ACCRUAL METHOD OF ACCOUNTING: TAX TREATMENT OF CERTAIN UNENFORCEABLE DEBTS—S. 2985

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

SECOND SESSION

ON

S. 2985

DECEMBER 15, 1982

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE

16-781 O WASHINGTON : 1983 HG 97-129

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ACCRUAL METHOD OF ACCOUNTING: TAX TREATMENT OF CERTAIN UNENFORCEABLE DEBTS—S. 2985

WEDNESDAY, DECEMBER 15, 1982

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to notice, at 10:07 a.m. in room 2221, Dirksen Senate Office Building, Hon. Robert Dole (chairman) presiding.

Present: Senator Dole.

[The press release announcing the hearing of the Joint Committee on Taxation's description of S. 2985 and the text of S. 2985 follows:]

Press Release No. 82- 177

PRESS RELEASE

FOR IMMEDIATE RELEASE
December 8, 1982

UNITED STATES SENATE
COMMITTEE ON FINANCE
2227 Dirksen Senate Office Bldg.

FINANCE COMMITTEE SETS HEARING ON S. 2985

The Honorable Bob Dole (R., Kans.), Chairman of the Senate Committee on Finance, announced today that the Committee will hold a hearing on Wednesday, December 15, 1982, on S. 2985.

The hearing will begin at 10:00 a.m. in Room 2221 of the Dirksen Senate Office Building.

The following proposal will be considered:

S. 2985--Introduced by Senator Cannon. S. 2985 would provide that an obligation would not accrue for income tax accounting purposes if it is not enforceable under applicable State law.

Requests to testify--Witnesses who wish to testify at the hearing must submit a written request to Robert E. Lighthizer, Chief Counsel, Committee on Finance, Room 2227 Dirksen Senate Office Building, Washington, D.C. 20510, to be received no later than noon on Monday, December 13, 1982. Witnesses will be notified as soon as practicable thereafter whether it has been possible to schedule them to present oral testimony. If for some reason a witness is unable to appear at the time scheduled, he may file a written statement for the record in lieu of the personal appearance. In such a case, a witness should notify the Committee of his inability to appear as soon as possible.

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

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.

II

97TH CONGRESS
2D SESSION

S. 2985

To amend the Internal Revenue Code of 1954 to provide that debts shall accrue only in certain circumstances.

IN THE SENATE OF THE UNITED STATES

SEPTEMBER 30 (legislative day, SEPTEMBER 8), 1982

Mr. CANNON (for himself and Mr. LAXALT) introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To amend the Internal Revenue Code of 1954 to provide that debts shall accrue only in certain circumstances.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) section 446 of the Internal Revenue Code of 1954 (relating to general rule for methods of accounting) is amended by adding at the end thereof the following new subsection:

"(f) TIME OF ACCRUAL OF DEBTS.—For purposes of paragraph (2) of subsection (c)—

"(1) an amount equal to a debt owed to the taxpayer shall not be included in the income of such taxpayer; and

"(2) an amount equal to a debt owed by the taxpayer shall not be deductible from the income of such taxpayer;

unless such debt is enforceable under the laws of the State in which it was incurred or unless such debt is paid.

(b) The amendments made by subsection (a) shall apply with respect to taxable years beginning after December 31, 1964.

The CHAIRMAN. The committee hearing this morning is on S. 2985, introduced by Senators Cannon and Laxalt. It provides that a taxpayer who employs an accrual method of tax accounting will not accrue an obligation that is not legally enforceable under the laws of the State in which it arises. Thus, the deduction will not be allowed to the payor for such an amount, nor will it be includable in income by the payee, until paid.

And I have a brief statement, which I will ask to be made part of the record.

We are very pleased to hear from Senator Laxalt.

[The opening statement of Senator Dole follows:]

STATEMENT OF SENATOR DOLE ON S. 2985

This morning we will hear the sponsors, Treasury Department, and public witnesses on legislation which would require that an obligation be legally enforceable under applicable State law before it may be accrued for tax purposes. Thus, this morning's hearing takes us back into many difficult tax accounting questions much like those with which the Congress wrestled last summer in the completed contract area.

In general, taxpayers are entitled to choose between cash and accrual methods of accounting, subject only to a very limited overall requirement that the method adopted must clearly reflect the taxpayer's income. If the taxpayer selects the cash method of accounting, he is allowed a deduction when amounts are paid and he takes into income amounts when payment is received. If a taxpayer adopts an accrual method of accounting, however, amounts are deductible and includible, respectively, when the obligation accrues. The standard formulation is that amounts accrue when all events sufficient to fix the liability with reaonable accuracy occur.

The issue before us this morning is whether gambling debts that are not enforceable under the laws of Nevada, as well as other obligations that are not enforceable under State law, may accrue before payment for Federal income tax accounting purposes. The issue arises in Nevada with respect to gambling debts. Under Nevada law, gambling debts are not enforceable. That means that the casinos cannot secure a judgment on gambling debts in any court of law. Recently, the courts have wrestled with the question whether gambling debts must be taken into income by the casinos when they arise, or when they are paid. The Tax Court has held that such amounts are not accruable; the Ninth Circuit has held that they are. A related issue is whether an accrual basis taxpayer can accrue such liabilities (to the limit of gambling income). Although an arcane area of the tax law, we will hear this morning as to the potential for reaching consequences of the various decisions. I look forward to hearing this morning's testimony.

STATEMENT OF HON. PAUL LAXALT, U.S. SENATOR FROM THE STATE OF NEVADA

Senator LAXALT. Thank you, Mr. Chairman.

First of all, I want to thank you, Mr. Chairman, as chairman of the Finance Committee for taking the time to hold these hearings. I don't know of anybody on this Hill or in this town for that matter who has a plate that is more full than Robert Dole. This isn't the only time this chairman has been very receptive to Nevada problems. He spends a lot of time in our State, and has a unique understanding of the problems that we seem to experience.

I realize that time, Mr. Chairman, is certainly at a premium for you, and I appreciate your consideration.

Mr. Chairman, Senate bill 2985 is a bill to correct what I believe to be a mistake in court rulings which overturn longstanding tax law and threatens to confuse every accrual method taxpayer. While the immediate case touches on Nevada's legalized gaming establishments, the end results could be widespread to the detriment of the U.S. Treasury.

In the court case, *Flamingo Resort, Inc.* v. *United States,* 485 F. Supp. 926 (1980), the United States District Court in Nevada ruled that the "all events" test for accrual taxpayers can be met even if the debt to be collected is legally void. In other words, accrual taxpayers must include as income legally unenforceable debts. In that case, the taxpayer was ordered to declare as income gambling debts which, under Nevada law, are void.

This result flies in the face of 40 years of tax law, as well as a recent case in the tax court. It is manifestly unfair for the taxpayer. Under the new law, the taxpayer would be forced to pay taxes on income he may never see and cannot legally collect.

While this looks at first like a real boon to the Treasury, the results, I feel, could be just exactly the opposite. The all-events test is used to determine when an accrual taxpayer can take deductions. If the all-events test is weakened so that legal enforceability is no longer a requirement, billions of dollars of deductions will be taken. The drain on the Treasury will be tremendous. At a minimum, the decision will tie up the courts in knots as every accrual taxpayer tests the new ruling.

Senate bill 2985 seeks to reverse the result of this recent case and preserve the current status quo. It would clarify the intent of Congress that debts must be legally enforceable before they can be included in gross income for accrual method taxpayers. It would protect both the taxpayers and the Treasury. There is no revenue loss since no revenue has been collected, yet, under the cases. It would strengthen the law and the all-events test.

I urge, Mr. Chairman, to you and to the members of the committee, that Senate bill 2985 be reported out favorably as quickly as possible for the reasons mentioned.

[The prepared statement of Senator Laxalt follows:]

STATEMENT BY SENATOR LAXALT

Before Senate Finance Committee

In support of S. 2985

December 15, 1982

MR. LAXALT. Mr. Chairman, first of all, I want to thank my good friend and the Chairman of the Finance Committee for taking the time to hold hearings on S. 2985. (I also want to thank my colleagues on the Committee for participating.) I realize that time is at a premium during this post-election session, and I appreciate your consideration.

Mr. Chairman, S. 2985 is a bill to correct what I believe to be a mistaken court ruling which overturns long-standing tax law and threatens to confuse every accrual method taxpayer. While the immediate case touches on Nevada's legalized gaming establishments, the end results could be widespread to the detriment of the U.S. Treasury.

In the court case Flamingo Resort, Inc. v. United States 485 F. Supp. 926 (1980), the U.S. District Court in Nevada ruled that the "all events test" for accrual taxpayers can be met even if the debt to be collected is legally void. In other words, accrual taxpayers must include as income legally unenforceable debts. In that case, the taxpayer was ordered to declare as income gambling debts which under Nevada law are void.

This result flies in the face of 40 years of tax law, as well as a recent case in the tax court. It is manifestly unfair for the taxpayer. Under the new law, the taxpayer would be forced to pay taxes on income he may never see and cannot legally collect.

While this looks like a real boon to the Treasury, the results could be the exact opposite. The "all events test" is used to determine when an accrual taxpayer can take deductions. If the "all events test" is weakened so that legal enforceability is no longer a requirement, billions of dollars of deductions will be taken. The drain on the Treasury will be tremendous. At a minimum, the decision will tie up the courts in knots as every accrual taxpayer tests the new ruling.

S. 2985 seeks to reverse the result of this recent case and preserve the current status quo. It would clarify the intent of Congress that debts must be legally enforceable before they can be included in gross income for accrual method taxpayers. It would protect both the taxpayers and the Treasury. There is no revenue loss since no revenue has been collected yet under the cases. It would strengthen the law and the "all events test."

I urge the Committee to report out S.2985 favorably.

Thank you.

The CHAIRMAN. Thank you, Senator Laxalt. I understand the Treasury will take a different view of S. 2985. There may be some way we can draft this to take care of your specific problem, without causing problems for the Treasury. I'm not certain that can be done, but I'm certain Mr. Chapoton will be pleased to take a hard look at that. He has been very helpful in the past.

