

# INCOME OR LIABILITY: HOW CASINOS' CLASSIFICATION OF OUTSTANDING CHIPS DETERMINE TAXABILITY

*John Bulloch\**

## I. INTRODUCTION

The Internal Revenue Service ("IRS") has sought ways to increase casinos' tax liabilities by changing their use of an accounting method that allows the casinos to exclude from income large amounts of cash they have on hand at the end of the year.<sup>1</sup> These large amounts of cash on hand result from the casinos' exchange of chips for cash.<sup>2</sup> Casinos generally exclude from income the cash they receive from these transactions by classifying them as an incurrence of a liability as opposed to an advancement of a receipt.<sup>3</sup> However, the IRS argues that the casinos' classification of these transactions as liabilities is inappropriate and at least a portion of the cash casinos receive in this exchange must be included in gross income.<sup>4</sup>

Casinos use the accrual method to account for income from gaming activities.<sup>5</sup> Under the accrual method of accounting, each casino calculates their income from gaming activities as the amount the casino has won on the patrons' wagering transactions less any amount the casino has lost from similar transactions.<sup>6</sup> Missing from this equation is the cash the casino receives in exchange for the chips the patrons use to gamble.<sup>7</sup> Instead of counting this cash received as income, casinos record these transactions on their books as outstanding liabilities.<sup>8</sup> This approach allows the casinos to exclude the exchange of cash for chips when the patron receives the chips and when the patron

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\* J.D. Candidate, May 2014, William S. Boyd School of Law, University of Nevada, Las Vegas. I would like to thank all those who helped me prepare this Note, especially Professor Lipman for her insight and direction throughout the research and writing process and the *UNLV Gaming Law Journal* staff for their hard work to achieve this publishable draft. I would also like to thank my father and mother for their love and guidance along my path. Above all, I must thank my wonderful wife, Jennifer, and our children for their love and support in all that I undertake. Without them I would not have achieved all that I have.

<sup>1</sup> C. KEVIN MCGEEHAN, *THE GAMING INDUSTRY: AN ANALYSIS OF CRITICAL FEDERAL TAX ISSUES* 11, 18 (1994).

<sup>2</sup> *Id.* at 17-18.

<sup>3</sup> *Id.* at 18.

<sup>4</sup> I.R.S. Non-Docketed Serv. Adv. Rev. 9274 (Feb. 22, 1990) at 1.

<sup>5</sup> *See id.*

<sup>6</sup> *Id.* at 2.

<sup>7</sup> *Id.*

<sup>8</sup> *See id.*

exchanges the chips back for cash from the income statement.<sup>9</sup> All transactions related to the exchange of cash for chips and chips for cash are accounted for on the balance sheet as a short-term liability.<sup>10</sup>

The tax laws governing advanced receipts provide for different tax treatment depending on the characteristics of the advanced receipt.<sup>11</sup> For instance, unearned rent revenue is included in gross income upon receipt where advanced payment for future services is not.<sup>12</sup> Tax professionals have criticized these opposing results.<sup>13</sup> Mr. Hasen, an associate professor of law at Santa Clara University School of Law, states:

The tax treatment of advance receipts, which include prepaid services income, loans, and deposits, remains a conceptually unsettled area of the law. Commentators taking opposed positions have characterized current law, and those who interpret it, as wrong, misguided, insufficiently conscious of . . . tax values, and guilty of bad economics, bad accounting and bad tax law.<sup>14</sup>

One major problem with the current law is that taxpayers can easily convert cash received from one category to the other in order to achieve their desired tax reporting.<sup>15</sup> An example of this problem arises with the different treatment of deposits and prepaids.<sup>16</sup> When a taxpayer classifies cash received as a deposit, the recipient does not include the cash in gross income.<sup>17</sup> However, if the taxpayer classifies the receipt of cash as prepaid income, the taxpayer may have to include the prepayment in gross income.<sup>18</sup> The problem arises when a taxpayer determines that one treatment is more desirable than the other and is able to choose the item's classification without altering the underlying economics of the transaction.<sup>19</sup>

Casinos have chosen to account for cash associated with outstanding chips as a liability instead of unearned or prepaid revenue.<sup>20</sup> This book treatment has allowed casinos to defer the possible income from the exchange of cash for chips until the patrons wager and lose the chips.<sup>21</sup> Even though the disagreement between the casinos and IRS over the classification of one type of transaction seems like a semantic argument, the actual increase in taxable income is very real. If the IRS could successfully change the way casinos account for their outstanding chips, casinos' taxable income would increase by millions of dollars. However, after multiple attempts by the IRS to reclassify the cash from these transactions as income, the IRS has only been able to tax a small portion

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<sup>9</sup> *Id.*

<sup>10</sup> MCGEEHAN, *supra* note 1, at 18.

<sup>11</sup> David Hasen, *The Tax Treatment of Advance Receipts*, 61TAX L. REV. 395, 400 (2008).

<sup>12</sup> *Id.*

<sup>13</sup> *Id.* at 396.

<sup>14</sup> *Id.* (internal quotations omitted).

<sup>15</sup> *See id.* at 397.

<sup>16</sup> *Id.*

<sup>17</sup> *Id.* at 396.

<sup>18</sup> *Id.*

<sup>19</sup> *Id.* at 397.

<sup>20</sup> MCGEEHAN, *supra* note 1, at 11.

<sup>21</sup> I.R.S. Non-Docketed Serv. Adv. Rev. 9274 (Feb. 22, 1990) at 1.

of the outstanding liability that represents the balance of the liability that will never be claimed.<sup>22</sup>

This note discusses the current issues presented by casinos' classification of cash on hand from chip recipients as compared to the desired classification of the same transaction by the IRS. Casinos attempt to classify the chips they receive from patrons in exchange for cash in the most tax favorable manner under the Internal Revenue Code of 1986, as amended ("IRC").<sup>23</sup> Conversely, the government attempts to include as much of that cash in the casinos' gross income.<sup>24</sup> Part I explains the casinos' accounting process; how casinos record the exchange of cash for chips on their books and the method they use to track the balance of the outstanding chips. Part II discusses the accrual accounting method and how accrual taxpayers must recognize income. Part III demonstrates theories that the IRS has used in an attempt to reclassify a casinos' outstanding chip liability in order to include the cash received in these transactions in a casinos' gross income; concluding that the IRS has succeeded in carving out a small portion of the outstanding chip liability and reclassifying it as gross income. Part IV concludes that the IRS is unable to require casinos to classify the cash they receive in exchange for chips as taxable income under the current tax code. The current tax code allows casinos to calculate their income under the accrual accounting method, which requires transactions to meet both prongs of the *All Events Test*. The largest portion of the cash that casinos receive in exchange for chips fails both prongs of the *All Events Test*. However, the IRS and casinos have agreed that the smaller portion of this cash could fulfill both requirements of the *All Events Test* and therefore, it should be classified as taxable. This section ultimately concludes that, given the IRS' inability to reclassify the full amount of this cash the casinos have on hand, the IRS will have to be content with this small victory until the tax code changes.

## II. ACCOUNTING PROCESS USED BY CASINOS

All casinos use chips in place of cash for most casino gaming.<sup>25</sup> Casinos issue chips by series with similar denominations across all series.<sup>26</sup> Each series has a distinct pattern, allowing the casinos to make sure only one series is in circulation at a time.<sup>27</sup> The casinos also place their name and location on each chip.<sup>28</sup> This helps the patron identify where each chip is from and where the patron must go to exchange the chip for cash.<sup>29</sup> Casinos are not required by

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<sup>22</sup> See *infra* Part III.E.

<sup>23</sup> See MCGEEHAN, *supra* note 1, at 18.

<sup>24</sup> *Id.*

<sup>25</sup> *Id.* at 17. (The chips are used when wagering at the table games, such as blackjack and poker tables. Mechanical games such as video poker and slot machines accept dollar bills or special tokens (used only for larger-denomination machines) and winnings are notated on printed tickets that may be redeemed for cash at the cage.)

