Accrual of Gambling Debts Under Internal Revenue Code Section 451

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Section 451(a) of the Internal Revenue Code generally requires that income be reported in the tax year in which it is accounted for under the taxpayer's method of financial accounting.[1] As Congress may have recognized,[2] however, the objectives of financial accounting and tax accounting differ[3] and often yield divergent results.[4] To promote a principal goal of tax accounting — ensuring that the tax-

1. I.R.C. § 451(a). *See also* I.R.C. § 446(a). The rule is expressly limited to cases where the IRS determines that the accounts clearly reflect income. I.R.C. § 446(b). *See* Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 541 (1979) (quoting Lucas v. American Code Co., 280 U.S. 445, 449 (1930)).

2. While § 446(a) of the Internal Revenue Code provides that "[t]axable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books," Congress created an exception when the taxpayer's method "does not clearly reflect income." I.R.C. § 446(b). *See* note 5 *infra*.

3. "[T]he characterization of a transaction for financial accounting purposes, on the one hand, and for tax purposes, on the other, need not necessarily be the same." Frank Lyon Co. v. United States, 435 U.S. 561, 577 (1978). "Tax accounting is not, and is not intended to be, the same as other accounting." G. HILLS, LAW OF ACCOUNTING 48 (1957).

Financial and tax accounting have distinct goals. The goal of financial accounting is to provide accurate financial information useful for decision-making by managers, investors, and creditors. Healy, *Narrowing the Gap Between Tax and Financial Accounting*, 22 TUL. TAX INST. 407, 414 (1973). "The primary goal of the income tax system, in contrast, is the equitable collection of revenue; the major responsibility of the Internal Revenue Service is to protect the public fisc." Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 542 (1979). *See generally* Statement of the National Association of Manufacturer's Subcommittee on Tax Revision (Aug. 1971) [hereinafter cited as Manufacturer's Statement], *reprinted in* B. BITTKER & L. STONE, FEDERAL INCOME TAXATION 1009 (5th ed. 1980).

Owing to the importance of accurate financial statements, financial accounting principles provide that errors in income measurement should be in the direction of understatement. *See* ACCOUNTING PRINCIPLES BOARD, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, STATEMENT NO. 4, BASIC CONCEPTS AND ACCOUNTING PRINCIPLES UNDERLYING FINANCIAL STATEMENTS OF BUSINESS ENTERPRISES ¶ 171 (1970) [hereinafter cited as ACCOUNTING PRINCIPLES BOARD], *reprinted in* FINANCIAL ACCOUNTING STANDARDS BOARD, ACCOUNTING PRINCIPLES BOARD & COMMITTEE ON ACCOUNTING PROCEDURE, FINANCIAL ACCOUNTING STANDARDS 437, 469 (1978). On the expense side, financial accounting encourages the use of estimates, probabilities and reasonable certainties. Thor Power Tool Co. v. Commissioner, 439 U.S. at 543. The IRS, on the other hand, conscious of its primary responsibility to protect the public fisc, cannot be satisfied with understatements and uncertainty. 439 U.S. at 542-43. For example, the financial accountant often sets up reserves to cover contingent liabilities, but because of their uncertainty, these reserves are not deductible. *See, e.g.*, Lucas v. American Code Co., 280 U.S. 445, 452 (1930).

4. First, differences arise from Code provisions under which specified revenues are exempt from taxation and specified expenses are not allowable as deductions in computing taxable income. R. WIXON, W. KELL & N. BEDFORD, ACCOUNTANTS' HANDBOOK § 6.10 (5th ed. 1970); Manufacturer's Statement, *supra* note 3.

Second, and most important in this case, tax accounting often fails to match income and expenses properly. *See, e.g.*, American Automobile Assn. v. United States, 367 U.S. 687, 690-92 (1961) (a taxpayer must recognize prepaid income when received, even though this would mismatch expenses and income in contravention of generally accepted accounting principles);

payer's method "clearly reflect[s] income"[5] — the Internal Revenue Service (IRS) has promulgated regulations to guide a taxpayer's use of different accounting methods. Thus, for the accrual taxpayer, regulation 1.451-1 requires inclusion 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."[6]

This regulation, known as the "all events test,"[7] has created an interpretive difficulty when applied to casinos using the accrual method of accounting. The IRS contends that these businesses must report outstanding gambling "markers" — essentially counterchecks for the amount of the chips transferred to a patron[8] — as taxable income in the year the markers are executed. The Nevada District Court has agreed with the IRS[9] that casinos will almost certainly collect the outstanding debts and should therefore accrue them as income.[10] The Tax Court, however, has held that regulation 1.451-1 does not require inclusion of outstanding markers in taxable income because they are not legally enforceable.[11] In contrast to the IRS,

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Guardian Inv. Corp. v. Phinney, 253 F.2d 326 (5th Cir. 1958); Eastman Kodak Co. v. United States, 534 F.2d 252 (Ct. Cl. 1976).

For tax purposes, an item need not be included as income in the year in which the expenses that generated it were deducted. Breeze Corps. v. United States, 117 F. Supp. 404, 407 (Ct. Cl. 1954); Globe Corp. v. Commissioner, 20 T.C. 299, 304-05 (1953); Foster Wheeler Corp. v. Commissioner, 20 T.C. 15, 19 (1953). Moreover, because the income tax laws operate on an annual basis, a complete correlation of income and related deductions is unlikely. *See* Guardian Inv. Corp. v. Phinney, 253 F.2d at 329; Marquardt Corp. v. Commissioner, 39 T.C. 443, 453 (1962); Drazen v. Commissioner, 34 T.C. 1070, 1078 (1960); Comment, *Accrual: The Uncertain Concept of Certainty — A History of the All Events Test*, 21 U. CHI. L. REV. 293, 294 (1954) ("One of the rules contributing to the ease of administration of tax accounting is that 'contingent' receipts or expenses, though perhaps properly accrued by business accounting standards, are not includable in income tax calculations."). *See generally* Kupfer, *The Financial Accounting Disclosure of Tax Matters; Conflicts with Tax Accounting Technical Requirements*, 33 N.Y.U. INST. FED. TAX. 1121 (1975).