Senator LAXALT. I think, with your general suggestion, he probably will be amenable to doing that.

The CHAIRMAN. Have you met Mr. Chapoton?

Senator LAXALT. Yes; I had the pleasure.

The CHAIRMAN. I didn't want you to miss that opportunity. [Laughter.]

We are also pleased to have Senator Cannon with us. Howard, do you want to come up?

I have no questions, Paul.

Senator LAXALT. Thank you, Mr. Chairman.

STATEMENT OF HON. HOWARD W. CANNON, U.S. SENATOR FROM THE STATE OF NEVADA

Senator CANNON. Thank you very much, Mr. Chairman. I'm pleased to be here today to express my strong support for S. 2985, legislation to amend the Internal Revenue Code to provide that certain debts shall accrue only when they are paid. This is a little known situation, but nevertheless, it is a detrimental one for not only my State, but to the Government as a whole.

Let me briefly explain this issue, and I believe that when the facts are known, you will agree with me that enactment of S. 2985 is critical.

In Nevada, the law states that gambling markers are not legally enforceable debts. Therefore, the markers are not accrued as income for tax purposes until the debts are paid to the taxpayer. Since 1967, the IRS has attempted to invalidate Nevada's law by bringing suit against two of its hotel-casinos for deficiency payments. It is interesting to note, however, Mr. Chairman, that a conflict has arisen on this issue between the U.S. Tax Court, which ruled in favor of Nevada, and the Ninth Circuit Court of Appeals, which ruled in favor of the Government.

Now the time-honored, all-events test is at issue in these cases. This legal principle states that income should not be accrued for tax purposes until all events have occurred which fix the taxpayer's right to receive the income. If we apply this test to Nevada, this would mean the point at which the money for the markers is actually collected; not when the markers are issued.

In the case before the U.S. Tax Court, the court ruled that in Nevada, because markers are not legally enforceable, all events had not occurred, giving rise to the right of the income. On the other hand, the ninth circuit ruled that the all-events test should not apply to Nevada's legal gaming industry. Now keep in mind, Mr. Chairman, that this ruling was made in spite of the fact that the all-events test has been applied to many other businesses for several years. Here is a case where the legal gaming industry is being singled out for differential treatment. And we have had a problem here for years in trying to have the gaming business recognized as a legal industry in our State. I served on the National Commission on Gaming Policy, and I thought we had well established the fact that it is a legal industry; should be treated the same as any other legal industry. You, yourself, have recognized that fact with respect to the tax impact that we have gone into in the past in the elimination or the removal of a good bit of the wagering tax and things of that sort, and the occupational tax, which were not fair as far as this industry is concerned—treated them differently.

I think there are serious implications to the court's ruling. First is the issue of States' rights. The IRS is attempting to invalidate Nevada law.

Second, there would be a significant impact on Nevada's economy, an economy which depends on its legal gaming industry for over 81 percent of its revenue, and 61 percent of its jobs. Now I think everyone can agree that now is certainly not the time to be eliminating jobs. If the ninth circuit's ruling is upheld, Nevada's hotel-casinos will be forced to utilize working capital to pay the IRS assessments. All who use the accrual method of accounting will be subject to back taxes and interest.

And, third, Mr. Chairman, if the court's determination stands, other taxpayers who use the accrual method of accounting could actually use the ruling to their benefit to defer perpetually taxes on reserves which have been established to meet predictable future expenses. For example, if insurance companies could deduct all their reserves, the loss would amount to billions of dollars to the Treasury.

Now in conclusion, Mr. Chairman, I believe that S. 2985 is a reasonable solution to this problem. It would not only protect the individual taxpayer, but would prevent a large revenue loss to the Treasury as well. I urge the committee to take prompt and favorable action on this measure. I appreciate the opportunity to discuss this with you. And if you have any questions, I will be very happy to answer them.

The CHAIRMAN. Thank you.

[The prepared statement of Senator Cannon follows:]

STATEMENT OF SENATOR HOWARD W. CANNON
BEFORE THE SENATE FINANCE COMMITTEE
ON S. 2985
DECEMBER 15, 1982

MR. CHAIRMAN, I AM PLEASED TO BE HERE TODAY TO EXPRESS MY STRONG SUPPORT FOR S. 2985, LEGISLATION TO AMEND THE INTERNAL REVENUE CODE TO PROVIDE THAT CERTAIN DEBTS SHALL ACCRUE ONLY WHEN THEY ARE PAID. THIS IS A LITTLE KNOWN SITUATION, BUT NEVERTHELESS, IT IS A DETRIMENTAL ONE FOR, NOT ONLY MY STATE, BUT TO THE GOVERNMENT, AS A WHOLE.

LET ME BRIEFLY EXPLAIN THIS ISSUE, AND I BELIEVE THAT WHEN THE THE FACTS ARE KNOWN, YOU WILL AGREE WITH ME THAT ENACTMENT OF S. 2985 IS CRITICAL.

IN NEVADA, THE LAW STATES THAT GAMBLING MARKERS ARE NOT LEGALLY ENFORCEABLE DEBTS. THEREFORE, THE MARKERS ARE NOT ACCRUED AS INCOME, FOR TAX PURPOSES, UNTIL THE DEBTS ARE PAID TO THE TAXPAYER. SINCE 1967, THE IRS HAS ATTEMPTED TO INVALIDATE NEVADA'S LAW BY BRINGING SUIT AGAINST TWO OF ITS HOTEL/CASINOS FOR DEFICIENCY PAYMENTS. IT IS INTERESTING TO NOTE, HOWEVER, MR. CHAIRMAN, THAT A CONFLICT HAS ARISEN ON THIS ISSUE BETWEEN THE U.S. TAX COURT, WHICH RULED IN FAVOR OF NEVADA, AND THE NINTH CIRCUIT COURT OF APPEALS, WHICH RULED IN FAVOR OF THE GOVERNMENT.

THE TIME-HONORED "ALL EVENTS TEST" IS AT ISSUE IN THESE CASES. THIS LEGAL PRINCIPLE STATES THAT INCOME SHOULD NOT BE ACCRUED FOR TAX PURPOSES UNTIL "ALL EVENTS" HAVE OCCURRED WHICH FIX THE TAXPAYER'S RIGHT TO RECEIVE THE INCOME. IF WE APPLY THIS TEST TO NEVADA, THIS WOULD MEAN THE POINT AT WHICH THE MONEY FOR THE MARKERS IS ACTUALLY COLLECTED--NOT WHEN THE MARKERS ARE ISSUED.

IN THE CASE BEFORE THE U.S. TAX COURT, THE COURT RULED THAT, IN NEVADA, BECAUSE MARKERS ARE NOT LEGALLY ENFORCEABLE, "ALL EVENTS" HAD NOT OCCURRED, GIVING RISE TO THE "RIGHT" OF THE INCOME. ON THE OTHER HAND, THE NINTH CIRCUIT RULED THAT THE "ALL EVENTS TEST" SHOULD NOT APPLY TO NEVADA'S LEGAL GAMING INDUSTRY. KEEP IN MIND, MR. CHAIRMAN, THAT THIS RULING WAS MADE IN SPITE OF THE FACT THAT THE "ALL EVENTS TEST" HAS BEEN APPLIED TO MANY OTHER BUSINESSES FOR SEVERAL YEARS. HERE IS A CASE WHERE THE LEGAL GAMING INDUSTRY IS BEING SINGLED OUT FOR DIFFERENTIAL TREATMENT.

I THINK THAT THERE ARE SERIOUS IMPLICATIONS TO THE COURT'S RULING. FIRST, IS THE ISSUE OF STATE'S RIGHTS. THE IRS IS ATTEMPTING TO INVALIDATE NEVADA LAW.

SECOND, THERE WOULD BE A SIGNIFICANT IMPACT ON NEVADA'S ECONOMY--AN ECONOMY WHICH DEPENDS ON ITS LEGAL GAMING INDUSTRY FOR OVER 81 PERCENT OF ITS REVENUE AND 61 PERCENT OF ITS JOBS. I THINK EVERYONE CAN AGREE THAT NOW IS CERTAINLY NOT THE TIME TO BE ELIMINATING JOBS. IF THE NINTH CIRCUIT'S RULING IS UPHELD, NEVADA'S HOTEL/CASINOS WILL BE FORCED TO UTILIZE WORKING CAPITAL TO PAY THE IRS ASSESSMENTS. ALL WHO USE THE ACCRUAL METHOD OF ACCOUNTING WILL BE SUBJECT TO BACK TAXES AND INTEREST.

THIRD, MR. CHAIRMAN, IF THE COURT'S DETERMINATION STANDS, OTHER TAXPAYERS WHO USE THE ACCRUAL METHOD OF ACCOUNTING COULD ACTUALLY USE THE RULING TO THEIR BENEFIT TO DEFER, PERPETUALLY, TAXES ON RESERVES WHICH HAVE BEEN ESTABLISHED TO MEET PREDICTABLE FUTURE EXPENSES. FOR EXAMPLE, IF INSURANCE COMPANIES COULD DEDUCT ALL THEIR RESERVES, THE LOSS WOULD AMOUNT TO BILLIONS OF DOLLARS TO THE TREASURY.

IN CONCLUSION, MR. CHAIRMAN, I BELIEVE THAT S. 2985 IS A REASONABLE SOLUTION TO THIS PROBLEM. IT WOULD, NOT ONLY PROTECT THE INDIVIDUAL TAXPAYER, BUT WOULD PREVENT A LARGE REVENUE LOSS TO THE TREASURY, AS WELL.

I URGE YOU TO TAKE PROMPT AND FAVORABLE ACTION ON THIS MEASURE.

THANK YOU FOR THE OPPORTUNITY TO DISCUSS THIS IMPORTANT ISSUE.

The CHAIRMAN. I have no questions, Senator Cannon. I understand this is some matter of urgency. I assume that will be detailed by the panel that will be following shortly. I know, however, that Treasury has some concern about this bill. We haven't heard from Mr. Chapoton. He's the next witness. We may ask some questions after we have heard all of the panel, and I would be happy to discuss it with you.