<sup>26</sup> *Id.* at 21.

<sup>27</sup> See *id.*

<sup>28</sup> I.R.S. Non-Docketed Serv. Adv. Rev. 9274 (Feb. 22, 1990) at 1.

<sup>29</sup> See MCGEEHAN, *supra* note 1, at 20.

state law to honor the chips of other casinos and, if they choose to do so, may only do so in limited circumstances.<sup>30</sup>

Casinos issue only one series of chips at a time.<sup>31</sup> Each casino has procedures in place that specify how long each series will be in use and how it will be taken out of circulation and retired.<sup>32</sup> The process of removing the series from circulation often includes collecting chips as patrons play them at the tables or when exchanging them for cash.<sup>33</sup> Casinos also notify the public of any imminent retirement and the date by which any chip holder must redeem the chips.<sup>34</sup>

Individuals that wish to gamble at the casino tables can exchange their cash for chips at the cage or one of the many tables.<sup>35</sup> Chips are used for a number of gaming transactions; wagering, winning, losing, and tipping.<sup>36</sup> Each casino calculates gaming income in a similar manner. A casino subtracts the amount that casino's patrons have won from the total amount of the casino's winnings.<sup>37</sup> The casino does not include in its calculation of income the transactions when the patrons exchange cash for chips or vice versa.<sup>38</sup> Instead, the casino counts the chips in the hands of the patrons as a liability on its books.<sup>39</sup>

At the end of any particular accounting period, each casino calculates the total number of its outstanding chips in order to determine that casino's total outstanding chip liability. To help calculate the number of outstanding chips, each casino maintains records of the total number of chips that casino has issued in each denomination within the series that is in circulation.<sup>40</sup> At the end of the casino's accounting period, the casino takes an inventory of all of the chips in its possession,<sup>41</sup> subtracting the amount in inventory from the total number of chips in circulation to arrive at its total outstanding chip liability.<sup>42</sup>

Casino management attempts to conduct this inventory count with minimal disruption to casino operations.<sup>43</sup> Managers stop play, table by table, long enough to count the chips at that table.<sup>44</sup> This procedure allows gambling to continue at all other tables while casino management conducts the chip count.<sup>45</sup>

This process does not result in a perfect count of the chips the casino has on hand. While managers are conducting the count, patrons will continue to

<sup>30</sup> *Id.* (Casinos are regulated by state laws and as such, each state can allow for specific circumstances when a casino may redeem the chips of another. *See Nev. Gaming Comm'n Reg. 12.060.4 (2013)*).

<sup>31</sup> *Id.* at 21.

<sup>32</sup> *See id.*

<sup>33</sup> I.R.S. Non-Docketed Serv. Adv. Rev. 9274 (Feb. 22, 1990) at 2.

<sup>34</sup> *Id.*

<sup>35</sup> MCGEEHAN, *supra* note 1, at 17.

<sup>36</sup> I.R.S. Non-Docketed Serv. Adv. Rev. 9274 (Feb. 22, 1990) at 1.

<sup>37</sup> *Id.* at 2.

<sup>38</sup> *Id.*

<sup>39</sup> MCGEEHAN, *supra* note 1, at 18.

<sup>40</sup> *Id.* at 21.

<sup>41</sup> *Id.* at 18.

<sup>42</sup> *Id.*

<sup>43</sup> *See* I.R.S. Non-Docketed Serv. Adv. Rev. 9274 (Feb. 22, 1990) at 1-2.

<sup>44</sup> *Id.* at 2.

<sup>45</sup> *See id.*

win chips from and lose chips to the casino.<sup>46</sup> Patrons also hold chips while they are dining at one of the restaurants, watching a show, or taking a break in their hotel room.<sup>47</sup> In addition to patrons holding chips, chips may be used by patrons as a form of currency while they are on the casino property.<sup>48</sup> Chips are often, “used to tip . . . dealers, waiters, and waitresses” employed by the casino or other businesses on the casino’s property.<sup>49</sup> Since casino managers do not shut down all gaming and recall all outstanding chips when conducting an inventory count, there will be chips left in the hands of patrons and others that will be imminently returned to the casino.<sup>50</sup>

In an ideal world for chip accounting, all patrons would cash in all of the chips in their possession once they are done gambling.<sup>51</sup> However, this is not the case and some patrons leave the casino prior to exchanging the chips for cash, resulting in an outstanding chip liability for that casino.<sup>52</sup>

All casinos recoup the overwhelming majority of the outstanding chips over time.<sup>53</sup> Patrons either return the outstanding chips for cash or gamble and lose the chips back to the casino.<sup>54</sup> However, a small percentage of chips will never find their way back to the casino.<sup>55</sup> The amount of chips that will never be returned consists of those that the patrons lost and those that the patrons decided to keep for a myriad of reasons, such as forgetting, not wanting to bother, or desiring a memento from their Las Vegas trip.<sup>56</sup> The chips the patrons decide to keep are considered “souvenir chips.”<sup>57</sup> Patrons that keep these souvenir chips generally retain the lower denomination chips with a higher frequency than the higher denomination chips.<sup>58</sup>

In general, the amount of outstanding chips increases year after year.<sup>59</sup> The fluctuation in the amount of chips the patrons are holding while on property accounts for a portion of this general increase in the outstanding chips.<sup>60</sup> The cumulation of the lost and souvenir chips accounts for the remaining increase.<sup>61</sup> Where the outstanding chips liability is made up of both the chips that will be returned and those that will not be returned, the casinos cannot be certain what percentage of the total outstanding chips have been lost or kept as souvenirs and will, therefore, never be redeemed.<sup>62</sup>

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<sup>46</sup> *See id.*

<sup>47</sup> *Id.*

<sup>48</sup> *See id.* at 1.

<sup>49</sup> *Id.*

<sup>50</sup> *See id.* at 2.

<sup>51</sup> MCGEEHAN, *supra* note 1, at 17.

<sup>52</sup> *Id.*

<sup>53</sup> *Id.* at 17-18.

<sup>54</sup> *Id.* at 18.

<sup>55</sup> *Id.* at 17-18.

<sup>56</sup> I.R.S. Non-Docketed Serv. Adv. Rev. 9274 (Feb. 22, 1990) at 2.

<sup>57</sup> MCGEEHAN, *supra* note 1, at 17.

<sup>58</sup> *Id.*

<sup>59</sup> I.R.S. Non-Docketed Serv. Adv. Rev. 9274 (Feb. 22, 1990) at 2.

<sup>60</sup> *See id.*

<sup>61</sup> *Id.*

<sup>62</sup> *Id.*

## III. ACCRUAL ACCOUNTING METHODS

IRC Section 61 defines gross income as “all income from whatever source derived.”<sup>63</sup> The Supreme Court has stated that this definition lacks limitations or restrictive labels on the source or nature of the income thus allowing Congress to freely exert “the full measure of its taxing power.”<sup>64</sup> This liberal interpretation recognized Congress’ intent to tax all the gains it desires while granting exemptions for other gains.<sup>65</sup> While this definition explains what Congress may tax, it does not define *when* a taxpayer is to include an item in gross income.<sup>66</sup> This gap in the definition allowed the Court to add the element of control to Congress’ definition of gross income by holding that a company is to include an item in gross income when there is an “undeniable accession[ ] to wealth, clearly realized . . . over which the taxpayer [has] complete dominion.”<sup>67</sup> This means that any increase is taxable, unless Congress has granted an exemption, once the taxpayer has the power to determine how the increase is to be used.