5. *See* I.R.C. § 446(b), which provides that if the taxpayer's method of financial accounting "does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income."

6. Treas. Reg. § 1.451-1(a) (1957).

7. *See* Comment, *supra* note 4, at 293.

8. Flamingo Resort, Inc. v. United States, 485 F. Supp. 926, 928 (D. Nev. 1980).

9. 485 F. Supp. at 929.

10. *See* Flamingo Resort, Inc. v. United States, 485 F. Supp. 926 (D. Nev. 1980). *But see* Desert Palace, Inc. v. Commissioner, 72 T.C. 1033 (1979).

The issues involved in this Note may also be applicable to casino operators in New Jersey. At one time, all gambling transactions were unlawful in New Jersey. N.J. REV. STAT. § 2A:40-1. Obligations arising out of gambling transactions were void. N.J. REV. STAT. § 2A:40-3. *See* Schwartz v. Battifarano, 2 N.J. 478, 483, 67 A.2d 148, 151 (1949). In 1977, following a statewide referendum, the New Jersey legislature legalized gambling in Atlantic City. N.J. STAT. ANN. § 5.12-1 (West Supp. 1981). Although the statute specifically exempted Atlantic City gambling from the provisions of § 2A:40-1, no mention was made of § 2A:40-3. N.J. STAT. ANN. § 5.12-124 (West Supp. 1981). Presumably, gambling debts are still void, even in Atlantic City. As of yet, no cases have addressed this issue.

11. Desert Palace, Inc. v. Commissioner, 72 T.C. 1033 (1979). Although Nevada has legalized gambling, the courts consider gambling on credit to be contrary to public policy. *See*

which stresses the certainty of eventual collection, the Tax Court and casinos argue that accrual of income depends on the legal enforceability of the item in question. They conclude that income should not be reported until the markers are collected.

This Note examines whether an accrual-basis taxpayer must include a legally unenforceable claim in taxable income when it is executed or satisfied. Section I of the Note interprets the "all events test" to require measurement of the likelihood of payment of a debt at the time it is executed: If payment is sufficiently certain, the debt must be accrued. The section concludes that the casinos must include the outstanding markers as income in the year of their execution, and cannot postpone their inclusion until the debts are repaid.[12] Section II argues that accrual-method taxpayers are entitled to use a "bad debt reserve" to deduct unenforceable debts that may prove uncollectible.

I. Interpreting the "All Events Test"

Generally, the Internal Revenue Code requires taxpayers to report gross income in the tax year in which it is "properly accounted for" under the taxpayer's method of financial accounting.[13] Since a casino using generally accepted accounting principles must accrue in income its outstanding markers, less a reserve for doubtful accounts,[14] the Code appears to require inclusion of the markers in

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Flamingo Resort, Inc. v. United States, 485 F. Supp. 926, 938 (D. Nev. 1980). The Nevada Supreme Court has held that the English anti-gambling statute — The Gaming Act, 1710, 8-12 Anne, c. 14, § 1 — is part of Nevada law. The courts will not enforce a gambling debt if the debtor pleads and proves, in some instances with the aid of a presumption, that the debt arose out of a gambling transaction. *See* Corbin v. O'Keefe, 87 Nev. 189, 484 P.2d 565 (1971) (per curiam); Wolpert v. Knight, 74 Nev. 322, 330 P.2d 1023 (1958); Weisbrod v. Fremont Hotel, Inc., 74 Nev. 227, 326 P.2d 1104 (1958) (per curiam); West Indies, Inc. v. First Natl. Bank, 67 Nev. 13, 214 P.2d 144 (1950); Craig v. Harrah, 66 Nev. 1, 201 P.2d 1081 (1949). Casinos may collect outstanding markers only if the patron pays voluntarily or fails to assert the "gambling purposes" defense. Desert Palace, Inc. v. Commissioner, 72 T.C. at 1043.

This Note is concerned only with credit that casinos extend to patrons for gambling purposes. It applies to all loans at the gambling tables. When the transaction occurs at the cashier's cage, however, the chips are not necessarily used for gambling. Patrons may also use them to purchase drinks, foods, or merchandise. Markers executed for these purposes are legally enforceable and do not raise the issues involved in this Note. *See generally* Desert Palace, Inc. v. Commissioner, 72 T.C. 1033 (1979).

12. The parties' divergent interests result from the time value of money. It is well recognized that

> [T]he heart of many tax cases is the issue of whether the tax should be paid sooner or later, it being conceded that a tax is due. Generally taxpayers prefer to postpone the recognition of taxable income and payment of tax as long as possible while the Treasury wishes to accelerate payment, since a tax deferred is a loss of immediate revenue. The desire by taxpayers to postpone the payment of taxes arises mainly from two factors — interest and inflation. The use of a dollar for another period of time results in additional monies to the taxpayer.

B. Bittker & L. Stone, *supra* note 3, at 1007.

13. *See* note 1 *supra*.

14. *See* Flamingo Resort, Inc. v. United States, 485 F. Supp. 926, 929 (D. Nev. 1980);

taxable income as well.[15] To justify not reporting markers until the year of collection, the casinos rely on treasury regulation 1.451-1, which provides for accrual of taxable income when the taxpayer's right to receive such income becomes fixed.[16] They argue that the regulation's language only permits accrual of claims that are legally enforceable.[17] As the analysis below indicates, the argument is flawed.

In applying the "all events test," courts must initially[18] determine the existence of a fixed right to receive the income in question,[19] a task that has precipitated some confusion.[20] A "right," commonly understood, "connotes an ascertainable and legally enforceable power."[21] Applying this definition, an unenforceable gambling claim could not conceivably be a "fixed right." But some courts have used "right" as a synonym for "claim"[22] and common-law

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Desert Palace, Inc. v. Commissioner, 72 T.C. 1033, 1044, 1046 (1979). The goal of financial accounting is to match current revenues with current costs. ACCOUNTING PRINCIPLES BOARD, *supra* note 3, at ¶ 11; G. JOHNSON & J. GENTRY, FINNEY AND MILLER'S PRINCIPLES OF ACCOUNTING, INTRODUCTION 27 (7th ed. 1970). *See also* R. WIXON, W. KELL & N. BEDFORD, *supra* note 4, at § 6.12 ("Without adjustment for accruals, *financial statements* prepared from books kept on a cash basis usually do not tend to show fairly, in accordance with generally accepted accounting principles, the financial position of an enterprise.") (emphasis in original).