Senator CANNON. Very good. Thank you very much.

The CHAIRMAN. Thank you, Senator.

I might say to all the remaining witnesses that we are on the gas tax bill on the Senate floor, and I am the manager of that bill, and we are back on it at 10:30 so we are going to have to try to expedite the hearing.

Mr. Chapoton.

STATEMENT OF HON. JOHN E. CHAPOTON, ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY

Mr. CHAPOTON. Thank you, Mr. Chairman. I appreciate your giving us the opportunity to present our views on S. 2985. And I think I can be very brief since the problem has been described quite well by the two Senators.

The statute proposed would, quite simply, make legal enforceability a prerequisite for the application of the all-events test. It would, as they have both indicated, overrule a ninth circuit case holding that the lack of legal enforceability did not prevent the accrual of income.

In general, as you know, taxpayers may elect to use the cash or accrual method. If they elect the accrual method, the income is reported, in general summarizing the cases, when all events have occurred which fix the right to receive such income, and the amount thereof can be determined with reasonable accuracy.

This bill would put gambling casinos and other taxpayers on the cash method of accounting for income while permitting them to continue to accrue current deductions for expenses related to that income. They would really have a mismatching, we think—a significant mismatching. They would defer the reporting of the income while taking related deductions currently on the accrual basis.

All accrual method taxpayers that extend credit to customers in the ordinary course of their business face the risk that the income may not, in fact, be received. Current law takes care of that problem by allowing them to establish a reserve for bad debts, and deducting a reasonable addition to that reserve each year. We think that is the remedy for the casinos to follow in the event that some of their debts will not be collectible. We think it is appropriate relief. And we think that should be the only method of relief if there is a problem on actual collectibility.

In the *Flamingo* case, the problem did not seem to exist. The court found that collections equaled up to 96 percent of the markers that were receivable. I think it is due in no small part to the fact that the casinos allow the markers, according to the facts in the case, only after an extensive credit check of the customers involved.

We think the *Flamingo* case correctly interprets the law. We think it is consistent with other cases in which taxpayers have been required to accrue income from obligations that were not legally enforceable. And I think this is the major point. The gambling industry has not been singled out in this area. Indeed, there are several cases—a D.C. circuit case involving the question of usurious interest where the interest arguably was not enforceable. The obligation to pay interest was not enforceable under State law. The court held that in any event the all-events test was applicable and the income had to be accrued.

Another earlier sixth circuit case—*Travis* v. *Commissioner*—held similarly in 1969.

There is an inconsistent tax court case as the Senators mentioned. I think that case represents a slip on our side in that the Government's counsel, for some reason that I am still not able to determine, conceded the issue not legal enforceability was a touchstone of the all-events test in a manner which seems to me totally inconsistent with the earlier cases. And we think that simply was an error.

So in sum, we think the law is correctly applied in the *Flamingo* case. We would have mismatching if we applied the rule sought to be enacted by S. 2985. And it would have far-reaching effects, far beyond the gambling industry in that there are many taxpayers that could argue that under State law a certain obligation was not legally enforceable. And the question has been presented to the courts several times and they have held that the all-events test nevertheless applies.

The Senators make the point that we look at the deduction side as well, and that this doing away with the legal enforceability requirement could cost the Treasury money by allowing accrual of deductions that would not be otherwise allowed. We don't think that is a problem.

What we are saying is that legal enforceability is not an absolute prerequisite on either side. It is certainly a factor to be taken into account in determining whether all events have occurred for the accrual of income or the accrual of a deduction. That's what we think the court said, and we think that is a proper and sound law.

Thank you, Mr. Chairman. We will be happy to answer any questions.

The CHAIRMAN. Is there some urgency about this particular bill?

Mr. CHAPOTON. No. We feel no urgency about it. We are taking the position consistent with this testimony. The Tax Court case that I mentioned that was adverse to the Government is being appealed. And we think the *Flamingo* case articulates the correct rule quite well. From our standpoint, there is no urgency. I can understand certainly from the standpoint of the taxpayers concerned with this bill there probably is because I am sure they are filing their returns claiming that the income is not accruable and they certainly would like to get the issue settled as soon as possible. I can certainly understand that.

The CHAIRMAN. Thank you very much, Secretary Chapoton. We will review the record on this, and make it available to other members of the committee. I'm not certain just what the timetable is because we are, I hope, in the last days of this session. It may be that after we have heard the panel we might have additional questions. Not today, but maybe we could submit those in writing.

Mr. CHAPOTON. That would be fine. We would be happy to answer them.

Thank you, Mr. Chairman.

[The prepared statement of Hon. John E. Chapoton follows:]

For Release Upon Delivery
Expected at 10 a.m. EST
December 15, 1982

STATEMENT OF
THE HONORABLE JOHN E. CHAPOTON
ASSISTANT SECRETARY
(TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SENATE FINANCE COMMITTEE

Mr. Chairman and Members of the Committee:

I am pleased to have the opportunity to present the views of the Treasury Department on S. 2985, which would make legal enforceability a prerequisite to the accrual of gross income represented by "debts" due and owing to a taxpayer at the end of the taxable year. Treasury is strongly opposed to S. 2985.

Description of S. 2985

Under current law, an accrual method taxpayer must include an amount 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. S. 2985 provides generally that an amount equal to a debt shall not be included in or deducted from income where the debt is not enforceable under state law unless and until the debt is paid. The provision would be effective for taxable years beginning after December 31, 1964.

S. 2985 would reverse retroactively a recent decision of the Ninth Circuit Court of Appeals which held that a gambling casino operating in Nevada must accrue winnings from customers who gamble on credit at the time the receivables arise, despite the fact that gambling debts are not enforceable under Nevada law. Flamingo Resort, Inc. v. United States, 664 F.2d 1387 (9th Cir. 1982).* The taxpayer in that case argued, as do the proponents of S. 2985, that because the casinos cannot legally enforce collection of their receivables their right to this income is not fixed. The taxpayer's position, therefore, was that the income represented by the receivables should not be accrued until it is paid.

The Ninth Circuit Court of Appeals, in rejecting the taxpayer's argument, stated that legal enforceability is relevant in determining whether all the events have occurred which fix the right to receive income. However, the court found that the lack of legal enforceability was not determinative of whether this test was met under the facts of the case before it. The court noted that the absence of legal enforceability did not seem to affect collection of the casino's outstanding receivables. Indeed, the collection rate was quite high. There was no evidence that legal enforceability would have increased the collection rate.

Discussion

Generally, under current law, taxpayers that do not maintain inventories may elect to compute taxable income under the cash or accrual method of accounting. Under the cash method of accounting, income is reported for tax purposes in the taxable year in which it is actually or constructively received. Deductions are taken into account in the taxable year in which payment is actually made. Under the accrual method of accounting, income is reported 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, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy.

The effect of S. 2985 would be to put gambling casinos on the cash method of accounting for income while permitting them to continue to accrue current deductions for expenses related to that income. This treatment would give the casinos the best of both worlds: they would be able to defer the reporting of income while taking related deductions currently. We do not think that the casinos have

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*In a case which presented virtually identical facts, the Tax Court has held that such receivables were not accruable. Desert Palace, Inc. v. Commissioner, 72 T.C. 1033 (1979). The Desert Palace case is currently on appeal to the Ninth Circuit.

demonstrated that such special treatment would be justified. All accrual method taxpayers that extend credit to customers in the ordinary course of business face the risk that income accrued at the end of a taxable year will not be received. Current law permits a taxpayer to account for this risk by establishing a reserve for bad debts and deducting a reasonable addition to its reserve each year. If, because of the lack of legal enforceability or some other reason, a casino determines that some of its receivables will not be collected, it can obtain appropriate relief through establishing such a reserve and reducing accrued income with a current bad debt deduction. The fact that the receivables of casinos are not legally enforceable does not provide a basis for granting them better treatment than other accrual method taxpayers. Indeed, from the facts presented in the Flamingo Resort case, the collection rate may be higher for casinos than for many other businesses.

The Treasury Department believes that the decision in the Flamingo Resort case correctly interprets current law and that it should not be overturned. The decision is consistent with other cases in which taxpayers have been required to accrue income from obligations that were not legally enforceable. For instance, income from usurious loans has been held to be accruable despite the lack of legal enforceability. Barker v. Magruder, 95 F.2d 122 (D.C. Cir. 1938). S. 2985 would reverse this longstanding decision. Similarly, income from executory contracts has been held to be accruable even though collection was not legally enforceable until performance had occurred. Travis v. Commissioner, 406 F.2d 987 (6th Cir. 1969). Enactment of S. 2985 would affect this decision as well. Thus, while the intended beneficiaries of S. 2985 are the Nevada casinos, the principle on which the bill is based would cover many other types of taxpayers and transactions.

We strongly disagree with the assertion that the accrual of an obligation should depend upon the enforceability of the obligation under local law. Basic principles of equity require that similarly situated taxpayers be taxed similarly. Since other accrual method taxpayers are required to accrue income that ultimately may not be collected, it would give an unfair preference to gambling casinos to permit them to defer the income from their receivables. The bad debt reserve deduction allowed to all accrual method taxpayers under current law is a more than adequate means of taking the risk of nonpayment into account in computing income from receivables.

Moreover, any rule that would make the tax consequences resulting from a transaction dependent upon the law of the state in which it is consummated would create numerous practical and administrative problems. In cases involving taxpayers who have transacted business in a number of states,

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the examining agent would have to be familiar with the law in each of those states to determine the taxpayer's proper tax liability. Additional administrative problems would be caused by the provision in S. 2985 which would apply this incorrect principle retroactively as far back as 1965.

Conclusion

The Treasury Department is strongly opposed to S. 2985. The rule that would be enacted by the bill is directly contrary to the general rule of accrual method tax accounting which disregards risks of future nonpayment in accruing income from receivables. This would give preferential treatment to a narrow class of taxpayers over other accrual method taxpayers. We believe that the bad debt reserve deduction provided by current law is adequate to account for the possibility that income from receivables ultimately may not be paid. Moreover, S. 2985 would create administrative problems and would establish a principle which, if enacted, would affect taxpayers and transactions far beyond the narrow group it is intended to benefit.

