opportunities for constructing conditions and thereby foreclosed the possibility of applying the corresponding substantial performance doctrine.[150] Basically, under the Service's position, a right to receive, or liability to pay an amount could not become fixed if a party had not fulfilled its obligation to submit documentation as required by a contract. The Service accepted the resulting implications for the all events tests as natural consequences flowing from the parties' mutual agreement about the need for documentation, as they chose to establish pursuant to their freedom to contract.[151]

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claim . . . . The Supreme Court was not allowing for the possibility of 'substantial performance' as creating the obligation.").

148. See id. ("[P]ursuant to the contract between Taxpayer and its customers, it is improper to accrue promotional allowances … prior to the receipt of a claim.").

149. See IRS Tech. Adv. Mem. 94-16-004 (Dec. 23, 1993) ("[T]he terms of that contract as interpreted under state law determines when the taxpayer's liability is fixed for tax purposes . . . . Consequently, the specific contract language which sets forth the parties' rights and obligations determines the taxpayer's liability.").

150. See id.

151. See IRS Field Serv. Adv. 1997 FSA LEXIS 350 (Feb. 10, 1997) ("[O]perating under its freedom of contract, [the taxpayer] set the terms of the cooperative advertising plans with retailers and that it was, in effect, the master of its offer, dictating the form and documentary requirements for reimbursement. By doing so, [the taxpayer] made the submission of certain documents a condition precedent to its own duty to perform."). For example, the Service concluded:

> In the instant case, Taxpayer's obligation to reimburse for advertising expenses is set forth under the terms of its contract. Thus, the contract term is controlling in determining what events fix the dealer's right to income and Taxpayer's obligation to reimburse for advertising expenses. The contract . . . provides . . . [for] reimburse[ment] if its expenditures are properly substantiated and it fulfills certain other requirements. Since this requirement appears to delineate the performance required by the contract, it is no less an element of performance than any other requirement such as the mandate that the advertising fulfill the program requirements. The parties determined the provisions of the contract

But the Service later changed its position again and ultimately concluded in a revenue ruling that under a cooperative advertising arrangement a liability could become fixed by the performance of required advertising services without the fulfillment of a required ministerial act, such as the submission of documentation.[152] The ruling reached that conclusion without referencing the substantial performance doctrine. Instead, the ruling noted the relevancy of written contract terms under the all events tests and how the performance of services, such as the promised advertising, can fix liabilities[153] in accordance with the Service's general standard for applying the all events test of section 461.[154] However, the ruling did not describe any conditional relationships that might exist between the promises of performance contained in a contract.

The Service's changing positions on cooperative advertising resulted in an untoward departure from using the substantial performance doctrine to justify the anomaly for ministerial acts under the all events tests. When the Service began asking if there had been full compliance with each requirement in determining whether a taxpayer had an unconditional right or obligation, the Service appeared to reject substantial performance under a mistaken impression about the conditional relationships among the promises. The impression that the performance of each required act (e.g., a requirement to submit advertising documentation) must occur before a right or liability (e.g., an obligation to pay for advertising services) becomes fixed assumed that such performance (i.e., submission) acted as an express or implied condition of another promise (i.e., promise to pay). But that assumption is appropriate only where the parties intended that result, which is not the case where the parties merely exchanged several promises to perform as consideration in forming a bilateral contract. If the parties exchanged such promises without intending to make the performance of one promise a condition for another promise, then a court would construct a condition for the latter promise only where necessary to preserve their expectations about an exchange of performances. With respect to a cooperating advertising agreement, a court would likely consider that the parties expected to exchange the advertising services *and* documentation submission for the payment. To preserve that expectation and avoid a potential forfeiture of the payment, the court would likely treat the performance of services and submission of documentation as conditions to the obligation to pay, unless

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> and there is no indication that the parties did not intend for all terms and conditions to be met.

IRS Tech. Adv. Mem. 94-16-004 (Dec. 23, 1993).

152. See Rev. Rul. 98-39, 1998-2 C.B. 198.

153. See id. at 199.

154. See supra note 122 and accompanying text.

the parties called for a different ordering of events. Thus a constructive condition would affect the relationship between express terms of a contract.