The IRC generally requires that taxpayers use the same accounting method to compute their taxable income as they use for their financial books.<sup>68</sup> The IRC describes permissible methods of accounting and includes both the cash and accrual methods in the list of allowed methods.<sup>69</sup> Even though both of these accounting methods are acceptable under certain circumstances, accrual accounting is required for businesses with gross receipts in excess of \$1 million.<sup>70</sup> Since casinos will generally have gross receipts in excess of \$1 million, the accrual accounting method is required for federal income tax reporting.<sup>71</sup>

Even though casinos keep both their financial books and tax records on an accrual basis, each has a different purpose.<sup>72</sup> For tax purposes, the desire is to accurately measure the entire amount of taxable income.<sup>73</sup> Under many circumstances, when there is uncertainty, the tax rules require taxpayers to report “all or nothing at all” as income.<sup>74</sup> On the other hand, financial reporting is designed to provide information for current or future shareholders, and tends to err on the side of understating rather than overstating income.<sup>75</sup> To accomplish this goal, financial reporting requires businesses to use estimates to more accurately report income and expenses.<sup>76</sup>

<sup>63</sup> I.R.C § 61(a) (2012).

<sup>64</sup> *Comm’r v. Glenshaw Glass Co.*, 348 U.S. 426, 429-30 (1955) (internal quotations omitted).

<sup>65</sup> *Id.* at 430.

<sup>66</sup> *See id.* at 431.

<sup>67</sup> *Id.*

<sup>68</sup> I.R.C § 446(a) (2012).

<sup>69</sup> *Id.* at § 446(c).

<sup>70</sup> *See Rev. Proc.* 2001-10, 2001-1 C.B. 272.

<sup>71</sup> *See I.R.S. Non-Docketed Serv. Adv. Rev.* 9274 (Feb. 22, 1990).

<sup>72</sup> William A. Klein, *The UCLA Tax Policy Conference: Tailor to the Emperor with no Clothes: The Supreme Court’s Tax Rules for Deposits and Advance Payments*, 41 UCLA L. REV. 1685, 1690 (1994).

<sup>73</sup> *Id.*

<sup>74</sup> *Id.*

<sup>75</sup> *Id.*

<sup>76</sup> *Id.*

### A. *Inclusion of Income*

The general tax rule for income inclusion states that items “shall be included in gross income in the taxable year” received, unless the accounting method used by the taxpayer would properly include that income in a different period.<sup>77</sup> Taxpayers using the accrual method of accounting recognize income as taxable in the year “when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy.”<sup>78</sup> Tax professionals commonly refer to this rule as the *All Events Test*.<sup>79</sup>

### B. *All Events Test*

The Treasury Regulations list two factors that must be met before an accrual method taxpayer must include an amount in income.<sup>80</sup> First, all events must have occurred to fix a right in the taxpayer to receive the income.<sup>81</sup> Second, the taxpayer must be able to determine the amount of income “with reasonable accuracy.”<sup>82</sup>

#### 1. *The First Treasury Requirement Before an Accrual Method Taxpayer Must Include an Amount In Income: Fixed Right*

Based on the general rule of when income is fixed, accrual taxpayers should recognize income at the earlier of when it is “paid, due, or earned.”<sup>83</sup> When income is considered “fixed” because it is due or earned, no money must change hands.<sup>84</sup> Income is considered due when the taxpayer has a right to payment based on the terms of the agreement.<sup>85</sup> Once the payment is due, the taxpayer must include the accrued amount in income even if the taxpayer’s right to payment is not legally enforceable.<sup>86</sup> On the other hand, income is earned once the taxpayer has performed or delivered the goods.<sup>87</sup> In contrast to amounts due and earned, amounts are “paid” when cash changes hands.<sup>88</sup>

#### a. *Existence of Contingencies*

Under any of the three methods, for the right to be fixed, all “material contingencies on the taxpayer’s eventual receipt of income [must] have been removed.”<sup>89</sup> For amounts due and amounts earned, this means that the taxpayer

<sup>77</sup> Internal Revenue Code, 26 U.S.C. § 451(a) (2013).

<sup>78</sup> Treas. Reg. § 1.446-1(c)(1)(ii) (2012).

<sup>79</sup> See George L. White, *Accounting Methods – General Principles*, BNA Tax Mgt. Portfolio No. 570-3rd (2010).

<sup>80</sup> Treas. Reg. § 1.446-1(c)(1)(ii) (2012).

<sup>81</sup> *Id.*

<sup>82</sup> *Id.*

<sup>83</sup> White, *supra* note 79, at A-93.

<sup>84</sup> *Id.*

<sup>85</sup> *Id.* at A-94.

<sup>86</sup> *Id.*

<sup>87</sup> *Id.*

<sup>88</sup> *Id.* at A-96.

<sup>89</sup> *Id.*

must determine whether a contingency is one that is precedent or subsequent.<sup>90</sup> A condition precedent is a condition that must exist before the taxpayer's right to the income is fixed.<sup>91</sup> A condition subsequent is a condition that may compel a taxpayer to return an amount that was previously accrued.<sup>92</sup> When a condition precedent exists, the right to the income is not fixed; therefore, the amount is not included in income.<sup>93</sup>

When the money is paid, the determination of whether a contingency is a condition precedent or a condition subsequent is no longer a concern.<sup>94</sup> Instead, the taxpayer must evaluate the amount received under the Claim of Right Doctrine.<sup>95</sup> Under the Claim of Right Doctrine, actual receipts must be included in income in the year it is received even if the taxpayer will refund the amount at a later date.<sup>96</sup> The contingency that could cause a later refund will only stop the accrual of the income if the contingency places "substantial limitations or restrictions" on the income or if the amount received can be classified as something other than income.<sup>97</sup>

If outstanding chip liabilities are to be classified as income, they must fall under actual receipts. This would mean that any contingency requiring the return of the amount initially traded for the chips would be ignored unless the IRS determines that a contingency is a substantial limitation. The fact that a majority of the chips are either gambled and lost or redeemed for cash could be considered as a substantial limitation to the recognition of income.

#### *b. Matching Principle*

Taxpayers have argued that the requirement to recognize income when payment is received violates the generally accepted accounting principle of matching.<sup>98</sup> Under the matching principle, the payment received is not included in income until the payee has earned the payment through performing the service or surrendering the good.<sup>99</sup> This approach assures that the income is recognized in the same year as the associated expenses.<sup>100</sup>

The Supreme Court rejected the use of the matching principle in a series of cases that started in the late 1950s.<sup>101</sup> The cases involved taxpayers who received payment in one year for services they would provide in a subsequent

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<sup>90</sup> *Id.*

<sup>91</sup> *Id.*

<sup>92</sup> *Id.*

<sup>93</sup> *Id.*

<sup>94</sup> *Id.*

<sup>95</sup> *Id.*

<sup>96</sup> *Id.* at A-93.

<sup>97</sup> *Id.* at A-96.

<sup>98</sup> Nicholas A. Mirkay, *It's All About Timing: Will Karns Impact the IRS Battles Over Advance Receipts*, 12 DEL. L. REV. 55, 62 (2010).

<sup>99</sup> *Id.*

<sup>100</sup> *Id.* at 64.

<sup>101</sup> *Id.* at 63-64 (discussing *Auto. Club of Mich. v. Comm'r*, 353 U.S. 180 (1957); *Am. Auto. Ass'n v. United States (AAA)*, 367 U.S. 687 (1961); *Schlude v. Comm'r*, 372 U.S. 128 (1963)).



year.<sup>102</sup> However, each case contained ambiguity as to the timing or eventual fulfillment of services.<sup>103</sup>

The final case in the series rejected the matching principle for payments made under a service contract.<sup>104</sup> In *Schlude v. Commissioner of Internal Revenue*, the taxpayer was a dance studio that received down payments for future lessons.<sup>105</sup> Though the lessons had an expiration date, the studio did not set up a specific schedule for the completion of each pre-paid lesson.<sup>106</sup> The contracts were also “noncancelable,” meaning that the studio would retain all pre-payments, i.e., the income, even if the services were never used by the customer.<sup>107</sup>

This accrual-based taxpayer deferred including the prepayment in income until the payment was earned.<sup>108</sup> To do so, the studio set up a “deferred income account” with the total amount of the contract price upon the execution of the contract.<sup>109</sup> As the client used the services, the dance studio determined what amount of revenue had been earned by multiplying the hours used by the predetermined per hour charge.<sup>110</sup> If no services had been provided during the year, the contract was deemed to be cancelled and the studio would recognize the remaining balance in the deferred income account in that taxable year.<sup>111</sup> The IRS challenged the studio’s treatment of these payments.<sup>112</sup>