15. If the casino did not accrue the outstanding markers in its financial statements, the IRS could, "in the exercise of its discretion," require accrual in the casino's tax return. Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 540 (1979). *See, e.g.*, American Automobile Assn. v. United States, 367 U.S. 687, 692 (1961).

16. *See* note 6 *supra*.

17. *See* Flamingo Resort, Inc. v. United States, 485 F. Supp. 926, 929 (D. Nev. 1980); Desert Palace, Inc. v. Commissioner, 72 T.C. 1033, 1048 (1979).

18. In the case of outstanding markers held by a gambling casino, there is no doubt that the amount can be determined with reasonable accuracy: "Each marker is for a specific dollar amount and there are no contingencies that could alter the amount of the obligation." 485 F. Supp. at 931.

19. "[I]t is the *right* to receive and not the actual receipt that determines the inclusion of an amount in gross income." Spring City Foundry Co. v. Commissioner, 292 U.S. 182, 184 (1934) (emphasis in original).

20. *See* Flamingo Resort, Inc. v. United States, 485 F. Supp. at 933.

21. United States v. Byrum, 408 U.S. 125, 136 (1972).

22. *See* Premier-Pabst Corp. v. Elm City Brewing Co., 9 F. Supp. 754, 758 (D. Conn. 1935); Southern Pac. R.R. v. United States, 38 F. 55, 56 (C.C.N.D. Cal. 1889); *In re* Estate of Wynn, 311 Ill. App. 190, 196, 35 N.E.2d 702, 705 (1941); Hathorn v. Robinson, 98 Me. 334, 341, 56 A. 1057, 1059 (1903); United States Fidelity & Guar. Co. v. Borough Bank, 161 App. Div. 479, 487-88, 146 N.Y.S. 870, 876, *affd.*, 213 N.Y. 628, 107 N.E. 1086 (1914); *Ex parte* Bailey, 20 Okla. 497, 501, 94 P. 553, 554 (1908); Alamo Dev. Corp. v. Thomas, 186 Tenn. 631, 639, 212 S.W.2d 606, 610 (1948).

> The word "right," . . . is a common term of broad signification. It is a generic, abstract, and comprehensive term, having a wide scope of meaning in its various legal applications, and it has no satisfactory definition or explanation except in connection with some concrete conception of the thing out of which it grows.

77 C.J.S. *Right* (1952) (footnotes omitted). *See* Clark v. Sweet, 187 Neb. 232, 234, 188 N.W.2d 889, 890-91 (1971); United States Fidelity & Guar. Co. v. Borough Bank, 161 App. Div. 479, 487-88, 146 N.Y.S. 870, 876 (1914), *affd.*, 213 N.Y. 628, 107 N.E. 1086 (1914); Hampton v. North Carolina Pulp Co., 223 N.C. 535, 546, 27 S.E.2d 538, 545 (1943).

cases qualified the term, using "unconditional" right,[23] "enforceable" right,[24] and other phrases[25] to conceptualize accrual for tax accounting purposes. To interpret their use of "right" to connote legal enforceability would read redundancy into these phrases. A more plausible construction of the term equates "right" with "claim."[26]

Applying this interpretation of the term to the "all events test" would more fully promote congressional policy than a construction requiring legal enforceability. First, a legal enforceability standard would undermine the purpose of the "all events test": to ensure accrual in taxable income of all income earned within a given year, even if payment has not yet been received.[27] If the refusal of courts to enforce claims can thwart the accrual of income for tax accounting purposes, the income that a taxpayer reports may not accurately reflect income that it has earned within the tax year and treated as earnings for financial accounting purposes.[28] The legal enforceability standard would also facilitate manipulation of tax liability.[29] If instead the IRS ascertained the probability of eventual payment, the agency would better ensure that reported income fully reflects income that is earned.[30]

Second, the legal enforceability standard frustrates the fundamental tax policy requiring similarly situated taxpayers to pay the same tax.[31] The Internal Revenue Code defines gross income for tax accounting purposes as "all income from whatever source derived."[32] Courts have interpreted this all-inclusive definition to mean that income received from an unlawful business or transaction

23. Lucas v. North Tex. Lumber Co., 281 U.S. 11, 13 (1930).

24. Breeze Corps. v. United States, 117 F. Supp. 404, 407 (Ct. Cl. 1954).

25. *See* Flamingo Resort, Inc. v. United States, 485 F. Supp. at 932 (citing Continental Tie & Lumber Co. v. United States, 286 U.S. 290, 295 (1932) ("right to payment"); Spring City Foundry Co. v. Commissioner, 292 U.S. 182, 184 (1934) ("fixed right to receive"); Lictenberger-Ferguson Co. v. Welch, 54 F.2d 570, 572 (9th Cir. 1931) ("definitely ascertained as to its amount, and acknowledged to be due")).

26. *See* Spring City Foundry Co. v. Commissioner, 292 U.S. 182, 184-85 (1934) (using "right" and "claim" interchangeably in applying the "all events test.").

27. *See* Commissioner v. Hansen, 360 U.S. 446, 466-67 (1959); Helvering v. Enright, 312 U.S. 636, 645 (1941).

28. The casinos treat the outstanding markers as income for financial accounting purposes. Flamingo Resort, Inc. v. United States, 485 F. Supp. at 929; Desert Palace, Inc. v. Commissioner, 72 T.C. at 1044.

29. For example, the taxpayer could manipulate income recognition simply by not pursuing his claim in court. *Cf.* Commissioner v. Hansen, 360 U.S. 446, 467 (1959) ("To permit accrual basis taxpayers to escape accrual and taxation, in a particular year, of such portion of their sales as they may permit to be retained by buyers . . . might well afford opportunities to accrual basis taxpayers to allocate income to years deemed most advantageous.").