In dealing with a relationship based on a constructive condition, the Service's earlier consideration of the substantial performance doctrine supported a better reasoned analysis of those cooperative advertising arrangements. As noted above, a constructive condition would avoid a risk of forfeiture by preventing a party from having to pay for advertising services before the services and documentation are provided. The risk of forfeiture shifts, however, once the services are rendered. At that time, substantial performance of the obligations occurs and the party rendering services faces a risk of not receiving payment due to noncompliance with a submission requirement. The same notions of justice and fairness, which initially shielded one party from the risk of having to pay for services it might not receive, should then shield the other party from the risk of not being paid for the services it actually rendered. Accordingly, substantial performance of the contractual obligations would be deemed to satisfy the constructive condition to the obligation to pay, and the liability to pay would become fixed despite the nonoccurrence of the ministerial act.

By relying on the doctrine of substantial performance to explain the special treatment of ministerial acts, taxpayers benefit from a stronger justification for disregarding noncompliance with requirements to perform those acts in applying the all events tests. The doctrine more fully accounts for all promises in contracts and for any performance or nonperformance of those promises in determining fixed rights and liabilities for tax purposes. In accordance with the objective of the all events tests to accrue unconditional rights to receive income and liabilities to make payments, the doctrine simply recognizes that substantial performance can fix an obligation under a bilateral contract, which had been constructively conditioned on such performance. This ability to recognize substantial performance as the last event that must occur to fix rights and liabilities for purposes of the all events tests makes reliance on the doctrine more justifiable in accruing income and expense items than simply disregarding ministerial acts because they are supposedly too insignificant or too technical to affect such accruals.

Although the doctrine requires assessments of substantial performance through imprecise and flexible standards,[155] the framework for analysis seems more structured than the current approach taken with respect to ministerial acts. The structure partially results from the more cohesive explanation provided for the relationship between substantial performance and the conditional promises, as described above, in comparison to the seemingly unexplained acceptance of the ministerial acts anomaly in the case law and the Service's rulings. Applying these imprecise standards seems easier than trying to deal with the uncertainty of identifying ministerial acts

155. See supra notes 59-61 and accompanying text.

because the reasons and objectives for applying the doctrine are more clearly stated and logical.

The enhanced structure also results from the more established circumstances evaluated under contract law to assess the substantiality of performance or the materiality of failure.[156] The applicable standards are neither perfect nor unambiguous under the doctrine of substantial performance. However, they provide more meaningful guidance than simply asking taxpayers to distinguish something of a technical, significant, or crucial nature from items of a minor, insubstantial, or nonessential importance in bilateral contracts.[157] Even though the doctrine has been invoked infrequently under contract law with respect to seemingly ministerial acts[158]—presumably due to the high cost of litigating a claim compared to the cost of completing the required act—the general principles underlying the doctrine provide a suitable framework for determining unconditional contractual obligations relative to these acts and provide adequate support for making accruals under the all events tests.

C. The Broader Role for Substantial Performance in Accrual Methods of Accounting

The substantial performance doctrine arguably impacts the all events tests more broadly than merely justifying the ministerial acts anomaly. As an initial matter, it is noteworthy that acceptance of the idea that substantial performance can fix rights and liabilities under a contract for tax purposes—such as using the doctrine to justify the anomaly for ministerial acts—

156. See supra note 62 and accompanying text.

157. See supra notes 108-16 and accompanying text.

158. See, e.g., Beard Family P'ship v. Commercial Indem. Ins. Co., 116 S.W.3d 839, 846-47 (Tex. App. 2003) (refusing to excuse an appellant's nonpayment, in light of the appellee's substantial performance, where the appellant promised to make payment after the presentation of an all-bills-paid affidavit, which had not been provided); Vowels v. Witt, 149 Cal. App. 2d 257, 262 (Cal. Ct. App. 1957) (holding that a contractor would be deemed to have substantially performed under a contract despite having delayed in its submission of subcontractor bills); B.F. Schlesinger & Sons v. Kohler & Chase, 103 Cal. App. 195, 199-200 (Cal. Ct. App. 1930) (concluding that a failure to give notice did not constitute a material failure of performance); Chas. T. Main, Inc. v. Mass. Tpk. Auth., 196 N.E.2d 821, 829-30 (Mass. 1964) (holding that a service company had a right to receive payment for services despite the failure of a utility company to submit a bill, which affected the company's payment by $12.61 out of more than $1,180,000 of total earned compensation); *In re* Sandman Assocs., L.L.C., 251 B.R. 473, 482-83 (Bankr. W.D. Va. 2000) (deeming a failure to sign an operating agreement, as required by a contract to acquire a membership interest in a limited liability company, as an immaterial breach of the contract under which substantial performance occurred).