I would be happy to answer your questions.

The CHAIRMAN. Now we have a panel consisting of Harry Wald, president of Caesar's Palace; John V. Giovenco, executive vice president, Hilton Hotels Corp.; Robert Frisch; Milton Levenfeld; James Ritchie; and Robert Juliano.

STATEMENT OF HARRY WALD, PRESIDENT, CAESAR'S PALACE, LAS VEGAS, NEV.

Mr. WALD. Mr. Chairman, ladies and gentlemen, my name is Harry Wald, and I am the president of Caesar's Palace Hotel and Casino in Las Vegas. I very much appreciate this opportunity to appear before you in support of Senate bill S. 2985.

You have copies of my prepared testimony, and rather than take up your valuable time reading that testimony in its entirety, I would like to request, Mr. Chairman, that my prepared testimony be placed in the record of this hearing. And I will then proceed to discuss with you a few highlights of that testimony.

The CHAIRMAN. It will be made a part of the record in its entirety, as well as other statements of other witnesses on the panel.

Mr. WALD. Thank you, sir.

My concern and that of other Nevada casino operators is a surprising decision of the U.S. District Court for the District of Nevada involving the Flamingo Hotel, which has now been affirmed by the court of appeals for the ninth circuit. That decision required Nevada casino operators to recognize income from casino credit transactions when the transaction takes place, even though a Nevada gambling debt may not be enforced in the courts of Nevada or any other State.

The *Flamingo* decision surprises us because it had been long believed that under the so-called all-events test of tax accounting, which is firmly embedded in court decisions and in the Treasury regulations, that the accrual method taxpayer does not have to recognize income and may not take a deduction until there is a legally enforceable right to receive the income or obligation to incur the expense which is being deducted.

Only 3 years ago Caesar's Palace won a case in the Tax Court which is directly contrary to the *Flamingo* decision, and held that a Nevada casino operator does not have to recognize income from casino credit transactions until it is paid. That holding, unfortunately, will probably fall because of *Flamingo.*

Indeed, the *Flamingo* decision came as something of a surprise to the Internal Revenue Service itself. In our Caesar's Palace case before the Tax Court, the Internal Revenue Service had advanced the theory of taxation of casino accounts receivable which was rejected by the Tax Court, and was similarly rejected by the district court in *Flamingo.*

However, when the Tax Court asked the Internal Revenue Service whether the Tax Court rejected its theory—it believed legally enforceability of casino accounts receivable is a necessary ingredient of a fixed right to receive income from them—the Internal Revenue Service in a brief signed by its chief counsel stated: "The unenforceability of the gambling debts receivables affects the accrual of income in that it presents a contingency which precludes accrual of income under the all-events test of Treasury Regulation Section 1.446-1(c)(1)(ii)."

Probably because the immediate issue in the *Flamingo* decision was a relatively narrow one, 2 weeks ago the U.S. Supreme Court declined to hear an appeal from that decision. However, as you are going to hear from another witness, the potential impact of the *Flamingo* decision in changing the law regarding the deductions is huge.

Meanwhile, the direct effect of *Flamingo* on the Nevada hotel-casinos is serious. It is easy to say that even though Nevada gambling debts are not legally enforceable, the Nevada hotel-casinos collect a very substantial portion of these debts. That is true. We collect debts because our customers know that if they ignore the gambling debts, they won't be given further credit by us, or probably by casinos any place else in the world.

However, it is not easy to collect our casino accounts receivable. If a customer dies or files bankruptcy, we know our claim will not be recognized by an executor or trustee. We lose millions of dollars because of this. Also, many of our customers will only pay their gambling debts if they receive substantial discounts.

Furthermore, because many of our customers are foreigners, even though our accounts receivable are theoretically payable in U.S. dollars, we frequently bear substantial losses because of currency devaluations in foreign countries. A perfect example of this is the recent devaluations of the Mexican peso. Caesar's Palace and several other of the large Nevada casinos were required to permit their Mexican customers to pay at the devalued peso exchange rate or risk not being paid at all.

Indeed, yesterday's newspapers contained lengthy stories of the sale of the Dunes Hotel-Casino in Las Vegas, and the fact that it was required because of losses that Dunes suffered with regard to credit grants to Mexican customers.

We are not the only industry that has had collection problems. However, we are probably the only legal industry in the United

States that does not have access to the courts to collect the accounts receivable. Although the courts in the *Flamingo* case made much of Flamingo's ability to predict statistically the percentage of its accounts receivable it was likely to collect, and the Internal Revenue Service did the same thing with regard to Caesar's Palace. In fact, Caesar's Palace's historical collection rate plummeted this past year due to economic conditions in the United States and abroad. The change was so substantial it reduced by almost 2 percentage points the historic rate of collections for the entire 16 years that Caesar's Palace has been opened. We are not asking to be permitted not to pay taxes. All we are asking is that because we cannot take our customers to court to collect account receivables we be permitted to delay paying our taxes until we collect our accounts receivables.

During the year ended June 30, 1982, Nevada hotel-casinos extended more than $2 billion of casino credit. By the end of that year, only approximately $248 million of this remained unpaid. It is likely that more than half of that was collected within the next 30 to 60 days, and more than 90 percent was collected within 4 to 6 months.

From the point of view of the Treasury the effects of delaying taxation until those collections take place are miniscule. However, requiring the Nevada casino operators to pay taxes before we are in a position to collect the accounts receivable could seriously impair our ability to extend the type of credit we do; therefore, to generate the kind of business we generate. The more than $2 billion of Nevada casino credit extended last year all represents gross taxable revenues and resulted in tens and perhaps hundreds of millions of dollars of U.S. income taxes.

And remember, we, Nevada casino operators, do pay our taxes. Our principal competitors, illegal gambling operators in the United States and foreign gambling operators do not pay U.S. taxes. Therefore, when the Government makes it harder for us to generate revenues, it is simply moving revenues from tax paying establishments to nontax paying establishments.

I am told, as you will be, that eliminating enforceability as a prerequisite to accrual could have serious effects on the timing of deductions. I know it can have serious effects on the Nevada casino operators.

Mr. Chairman, I thank you for your time.

The CHAIRMAN. Thank you very much, Mr. Wald. I don't mean to rush the witnesses, but I am in charge of a bill on the floor. Not that I will be missed there, but I don't want anything to happen.

[The prepared statement of Harry Wald Follows:]

TESTIMONY OF HARRY WALD IN SUPPORT OF S.2985
BEFORE THE SENATE FINANCE COMMITTEE
SENATOR ROBERT DOLE, Chairman

Mr. Chairman, Members of the Committee,
Ladies and Gentlemen:

My name is Harry Wald and I am the President of Caesars Palace Hotel & Casino in Las Vegas. I very much appreciate this opportunity to appear before you and tell you why S.2985 is so important to us in Nevada, and we think to the Federal Treasury as well.

Let me start by trying, in a somewhat inexpert way, to tell you what S.2985 does. More than 50 years ago, the United States Supreme Court ruled that an accrual method taxpayer could not accrue a deduction, and did not have to accrue income, until all the events had occurred which established the fact of the liability giving rise to the deduction, or fixed the right to receive the income, and the amount of the expense or income could be determined with reasonable accuracy. This principle of tax accounting, widely referred to as the "all events test," is expressly set forth in the Income Tax Regulations. For years, virtually everyone believed the all events test meant that you couldn't deduct an expense until you were legally obligated to incur that expense and you didn't have to accrue income until you had a legally enforceable right to receive it. As you are going to hear from another witness, the all events test has been a very, very important rule of tax accounting on the expense side. However, for us in Nevada, it has also been an important rule of tax accounting on the income side.

As I suspect some of you may be surprised to hear, although casino gambling has been legal in Nevada since the early 1930's, a gambling debt incurred in

Nevada is not enforceable in the Nevada courts. This is because, when Nevada became a state, it adopted the English common law, including a 17th century English statute, the Statute of Anne, which states that a gambling debt is "null and void and of none effect." The Nevada Supreme Court has repeatedly ruled that the Statute of Anne is part of the law of Nevada, and therefore gambling debts are not enforceable in the courts of Nevada. Because of this, gambling debts incurred in Nevada are not legally enforceable in the courts of any state of the United States.

I don't think that after what I have just said any of you is going to be surprised to learn that most of the Nevada casino operators have long belived that, because a gambling debt incurred in Nevada is not legally enforceable, when a customer of a Nevada casino loses chips he obtained on credit, the casino does not have to take its win into income unless and until the purchase price of the chips is paid. Until then, the casino has nothing but an unenforceable promise to pay, and as I said earlier, until recently virtually everyone believed that an unenforceable promise to pay did not result in taxable income.

Approximately 15 years ago, the District Director of Internal Revenue in Nevada began to argue that casino credit transactions were taxable when they occurred, even though the resulting accounts receiveable were not legally enforceable. At first, when this position was raised by Internal Revenue agents auditing Nevada casinos, it either was dropped or it led to settlements which really didn't alter very much the position the casino operators had taken. However, in approximately 1970 the Internal Revenue Service decided to make an issue of the matter. Therefore, in an audit of the tax returns of Caesars Palace, the Internal Revenue Service took the position that Caesars Palace should have recognized income from casino credit transactions when they arose, rather than when the resulting accounts receivable were collected. Shortly afterward, the Internal Revenue Service took a similar position with regard to the Flamingo Hotel and Casino, which now is owned by Hilton Hotels Corporation.