The Supreme Court ruled in favor of the government in *Schlude*.<sup>113</sup> The Court’s decision was based in part on the fact that the dates of the lessons were up “to the discretion of the client and the instructor” and due to the no cancellation provision, a possibility existed that the services would never be used.<sup>114</sup> Even though the Supreme Court has acknowledged that the matching principle has some value, it has declined to allow income deferral unless there is a “sufficiently determinate showing of the future expense.”<sup>115</sup>

Casinos are also accrual-based taxpayers.<sup>116</sup> However, casinos do not account for the outstanding chips in the same way that the dance studio accounted for their prepayment.<sup>117</sup> When a patron exchanges cash for chips, the casino classifies the cash as a liability as opposed to unearned or deferred revenue.<sup>118</sup> This is partially due to the fact that the money received in exchange for the chips is “refundable,” which is dissimilar to the prepayments received under the dance studio’s contracts. At any time a person with a chip from a particular

<sup>102</sup> *Id.*

<sup>103</sup> *Id.*; see also *Auto Club*, 353 U.S. at 189; see also *AAA*, 367 U.S. at 690-91; see also *Schlude*, 372 U.S. at 135-36.

<sup>104</sup> *Schlude*, 372 U.S. at 135-36.

<sup>105</sup> Mirkay, *supra* note 98, at 64; see also *Schlude*, 372 U.S. at 130.

<sup>106</sup> Mirkay, *supra* note 98, at 64; see also *Schlude*, 372 U.S. at 130.

<sup>107</sup> Mirkay, *supra* note 98, at 64; see also *Schlude*, 372 U.S. at 130.

<sup>108</sup> Mirkay, *supra* note 98, at 64; see also *Schlude*, 372 U.S. at 131-32.

<sup>109</sup> Mirkay, *supra* note 98, at 64; see also *Schlude*, 372 U.S. at 131-32.

<sup>110</sup> Mirkay, *supra* note 98, at 64; see also *Schlude*, 372 U.S. at 131.

<sup>111</sup> Mirkay, *supra* note 98, at 64; see also *Schlude*, 372 U.S. at 132.

<sup>112</sup> Mirkay, *supra* note 98, at 64; see also *Schlude*, 372 U.S. at 132-33.

<sup>113</sup> Mirkay, *supra* note 98, at 64; see also *Schlude*, 372 U.S. at 137.

<sup>114</sup> Mirkay, *supra* note 98, at 64.

<sup>115</sup> *Id.*

<sup>116</sup> MCGEEHAN, *supra* note 1, at 21.

<sup>117</sup> See *id.*

<sup>118</sup> *Id.*

casino can return to the casino to redeem the chip for cash.<sup>119</sup> If the chips are from a series that is still in circulation, the casino has a legal obligation to honor the chip at face value.<sup>120</sup> However, for a casino to recognize revenue, the patron must either decide to keep the chip as a souvenir or wager *and* lose the chip at one of the games. Even when patrons decide to keep the chips as souvenirs, the patrons can, at any time, change their mind and exchange the chips for cash until that particular series of chips has been retired.

As with *Schlude*, the patron has the discretion of when to gamble or return the chip.<sup>121</sup> However, the Supreme Court's second point, that the dance studio's no cancellation provision resulted in the possibility that the studio may never have to provide services, is not so easily applied to casinos.<sup>122</sup> Without the casinos retiring the series of chips, there is not any form of "noncancelable" provision; however, there is still no guarantee that the service would ever be used. The Supreme Court agrees that there is value to matching revenues and expenses, but companies would be able to defer income indefinitely if they did not have a noncancelable provision because no further expenses would be incurred to earning the revenue.<sup>123</sup> How casinos recognize revenue is different from that of the dance studio because of the two distinct situations in which revenue would be earned.<sup>124</sup> The first situation, where the patron keeps the chip as a souvenir, is more analogous to the prepayments made to the dance studio.<sup>125</sup> In that situation, the casino incurs no additional expenses. The only other way for the casino to include the money that was exchanged for chips in income (i.e., to earn the revenue) would be for the patron to gamble *and* lose the chips back to the casino.<sup>126</sup> When patrons gamble and lose the chips, the casinos would recognize the income under the matching principle because the casinos incurred expenses associated with providing the gaming activities; the cost of keeping the casino open for business as well as the salaries of the dealers and other employees.

*2. The Second Treasury Requirement Before an Accrual Method Taxpayer Must Include an Amount in Income: Amount Determined with Reasonable Accuracy*

The second prong of the *All Events Test* requires that taxpayers must be able to determine the amount of income with reasonable accuracy.<sup>127</sup> The reasonable accuracy requirement means that the taxpayer does not need to know the exact amount of the income.<sup>128</sup> When the exact amount the taxpayer will

<sup>119</sup> See *id.* at 20.

<sup>120</sup> Nev. Gaming Comm'n Reg. 12.060.2(c) (2013) (alternatively, if the chips are being redeemed within 120 days of the cessation of their circulation, or within a time-limit approved by the chairman of the Nevada Gaming Commission, the casino has a legal obligation to honor the chip. See Nev. Gaming Comm'n Reg. 12.070.2(a) (2013)).

<sup>121</sup> Mirkay, *supra* note 98, at 64.

<sup>122</sup> See *id.*

<sup>123</sup> See *id.* at 62.

<sup>124</sup> See *supra* Part I.

<sup>125</sup> *Id.*

<sup>126</sup> *Id.*

<sup>127</sup> Treas. Reg. § 1.446-1(c)(1)(ii).

<sup>128</sup> White, *supra* note 79, at A-93.

receive is unknown or disputed, the taxpayer is allowed to make a reasonable estimate.<sup>129</sup> Most of the cases where a taxpayer attempts to determine income with reasonable accuracy involve a taxpayer that receives an amount through a judgment or settlement.<sup>130</sup>

The Supreme Court demonstrated that it understands there will likely be a discrepancy between the amount accrued and the actual amount the taxpayer will receive.<sup>131</sup> The Court has stated that this discrepancy will be corrected in the year the taxpayer receives the income by the taxpayer increasing or decreasing their income by the difference.<sup>132</sup>

The determination of whether an estimate is reasonably accurate is considered on a case-by-case basis.<sup>133</sup> The analysis depends heavily on the facts and circumstances of each case<sup>134</sup> and on the information the taxpayer had at their disposal at the end of the tax year in which the amount was to be accrued.<sup>135</sup> However, if the IRS and taxpayers have generally agreed as to how an estimate should be calculated, the calculation will be deemed to be reasonably accurate and the taxpayers must include the estimate in gross income.<sup>136</sup>

An estimate may lack reasonable accuracy when the parties cannot agree to a reasonable method of calculation.<sup>137</sup> When the parties dispute the calculation method, the court may look to other objective standards that could be used to calculate the estimated amount of income.<sup>138</sup> One such objective standard that a taxpayer can use to calculate an estimate is past experience.<sup>139</sup> However, when no such objective standard exists, the taxpayer cannot reasonably estimate the amount of income and is not required to accrue income under the *All Events Test*.<sup>140</sup>

#### IV. THE GOVERNMENT ATTEMPTS TO RECLASSIFY THE OUTSTANDING CHIP LIABILITY

The government has attempted to reclassify a casino's outstanding chip liability as some form of revenue.<sup>141</sup> The government understands, as do the casinos, that revenues are included in income where liabilities are excluded.<sup>142</sup> If the IRS can find some way to justify the reclassification, the IRS will increase tax revenue by including the large sum of cash the casinos hold in their outstanding chip liability accounts in the casinos' income.<sup>143</sup>

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<sup>129</sup> *Id.* at A-102.

<sup>130</sup> *Id.*

<sup>131</sup> *Id.* at A-103.

<sup>132</sup> *Id.*

<sup>133</sup> *Id.*

<sup>134</sup> *Id.*

<sup>135</sup> *Id.* at A-93.