provides indirect support for a conclusion that the all events tests must account for constructive conditions.[159] That support results from the fact that substantial performance can only excuse the nonoccurrence of an event that serves as a constructive condition to a performance obligation.[160] But more importantly with respect to the discussion in this Article, nothing in the tax law suggests that considerations of the substantial performance doctrine must be confined to the nonessential, noncritical, or technical requirements of contracts. Instead, the doctrine seems equally relevant in accruing income and expense items as a result of the substantial performance of primary contractual obligations (e.g., substantial performance of a promise to render services under a contract for services or a promise to deliver goods under a contract for a sale of goods).

The need to recognize the doctrine, outside the ministerial acts context, seems partially compelled by references in existing authorities and guidance to substantial performance relative to income and expense accruals for primary contractual obligations. For example, courts and the Service have often determined when sales of property have taken place for tax purposes by considering various factors, including whether substantial performance has occurred with respect to any conditions precedent.[161] Such determinations are important under an accrual method of accounting because the identification of when a sale takes place establishes when a seller secures a fixed right to receive payment under the sales contract for purposes of the all

159. See supra note 127 and accompanying text.

160. See supra notes 44-47 and accompanying text.

161. See, e.g., Commissioner v. Segall, 114 F.2d 706, 710 (6th Cir. 1940) (noting that substantial performance constitutes a factor taken into account in determining when a sale is consummated for tax purposes); Bradford v. United States, 444 F.2d 1133, 1143 (Ct. Cl. 1971) (describing how the substantial performance of conditions precedent, where payment of the purchase price was the only unfulfilled promise under a contract, created an unconditional obligation on a buyer to purchase property and permitted the buyer to acquire the benefits and burdens of ownership); Int'l Paper Co. v. United States, 33 Fed. Cl. 384, 394 (1995) (citing *Bradford* with approval in distinguishing a "contract of sale" from a "contract for sale"); Harmston v. Commissioner, 61 T.C. 216, 228 (1973) (quoting the description about the relevance of substantial performance from *Segall*); IRS Tech. Adv. Mem. 80-40-015 (June 27, 1980) (same); IRS Priv. Ltr. Rul. 87-18-003 (Jan. 7, 1987) (highlighting the occurrence of substantial performance of conditions precedent as a relevant factor in determining whether a purchaser has an unconditional obligation to pay in a sale transaction); IRS Field Serv. Adv. 1997 FSA LEXIS 713 (Dec. 16, 1997) (same); see also IRS Gen. Couns. Mem. 33,966 (Nov. 13, 1968) (concluding that substantial performance of conditions precedent could make a stock subscription contract absolute and establish a documentary stamp tax liability).

events test of section 451.[162] Although neither the courts nor the Service has elaborated about the connection between substantial performance and the occurrence of a sale, they have emphasized that substantial performance constitutes just one factor considered as part of the analysis.[163] These references at least acknowledge the general relevancy of substantial performance in determining when to recognize income (and presumably expenses) under the all events tests.