Caesars Palace refused to accept the assertion of the Internal Revenue Service and instead went to the United States Tax Court. Interestingly, when the issue was presented to the Tax Court, the Internal Revenue Service did not argue that enforceability is not an essential element of the "all events test" which I discussed a little while ago. Rather, the Internal Revenue Service argued that a casino credit transaction was really two transactions. The first was a loan transaction in which the casino "loaned" a customer chips in exchange for a note, and the second was a gambling transaction in which the customer lost his chips. This is very much like arguing that when one of you goes into Garfinkel's to buy a suit, you do not really buy the suit on credit. Rather, Garfinkel's lends you the purchase price of the suit and you then buy the suit with what you were loaned by the store. Not surprisingly, the Tax Court rejected this argument.

The Tax Court did not, however, stop at merely rejecting the two transaction theory advanced by the government. Rather, after the Caesars Palace case had been argued, but before the Tax Court rendered its decision, it directed the parties to submit briefs on the question whether, if it should reject the Internal Revenue Service theory that accounts receivable may be disassociated from the gambling transactions in which the money was lost, the taxpayer nevertheless should be required to accrue amounts represented by casino accounts receivable as income prior to receipt of payment. It asked that the parties specifically address the question, "Whether legal enforceability of such receivables is a necessary ingredient of a fixed right to receive income from them." In response to this request, the Internal Revenue Service, in a brief signed by its Chief Counsel, stated, and I am quoting:

> "The unenforceability of the gambling debts receivables affects the accrual of income in that it presents a contingency which precludes accrual of income under the all events test of Treas. Reg. Section 1.446-1(c)(1)(ii)."

As you are going to hear from one of the other witnesses, there are important revenue collection reasons for the position taken by the Internal Revenue Service in the Tax Court. The all events test has delayed accrual of deductions, just as we believed it delayed accrual of income. Therefore, the Internal Revenue Service was wisely concerned about anything which might alter the all events test.

Following the submission I have just described, the Tax Court decided that Caesars Palace had been correct in not recognizing income from casino credit transactions until the resulting accounts receivable were paid. Meanwhile, Hilton Hotels Corporation had gone into the Untied States District Court to object to a position taken with regard to the Flamingo which was similar to the position the Internal Revenue Service had taken in its audit of Caesars Palace. Before the District Court, the government argued, as it had before the Tax Court, that the reason a casino should recognize income from a casino credit transaction is that it is in effect two unrelated transactions. The District Court rejected this concept just as had the Tax Court. However, I think to everyone's surprise, the District Court held that a Nevada casino must recognize income from casino credit transactions when they occur because there is a reasonable probability the resulting accounts receivable will be paid. In other words, it rejected the concept that legal enforceability is a necessary prerequisite to accrual of income. Because we had other tax issues in the Caesars Palace case, our case did not become appealable until quite recently. However, the Flamingo case became appealable as soon as the District Court rendered its decision, and on appeal the United States Court of Appeals for the Ninth Circuit affirmed the Flamingo decision. It noted that there is a reasonable probability the accounts receivable will be collected (pointing out that approximately 96% of the Flamingo's accounts receivable eventually were collected) and it said that since the right to receive the income was "as 'fixed' as it is possible to be" a Nevada casino should recognize income from casino credit transactions when the resulting accounts receivable are created. Because the immediate issue presented by the Flamingo decision is a relatively limited one, that is whether a Nevada casino must accrue income when a casino credit transaction takes place, two weeks ago the United States Supreme Court declined to hear an appeal from that decision. The government is now appealing the decision in the Tax Court case regarding Caesars Palace, and since that appeal is to the same court which decided the Flamingo appeal, we are somewhat pessimistic.

I am not the person to explain to you the potential over-all impact on revenue collections of the Flamingo holding that a reasonable certainty is sufficient to enable accrual of an item even though there is no legally enforceable obligation associated with it. That is going to be done by someone else. What I would like to do is try to explain to you the enormous injustice to the Nevada hotel/casinos of the Flamingo decision.

It is very easy to say that even though Nevada gambling debts are not legally enforceable, the Nevada hotel/casinos collect a very substantial portion of those debts. That is true. And furthermore, we don't do it the way you read about in novels. We do it because if customers ignore their gambling debts, they won't be given further credit by us and there is a substantial interchange of credit information among casinos throughout the world, so a person who ignores his gambling debts in Nevada probably won't be granted credit by casinos anywhere. This a major incentive to people who like to gamble to pay their gambling debts.

However, that does not mean it is always easy to collect our casino accounts receivable. Very much to the contrary. If a customer dies or files in bankruptcy, we know our claim will not be recognized by an executor or trustee. Millions of dollars of casino accounts receivable are lost because of this. Also, many of our customers will only pay us if we will given them discounts. Further, whenever there is any substantial external reason for a customer not to pay his gambling debts, he is very likely not to do so. A perfect example is the recent devaluations of the Mexican peso. Caesars Palace and several other of the large Nevada hotel/casinos have a number of very good Mexican customers. Our accounts receivable are, by their terms, payable in United States dollars. Nonetheless, when there is a devaluation of the peso, and there have been three in recent years, our Mexican customers insist that they will not pay their gambling debts unless they can be paid at the devalued peso exchange rate. This can cost us 30%, 40% or more of what we are owed by these customers. We can't sue the customers for their dollar obligations, because those obligations are not legally enforceable. And we can't refuse to let our Mexican customers ever again gamble in our casinos, because they represent too important a segment of our clientele. Therefore, we have to acceed to their requests that they be able to pay us on the basis of devalued pesos. This is not an isolated example. We are constantly under pressure to reduce debts if we want to collect anything at all.

I am not saying that the Nevada casino industry is the only industry beset by problems collecting accounts receivable. Obviously it is not. However, we are one of the very few industries, and possibly the only industry, in the United States that doesn't have access to the courts to collect the accounts receivable. Yes, we have historically had a pretty good idea of the percentage of our accounts receivable we are going to collect. But we couldn't tell which accounts receivable we were going to collect and we couldn't tell when we were going to collect them. In fact, although the courts in the Flamingo case made much of Flamingo's ability to predict statistically the percentage of its accounts receivable it was likely to collect, and the Internal Revenue Service took a similar position in the case involving Caesars Palace, in fact our historical collection rate plummeted this past year due to economic conditions, both in the United States and abroad. And I am not just talking about our collection rate with regard to casino accounts receivable created last year. The change was so substantial that it reduced by almost two percentage points the historic rate of collections for the entire 16 years that Caesars Palace has been open.

What is the effect on the Treasury of the rule of tax accounting the Nevada hotel/casinos have been advocating. Very little. It is not that we don't pay our taxes. We do. The only thing is that we pay our taxes when we collect the accounts receivable, not when they are created. Yes, this results in a short delay in the payment of some or our taxes. However, it also protects us against having to pay taxes on money we have no legally enforceable ability to collect.

How much money is at stake? Out of more than $2 billion of casino credit extended in Nevada during the year ended June 30, 1982 only approximately $248,000,000 remainded unpaid at year end. It is likely that more than half of that was collected within 30 to 60 days and that more than 90% was collected within four to six months. From the point of view of the Federal Treasury, the effects of delaying taxation until those collections take place are miniscule. However, from the point of view of a Nevada hotel/casino, having to pay taxes before we are in a position to collect the accounts receivable is a major problem. Suddenly, in deciding whether to compromise on accounts receivable in order to effect collections, we would be faced with the stark reality that we had already paid taxes on the money that we were compromising. Indeed, it's not even clear that after agreeing to accept the reduced amount in satisfaction of a debt we would be able to deduct the portion we will never receive. Suddenly, when deciding whether to grant credit, we would have to take into account the tax cost of granting that credit. The more than $2 billion of Nevada casino credit extended last year represents is more than $2 billion of gross taxable revenues and resulted in tens, and perhaps hundreds, of millions of dollars of United States income taxes. And we do pay our taxes. I might note that the principal competitors of the legal gambling industry in the United States are illegal United

States gamblers and foreign gambling operations. Neither of them pays United States taxes. Therefore, when you make it harder for us to generate revenues, you are simply moving revenues from taxpaying establishments to non-taxpaying establishments.

Bottom line, the change in what almost everybody had long believed to be the requirement that there be a legally enforceable obligation before there was accrual of income or a deduction will generate very little additional income for the United States Treasury. On the other hand, it poses a very major problem to us in the Nevada gaming industry. Also, as you are going to hear from another witness, while the immediate effect of the Flamingo decision may be to speed up a relatively small amount of tax collections, the long-term effect could be massive, and it will be to delay collections, not to increase them.

Members of the Committee, I appreciate your having given me an opportunity to express myself to you. Thank you very much.

STATEMENT OF JOHN V. GIOVENCO, EXECUTIVE VICE PRESIDENT, FINANCE, HILTON HOTELS CORP., BEVERLY HILLS, CALIF.

The CHAIRMAN. Mr. Giovenco.

Mr. GIOVENCO. Mr. Chairman, my name is John Giovenco. I am executive vice president of finance and a director of Hilton Hotels Corp. You have copies of my prepared testimony, and rather than take up any more of your time—in fact, I will summarize my summary.

The gaming casinos in Hilton provide about 40 percent of the total income within Hilton Hotels Corp. And, the credit policies are an important adjunct of that 40 percent. We are going to suffer unexpected and severe depletion of our working capital by the accelerated payment of income taxes caused by the decision of the ninth circuit.

There's one fact that I would like to bring to your attention, rather than to repeat the testimony of other witnesses. We currently have more than $20 million in reserves for workmen's compensation claims on our books, which are not deducted or are not deductible because of the all-events test. We have $7 million of casino receivables, which we have not included in income because of the all-events test.

If the all-events test is weakened, are we going to be allowed to deduct the $20 million in reserves for workmen's compensation claims? We will certainly try.

The decision of the ninth circuit is contrary to the law which has been established by the Supreme Court for over 50 years. And, it will cause a severe setback to the casino industry.

Thank you.

The CHAIRMAN. Thank you very much.