30. In this way, the IRS discharges its primary responsiblility to preserve the public revenue. *See* Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 542 (1979). *See generally* Manufacturer's Statement, *supra* note 3.

31. *See* Thor Power Tool Co. v. Commissioner, 439 U.S. at 544.

32. I.R.C. § 61.

is taxable at the same rate as other sources of income.[33] This policy's application to the accrual of gambling markers raises a compelling argument: The tax laws should not enable casinos to gain an unfair preference over other businesses[34] merely because they extend credit unlawfully.[35]

Taxpayers who oppose accrual of gambling markers in the year of execution might rely on cases that seem to demand a level of certainty even greater than a legal enforceability test would require.[36] In *Lucas v. North Texas Lumber Co.*, the Supreme Court held that a vendor could not accrue income until there was "unconditional liability" on the purchaser's part.[37] The taxpayer had sought to avoid its increased tax liability by accruing income in the year preceding a tax rate increase. In taking the unusual position[38] that the taxpayer must postpone income recognition, the IRS argued that normal financial accrual principles requiring accrual in the earlier year were inapplicable to accrual of income for tax purposes. The IRS analogized to *United States v. Anderson*,[39] which had set forth the test for accrual of deductions. Given financial accounting's reliance on estimates in calculating expenses, the Supreme Court had recognized the importance of a rule of certainty for tax purposes to assure that

33. Commissioner v. Tellier, 383 U.S. 687, 691 (1966). *See, e.g.*, James v. United States, 366 U.S. 213 (1961); Rutkin v. United States, 343 U.S. 130 (1952); United States v. Sullivan, 274 U.S. 259, 263 (1927) (mere fact that a business engages in a transaction that is unlawful does not "exempt it from paying taxes that if lawful it would have to pay"); United States v. Stafoff, 260 U.S. 477, 480 (1923); United States v. Yuginovich, 256 U.S. 450 (1921); Treas. Reg. § 1.61-14 (1960).

34. If two taxpayers are alike in all respects except that one taxpayer's income is earned from an unlawful source and is accrued in a later tax year, their treatment for tax purposes will be unequal. First, the unlawful entity's income may rise or fall in subsequent years, so that including the income in a later year may mean that it is taxed at a different marginal rate. WEST'S FEDERAL TAXATION: INDIVIDUAL INCOME TAXES 73 (1979 ed.). Second, even if the marginal tax rates were identical, the taxpayer would still benefit from the time value of money. *See* W. ANDREWS, BASIC FEDERAL INCOME TAXATION 206-10 (2d ed. 1979); B. BITTKER & L. STONE, *supra* note 3, at 1007.

35. *See* J. SKOLNICK, HOUSE OF CARDS 80-81 (1978). While all "illegalities" are "unlawful," the converse is not true.

> [I]n the proper sense of the word, "unlawful," as applied to promises, agreements, considerations, and the like, denotes that they are ineffectual in law because they involve acts which, although not illegal, i.e., positively forbidden, are disapproved of by the law, and are therefore not recognized as the ground of legal rights, either because they are immoral or because they are against public policy.

BLACK'S LAW DICTIONARY 1705 (4th ed. 1951) (citations omitted). *See* note 11 *supra*.

36. Holland, *Accrual Problems in Tax Accounting*, 48 MICH. L. REV. 149, 154 (1949).

37. 281 U.S. 11, 13 (1950) (applying § 13(d) of the 1916 Revenue Act which is similar to § 446). *See* Freeman, *Tax Accrual Accounting for Contested Items*, 56 MICH. L. REV. 727, 734 (1958).

38. Normally, in the income area, the IRS is more concerned with requiring inclusion of items received, although not yet earned. *See, e.g.*, Schlude v. Commissioner, 372 U.S. 128 (1963); American Auto. Assn. v. United States, 367 U.S. 687 (1961). *See also* McClure, *Diverse Tax Interpretations of Accounting Concepts*, J. ACCOUNTING, Oct. 1976, at 67, 68.

39. 269 U.S. 422 (1926).

only proper deductions were taken from gross income.[40]

While financial accounting relies on estimates in calculating expenses, it turns to *certainties* in accruing income. As commentators have noted, income that is certain enough for financial accrual is sufficiently certain to satisfy the IRS's standard for tax accrual,[41] except in the rare case where a taxpayer such as the North Texas Lumber Co. may evade tax liability by accruing income in the earlier year.[42] The adequacy of financial accounting's standard for accrual of income justifies distinguishing *North Texas Lumber* from cases — including those concerning gambling markers — in which accrual does not facilitate tax evasion.[43] Where the objectives of financial and tax accounting converge, Congress required that income be reported in the tax year in which it is accounted for under the taxpayer's method of financial accounting.[44]

40. Subsequent decisions relaxed the strict requirement of *North Texas Lumber*, never again using the term "unconditional" to describe the "right" to income. *See* Commissioner v. Hansen, 360 U.S. 446, 464 (1959) ("[I]t is the time of acquisition of the *fixed right to receive* the reserves and not the time of their *actual receipt*") (emphasis in original); United States v. Safety Car Heating & Lighting Co., 297 U.S. 88, 93 (1936) ("contested and uncertain"); North Am. Oil Consol. v. Burnet, 286 U.S. 417, 423 (1932) ("not required . . . to report as income an amount which it might never receive"); Continental Tie & Lumber Co. v. United States, 286 U.S. 290, 295 (1932) ("right to payment"). The Court, however, continued to show concern for certainty. *See, e.g.*, Estate of Putnam v. Commissioner, 324 U.S. 393, 400 (1945) ("Such uncertainty destroys any conception of accrual as involving a right to receive or an obligation to pay, elements which we think are essential for accrual under our decisions.") (footnote omitted).