More significantly, in a few instances, the Tax Court and the Service have directly focused on substantial performance of primary contractual obligations in applying the all events tests. For example, the substantial performance doctrine most prominently impacted the decision in *Levert v. Commissioner*.[164] In that case, the taxpayers entered into contracts to receive services, which were performed in years after years during which the taxpayers entered into the contracts.[165] The taxpayers, using an accrual method of accounting, attempted to deduct the costs of the services for the taxable year during which the taxpayers entered into the contracts whereas the Service argued that the costs were not deductible until the years during which the services were completed.[166] The Tax Court, relying on a constructive condition, agreed with the Service and held that the taxpayers lacked fixed liabilities to pay for the services when they entered into the contracts.[167] But in describing when the obligations became fixed, the court noticeably contemplated applying the all events tests with due regard for substantial performance and material failures of performance:

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162. See Hallmark Cards, Inc. v. Commissioner, 90 T.C. 26, 32 (1988) ("The objective is to determine at what point in time the seller acquired an unconditional right to receive payment under the contract.").

163. See id. (noting that no one factor controls in determining when a sale takes place). *But cf.* Steiner v. Commissioner, T.C. Memo 1995-122, 69 T.C.M. (CCH) 2176, 2194 (1995) ("What may be fairly regarded as ministerial when an accrual basis taxpayer is required to determine—or to estimate—how much income to recognize, often well in advance of any right to present possession of the income, may be far different from what is ministerial when a small shift in amount of corporate income affects whether or not the taxpayer becomes the owner of stock.").

164. T.C. Memo 1989-333, 57 T.C.M. (CCH) 910 (1989), *aff'd by court order*, 956 F.2d 264 (5th Cir. 1992).

165. See id. at 916.

166. See id.

167. See id. 916-17. In support of its holding, the court relied on a quote from Levin v. Commissioner, 219 F.2d 588 (3d Cir. 1955), about the conditional nature of performance obligations due to unsatisfied constructive conditions. See *Levert*, 57 T.C.M. (CCH) at 917 (quoting *Levin*, 219 F.2d at 589). The Service later relied on the lower court opinion in *Levin* to support its denial of deductions for costs attributable to bilateral contractual arrangements prior to an obligee's performance of the promised services. See Rev. Rul. 2007-3, 2007-1 C.B. 350.

> [The taxpayers] did not become unconditionally liable for the full amounts of the contract prices until the contractor[s] completed, at least in substantial part, [their] duties under the contracts. Until that time, the possibility remained that a "material failure" of performance would excuse [the taxpayers'] refusal to pay.
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> . . . We find that the parties contemplated significant performance by the contractor[s] prior to the time [the taxpayers] were required to make full payment of the contract prices. . . .
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> . . . While there is some evidence that minimal [required services] may have occurred . . . later . . ., we find that [the required services] were completed in the years following [the] execution [of the contracts] and that the contractor[s] substantially performed [their] obligations under both contracts in those years.[168]

With respect to the cost of the acquired services, the court accordingly found a deduction appropriate for the year during which the contractors had substantially performed the promised services.[169]

Levert clearly expresses the idea that substantial performance of a primary contractual obligation is sufficient to establish an unconditional right to receive and liability to make payment for that performance under the all events tests. The idea is not surprising insofar as one might expect the means for distinguishing between conditional and unconditional rights and liabilities for tax purposes to correspond with the role of substantial performance in distinguishing between legally enforceable and unenforceable obligations for contact law purposes. Accordingly, the Service has relied on *Levert* to deny deductions for the cost of unperformed services due to the possibility that a "'material failure' of performance could excuse the taxpayer from fulfilling its obligations [to pay] under the terms of the contract"[170] and the Tax Court has relied on *Levert* to deny a deduction for the cost of moving services under an agreement with "C.O.D." payment terms due to the legally contingent nature of the obligation prior to delivery

168. *Levert*, 57 T.C.M. (CCH) at 917.

169. See id.

170. IRS Field Serv. Adv., 1997 FSA LEXIS 577 (Apr. 3, 1997). Asking whether a material failure of performance has occurred involves the same considerations as asking whether substantial performance has occurred. See supra note 58 and accompanying text.

of the goods.[171] Although these few instances in which *Levert* has been followed only involved situations where substantial performance had not occurred by year end, their approach strongly suggests that the occurrence of substantial performance would simultaneously establish enforceable obligations under contract law and fixed rights/liabilities under the tax law. Thus, a taxpayer would properly accrue an expense item under a contract for services, for example, when notions of equity shift from creating a constructive condition—as protection for the taxpayer against a risk of having to pay if the services were not forthcoming—to expecting the taxpayer to perform as promised—as a result of the other party's substantial performance of the services.[172]