<sup>136</sup> *Id.* at A-103.

<sup>137</sup> *Id.*

<sup>138</sup> *See id.*

<sup>139</sup> *See id.* at A-96-100.

<sup>140</sup> *Id.*

<sup>141</sup> *See* MCGEEHAN, *supra* note 1, at 18.

<sup>142</sup> *See generally* I.R.S. Non-Docketed Serv. Adv. Rev. 9274 (Feb. 22, 1990).

<sup>143</sup> *See generally id.*

After a few failed attempts, the IRS has found a way to tax a portion of the outstanding chip liability.<sup>144</sup> The IRS accomplished this through a settlement with Eldorado Hotel Associates, the parent company of Eldorado Casino; other casinos have since followed.<sup>145</sup> In that settlement, the casino agreed to calculate and include in income a small portion of the outstanding chip liability that would be deemed revenue.<sup>146</sup> The result is that the casino would include this calculated portion of revenue in its income for the year of the calculation.<sup>147</sup>

A. *IRS's Attempt to Classify the Exchange of Cash for Chips as a Sale*

In the past, the IRS has attempted to tax the amount the casinos receive from the exchange of cash for chips as either a sale or purchase of chips by the exchanging casino.<sup>148</sup> This would have meant that any time a patron exchanged cash for chips; the transaction would constitute a sale that the casino would have to include in taxable income.<sup>149</sup> However, the income from this transaction would be offset by the casino's eventual repurchase when the patron returned the chips for cash, which would constitute cost of sales.<sup>150</sup> If the IRS required casinos to classify each transaction as a separate purchase or sale of chips,<sup>151</sup> both of the factors under the *All Events Test* would be fulfilled.

The casinos would have fixed income at the time of the exchange. Under the Claim of Right Doctrine, the cash received should be included in income unless there is a substantial limitation or restriction on the income received.<sup>152</sup> The casinos' refund of the cash to their patrons finalizes the sale and the patrons' exchange of chips for cash would constitute a separate transaction, not a limitation or restriction on the previous transactions. There would also be no problem with determining the amount of income because it would be the amount taken in from the exchange. This approach would result in the full amount of the cash relating to the outstanding chip liability on the casinos' books being recognized in each of their incomes.<sup>153</sup>

Even though this approach would meet the requirements of the *All Events Test*, this approach gives rise to multiple problems.<sup>154</sup> Casinos are not in the business of selling chips.<sup>155</sup> If the IRS attempted to change the casinos' business purpose to include the sale of chips, the casinos would have to make substantial changes to the accounting method they use for financial accounting recordkeeping purposes.<sup>156</sup> There is also a great possibility for double counting of income because income would be recorded when the chips are sold and then

<sup>144</sup> See *infra* Part III.E.

<sup>145</sup> *Id.*

<sup>146</sup> *Id.*

<sup>147</sup> *Id.*

<sup>148</sup> MCGEEHAN, *supra* note 1, at 18.

<sup>149</sup> *Id.*

<sup>150</sup> *Id.*

<sup>151</sup> See *id.*

<sup>152</sup> See *supra* Part II.B.1.a.

<sup>153</sup> MCGEEHAN, *supra* note 1, at 21.

<sup>154</sup> See *id.*

<sup>155</sup> See *id.* at 18.

<sup>156</sup> See *supra* Part I.

again when the chips are wagered and lost by casino patrons.<sup>157</sup> The double counting would occur because the patrons would no longer have the chips to redeem; thereby decreasing the intended offset to the income the casinos record from the sale of chips.<sup>158</sup>

No court has considered the income tax consequences of requiring casinos to account for the exchange of chips for cash as a sale.<sup>159</sup> However, the Third Circuit has evaluated whether the exchange of chips for cash should be considered a sale of property.<sup>160</sup> In *Zarin v. Commissioner of Internal Revenue*, Zarin, the taxpayer, gambled away more than \$3.4 million in chips he had received on credit from Resorts International.<sup>161</sup> Zarin was unable to pay the debt, and Resorts International took him to court in an attempt to enforce the liability.<sup>162</sup> But, the credit advances from Resorts International to Zarin were not performed in accordance with New Jersey gaming law.<sup>163</sup> Zarin argued that this violation relieved him of the debt because the debts were unenforceable.<sup>164</sup> Resorts International decided to settle the case with Zarin for \$500,000.<sup>165</sup>

The IRS then argued that Zarin had income from the settlement in the form of a discharge from indebtedness.<sup>166</sup> Zarin responded by arguing that the settlement was not a discharge of indebtedness, rather his receipt of the chips was an exchange of property for a note and that the settlement was a mere adjustment in the amount of the note.<sup>167</sup> The Tax Court was not amenable to Zarin's argument and ruled in favor of the IRS.<sup>168</sup>

The Third Circuit reversed the Tax Court by holding that Zarin did not receive income in the form of debt forgiveness while affirming that no sale occurred during the exchange of chips.<sup>169</sup> The Third Circuit agreed with the Tax Court's finding that casino chips were merely a "substitute for cash" that the patrons used as a "medium of exchange" while on the casino's property.<sup>170</sup> Because the chips were only a "medium of exchange," they were not property but solely "an accounting mechanism to evidence debt."<sup>171</sup>

Although the Third Circuit's rationale for holding that Zarin did not have income from his debt forgiveness has been long disputed,<sup>172</sup> experts agree with

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<sup>157</sup> *See id.*

<sup>158</sup> *See id.*

<sup>159</sup> MCGEEHAN, *supra* note 1, at 18.

<sup>160</sup> *Id.*

<sup>161</sup> *Id.*

<sup>162</sup> *Id.*

<sup>163</sup> *Id.*

<sup>164</sup> *Id.*

<sup>165</sup> *Id.*

<sup>166</sup> *Id.*

<sup>167</sup> *Id.*

<sup>168</sup> *Id.*

<sup>169</sup> *Id.*

<sup>170</sup> *Zarin v. Comm'r*, 916 F.2d 110, 113 (3d Cir. 1990) (internal quotations omitted).

<sup>171</sup> *Id.*

<sup>172</sup> *See generally* Joh D. Rigney, *Zarin v. Commissioner: The Continuing Validity of Case Law Exceptions to Discharge of Indebtedness Income*, 28 SAN DIEGO L. REV. 981(1991); *see generally* Mark J. Marroni, *Zarin v. Commissioner: Does a Gambler Have Income from the Cancellation of a Casino Debt?*, 27 NEW ENG. L. REV. 993 (1993); *see generally* Theodore P. Seto, *Inside Zarin*, 59 SMU L. REV. 1761 (2006).

the determination that the exchange of cash for chips is not a sale of property.<sup>173</sup>

Unfortunately for the IRS, the Third Circuit's ruling in *Zarin* undermined its position that the exchange of chips for cash should be considered a sale of property and the cash the casinos receive should be included in income. Not surprisingly, the IRS has abandoned its position that casinos should be taxed on the sale of chips in an attempt to classify the outstanding chip liabilities as income.

*B. Argument to Classify the Exchange of Chips for Cash as a Deposit*

Tax professionals have argued that a casino's exchange of chips for cash is more like a deposit than a sale of property,<sup>174</sup> because a patron can return anytime while the series of chip is still in circulation to redeem the chips for the face value in cash.<sup>175</sup> As with the sale of chip approach, the analysis of the possible taxation of deposits would be evaluated under the Claim of Right Doctrine.<sup>176</sup>

The major issue with deposits under the Claim of Right Doctrine is whether a substantial limitation or restriction exists that would block the accrual of the income received. In a deposit transaction there is actual receipt, so there is no need to evaluate whether there is a condition precedent. Also, there is no question as to whether the amount can be reasonably determined because it would be the amount received at the time of the exchange.<sup>177</sup>

The Supreme Court has ruled on cases involving situations when deposits should have been included in income.<sup>178</sup> One such case hinged on whether the taxpayer had "complete dominion" over the deposit.<sup>179</sup> In *Commissioner of Internal Revenue v. Indianapolis Power & Light Co.*, the taxpayer was a utilities company that required certain customers to pay a deposit prior to providing services.<sup>180</sup> The deposits paid were not separated from the rest of the company's income.<sup>181</sup> However, the customers could earn a refund of the deposit by either making timely payments or by holding a positive credit score.<sup>182</sup> The IRS challenged the utility company's treatment of the deposits as liabilities and insisted the deposits should be treated as advanced payments instead.<sup>183</sup> The government's argument was based on the idea that the deposits were used to secure future payments that would be reported as income.<sup>184</sup>

The Court determined the case turned upon which rights and obligations the taxpayer assumed by accepting the deposit.<sup>185</sup> For the deposit to be

<sup>173</sup> MCGEEHAN, *supra* note 1, at 19.