41. *See generally* Kupfer, *supra* note 4; Simonette, *A Challenge: Can the Accounting Profession Lead the Tax System?*, J. ACCOUNTING, Sept. 1968, at 66. Normally, the IRS will not question a taxpayer's decision to report income in its tax return. *See* Raby & Richter, *Conformity of Tax and Financial Accounting*, J. ACCOUNTING, Mar. 1975, at 42, 43-44.

Although adopting the *Anderson* test in the income situation maximized tax revenues in the *North Texas Lumber* case, it will not always work to the Commissioner's advantage. *See* United States v. Consolidated Edison Co., 366 U.S. 380, 385 (1961); Tandy Corp. v. United States, 626 F.2d 1186, 1195 (5th Cir. 1980). This is because the use of the "all events test" in the income situations has two effects: a taxpayer cannot report uncertain income, nor can the IRS require him to do so. Uncertain income must always be deferred even if the taxpayer has accrued the amounts on its financial statements. *See* Security Flour Mills Co. v. Commissioner, 321 U.S. 281, 286-87 (1944).

42. If a taxpayer expects its income to rise substantially in subsequent years, it may avoid the commensurately higher marginal tax rates by reporting uncertain income in the current tax year, thus reducing its aggregate tax liability. A taxpayer may also seek early accrual of income if Congress passes a tax rate increase.

43. Postponing accrual of gambling markers will in fact facilitate tax evasion. *See* note 94 *infra* and accompanying text.

44. *See* notes 1-5 *supra* and accompanying text.

While complete conformity of tax and financial accounting neither exists nor is feasible, conformity does benefit taxpayers, the IRS, and the general public by reducing "the effort and cost of tax compliance and administration, and . . . [the] confusion in financial reporting." *Statement on Conformity of Tax and Financial Accounting Adopted by the Board of Directors of the American Institute of Certified Public Accountants*, *reprinted in* B. BITTKER & L. STONE, *supra* note 3, at 1013-14. This, in turn, leads to "greater confidence in the fairness and integrity of the tax." *The Report of the President's Task Force on Business Taxation* (Sept. 1970), *reprinted in* B. BITTKER & L. STONE, *supra* note 3, at 1013. Since financial accounting tends to understate income, *see* note 3 *supra*, and since the I.R.C. should be construed to "reconcile business and tax treatment of an item, rather than driving them further apart," Eastman Ko-

An analysis of tax policy, therefore, reads section 451 not to require legal enforceability of an outstanding debt for accrual. Careful examination of the cases discussing income accrual is corroborative: Legal enforceability is accorded some weight but is never dispositive.[45] The courts instead focus on the certainty, at the time a debt is executed,[46] that it will eventually be collected.[47]

In *Barker v. Magruder*,[48] the Court of Appeals for the District of Columbia Circuit held that a lender must include in income interest on a note that it had accrued on its books, even though the interest receivable was unenforceable because it violated the state's usury laws.[49] The court stated that whether an item is accruable "depends not so much . . . upon the legal right to enforce collection as upon the existing probability of its being received."[50] The same interests may have owned and controlled the debtor and taxpayer,[51] assuring payment of the obligation. The debts were secured,[52] and payments had been regularly made in the past.[53] The claim was therefore certain despite its unenforceability.[54]

dak Co. v. United States, 534 F.2d 252, 258 (Ct. Cl. 1976), there is no compelling reason to postpone inclusion of the outstanding markers in income.

45. *See* 2 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 12.62 (rev. ed. 1974).

46. *See* Universal Oil Prods. Co. v. Campbell, 181 F.2d 451, 470-71 (7th Cir.), *cert. denied*, 340 U.S. 850 (1950) ("Vague possibilities that income may have to be returned or that it may possibly be subject to diminution or offset will not alone suffice to postpone accrual and reporting of taxable income"); Dingle-Clark Co. v. Commissioner, 26 T.C. 782, 791 (1956) (Theoretically possible events, not realistic in light of known facts, should not postpone the accrual of income which is established with reasonable certainty both as to liability and amount).

47. *See* San Francisco Stevedoring Co. v. Commissioner, 8 T.C. 222, 225-26 (1947); 2 J. MERTENS, *supra* note 45, at § 12.60. The correct application of this test is often cumbersome because its result turns on questions of degree. *See id.* at § 12.62.

48. 95 F.2d 122 (D.C. Cir. 1938).

49. 95 F.2d at 125. Arguably, the court was concerned only with preventing the taxpayer from profiting from his own wrongdoing, but this is not the purpose of the tax laws. The federal income tax "is a tax on net income, not a sanction against wrongdoing." Commissioner v. Tellier, 383 U.S. 687, 691 (1966). In any event, a gambling casino does not violate any laws by extending credit to its patrons. Although this Note concurs in the conclusion of the federal district court in Flamingo Resort, Inc. v. United States, 485 F. Supp. 926 (D. Nev. 1980), one of the court's major premises was that a taxpayer should not profit from his own wrongdoing. 485 F. Supp. at 938. This premise is neither proper nor persuasive under the federal income tax laws.

50. 95 F.2d at 123.

51. 95 F.2d at 123. *See* Holland, *supra* note 36, at 158. This relationship presented the opportunity for manipulation of income recognition so as to avoid or defer taxation.

52. 95 F.2d at 124.

53. 95 F.2d at 125.

54. *See* Holland, *supra* note 36, at 158. *See also* Barker v. United States, 26 F. Supp. 1004 (Ct. Cl. 1939) (almost identical to, involved the same lender, and reached the same result as *Barker v. Magruder*).

