

DESCRIPTION OF TAX BILL  
(S. 2985)

Relating to

TIME FOR ACCRUAL OF DEBTS

Scheduled for a Hearing

Before the

Senate Committee on Finance

on December 15, 1982

Prepared by the Staff

of the

Joint Committee on Taxation

December 14, 1982

JCX-51-82



## INTRODUCTION

The Senate Committee on Finance has scheduled a hearing on S. 2985 (introduced by Senators Cannon and Laxalt) for Wednesday, December 15, 1982. The bill relates to the time for accrual of income and deductions arising from debts which may not be legally enforceable in the State in which they are incurred.

The first part of this document is a summary of the bill. This is followed by a more detailed description of the bill, including present law, explanation of the provisions, and effective date.



## I. SUMMARY

Under the accrual method of accounting, a taxpayer recognizes income, or is allowed a deduction, in the year when all the events have occurred which fix the right to receive income, or establish the fact of the liability, and the amount thereof can be determined with reasonable accuracy. Present law is unclear as to whether legal enforceability is a prerequisite to accrual.

S. 2985 would provide that income or deductions arising from an obligation would not accrue for income tax accounting purposes if it is not enforceable under applicable State law.



## II. DESCRIPTION OF TAX BILL

### Present law

A taxpayer using the accrual method of accounting recognizes income in the taxable year when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Similarly, a taxpayer is allowed a deduction for the year in which all the events have occurred which establish the fact of the liability giving rise to the deduction and the amount thereof can be determined with reasonable accuracy (Treas. Reg. sec. 1.446-1(c)(1)(ii)). Under the accrual method, income is recognized even though some or all of it may not be collected. Instead, the accrual method accounts for the possibility that the income may not be collected by allowing a deduction for an addition to the reserve for bad debts (sec. 166(c)).

Present law is unclear as to whether all the events have occurred to fix the right to receive income, or establish the fact of the liability, when the debt giving rise to the income or deduction is not legally enforceable under applicable State law. For example, in Desert Palace, Inc. v. Commissioner, 72 T.C. 1033 (1979), the Tax Court held that debts arising out of certain gambling transactions which were void under Nevada law did not result in taxable income until collected. However, in Flamingo Resort, Inc. v. U.S., 664 F.2d 1387 (9th Cir. 1982), the Court of Appeals reached an opposite conclusion when it held that debts arising out of certain gambling transactions which were void under Nevada law resulted in taxable income when incurred. Similarly, in a case which involved usurious interest, the Court of Appeals held that the lender must accrue interest in income despite the fact that, under the usury statute of the applicable local law, the lender was entitled only to the return of the principal and no interest (Barker v. Magruder, 95 F.2d 122 (D.C. Cir. 1938)).

### Issue

The issue is whether income arising from an unenforceable debt should be recognized under the accrual method of accounting when collected or whether such income should be recognized when the debt is incurred and an offsetting deduction for bad debts allowed to reflect any debts that may not be collected. A related issue is whether deductions arising from an unenforceable debt should be allowed under the accrual method of accounting only when paid or at some time preceding payment.





Explanation

The bill provides that a taxpayer using the accrual method of accounting would not include in income an amount equal to a debt owed to such taxpayer, or be allowed to deduct an amount equal to a debt owed by such taxpayer, unless the debt is enforceable under the laws of the State in which it was incurred or unless the debt is paid.

Effective Date

The provisions of this bill would apply to taxable years beginning after December 31, 1964.

Revenue Effect

The revenue estimate is not available at this time.