<sup>174</sup> *Id.*

<sup>175</sup> *See id.* *See also*, Nev. Gaming Comm'n Reg. 12.060.2(c), 12.070.2(a) (2013).

<sup>176</sup> *See supra* Part III.A.

<sup>177</sup> *Id.*

<sup>178</sup> MCGEEHAN, *supra* note 1, at 19.

<sup>179</sup> *Comm'r v. Indianapolis Power & Light Co.*, 493 U.S. 203, 210 (1990).

<sup>180</sup> *Id.* at 203.

<sup>181</sup> *Id.* at 209.

<sup>182</sup> *Id.* at 204-05.

<sup>183</sup> *Id.* at 208.

<sup>184</sup> *Id.* at 209.

<sup>185</sup> *Id.*

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included in income, the taxpayer must have complete dominion over the funds of the deposit.<sup>186</sup> The Court then stated:

In determining whether a taxpayer enjoys “complete dominion” over a given sum, the crucial point is not whether his use of the funds is unconstrained during some interim period. The key is whether the taxpayer has some guarantee that he will be allowed to keep the money.<sup>187</sup>

When taxpayers have a guarantee that they will be able to keep the money, the taxpayer is not able to defer the income and must recognize the income as an accrual.<sup>188</sup>

The Supreme Court determined that the utility company did not have to accrue income for the deposits because the company did not have a guarantee that it would retain the deposits, even though it had control until the customer took some action.<sup>189</sup> The Court based its decision on the fact that the utility company had an express obligation to refund the deposit upon actions by the customer and the customer did not have an agreement to purchase further services from the utility.<sup>190</sup>

The casinos are similar to the utility company in that the exchange for chips would be similar to the deposit for the utilities.<sup>191</sup> The patron exchanges money for chips with the express knowledge that at any time the patron could end further services and return the chips.<sup>192</sup> Unlike the utility company, there is not an agreement where the customer is informed of the various ways to receive a refund of the deposit; however, the state’s casino regulatory schemes<sup>193</sup> guarantee the repayment of cash when chips are presented.<sup>194</sup>

One analyst has stated that the most important distinction is the fact that casinos have even less dominion over the cash they have received in exchange for the chips and tokens.<sup>195</sup> With the casinos, the refund is almost completely in the control of the customer.<sup>196</sup> The casinos’ patrons have no other obligation to get a refund than to present the chips or tokens at the cage.<sup>197</sup> “There are absolutely no restrictions on the customers’ power to compel the return of the cash.”<sup>198</sup>

Therefore, if the money from the exchange of chips for cash is classified as a deposit, the casinos would not have to recognize income because there is a substantial limitation or restriction on the funds received. Like the utility company, the casinos lack any assurance that they will be able to keep the funds even though casinos have unconstrained access to the funds during the holding

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<sup>186</sup> *Id.*

<sup>187</sup> *Id.* at 210.

<sup>188</sup> *Id.*

<sup>189</sup> *Id.* at 212-14.

<sup>190</sup> *Id.* at 213-14.

<sup>191</sup> MCGEEHAN, *supra* note 1, at 20.

<sup>192</sup> *Id.*

<sup>193</sup> See Nev. Gaming Comm’n Reg. 12.060 (2013).

<sup>194</sup> MCGEEHAN, *supra* note 1, at 20.

<sup>195</sup> *Id.*

<sup>196</sup> *Id.*

<sup>197</sup> *Id.*

<sup>198</sup> *Id.*

period. When the refund is completely in the hands of the patrons, the casinos would not be required to recognize income.

*C. IRS's Attempt to Classify the Exchange of Chips as a Taxable Deposit: Analogy to Returnable Bottle Deposits*

The IRS has attempted to take the deposit argument a different direction and apply the taxability of deposits merchants collect on returnable items to the amount casinos receive for the chips.<sup>199</sup> One example of these returnable items is the deposit required on glass and plastic beverage bottles.<sup>200</sup> Deposits on returnable bottles have been determined by the court to be taxable to the taxpayer that is receiving the deposit.<sup>201</sup> This is because the deposit is to be included in the amount received for the sale of the container.<sup>202</sup> The rationale to include the amount of the deposit in the sale of the beverage is because the return of the bottle is not restricted to the location of sale; bottles can be returned anywhere.<sup>203</sup>

The deposit is taxable in the year received because it fulfills both prongs of the *All Events Test*.<sup>204</sup> Courts have held that the right to receive the deposit income is fixed and that the amount of the deposit income is determined when the sale is made.<sup>205</sup> The trigger to include the deposit in income is that the container is sold together with the contents.<sup>206</sup> When containers are returnable, the later return and refund are considered a resale to the merchant.<sup>207</sup> The fulfillment of these two criteria results in the inclusion of the deposit in income for the year the deposit is received.<sup>208</sup>

In *Okonite Co. v. Commissioner of Internal Revenue*, the Tax Court listed several factors which relieve any doubt that a merchant sold an item to a patron.<sup>209</sup> There is no doubt that a merchant sold the items when (1) the merchant retained no title to the items; (2) the merchant charged a standard price, giving the patrons the freedom to do what they will with the item received, including keeping, returning, or reselling the item; (3) the merchant agreed to repurchase the item at the original price within a specified period of time; and (4) the merchant has no mechanism to force the patron to return the item.<sup>210</sup>

The IRS contends that the casinos' practices are comparable to those of the retailer in *Okonite*.<sup>211</sup> An IRS agent in a Non-Docketed Service Advice Review pointed out that, like the retailer in *Okonite*, "casinos do not retain title

<sup>199</sup> See generally I.R.S. Non-Docketed Serv. Adv. Rev. 9274 (Feb. 22, 1990) at 3.

<sup>200</sup> See *id.* at 4.

<sup>201</sup> MCGEEHAN, *supra* note 1, at 20.

<sup>202</sup> *Id.*

<sup>203</sup> *Id.*

<sup>204</sup> See generally I.R.S. Non-Docketed Serv. Adv. Rev. 9274 (Feb. 22, 1990) at 5.

<sup>205</sup> *Id.* at 4.

<sup>206</sup> *Id.*

<sup>207</sup> *Id.*

<sup>208</sup> See *id.*

<sup>209</sup> *Okonite Co. v. Comm'r*, 4 T.C. 618, 628 (1945).