The prospect of accruing items upon the substantial performance of primary contractual obligations would also nicely complement a rationale used to reject tax deductions for promises to pay in executory contracts, despite any potential liability for breach. Generally, a loss deduction cannot be claimed for anticipated damages that might arise from a breach of contract claim because the loss is not certain to occur even if the events that caused the breach have already happened.[173] Nevertheless, taxpayers have occasionally asserted that deductions were proper for the amounts they promised to pay under executory contracts, for the years during which they entered into those contracts, in anticipation that the taxpayers could be held liable for breach if they fail to make the payments.[174] The courts have rejected those deductions because any liability for damages remains contingent until a breach occurs.[175] The courts further explained that no such breach could occur for a promise to pay that remains subject to an unsatisfied condition precedent, and that the unfulfilled performances contemplated by executory contracts usually represent the unsatisfied constructive conditions to those promises to pay.[176] For example, a constructive condition would generally keep a promise to pay for future services from becoming due as long as the contract remained executory.[177] So no breach could occur with

171. See Halle v. Commissioner, T.C. Memo 1996-116, 71 T.C.M. (CCH) 2377, 2385-86 (1996).

172. See supra notes 49-52 and accompanying text.

173. See Lucas v. Am. Code Co., 280 U.S. 445, 450 (1930) (noting the lack of certainty insofar as a harmed party might forgive the breach or refrain from prosecuting a claim or a taxpayer's possible success in defending against a claim of breach).

174. See, e.g., Hallack & Howard Lumber Co. v. Commissioner, 18 B.T.A. 954, 957-58 (1930).

175. See, e.g., Levin v. Commissioner, 219 F.2d 588, 589 (3d Cir. 1955).

176. See, e.g., id.

177. See supra note 29 and accompanying text.

respect to the promise to pay,[178] and consistent with the courts' rationale, no deduction could be claimed for the payment before the rendering of the promised services.[179]

An accrual resulting from substantial performance would logically follow from this rationale expressed by the courts in denying deductions for amounts payable under executory contracts. Upon substantial performance of the services in the above example, the promise to pay would become unconditional and—although a claim of breach might arise for nonpayment—the liability to pay the promised amount would become fixed for tax purposes.[180] Accruals triggered by substantial performance would accordingly complement the denials of deductions for anticipated damages. In particular, if unsatisfied conditions served as the basis for keeping taxpayers from claiming deductions for amounts payable under executory contracts, then the satisfaction of those conditions through substantial performance must logically trigger accruals for the promised payments that had been subject to those conditions.

These considerations of substantial performance suggest that fixed rights and liabilities align rather closely with legally enforceable obligations. In the past, courts have refused to equate fixed rights/liabilities with legally enforceable obligations in order to require accruals for certain legally unenforceable obligations.[181] Their refusals, however, do not mean that the all events tests cannot require recognition of legally unconditional obligations. To the contrary, the concept of recognizing legally unconditional obligations appears very consistent with the objectives of the all events tests. In fact, it would be hard to construe the all events tests in a way that would deny the establishment of a right to receive or the fact of liability under a contract in which such right or liability is legally unconditional as a result of substantial performance.

Nevertheless, despite the theoretical soundness of accounting for substantial performance, these considerations might create considerable practical issues in applying the all events tests. In particular, substantial performance could result from any deficient performance, regardless of

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178. See supra note 8 and accompanying text.

179. See *Hallack & Howard Lumber*, 18 B.T.A. at 958 ("We think no liability was incurred by the petitioner under its contract [for services] with Allen until . . . Allen commenced his performance.").

180. Note that any damages payable under a breach of contract claim might differ from the amount payable under the terms of the contract. See *Levin*, 219 F.2d at 589; *Hallack & Howard Lumber*, 18 B.T.A. at 958.