Similarly, in Herberger v. Commissioner, 9 T.C.M. (CCH) 546, 549 (1950), *affd.*, 195 F.2d 293 (9th Cir. 1952), the Tax Court required the taxpayer to include in income an amount due that was not legally enforceable because it was in excess of government price ceilings. The court stated that illegality does not entitle a taxpayer to postpone accrual. Great emphasis was

The Sixth Circuit followed *Barker* in *Travis v. Commissioner*,[55] ordering a dance studio, which had not yet performed services required by student enrollment agreements, to include installment payments due as income.[56] The taxpayer argued that the receivables were not accruable because, under the governing state law, they represented legally unenforceable executory contracts.[57] The court, however, found that the certainty of eventual payments outweighed the contracts' unenforceability.[58] It concluded that the language of the student enrollment agreements had convinced patrons that they were bound by the contract's payment terms[59] since the students paid many installments and the taxpayer rarely resorted to litigation.[60] In addition, delivery of the dance lessons would have enabled the studio to enforce its contract rights under state law.[61] The court thus viewed the case "in light of realism and practicality"[62] to find the claims sufficiently certain to require accrual.[63]

Some cases purport to require legal enforceability in permitting taxpayers to postpone inclusion, but on closer examination they reveal that the amounts due were too uncertain to be accrued. In *Cuba*

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placed on the fact that there was no dispute as to liability, nor fear on the taxpayer's part that he might not be paid. The debt was, in fact, paid at the beginning of the following year.

55. 406 F.2d 987, 990 (6th Cir. 1969).

56. 406 F.2d at 990.

57. 406 F.2d at 989.

58. 406 F.2d at 990.

59. 406 F.2d at 990.

60. 406 F.2d at 990.

61. Though the court did not discuss this fact, the taxpayer's capability of manipulating income recognition was identical to that presented in Barker v. Magruder, 95 F.2d 122 (D.C. Cir. 1938). *See* notes 48-54 *supra* and accompanying text.

62. 406 F.2d at 990 (citing Commissioner v. Segall, 114 F.2d 706, 709 (6th Cir. 1940), *cert. denied*, 313 U.S. 562 (1941)).

63. 406 F.2d at 990.

In Gar Wood Indus., Inc. v. United States, 437 F.2d 558 (6th Cir. 1971), the Sixth Circuit used language that could be interpreted as overruling *Travis*, although the latter case was not specifically mentioned. In *Gar Wood*, the accrual-basis taxpayer entered into contracts with the U.S. Army Corps of Engineers that provided for periodic payments for work in progress. In violation of the contract provisions, the Corps withheld amounts due the taxpayer pending redetermination and renegotiation of the contract prices. The IRS sought to require accrual of the withheld sums. In refusing to require accrual, the court stated that a taxpayer must have a "fixed, determined, and enforceable right" to receive the amounts before accrual is proper. 437 F.2d at 560. The taxpayer may, in fact, have had a legally enforceable right to some payment. The court's determination, however, hinged on uncertainties as to the *amount* involved: the parties had undergone renegotiation and were unable to agree on a redetermined price. The court may have based its holding, therefore, not on the enforceability issue, but on the requirement of the "all events test" that the "amount . . . be determined with reasonable accuracy." This is entirely consistent with the *Travis* rule that a claim must be sufficiently certain to require accrual.

In Case v. Commissioner, 103 F.2d 283 (9th Cir. 1939), the court held that an accrual basis taxpayer need not include in income gain realized yet not received on an exchange of stock. Even though he had an enforceable contract, the gain was not sufficiently certain until actually received three years later because of a dispute concerning the value of the underlying assets.

Railroad v. Commissioner,[64] the taxpayer had performed transportation services for the Cuban government, for which the latter admitted liability.[65] The taxpayer could have obtained a judgment against the government in Cuban courts,[66] but Cuban law limited collection to the extent of the budget,[67] and the Cuban legislature refused to appropriate an amount sufficient for payment.[68] In spite of its concern for legal enforceability,[69] the court based its decision not requiring inclusion[70] on the "great uncertainty as to when and whether the Cuban government would pay the amount."[71] Similarly, in *Maryland Shipbuilding & Drydock Co. v. United States*,[72] the Court of Claims did not require the taxpayer to include insurance proceeds in the year that it sustained a loss. While the court stated that to accrue income a taxpayer must have an "enforceable" right,[73] its argument relied on the payment's uncertainty:[74] Liability was disputed,[75] and the amount of recovery was undetermined and subject to negotiation.[76]

When determining whether an item is sufficiently certain to accrue as income, the courts thus focus on a number of factors besides legal enforceability, including (1) the existence and completeness of any written agreement between the parties,[77] (2) the ease of collection and the collection rate on the receivables,[78] (3) the frequency of

64. 9 T.C. 211 (1947).

65. 9 T.C. at 214.

66. 9 T.C. at 214.

67. 9 T.C. at 214.

68. 9 T.C. at 212-13.

69. 9 T.C. at 215.

70. 9 T.C. at 215.

71. 9 T.C. at 215. *See also* Breeze Corps. v. United States, 117 F. Supp. 404 (Ct. Cl. 1954). There, the Court of Claims held that the taxpayer was entitled to a refund because it had erroneously included in income the estimated receipt expected on a war contract cancellation claim. The court stated that accrual required an enforceable right, yet there was great uncertainty as to the amount of and liability for the claim. The evidence included voluminous correspondence, many proposed partial settlement agreements, a complete denial of the claim at one time, several years of negotiation, and final settlement for only one third of the claim. 117 F. Supp. at 405-06.

72. 409 F.2d 1363 (Ct. Cl. 1969) (per curiam).

73. 409 F.2d at 1366 (quoting Breeze Corps. v. United States, 117 F. Supp. 404, 407 (Ct. Cl. 1954)).

74. 409 F.2d at 1369.

75. The insurer never made an unqualified admission of liability in the year of loss. 409 F.2d at 1369. The taxpayer's loss was covered by multiple policies. The insurer conditioned payment of the total loss under one policy on the taxpayer's agreeing to waive recovery under other policies. 409 F.2d at 1367.

76. 409 F.2d at 1369. The court was also satisfied that the taxpayer had not attempted to influence or manipulate the timing of the settlement agreement. 409 F.2d at 1369.

77. *See* Travis v. Commissioner, 406 F.2d 987, 990 & n.3 (6th Cir. 1969).