<sup>210</sup> *Id.*

<sup>211</sup> I.R.S. Non-Docketed Serv. Adv. Rev. 9274 (Feb. 22, 1990) at 4.



to the chips.”<sup>212</sup> Once cash is exchanged for chips, the patron is free to do with the chips what they will, whether they want to gamble, return them for cash, or keep them for any purpose.<sup>213</sup> Also, the casinos do not have any process or right to force the return of the chips.<sup>214</sup> Based on this argument, the agent concluded that the “casino[s] *must* include in gross income the amount collected on unredeemed chips.”<sup>215</sup>

However, the IRS agent either overlooked or chose to avoid the factors that differentiated the exchange of cash for casino chips and the sale of a returnable item.<sup>216</sup> First, the IRS agent failed to mention that one of the factors in *Okonite* was the customers’ ability to do with the property as they willed.<sup>217</sup> The court stated that the ability of the customer to sell the item elsewhere is evidence that the transaction should be classified as a sale.<sup>218</sup> Casinos print their name and location on the chips, which places the patron on notice of where they can exchange the chip for cash.<sup>219</sup> With one small exception that applies only in extremely limited and extraordinary circumstances,<sup>220</sup> no casino or other business is required or even allowed to redeem the chips of another casino.<sup>221</sup> Second, the cash exchanged for chips is distinguishable from container deposits because the container deposits are paid as part of the purchase of the product.<sup>222</sup> The deposit paid when a person purchases a soda is included as an incidental cost.<sup>223</sup> As discussed in Part III (A), the Third Circuit Court of Appeals has held that chips are not property.<sup>224</sup> In addition to the fact that chips are not property, the patrons did not receive any other property in the exchange.<sup>225</sup> Therefore, the exchange of cash for chips is not a deposit that is incidental to the exchange of other property.<sup>226</sup>

These two differences are sufficiently meaningful to afford a different tax treatment of cash exchanged for chips from deposits paid on returnable items. Therefore, casinos should be allowed to exclude from income the cash received for chips even though merchants must include certain deposits they receive in taxable income.

#### D. *Income of Credit Extended*

Casinos often extend credit to patrons.<sup>227</sup> In *Flamingo Resorts, Inc. v. United States*, the Ninth Circuit Court of Appeals held that an accrual-based

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<sup>212</sup> *Id.*

<sup>213</sup> *Id.*

<sup>214</sup> *See id.*

<sup>215</sup> *Id.* (emphasis added).

<sup>216</sup> *See id.*

<sup>217</sup> *Id.*

<sup>218</sup> *Id.*

<sup>219</sup> *Supra* Part I.

<sup>220</sup> MCGEEHAN, *supra* note 1, at 20.

<sup>221</sup> *Supra* Part I.

<sup>222</sup> MCGEEHAN, *supra* note 1, at 20.

<sup>223</sup> *Id.*

<sup>224</sup> *Id.*

<sup>225</sup> *Id.*

<sup>226</sup> *Id.*

<sup>227</sup> *See* I.R.S. Non-Docketed Serv. Adv. Rev. 9274 (Feb. 22, 1990) at 3.

casino shall include “gambling revenue from customers gambling on credit” in income in the year the credit has been extended.<sup>228</sup>

In *Flamingo Resorts*, the casino excluded receivables from its income which were the results of outstanding loans.<sup>229</sup> These loans were extended to gamblers in order to facilitate the casino’s gaming operations.<sup>230</sup> Prior to receiving a loan or credit extension, the patron or gambler was required to sign a “marker” which solidified the liability and the amount owed to the casino.<sup>231</sup> Flamingo Resorts accounted for these loans as receivables.<sup>232</sup> However, Flamingo Resorts generally attempted to collect payment of debts prior to the patrons leaving, decreasing the total outstanding receivable.<sup>233</sup> Flamingo Resorts estimated that 96 percent of these outstanding receivables would eventually be collected.<sup>234</sup>

Relying on the *All Events Test*, the district court ruled that when Flamingo Resorts issued the marker, the amount the casino would eventually receive was fixed and determinable with reasonable accuracy, thus satisfying both factors of the *All Events Test*.<sup>235</sup> The Ninth Circuit Court agreed. As a result, the casino had to include the marker amount as income in the taxable year the marker was distributed.<sup>236</sup>

In an IRS Non-Docketed Service Advice Review, the IRS attempted to extend the logic from *Flamingo Resorts*, which deemed uncollected markers as income, to all casinos’ liability for outstanding chips.<sup>237</sup> In doing so, the IRS contested that cash received is clearly income at the moment of receipt.<sup>238</sup> Additionally, the IRS stated, “a collectible is considered income in the year when exchanged for chips, then, a fortiori, cash should be income in the year when so exchanged.”<sup>239</sup>

However, the IRS’s analysis left out an important part of the *Flamingo Resorts* holding.<sup>240</sup> In addition to the holdings outlined by the IRS, *Flamingo Resorts* also held that the amount is includible in income because “no contention has been made that the amounts cannot be determined with reasonable accuracy.”<sup>241</sup> There is however, a reasonable contention that, while the income generated from a receivable can be determined with reasonable accuracy, the amount that should be moved from a liability to income in a given year cannot be determined with reasonable accuracy.

The justification for the higher level of accuracy in determining the amount of receivables that should be included in income can be explained by

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<sup>228</sup> *Id.*

<sup>229</sup> *Id.*

<sup>230</sup> *Id.*

<sup>231</sup> *Id.*

<sup>232</sup> *Id.*

<sup>233</sup> *See id.*

<sup>234</sup> *Id.*

<sup>235</sup> *Id.*

<sup>236</sup> *Id.*

<sup>237</sup> *Id.*

<sup>238</sup> *Id.*

<sup>239</sup> *Id.*

<sup>240</sup> *See id.*

<sup>241</sup> *Flamingo Resort, Inc. v. United States*, 664 F.2d 1387, 1390 (9th Cir. 1982).

reviewing how gaming revenue is calculated. Casinos determine their gaming revenue as the excess of the casinos' wins over the casinos' losses.<sup>242</sup> The receivables Flamingo Resort excluded from gross income was the balance of the patrons' loans upon leaving the Flamingo casino.<sup>243</sup> The facts do not specify, but it can be assumed that no gaming would have occurred after the patron had left the casino and any chips that the patron would have exchanged for cash would have been done prior to the patron leaving.<sup>244</sup> Therefore, at the time the patron left the casino, any gaming losses the casino had incurred would be calculated and included in the casino's taxable income. If the casinos do not include the receivable in income, the gaming losses would be overstated because the gaming income associated with these losses would be deferred to a later period.

This differs from exchanging cash for chips in that once the cash is received, the casinos do not (and from a practical matter could not) monitor when patrons leave (and often return to) the casino. The court also only ruled on the inclusion of outstanding receivables. Therefore, it does not necessarily follow that the court would view the exchange of cash for chips as a sale and then require that sale to be included in taxable income based on the treatment of loan receivables.

#### *E. Current Taxation of Outstanding Chips*

Presently, the government has been unsuccessful in taxing the full amount of the casinos' outstanding chips.<sup>245</sup> After failed attempts to include the full amount of the outstanding chips in income, the IRS has continued to pursue classifying a portion as income.<sup>246</sup> This has resulted in the IRS taking the position that the portion of the outstanding chips that will never be returned to the casino is includible in income.<sup>247</sup>

In an IRS Non-Docketed Service Advice Review, one of their agents stated that casinos concede that the portion of outstanding chips that will never be returned should be included in the casino's income in the tax year in which that determination can be made.<sup>248</sup> However, casinos and the IRS presently disagree as to how and when the determination can and should be made.<sup>249</sup> Casinos argue that estimating this number every year is inaccurate and suggest that making the determination at the time the chips are retired would be more appropriate.<sup>250</sup> However, the IRS contends that waiting until the chips are retired to count any unreturned chips as income "has not been consistent[ly]" accurate in reporting income.<sup>251</sup>

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<sup>242</sup> *Supra* Part I.

<sup>243</sup> I.R.S. Non-Docketed Serv. Adv. Rev. 9274 (Feb. 22, 1990) at 3.

<sup>244</sup> *See Flamingo Resort*, 664 F.2d at 1390.

<sup>245</sup> *See supra* Part III.A-D.

<sup>246</sup> *See generally* Order Adjusting Partnership Income at 3, *Eldorado Hotel Assocs. v. Comm'r*, T.C. No. 2862-95 (April 1, 1996) [hereinafter *Eldorado Order*].

<sup>247</sup> *Id.*

<sup>248</sup> I.R.S. Non-Docketed Serv. Adv. Rev. 9274 (Feb. 22, 1990) at 2.