[The prepared statement of John V. Giovenco follows:]

TESTIMONY OF JOHN V. GIOVENCO
BEFORE THE SENATE FINANCE SUBCOMMITTEE

SENATOR ROBERT DOLE, CHAIRMAN

Good Morning Senators:

My name is John Giovenco and I am Executive Vice-President-Finance and a Director of Hilton Hotels Corporation. Our Chairman, Barron Hilton, regrets that he cannot be here to meet with you and explain Hilton's position with respect to S.2985, a bill to correct a misinterpretation of the "all events" test by the 9th Circuit Court of Appeals. This ruling, if allowed to stand, would not only be a shock to the tourism industry of Nevada, but it also threatens to confuse accrual basis taxpayers and cause a great loss of revenue to the Treasury.

Hilton is a major factor in the hotel and tourist industry in the United States, which has been adversely affected by the current recession, as travel has been severely limited for economic reasons. Hilton owns, manages and franchises 219 hotels and inns with a total of 77,400 rooms. Hilton has properties located in each of the nation's 100 largest population centers, including all of the major convention cities in the country. Hilton's properties stretch across the United States from Bangor, Maine to Honolulu, Hawaii and from Anchorage, Alaska to Miami Beach, Florida. At the end of 1981, there were approximately 77,000 Hilton employees performing hundreds of different jobs at all levels in a business that requires excellence in service.

Hilton's hotel casinos in Nevada have been a cornerstone of our business with a combined total of over 5,500 rooms. These hotel casinos contributed 40% of Hilton's profits in 1981 and 1982, and are the most profitable properties in the Hilton chain. Hilton's success in Nevada, as that of other top-flight casinos, had largely been based upon its credit policies, as over 30% of the gambling in its casinos is done by credit customers. A key to these credit policies is Nevada law, which carries over from England, making gambling debts unenforceable. Because of the legal unenforceability of gambling debts, credit policies have developed which have resulted in selected and knowledgeable extensions of credit. Legal unenforceability has also been a factor in the willingness of patrons to accept credit and to patronize Nevada gambling casinos.

The gambling casinos are not only important to the financial health of Hilton, but are vital to the financial health of the state of Nevada, which raises 81% of its revenue from taxation of the casinos.

Hilton has always paid tax on casino receivables when we receive payment from casino patrons, following the clear mandate of the "all events" test. Hilton has done this because it has no way to compel the payment of the casino receivables by its patrons and therefore has no "right to income" until the receivable is collected. Hilton was clearly right in this method of accounting for casino receivables under the law as it existed in 1972 when Hilton first entered into the casino business in Nevada.

However, since then, the Nevada District Director took the novel position that Hilton had a "right to income" with respect to casino receivables (even though it could not legally enforce them) and therefore had to report the casino receivables as income in the year that they were created. Although the District Director's position was completely contrary to over 50 years of Supreme Court cases requiring legal enforceability for accrual, the District Court in Nevada overturned this settled law, and its decision was recently upheld by the Circuit Court of Appeals for the 9th Circuit. This novel position has thus become law in the 9th Circuit, where Nevada is located.

Hilton will suffer unexpected and severe depletion of its working capital by the accelerated payment of income taxes caused by the 9th Circuit decision, which is in effect treating the gambling industry as different from all other businesses by requiring the accrual of unenforceable receivables. Hilton had hoped to escape this result by creating a cash basis casino subsidiary, but the Internal Revenue Service has continued its relentless attack by proposing that this subsidiary be required to report casino receivables as received, not when paid. Not only will Hilton be affected, but all of the casinos with credit customers will be adversely affected, thus dealing a severe blow to the gambling industry in Nevada, and the tax collections of the State of Nevada which so heavily depend upon taxation of gambling revenues.

Thus the courts have turned the "all events" test upside down and ignored the Nevada law concerning legal unenforceability, and severely affected one of the most important Nevada industries (which employs thousands) and one of the most important sources of Nevada's tax revenues.

Hilton believes that this change in the law should be retroactively reversed by Congress, so that the reasonable expectation of the gambling casinos and the State of Nevada with respect to the "all events" test can again be realized.

I thank this Committee for its kind consideration of this important issue, which I understand has substantial ramifications with respect to the accrual of deductions, which will be discussed by others who are better able to explain the technicalities of tax accruals.

STATEMENT OF ROBERT FRISCH, ESQ., ROGERS AND WELLS, NEW YORK, N.Y.

The CHAIRMAN. Mr. Frisch.

Mr. FRISCH. Mr. Chairman, my name is Robert Frisch. I am a senior partner of Rogers and Wells. You have my testimony. I am familiar with the issues, since I represented Caesar's Palace before the Tax Court.

Rather than go through even a summary, in view of your time pressure, in which I was going to stress the need for certainty in the tax laws, something the Supreme Court has said that there should be for many years, I would like to refer to something Mr. Chapoton said earlier. He said that casinos would be entitled to bad-debt reserves as are other taxpayers on the accrual method—this is a paraphrase, of course—and, therefore, to allow casinos to defer the accrual of markers would be, in effect, to single them out for special treatment.

With all respect, that is simply not so. The regulations do not permit any type of deduction on account of a bad debt unless it is enforceable. The Internal Revenue Service recognizes this because in the *DPI* case they granted no deduction whatever on account of bad-debt reserves or specific writeoffs.

I am, at the moment, in consultation with the national office of the Internal Revenue Service because they seem to be, to coin a phrase, quite embarrassed at that result because of its apparent inequity.

This bill would eliminate that inequity.

Thank you.

The CHAIRMAN. Thank you very much.

[The prepared statement of Robert Frisch follows:]

TESTIMONY OF ROBERT E. FRISCH IN SUPPORT OF S.2985
BEFORE THE SENATE FINANCE COMMITTEE
SENATOR ROBERT DOLE, Chairman

Mr. Chairman, Members of the Committee,
Ladies and Gentlemen:

My name is Robert E. Frisch. I am a member of the law firm of Rogers & Wells and head the Tax Department of that firm. I am intimately familiar with the recent court decisions regarding whether enforceability of an obligation is a prerequisite to accrual, having represented Caesars Palace in a recent Tax Court case which held it was, but which now is on appeal to the Court of Appeals for the Ninth Circuit. I am also very familiar with the recent decision of that court in Flamingo v. United States to the effect that enforceability of a right to receive payment is not a prerequisite to accrual of income.

You have already heard Mr. Wald and Mr. Giovencho discuss some of the business problems of the Nevada casino industry and of the State of Nevada itself which are posed by the Flamingo decision. I am going to discuss the potentially far greater consequences of the Flamingo decision on the United States Treasury if its holdings are applied to the law regarding accrual of deductions.

As you know, the basic rule as to the time for accrual of income and deductions is the so-called "all events test." Under the all events test an item of deduction or income should be accrued when all the events have occurred which establish the fact of the liability giving rise to the deduction, or fix the right to receive the income, and the amount of the expense or income can be determined with reasonable accuracy.

The all events test is generally believed to have originated in a 1926 United States Supreme Court decision entitled United States v. Anderson. That decision had to do with the time at which a taxpayer could accrue a deduction. Six years later, in a case named Spring City Foundry Co. v. Commissioner, the Supreme Court applied the all events test in determining when a taxpayer should accrue income. Actually the Anderson and Spring City cases were only affirmations of a position the Internal Revenue Service (then the Bureau of Internal Revenue) had been taking for years. However, Anderson judicially affirmed that position and made it clear that the all events test governs the timing of accruals of deductions. The Spring City case then applied the same rule to accruals of income. By now, the all events test is embodied in the Income Tax Regulations themselves, as to both deductions and income.

The Flamingo case was an interpretation of the "all events test." The question was whether a Nevada casino had to accrue income from credit transactions even though it had no legally enforceable right to be paid. To virtually everyone's surprise, and contrary to a great deal of prior judicial authority, the District Court and then the Court of Appeals in Flamingo ruled that even though a gambling debt owed to a Nevada casino cannot be enforced in court, the casino must take the amount of the debt into income when it arises, rather than waiting until it is collected. The Supreme Court refused to hear an appeal from Flamingo. Thus, under the most recent judicial interpretation of the "all events test," enforceability is not necessarily a prerequisite to accrual of income. The next question is what this means with regard to deductions.

During the years since the Anderson case, there have been a substantial number of court decisions and Internal Revenue Service pronouncements applying the all events test on the deductions side and stating that a legally enforceable obligation is a prerequisite to the right to accrue a deduction. Examples of Internal Revenue pronouncements are a 1973 revenue ruling in which the Internal Revenue Service stated that a magazine publisher may not deduct sales commissions which are due when subscription installments are collected until the installments are actually collected, because collection is "an event which must occur to fix the legal obligation of the taxpayer to pay the commission." Another Internal Revenue Service ruling stated that a taxpayer may not accrue in a year bonuses to employees that the taxpayer "is not legally obligated prior to the close of the taxable year to pay." Among the court cases which have required a legally enforceable obligation before a deduction could be accrued are a case holding that an airline could not deduct a reserve for engine overhauls which, under Federal Aviation Administration regulations, would have to be made on completion of prescribed numbers of flight hours, a case holding that a manufacturer may not deduct salaries which, although earned, were not required to be paid until the board of directors determined the corporation was financially able to pay them, and a case holding that a manufacturer may not deduct a reserve for refunds under a price redetermination provision of a contract with the Federal government until the contracting agency makes its claim against the taxpayer.

More significant, however, are a series of cases holding that an accrual method taxpayer may not take deductions for statistically predictable expenses until legal obligations to incur those expenses arise. Most important among these are cases holding that a manufacturer may not deduct reserves for warranty expenses until claims are made against the manufacturer, even though the manufacturer knows at the time it makes sales that a statistically predictable percentage of each dollar it receives eventually will have to be spent fulfilling warranty obligations. Similarly, there are cases holding that a freight carrier may not deduct a reserve for statistically predictable cargo loss and damage claims, a record wholesaler or magazine publisher may not deduct a reserve for returns it will be obligated to accept when they are made, and a self insurer may not deduct reserves for future workmens compensation claims even though under state law it is required to set aside funds to be used to pay these claims. In each case the all events test has been applied to delay the deduction until an actual, enforceable obligation to a specific person arises.