181. See, e.g., Flamingo Resorts, Inc. v. United States, 664 F.2d 1387, 1390 (9th Cir. 1982) (concluding that an inability to enforce the collection of gambling markers in court did not prevent a casino from having a fixed right to receive income).

whether it is nonconforming or incomplete.[182] Therefore, a taxpayer would need to ask if sufficient performance had occurred to justify treating contractual rights and obligations as unconditional irrespective of the likelihood of any cure of the deficient performance or the simple completion of the promise after year end. As a result, the all events tests would call for assessments at year end of whether enough performance has occurred to make any primary contractual obligations legally unconditional and to require corresponding accruals for income and expense items. With respect to a typical contract for services, for example, a taxpayer might then expect to accrue any income and expense items at some point—determined under equitable notions—after the execution of the contract but before the completion of the promised services. Despite the impracticality of making this determination, it seems necessary under a method that focuses on fixed rights and liabilities unless one could somehow conclude that only full performance could represent an event that could fix a right or liability.

The all events tests therefore seem to require accruals for certain primary contractual obligations prior to the completion of performance even though determinations of taxable income would depend on fluid concepts like fairness. The tests would otherwise: (1) lose meaning if they disregarded substantial performance, which makes obligations legally enforceable, as an event that could fix rights and liabilities, (2) struggle to justify the ministerial act anomaly without relying on substantial performance,[183] and (3) create an

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182. See Houchin v. Commissioner, T.C. Memo 2006-118, 91 T.C.M. (CCH) 1248, 1251 (2006) (concluding that a right to income became fixed upon the effective date of a settlement agreement despite the contemplated later delivery of a payment in exchange for the compromise and satisfaction of the taxpayers' counterclaims in a lawsuit).

183. Without explaining its understanding of the all events tests in terms of constructive conditions and substantial performance, the Service appears to have relied on these contract law doctrines in applying the tests:

> Where the [t]axpayer's liability is set forth in a written contract, the terms of that contract as interpreted under state law determine when the taxpayer's liability is fixed for tax purposes. Consequently, the specific contract language which sets forth the parties' rights and obligations determines the taxpayer's liability. However, if the taxpayer is able to clearly demonstrate that under applicable state law a specific term of the contract which is not satisfied by year-end would be ignored by the courts and all other terms of the contract would be enforced despite noncompliance with that term, the liability under the contract will be fixed by year-end.

IRS Tech. Adv. Mem. 95-22-003 (June 2, 1995) (citations omitted). The Service supported the last sentence of this quote by citing, without explanation, Micro-Managers, Inc. v. Gregory, 434 N.W.2d 97 (Wis. Ct. App. 1988), which applied the

inconsistency to the extent that the tests have relied on constructive conditions, developed through concepts of fairness, to defer income and expense recognition under executory contracts.[184] Accordingly, the all events tests appear to require accruals for a contractual obligation, which had been subject to a constructive condition, when the occurrence of substantial performance has made it "fair" to expect the obligation to be fulfilled as promised.

I. SHOULD THE ALL EVENTS TESTS ACCOUNT FOR SUBSTANTIAL PERFORMANCE?

Irrespective of how well the doctrine of substantial performance justifies the treatment of ministerial acts and how well the doctrine fits with the all events tests generally, a fundamental question arises about whether the all events tests should account for substantial performance. The doctrine, which originated to resolve contractual disputes, brings complexity and uncertainty to the tax system insofar as it relies on flexible and imprecise standards to determine unconditional contractual obligations. Despite these undesirable traits, it nevertheless seems preferable—if not necessary—to account for substantial performance in applying the all events tests to the extent those tests also take constructive conditions into account.[185]

The difficulty of applying uncertain standards in assessing the substantiality of performance definitely weighs against incorporating the doctrine into the all events tests. One could attribute the difficulty, which such factually-intensive assessments would bring to the all events tests, to the fact that the doctrine originated to resolve disputes under contract law. The doctrine, which a court would invoke to determine the fairness of enforcing a promise in a single contract, might appear ill-suited for the task of routinely assessing all of a taxpayer's fixed rights and liabilities at year end.[186] Thus, the reasonableness of making an inquiry relative to a single

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substantial performance doctrine in upholding a defendant's liability to pay for services rendered by a plaintiff in developing computer software.