78. *See* 406 F.2d at 990. The Ninth Circuit articulated what was later interpreted to be an exception to the "all events test": "[N]o income accrues unless there is a reasonable expectancy that the right will be converted into money or its equivalent." H. Liebes & Co. v. Com-

litigation involving the receivables,[79] (4) the opportunity for manipulation of income recognition in order to avoid taxation,[80] (5) the treatment of the item for financial reporting purposes,[81] (6) the existence of any contingencies to the receipt of payment,[82] and (7) the existence of any dispute as to the debtor's liability.[83]

When applied to unenforceable gambling debts, these criteria require accrual in the year the markers are executed. The markers that a credit customer executes represent not only negotiable counter-checks for the amount of the chips transferred to him,[84] but also the existence of a debtor-creditor relationship with the casino.[85] The casino performs a thorough credit check and then extends a maximum line of credit that it expects to collect.[86] Most credit patrons settle liabilities after concluding play.[87] Unsatisfied markers are classified as accounts receivable[88] and are ordinarily collected through normal

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missioner, 90 F.2d 932, 937 (9th Cir. 1937). *See* Clifton Mfg. Co. v. Commissioner, 137 F.2d 290, 292 (4th Cir. 1943); Franklin County Distilling Co. v. Commissioner, 125 F.2d 800, 805 (6th Cir. 1942) (following the rule in *Liebes*). The rule, however, is consistent with an interpretation of the "all events test" requiring sufficient certainty. *See, e.g.*, Stephens Marine, Inc. v. Commissioner, 430 F.2d 679, 684 (9th Cir. 1970) (requiring substantial uncertainty or a contingency for the rule to apply). *Cf.* Jones Lumber Co. v. Commissioner, 404 F.2d 764, 766-67 (6th Cir. 1968) (requiring debtor's financial instability or insolvency for the rule to apply).

79. *See* Travis v. Commissioner, 406 F.2d 987, 990 (6th Cir. 1969).

80. *See* Travis v. Commissioner, 406 F.2d 987 (6th Cir. 1969); Case v. Commissioner, 103 F.2d 283 (9th Cir. 1939); Barker v. Magruder, 95 F.2d 122 (D.C. Cir. 1938); Maryland Shipbuilding & Drydock Co. v. United States, 409 F.2d 1363, 1369 (Ct. Cl. 1969). *Cf.* Commissioner v. Hansen, 360 U.S. 446, 467 (1959) ("To permit accrual basis taxpayers to escape accrual and taxation, in a particular year, of such portions of their sales as they may permit to be retained by buyers . . . might well afford opportunities to accrual basis taxpayers to allocate income to years deemed most advantageous.").

81. *See* Barker v. Magruder, 95 F.2d 122 (D.C. Cir. 1938). Given financial accounting's conservatism in reporting income, an item's financial treatment is a good indication of its certainty. *See* notes 41-42 *supra* and accompanying text. If, however, other factors point to uncertainty, the taxpayer's accrual of the amount in his financial statements is not controlling. *See* note 41 *supra*.

82. *See* Maryland Shipbuilding & Drydock Co. v. United States, 409 F.2d 1363, 1369 (Ct. Cl. 1969); Cuba R.R. v. Commissioner, 9 T.C. 211, 214-15 (1947).

83. *See* Gar Wood Indus., Inc. v. United States, 437 F.2d 558 (6th Cir. 1971); Case v. Commissioner, 103 F.2d 283, 287-88 (9th Cir. 1939); Maryland Shipbuilding & Drydock Co. v. United States, 409 F.2d 1363, 1369 (Ct. Cl. 1969); Breeze Corps. v. United States, 117 F. Supp. 404, 410 (Ct. Cl. 1954); Herberger v. Commissioner, 9 T.C.M. (CCH) 546, 549 (1950), *affd.*, 195 F.2d 293 (9th Cir. 1952).

84. *See* note 8 *supra*.

85. The existence of a debtor-creditor relationship is a conclusion of law. It is supported by the circumstances examined in the text at notes 86-94 *infra*.

86. Flamingo Resort, Inc. v. United States, 485 F. Supp. 926, 928 (D. Nev. 1980); Desert Palace, Inc. v. Commissioner, 72 T.C. 1033, 1038 (1979). Approximately 20% of the revenue generated by gambling is in the form of outstanding markers. *See* 485 F. Supp. at 928; 72 T.C. at 1036.

87. 485 F. Supp. at 928; 72 T.C. at 1039.

88. *See* 72 T.C. at 1042-43. The casinos charge no interest on these receivables, nor are they secured in any way. *See* 72 T.C. at 1041.

banking channels[89] or after extensive collection efforts.[90] On the rare occasions when the casino resorts to litigation,[91] it often obtains judgment against debtors who fail to assert the "gambling purposes" defense.[92] With these efforts, casinos eventually collect ninety-five percent of the outstanding markers.[93] Failure of the courts to require accrual may facilitate tax evasion; the casino may then manipulate its taxable income by postponing payment due dates or decreasing collection efforts.[94] Moreover, the casino includes the markers as gross income in its financial statements.[95] Unless a particular credit patron makes payment of his debt contingent or disputes his liability, eventual payment of a gambling debt will be sufficiently certain to require accrual in the year it is executed.

II. THE BAD DEBT RESERVE

The accrual of outstanding gambling markers as taxable income in the year of execution raises the possibility of taxing income that the taxpayer may never receive.[96] To tax only the income actually received, section 166(c) of the Internal Revenue Code allows a deduction "for a reasonable addition to a reserve for bad debts."[97] Although accrual-basis taxpayers usually reflect doubt about income receipt by taking such a deduction, and the Commissioner has allowed a reserve in one of the two gambling marker cases,[98] a treasury regulation may require legal enforceability before a taxpayer may take a bad debt deduction using the reserve method. Regulation 1.166-1(c) interprets the Code only to permit deduction of a

89. *See* 485 F. Supp. at 928-29; 72 T.C. at 1042.

90. Casino personnel will typically contact the debtor by telephone or in person on one or more occasions. If this fails, the casino will usually refer the claim to an attorney or collection agency. Court action is commenced as a last resort. *See* 72 T.C. at 1043.

91. *See* note 90 *supra*. There is no apparent dispute concerning the debtor's liability at the time the markers are executed. 485 F. Supp. at 934.