Consider the similarity between the facts in these deduction cases and those in the Flamingo case. In each of the several instances I have just mentioned, the taxpayer can predict with substantial accuracy the percentage of its revenues it will eventually have to pay out, and under generally accepted accounting principles, for financial statement purposes it is required to accrue a reserve for the expenses when the original sale transactions take place. Similarly, a Nevada casino can predict with reasonable accuracy the percentage of its casino accounts receivable it will collect, and under generally accepted accouting principles, for financial statement purposes the casino is required to accrue that percentage of the amount it wins from credit customers as income when the casino credit transactions take place. However, in each of the instances I have just mentioned the taxpayer is not legally obligated to anyone to incur the expense until a future event takes place (for example, until a warrantied product proves defective). Therefore, although the taxpayer can predict how much it will have to pay out, it does not know when or to whom it will become legally obligated to make payments. Similarly, a Nevada casino has no legal right to receive income until a future event takes place (that being actual payment). Therefore, although the casino can predict how much it will collect, it does not know when or from whom it will receive payments.

This then is the potentially huge problem posed by the recent decision of the Court of Appeals for the Ninth Circuit in Flamingo Resort, Inc. v. United States. In Flamingo the Court found the fact that there was "a reasonable expectancy of collection," the amount of which could "be determined with reasonable accuracy" sufficient to require accrual of income. When RCA sells television sets, it knows it will receive warranty claims, and the amount it will be required to pay out can be determined with substantial accuracy. Thus, why, if Flamingo and the other Nevada casinos are required to accrue income when the unenforceable casino accounts receivable are created, isn't RCA entitled each time it sells a television set, or General Motors each time it sells an automobile or a truck, entitled to deduct the portion of the purchase price which it can predict with reasonable accuracy will be used to pay warranty claims? Why when a motor carrier, a railroad or an airline carries freight isn't that carrier entitled to deduct the portion of its revenues it can predict eventually will be expended for cargo loss and damage claims? Why when a record company sells records, or a publisher sells magazines, isn't it allowed to deduct the portion of its revenues it can predict will be paid out for returns? I have serious difficulty answering those questions.

I am not the only one who is having difficulty answering the questions. Last summer, a few months after the Flamingo decision, a panel of the Ninth Circuit decided the Nightingale case. That case involved an attempt by a Nevada casino operator to deduct reserves for potential future liabilities. The court refused to permit deduction of the reserve, and included in its opinion a fairly traditional discussion of the all events test, which did not mention Flamingo. The taxpayer, who of course was very much aware of Flamingo, filed a petition for rehearing by the entire court, in which the taxpayer did virtually nothing but point out the inconsistency between Flamingo and the taxpayer's decision. The Ninth Circuit, in its discretion, refused to grant the rehearing. But I am sure that is not the last taxpayer who is going to argue that the Flamingo sword has two edges.

Insofar as I am aware, the Nevada casino industry is the only legal industry in the United States which generates unenforceable accounts receivable. If there is another, it does not readily come to mind. In an effort to speed up slightly collections of taxes from that tiny industry, the government has obtained a court decision which could overturn a 60 year old priciple of tax accounting that is responsible for delaying billions of dollars of deductions.

This not to accuse the Internal Revenue Service of having been penny wise and pound foolish. Quite to the contrary. As Mr. Wald pointed out in his testimony, in the lower courts in both the Caesars Palace case and the Flamingo case, the government refused to argue that legal enforceability was not a prerequisite to accrual under the all events test. It was only after the District Court in the Flamingo case ruled on its own initiative that legal enforceability is not a prerequisite to accrual that the government changed its position with regard to that issue. I respectfully submit that the Internal Revenue Service acted very wisely before the lower courts in not trying to change the all events test in order to accelerate revenues from Nevada casino operators. It has not acted as wisely since, and I believe that unless Congress or the courts do something to change the Flamingo interpretation of the all events test, the government may well come to rue the day it won the Flamingo case.

Thank you.

The CHAIRMAN. Mr. Levenfeld.

STATEMENT OF MILTON LEVENFELD, LEVENFELD, EISENBERG, JANGER, GLASSBERG, AND LIPPITZ, CHICAGO, ILL.

Mr. LEVENFELD. Mr. Senator, I have a prepared testimony which I wish to have admitted to the record.

I think that the most important thing that is done by this bill is to treat the Government and the taxpayers equally. This is the great virtue of the all-events test. The Supreme Court in the *Security Flour Mills* case said the tax law must be neutral, not manipulated to favor either the taxpayer or the Government in a particular case.

If the *Flamingo* rationale becomes the law of the land, it will bring into the decision on taxability and accruability judgments which are not neutral, judgments about whether an item is statistically determinable. It will be a battle of statisticians; not a determination of the correct law. The *Flamingo* decision is bringing into accruability a murky area which the Supreme Court has tried to avoid by creating the all-events test.

Even if the Supreme Court eventually is able to reinstate the all-events test, we are going to have a period in which the attorneys of many corporations are going to be creating deductions. Attorneys will be advising a corporation like Hilton Hotels Corp. concerning their workmen's compensation reserves, which now we understand are not to be deductible. But, because Hilton is in the ninth circuit, I think I can advise them to deduct the reserves because they have the statistical ability to justify the deduction. This will cost billions of dollars of revenue losses. The Treasury should be certainly much more concerned about it than they are now.

In the ninth circuit it is going to be devastating to the revenue. The lawyers, I think, are not going to have too many restraints. And it is something that I think that you have always shown an interest in—the protection of the revenues, for example, with respect to withholding taxes and with respect to the tip area. And I think, Mr. Senator, that this is probably more important and dwarfs all of those areas in terms of potential revenue losses.

Thank you very much.

The CHAIRMAN. Have you discussed the point you just made with the Treasury officials?

Mr. LEVENFELD. We have discussed this with Treasury officials, who are in charge of litigation. And they seem to be more interested in winning the battle than the war. And we find that very difficult to understand, that they wouldn't be more concerned with the potential revenue impact than the little amount of revenue that they are getting from the casino industry. It is beyond our comprehension. I just see years of litigation in terms of the gray areas where before there was certainty. You looked whether there was legal enforceability or not and the courts were able to do a good job. Even the ninth circuit, before this aberration, stated the all events test dutifully, requiring two things, which the Treasury regulations say. It requires a fixed right, and a fixed right can't mean anything but legal enforceability because you don't have a right unless you can legally enforce it. And it required a reasonably ascertainable amount. What the ninth circuit has said is let's forget fixed right, let's go to reasonably ascertainable amount.

Well, you will get reserves for warranties for General Motors, for example, which aren't legal liabilities. But I am sure that their statisticians can predict it with great accuracy. And it is going to dwarf what we have here for the casino industry.

[The prepared statement of Milton Levenfeld follows:]

TESTIMONY OF MILTON A. LEVENFELD
BEFORE SENATE FINANCE COMMITTEE
WITH RESPECT TO S.2985

SENATOR ROBERT DOLE, CHAIRMAN

Mr. Chairman, Members of the Committee,
Ladies and Gentlemen:

I am grateful for the opportunity to appear before you on this important matter. I am a member of the law firm of Levenfeld, Eisenberg, Janger, Glassberg and Lippitz, of Chicago, Illinois. My firm is Federal income tax counsel for Hilton Hotels Corporation, and as such we are very familiar with the "all events" test, its purpose and its history, because of our extensive representation of Hilton on matters involving this issue.

As a result of the recent decision in Flamingo Resorts, Inc. v. United States, 664 F.2d 1387 (9th Cir.; January 7, 1982), taxpayers in the casino industry who use the accrual method of accounting are now required to accrue gaming accounts receivable (i.e., "markers") upon receipt, even though those accounts receivable are not legally enforceable under the law of the State of Nevada and therefore not legally enforceable in any state of the United States. The holding of the Flamingo case is set forth in its essentials by the Ninth Circuit in the following language:

> The lack of legal liability did not interfere with Flamingo's operation, and it is doubtful that legal enforceability of the "markers" would or could increase its recovery rate. Under these circumstances, the obligations of Flamingo's patrons are as "fixed" as it is possible to be and, in fact no less so than those of other businessess .... The debts which "markers" represent are therefore, fixed; there is a reasonable expectancy of collection; and no contention has been made than the amounts cannot be determined with reasonable accuracy (footnote omitted - emphasis supplied). 664 F.2d at 1390.

Although the Court of Appeals recognized that enforceability of a right to income was relevant in determining when income should be accrued, it nevertheless held that its absence was not controlling, [1] and that "reasonable expectancy" of collection was sufficient for accrual.

1 In United States v. Byrum, 408 U.S. 125, 136-137 (1972), the Supreme Court stated

> The term "right," certainly when used in a tax statute, must be given its normal and customary meaning. It connotes an ascertainable and legally enforceable power .... Here the right ascribed to Byrum was the power to use his majority position and influence over corporate directors to "regulate the flow of dividends" to the trust. That "right" was neither ascertainable nor legally enforceable and hence was not a right in

The standards for the accrual of deductions[2] are indistinguishable from the standards for accrual of income.[3] Consequently, with the holding that "reasonable expectancy" is sufficient for accrual, the Flamingo decision could open up the floodgates of deductibility based upon estimates, thus costing the Government billions of dollars in revenue by permanent deferrals of reserves by taxpayers. Accelerated deductions based upon estimates would cause the permanent deferral of statistically estimated liabilities relating to large groups without any liability becoming legally enforceable against the taxpayer by any member of the group, which was previously thought to be a requirement for accrual. The Flamingo case could herald the end of years of application of a test requiring legal liability for the accrual of income and expenses, which test was created to foster objectivity, because

> the tax law must be neutral, not manipulated to favor either the taxpayer or the Government in a particular case. Security Flour Mills Co. v. Commissioner, 321 U.S. 281, 285-87 (1944).

The Supreme Court in Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 43 AFTR 2d 79-362 (1979), where the Court disallowed an inventory write-down to an estimated market value, reiterated the principles involved:

> Financial accounting, in short, is hospitable to estimates, probabilities, and reasonable certainties; the tax law, with its mandate to preserve the revenue, can give no quarter to uncertainty. 439 U.S. at 542-43.