184. See supra note 127.

185. See Walberg, supra note 127, at 468-73 (expressing a preference for making only express and implied conditions relevant in applying the all events tests).

186. See, e.g., Travis v. Commissioner, 406 F.2d 987, 989-90 (6th Cir. 1969) (rejecting an argument that a fixed "right to receive income" was "intended to equate that phrase in all respects with 'a legally enforceable right to receive income'" due, in part, to "so many practical problems which would be engendered in tax cases" with such an interpretation); cf. E.E. Black, Ltd. v. Alsup, 211 F.2d 879, 880 (9th Cir. 1954) (applying a plain meaning to a "finally completed and accepted" reference in prior regulations governing the completed contract method and rejecting the Tax Court's interpretation of the reference, which had accounted for substantial

dispute might not readily extend to a comprehensive analysis of all outstanding promises of performance at year end. In addition, the use of a doctrine designed to identify which party to charge with the first material failure of performance conceptually seems at odds with the objective of accruing income and expense items for promises that contracting parties presumably intend to keep. The all events tests accordingly would require difficult analyses if they asked a taxpayer to determine, based on performance occurring by year end, the legal enforceability of individual obligations in a contract that the taxpayer might reasonably expect to see eventually satisfied through full performance.

However, the difficulty of applying the doctrine in accruing income and expense items cannot overcome its usefulness in providing a coherent explanation about what items to accrue. The tax system benefits from operating with clearly articulated principles and avoiding seemingly arbitrary approaches. The doctrine of substantial performance, although possibly difficult to apply, supplies a reasonable and consistent explanation about when tax accruals are appropriate for items about which the tax treatment might otherwise appear unjustifiable or haphazard. For example, as discussed above, a general willingness to disregard ministerial acts seems like a true anomaly in applying the all events tests[187] unless one considers the substantiality of other performances under a contract.[188] Similarly, one might question what principles should apply in determining whether a taxpayer has a fixed right to income from a sale of goods if the taxpayer unknowingly delivers defective goods (e.g., a taxpayer promises to convey 100 widgets, but delivers 99 operable units and 1 damaged unit to fulfill its promise).[189] It becomes difficult to explain how the all events test could apply to that sale, given that the taxpayer failed to perform fully as promised, without considerations of substantial performance. Finally, if a taxpayer were to identify an obligation that became legally enforceable as a result of substantial performance, the tax system would appear fairly arbitrary unless that unconditional obligation was also regarded as fixed for tax purposes. The doctrine of substantial performance thus provides a useful explanation about how the tax system can consistently account for many items, like those mentioned in these examples.

The difficult task of assessing the substantiality of performance arguably would merely replace existing problems in dealing with uncertain

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completion, as "import[ing] into the tax law an unwarranted and undesirable uncertainty").

187. See supra Part III.A.

188. See supra Part III.B.

189. See Rev. Rul. 2003-10, 2003-1 C.B. 288 (requesting comments on the application of the all events test of § 451 to accrue income from shipments of defective goods where a customer discovers the defect in a later taxable year).

tax accruals without adding complexity to the tax system. Existing authority and guidance create uncertainty about how a taxpayer should account for ministerial acts and defective performance, for example, which fosters confusion and controversy and makes the tax system difficult to administer. For instance, in applying existing case law and Service guidance, a taxpayer would face considerable uncertainty in simply deciding what acts to deem as being ministerial in nature for purposes of the all events tests.[190] Considerations of substantial performance could minimize this uncertainty and make the tax system easier to administer by offering a single doctrine that could consistently apply to many tax accruals. The application of the doctrine, however, requires some effort and creates its own uncertainty by relying on imprecise standards. It seems reasonable to conclude therefore that the burdens of applying the doctrine under the all events tests would offset the benefits realized in the tax system from having a consistent and meaningful justification for tax accruals.