<sup>249</sup> *See generally id.*

<sup>250</sup> *Id.*

<sup>251</sup> *Id.*

The IRS and the gaming industry have finally reached a compromise on how and when casinos are to calculate the portion of their outstanding chips as taxable. This compromise comes by way of the struggle and settlement between the IRS and the Eldorado Hotel Associates.<sup>252</sup> Despite the lack of precedent, many other casinos have since followed the method in this settlement to estimate what amount of their outstanding chips are to be included in the current year's income as souvenir chips.<sup>253</sup> The settlement requires the taxpayers to increase or decrease their gross income each year for the fluctuation in the portion of the outstanding chips that will never be redeemed.<sup>254</sup>

The Eldorado settlement requires casinos to compute the taxable portion of their outstanding chips on a year-to-year basis.<sup>255</sup> Casinos are to determine the amount of each component of the calculation by a set day, within thirty days after the end of the taxable year.<sup>256</sup> To compute the taxable portion of their outstanding chips, casinos are allowed to increase or decrease their income by the increase or decrease in an "Annual Float" amount.<sup>257</sup> The Eldorado agreed to adjust their Annual Float every year based on a calculation of their Adjusted Float.<sup>258</sup> The Adjusted Float is calculated as follows:

- 1) Determine the total value of chips and tokens in active circulation.
- 2) Subtract the value of chips and tokens in the custody or under the control of the house as determined in accordance with normal counting procedures (including tokens in the taxpayer's slot machines).
- 3) Subtract the value of outstanding chips and tokens in denomination of \$100 or more.
- 4) Subtract the adjustment for chips and tokens in denominations of less than \$100 (the "Small Denomination Adjustment"). The Small Denomination Adjustment may be determined by either of the following alternative methodologies:
  - i. The Experience Method (Alternative 1): The Small Denomination Adjustment shall be determined as the sum of items (a) and (b).
    - a) The value of chips and tokens of denominations of less than \$100 in patrons' hands determined by accrual or observable count as of the Computation Date.
    - b) The value of total chip returns in denominations of less than \$100 over the one-week period immediately following the Computation Date and the value of total token returns in denominations of less than \$100 over the two-week period immediately following the Computation Date that are received by the taxpayer.
      - (i) From Bright Exchange or other clearinghouse facilities, and
      - (ii) From other casinos directly.
  - ii. The Percentage Method (Alternative 2): The Small Denomination Adjustment shall be determined as the sum of items (a), (b), and (c) as applied to chips and tokens (other than souvenir chips and tokens which shall be separately treated under subparagraph H):

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<sup>252</sup> See generally Eldorado Order, *supra* note 246.

<sup>253</sup> See *id.*

<sup>254</sup> See *id.* at 8.

<sup>255</sup> *Id.* at 3.

<sup>256</sup> *Id.* at 4-5.

<sup>257</sup> *Id.* at 8.

<sup>258</sup> *Id.* at 3.

- a) 75% of the value of outstanding chips and tokens in denomination of \$10 or greater but less than \$100;
  - b) 35% of the value of outstanding chips and tokens in denominations of \$5 or greater but less than \$10;
  - c) 10% of the value of chips and tokens of denominations of less than \$5.
- 5) The amount recorded in gross income is any excess of current year outstanding chips over the prior year calculation.<sup>259</sup>

The Adjusted Float modifies the casino's income by changing the Annual Float.<sup>260</sup> The Annual Float is the difference between the current year's Adjusted Float and the Adjusted Float of the taxable year immediately preceding the current taxable year.<sup>261</sup> If the current year's Adjusted Float is greater than the prior year's Adjusted Float, the Annual Float is positive and the casino must add the amount to their income.<sup>262</sup> When the current year's Adjusted Float is less than the prior year's Adjusted Float, the Annual Float is negative and the casino deducts that amount from their income.<sup>263</sup>

If the IRS was concerned with accuracy, casinos would have a more accurate way to determine the total chips that would never be redeemed.<sup>264</sup> As part of issuing chips by series, casinos will designate a time by which it will retire the series being used.<sup>265</sup> Depending on the jurisdiction where the casino is located, the casino may not have any responsibility to honor retired chips that are presented for redemption.<sup>266</sup> In the jurisdictions where the casino's liability ends once the chips are retired, the casino could make an accurate final determination after the point in time that the casino would no longer be held liable to honor the chips when presented.<sup>267</sup> The amount of chips that would never be returned to the casino would simply be calculated as the difference of the total chips issued and the total chips the casino has on hand.<sup>268</sup> However, the IRS prefers not to wait until a casino retires a series of chips to include any outstanding chips in gross income. This may be because the chip redemption period is solely up to the casino and could be used as a way to defer income recognition. Moreover, the annual accounting period is likely more consistent with any recognition for financial accounting purposes as well.

The Eldorado settlement includes consideration that permanent retirement of chips and tokens are part of the natural life of chips and tokens.<sup>269</sup> In the year the chips or tokens are retired, an amount shall be recognized as income for the chips and tokens that have not and will not be redeemed.<sup>270</sup> To avoid double counting of amounts included in income in prior years, the amount of

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<sup>259</sup> *Id.* at 5-7.

<sup>260</sup> *See id.*

<sup>261</sup> *Id.* at 8.

<sup>262</sup> *Id.*

<sup>263</sup> *Id.*

<sup>264</sup> MCGEEHAN, *supra* note 1, at 21.

<sup>265</sup> *Id.*

<sup>266</sup> *Id.*

<sup>267</sup> *Id.*

<sup>268</sup> *Id.*

<sup>269</sup> *See* Eldorado Order, *supra* note 246, at 9.

<sup>270</sup> *Id.*

outstanding chips and tokens on the day of retirement is decreased by any amount previously recognized in income.<sup>271</sup>

Although the government has not been successful in including the full amount of casinos' outstanding chip liability in income, the government has been able to include the low hanging fruit. Casinos have conceded that a small portion of the outstanding chips will never be returned. They have also been able to agree, by adopting the terms of the Eldorado settlement, that a reasonable estimate can be calculated based on historical data for chips that were never returned. The fact that other casinos have followed this calculation voluntarily suggests that the government has won a number of small, income-recognition battles with this one settlement.

#### V. CONCLUSION

Based on the current federal tax laws, the government will have to be content with the little slice of casinos' outstanding chip liability it has been able to reclassify as gross income. Casinos generally have gross receipts in excess of \$1 million which requires them to use accrual accounting methods to calculate their taxable income. The accrual accounting method requires the taxpayer to include an amount in income, under the *All Events Test*, once the right to the income is fixed and the amount can be determined with reasonable accuracy.

A large majority of the outstanding chips fail both prongs of the *All Events Test*. The majority of a casino's income associated with the outstanding chips is recorded when patrons gamble and lose the chips back to the casino. Together, these two contingencies result in a substantial limitation on the casino's possible income. The chips are also redeemable at the will of the patron. This "at will" relationship makes it impossible for casinos to reasonably calculate what percentage of the outstanding chip liability will be redeemed and what will be converted into revenue. Therefore, under the accrual accounting methods, casinos are able to classify a large majority of their receipt of cash in exchange for chips as a liability, allowing them to hold large amounts of cash without reporting it in their gross income.

In contrast, both the IRS and casinos agree that there is a small portion of the outstanding chip liability that would fulfill both requirements of the *All Events Test* and therefore, should be reclassified as income. This small portion of the outstanding chips that should be included in income is the portion that the patrons misplaced or decided to keep. The casinos' right to these chips becomes fixed at the time of the exchange, thus fulfilling the first prong. The casinos have also agreed to follow the terms of the Eldorado settlement as a reasonable method to calculate the casinos' history of chip collecting. Because both requirements of the *All Events Test* are fulfilled, the inclusion in income of this portion of the outstanding chip liability falls squarely within the tax laws.

Based on the failures of previous theories of how to reclassify the outstanding chip liability, the IRS should be content with the fact that it was able to carve out a portion that fulfills the accrual requirements for inclusion in income. Until Congress utilizes the full power of its taxing authority to change

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<sup>271</sup> *Id.*

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the tax code to disallow the casinos' method of accounting, the government will be unable to tax the remaining cash the casinos hold as a liability for outstanding chips.