Examples of the estimated liabilities to an undifferentiated group are sufficient to point up the magnitude of the problem:

> (a) Automobile manufacturers have reserves for warranties, which are statistically predictable with an extraordinarily small margin for error; their reserves would become deductible even though liability to a particular car owner has not been established, resulting in a permanent deferral of huge reserves which are growing each year.

1 continued

> any normal sense of that term. 408 U.S. at 136-137. (Emphasis added)

While that definition of the term "right" would seem to preclude any exception, nevertheless in Flamingo, the Court in effect has carved an exception.

2 "...all events have occurred which establish the fact of liability ...." Regs. §1.446-1(c)(1)(ii), which is set forth in full in Appendix A.

3 "...all the events have occurred which fix the right to receive such income ...." Regs. §1.446-1(c)(1)(ii), which is set forth in full in Appendix A.

(b) Most large corporations self insure against product liability and other forms of liability, which self insurance reserves are in the many billions of dollars; these reserves would become deductible because of statistical probability before the liability to particular customers is established, resulting in a permanent deferral of the tax on these amounts.

The examples could go on and on[4], and the resulting large reduction of the revenues made even clearer. Suffice to say, the Ninth Circuit's granting of a victory to the Government in a single case involving little revenue could cost billions of dollars of revenue loss to the Government.

The Ninth Circuit has already expanded its unique and erroneous interpretation of the "all events" test by allowing reserves for workmen's compensation payments to be deductible when the value of the medical and disability payments with respect to an employee's injury can be estimated, without requiring legal liability for payment thereof. Kaiser Steel Corp., D.C. Calif., 83-2 USTC ¶9635 (August 18, 1982). This is directly contrary to the position of the Internal Revenue Service as stated in Rev. Rul. 80-191, 1980-2 C.B. 68, which held workmen's compensation benefits are deductible only when the liability for payment thereof is established, and such deductibility cannot be based upon estimates. Legislative action should be taken to the earliest possible moment to ward off the substantial danger of reduced revenues to the Treasury, which can be caused by further expansion of the Ninth Circuit's erroneous interpretation of the "all events" test.

The proposed amendment would restore the state of the law with respect to the timing of items of income and deductions for taxpayers using the accrual method as it existed prior to the Flamingo case. It would eliminate the substantial possibility of future litigation between the Government and taxpayers with respect to that timing. In other words, it will eliminate the substantial possibility that taxpayers may seek to accelerate deductions as a result of Flamingo by claiming that there is such a statistically substantial probability of liability that there should be a deduction for a reserve even before there is an enforceable liability, or that the Internal Revenue Service will take a similar stance with respect to the accrual of income. Such legislation should also be stated to be declarative of present law so that refunds or tax deficiencies for prior years are not sought by taxpayers or the Government based upon the Flamingo case.

4 See Appendix B for additional examples of potential revenue losses.

APPENDIX A

Reg. §1.446-1(c)(1)(ii) of the Income Tax Regulations as now in effect:

(ii) Accrual method. Generally, under an accrual method, income is to be included for 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. Under such a method, deductions are allowable for the taxable year in which all the events have occurred which establish the fact of the liability giving rise to such deduction and the amount thereof can be determined with reasonable accuracy ....

APPENDIX B

The following cases and revenue rulings have applied the requirements of legal enforceability to deny deductions of reserves for liabilities relating to large groups which could be estimated with a high degree of statistical certainty, although there was no present liability to any member of the group.

Reserves for Returned Merchandise

Ertegun v. Commissioner, 531 F.2d 1156, 37 AFTR 2d 76-1014 (2d Cir. 1976) (record wholesaler may not deduct a reserve for obligation to accept returns); J. J. Little & Ives Co., ¶66,068 P-H Memo TC (magazine wholesaler may not deduct a reserve for anticipated returns); LaSalle Portland Cement Co., 4 B.T.A. 438 (1926) (a cement company may not deduct a reserve set up to pay for returned cement bags).

Reserves for Warranties and Services

Villafranca v. Commissioner, 359 F. 2d 849, 17 AFTR 2d 929 (6th Cir. 1966) cert. denied 385 U.S. 840 (no deduction for estimated expense of providing dancing instructions for which income had been recognized); Bell Electric v. Commissioner, 45 T.C. 158 (1965) (equipment manufacturer may not deduct a reserve for estimated future warranty service costs until services demanded); World Airways v. Commissioner, 62 T.C. 786 (1974) (an airline may not deduct a reserve for estimated costs of future engine overhauls required by F.A.A. regulations); Simplified Tax Records v. Commissioner, 41 T.C. 75 (1963) (an accounting service may not deduct a reserve for reasonably certain estimate of expenses to prepare tax returns for requesting subscribers).

Reserves for Compensation

Trinity Construction Co. v. U.S., 424 F.2d 302, 25 AFTR 2d 70-930 (5th Cir. 1970) (a company may not deduct a reserve for officers' life insurance premiums); Reuben H. Donnelley Corp. v. Commissioner, 22 B.T.A. 175 (1931) (publisher may not deduct a reserve for earned commissions where payment contingent on purchaser's payment); Rev. Rule 73-125, 1973-1 C.B. 215 (magazine publisher may not deduct earned commissions where payment contingent on subscriber payment).

Reserves for Damage Claims and State Workmen's Compensation Obligations

Milwaukee and Suburban Transport Co. v. Commissioner, 293 F. 2d 628, 8 AFTR 2d 5455 (7th Cir. 1961) (railroad may not deduct a reserve for anticipated damage claims); Spring Canyon Coal Co. v. Commissioner, 43 F.2d 78, 9 AFTR 30 (10th Cir. 1930) (a self-insurer may not deduct a reserve for workmen's compensation benefits); Gateway Transport Co. v. U.S., 39 AFTR 2d 77-647 (U.S. D.C., W.D. Wisc. 1976) (a motor carrier may not deduct a reserve for cargo loss or damage); Rev. Rul. 70-262, 1970-1 C.B. 122 (airline may not deduct a reserve for payments to widows of deceased pilots where payment required by State Workmen's Compensation Act.)

The ruling in Flamingo implicitly reverses the above cases and rulings because deductions were disallowed until a legally enforceable liability had been established; after Flamingo, the lack of legal enforceability will not prevent the fixing of rights where there is a reasonable expectancy that payment will be made, even though there is no legal liability to any member of a group.

The CHAIRMAN. Mr. Ritchie, do you have anything to add?

Mr. RITCHIE. No, Mr. Chairman.

The CHAIRMAN. Mr. Juliano, do you want to say anything on tips or on any other subject?

STATEMENT OF ROBERT JULIANO, LEGISLATIVE CONSULTANT, HOTEL AND RESTAURANT EMPLOYEES AND BARTENDERS INTERNATIONAL UNION, WASHINGTON, D.C.

Mr. JULIANO. The least we could do is consider this since we are going to get you all the money from the increased reporting of tips. They are already starting to roll into the Treasury.

This is our jobs bill for 1982, so any consideration you can give, we will be grateful.

The CHAIRMAN. What kind of a timeframe are you dealing with on this question? Is this a matter of urgency that must be dealt with this calendar year?

Mr. FRISCH. We, in the case of Caesar's Palace, Mr. Chairman, its tax return for July 31, 1982 cannot be delayed beyond March 15, 1983. The case is on appeal, as Mr. Chapoton said. In fact, it will be argued tomorrow, but they have to decide quite quickly how they are going to treat their markers received during fiscal 1982, which remained unpaid in several tens of millions of dollars.

The CHAIRMAN. As I understand, one provision that Treasury strongly objects to is the retroactivity.

Mr. FRISCH. The retroactivity in the bill here, Mr. Chairman, simply goes back to the open years for Flamingo and Caesar's Palace. No taxes have been paid by Caesar's Palace so there would be no refund. It would simply say that Caesar's Palace is on the proper method of tax accounting back to all of its open years which goes back to 1967.

In the case of Flamingo, that action is a refund action on account of 1967. It's the only year at issue. So the retroactivity there would permit Hilton to recover the amount of tax for which it sued on a refund claim.

Mr. LEVENFELD. Mr. Chairman, could I comment?

The CHAIRMAN. Yes.

Mr. LEVENFELD. In terms of retroactivity, I don't think that should be a problem. This is merely a statement of the all-events test as it was understood before the *Flamingo* case. And in a sense, it's a declaration by Congress—it would be a declaration by Congress of the law as it existed, and not wanting it to deviate because of the *Flamingo* case.

Second, I think the urgency is more than the casino industry. I think the urgency with respect to the Treasury on all of the tax returns that are being prepared now and all of the decisions that are going to be made by industry in general as to whether to deduct reserves because of this new opening.

The CHAIRMAN. When the transcript is prepared, which will probably be today or tomorrow, we will have it reviewed not only by our staff but by Senator Long's staff and also by Mr. Chapoton's staff. Based on your statements and the comments made today, we will see if there is any change in attitude on the part of the Treasury.

As you all know, we are in the closing days of this Congress. It's possible that we might be here until January 3, but not desirable. But I know Senator Cannon and Senator Laxalt will remind us daily on this as long as we are here. There may be some areas that we might be able to fine tune this bill. I'm not certain. I don't know that much about it. You are all experts and you have dealt with it a long time. I will have our staff look at it. We will keep in touch with counsel and Senators Cannon and Laxalt to see if there is any possibility of doing anything yet this year. I would say even if we did on the Senate side, it would be necessary, obviously, that it be retained on the House side. I'm not certain what the attitude is on the House side.

Have you checked that out, Bob?

Mr. JULIANO. Not yet, no.

The CHAIRMAN. We thank you very much. As I mentioned your entire statements will be made a part of the record. I apologize for having to sort of rush the hearing, but we did try to schedule it as quickly as we were notified of the matter by the Senators. At least we hope that we have made the record. Now we will go back to the Treasury and see whether or not they can be helpful.

Thank you.

[Whereupon, at 10:42 a.m., the hearing was concluded.]

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