In any case, the all events tests might already require considerations of substantial performance even though courts have refused to equate fixed rights and liabilities with legally enforceable obligations and the doctrine has not been formally incorporated into the tests. In rejecting legal enforceability as the standard for accruing income and expense items, the courts have determined fixed rights and liabilities by making inquiries about a "reasonable expectancy" of performance[191] through a pragmatic approach[192] of viewing a transaction "as a whole and in the light of realism and practicality."[193] It becomes difficult to conceive of how one might apply the all events tests without having a party's substantial performance of contractual obligations influence any reasonable expectations about future performance. The realistic and practical implications of an immaterial failure of performance presumably would not preclude the deemed satisfaction of a condition precedent for tax purposes, particularly in light of the general willingness of courts to disregard the nonperformance of ministerial acts.

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190. See, e.g., United States v. General Dynamics Corp., 481 U.S. 239, 244 n.4 (1987) (refusing to challenge the characterization of processing a claim form as a ministerial act but concluding that the filing of the claim did not represent a ministerial act).

191. See Flamingo Resort, Inc. v. United States, 664 F.2d 1387, 1389 (9th Cir. 1982) (requiring an accrual for income from pit markers despite "certain speculative and potential legal objections to payment" that gamblers could make because courts would not enforce those gambling debts); Barker v. Magruder, 95 F.2d 122, 124-25 (D.C. Cir. 1938) (applying similar reasoning to usurious interest).

192. See *General Dynamics*, 481 U.S. at 251 (O'Connor, J., dissenting) (recognizing the pragmatic origin of determining fixed liabilities under the all events test of § 461).

193. *Travis*, 406 F.2d at 990 (6th Cir. 1969) (quoting Commissioner v. Segall, 114 F.2d 706, 709 (6th Cir. 1940)).

These calls for pragmatic considerations thus appear to contemplate a role for the doctrine in applying the all events tests. Moreover, the doctrine could assume a more formal role if these pragmatic considerations were reframed in terms of equitable notions of fairness and justice.

Those equitable notions already appear to impact applications of the all events tests through the recognition of constructive conditions to otherwise seemingly unconditional obligations in bilateral contracts. As argued elsewhere, the standards applied by the Service for determining fixed rights and liabilities under the all events tests depend on constructive conditions.[194] For example, the Service generally takes a position that an obligation to pay for services does not become fixed before such services are rendered,[195] which reflects the idea that the obligation is constructively conditioned on the performance of the service consistent with the commonly-held understanding that work precedes payment.[196] Because courts use the same notions of fairness and justice to determine whether substantial performance has occurred as they use to impose constructive conditions, considerations of the substantial performance doctrine would impose no greater burdens on taxpayers in determining fixed rights and liabilities than they currently face in accounting for constructive conditions. More importantly, the complementary relationship between the doctrine and constructive conditions makes such recognition seem necessary to the extent that the all events tests already take constructive conditions into account.

Considerations of substantial performance therefore seem desirable for accruing income and expense items in a manner consistent with the principles of the all events tests. If the theoretical desirability of assessing substantial performance were to conflict too severely with the practical difficulty of making the assessment, then the Service should provide simplified means for identifying fixed rights and liabilities. The Service might consider issuing guidance as an exercise of administrative grace that provides simplifying conventions or safe-harbor methods, which comprehensively address constructive conditions and substantial performance, to ease tax compliance efforts, particularly through automated systems. However, the doctrine of substantial performance justifies accruals of income and expense items so well that courts and the Service should not reject the doctrine as being incompatible with the all events tests.

194. See Walberg, supra note 127, at 463-68.

195. See, e.g., Rev. Rul. 2007-3, 2007-1 C.B. 350, 351; IRS Chief Couns. Adv. 2007-26-023 (May 25, 2007).

196. See supra 124-27 and accompanying text.

V. CONCLUSIONS

The doctrine of substantial performance can fill a gap in the tax law to explain why taxpayers accrue income and expense items under bilateral contracts prior to the full performance of all promises. In particular, the doctrine facilitates a determination of taxable income without having to resort to a practice of disregarding certain unfulfilled contractual requirements, such the nonperformance of ministerial acts, in assessing whether all events have occurred to fix rights and liabilities. Accruals for such rights and liabilities are often deferred because the rights and liabilities remain subject to unsatisfied constructive conditions. But the substantial performance of contractual promises results in the deemed satisfaction of those conditions, which justifies accruals insofar as such performance represents the last event necessary to fix those rights and liabilities.