92. *See* 72 T.C. at 1043. The legal unenforceability of the markers does not make them so speculative as to prevent accrual. Although legal unenforceability creates the theoretical possibility that the income ultimately will not be received, it has virtually no effect on the casino's collection rate.

93. *See* 485 F. Supp. at 928; 72 T.C. at 1042.

94. Currently, the casino permits a patron to satisfy his or her marker with a check postdated beyond the close of the taxable period. *See* 485 F. Supp. at 929; 72 T.C. at 1043. If the casino wished to defer recognition, it could easily arrange with patrons to make actual payment at the later time it desires.

95. *See* 485 F. Supp. at 929; 72 T.C. at 1044.

96. The casinos can expect not to collect 5% of the outstanding markers. *See* note 93 *supra*. Yet, having been reported as income on an accrual basis, this income will be subject to tax.

97. I.R.C. § 166(c). This is the normal manner of reflecting doubt about income receipt. *See* J. MERTENS, *supra* note 45, at § 12.75.

98. Flamingo Resort, Inc. v. United States, 485 F. Supp. 926, 938 (D. Nev. 1980). In Desert Palace, Inc. v. Commissioner, 72 T.C. 1033 (1979), the Commissioner allowed a bad debt deduction under § 166(a), 72 T.C. at 1034, but may have disputed a deduction under § 166(c) for an addition to the taxpayer's bad debt reserve. 72 T.C. at 1034 n.2.

"bona fide" debt, which it defines as one that "arises from a debtor-creditor relationship based on a valid and enforceable obligation to pay a fixed or determinable sum of money."[99] Courts might also deny bad debt deductions if they believe that they frustrate a public policy against extending credit for gambling purposes.[100] This Section of the Note argues that the IRS must allow the casinos to establish a bad debt reserve because the regulation requiring an "enforceable obligation" can be plausibly interpreted only to preclude deductions where no bona fide debt has in fact been incurred. This interpretation would also promote the tax policy against taxing income that the taxpayer has never received without undermining the public policy of Nevada.

A proper interpretation of regulation 1.166-1(c) begins at its origin: the legislative history of section 166. Congress conditioned the applicability of that provision on "the existence of a bona fide debt as distinguished from a gift or a contribution to the capital of the corporation."[101] In each of the latter cases, no debtor-creditor relationship arises because the party receiving the money is not obligated to return it to the taxpayer.[102] As a result, the taxpayer cannot claim to have suffered a loss for which a deduction should be allowed. For this reason, cases preceding the regulation[103] and the regulation itself[104] distinguish debts from gifts and capital contributions. The courts and the IRS have only used the bona fide debt standard where, because of uncertainty,[105] the existence of a debt was in issue.[106]

99. Treas. Reg. § 1.166-1(c) (1959).

100. *See* notes 124-25 *infra* and accompanying text.

101. *See* H.R. REP. No. 1337, 83d Cong., 2d Sess. 21-22, A47-A48, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4017, 4184; S. REP. No. 1622, 83d Cong., 2d Sess. 24-25, 199-200, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4834-35. Congress used this language to distinguish debts from gifts and capital outlays.

Treasury Regulations, if not unreasonable or inconsistent with express statutory provisions, have the force and effect of the law and will not be overruled except for substantial reasons. *See* Commissioner v. South Tex. Lumber Co., 333 U.S. 496, 501 (1948); Maryland Cas. Co. v. United States, 251 U.S. 342, 349 (1920); Latham Park Manor, Inc. v. Commissioner, 69 T.C. 199, 211-12 (1977).

102. *See* Treas. Reg. § 1.166-1(c) (1959).

103. *See, e.g.*, W.F. Young, Inc. v. Commissioner, 120 F.2d 159 (1st Cir. 1941) (gift); Kubitzki v. Commissioner, 11 T.C.M. (CCH) 1182 (1952) (gift); Houston Chronicle Publishing Co. v. Commissioner, 3 T.C. 1233 (1944) (gift); Jacob Grossman, 9 B.T.A. 643 (1927) (gift).

104. Treas. Reg. § 1.166-1(c) (1959). The language immediately follows the bona fide debt definition.

105. *See* Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 542-43 (1979).

106. The early cases focused on whether a debt existed. *See, e.g.*, Cullinan v. Commissioner, 19 B.T.A. 930 (1930) (loan to political campaign committee); Missouri Valley Bridge & Iron Co. v. Commissioner, 14 B.T.A. 1162 (1929) (lost suit on construction contract); Federal Fuel Co., 3 B.T.A. 814 (1926) (forfeited performance deposit is not a debt); Louis Titus, 2 B.T.A. 754 (1925) (no authority to contract); Luke & Fleming, Inc., 1 B.T.A. 12 (1924) (insurance policy).

Only one case, Domhoff & Joyce Co. v. Commissioner, 17 B.T.A. 1015 (1929), *affd.*, 50

The foregoing analysis suggests that regulation 1.166-1(c) does not contemplate the unenforceable markers held by casinos. Such loans are made with the belief that they will be repaid, and they are accrued as income.[107] Unlike gifts and capital contributions, therefore, gambling loans create a true debtor-creditor relationship,[108] and casinos face the prospect of a loss for each marker that they do not collect. Because of these differences, the regulation's enforceability requirement should be interpreted to apply only to gifts and capital contributions, and not to accrued income.[109]

Interpreting the regulation to deny a reserve for bad gambling debts also risks taxation of income that the casino has never received. While such a result would undermine fundamental tax policy,[110] opponents of the bad debt reserve might rely on *Herbert E. Tharp*,[111] which denied a bad debt deduction but allowed a section 165 loss deduction. Tharp was an accrual method taxpayer whose loans, made at usurious interest rates, were unenforceable under state law.[112] According to the court, the loans, as unenforceable claims, did not qualify as debts for which the taxpayer could take a section 166 deduction.[113] The court, however, allowed the loss deduction because it recognized the inequity of taxing accrued income that the taxpayer would never receive: "To deny a deduction in this case would come close to making this business taxable on the basis of gross receipts, while all other businesses would be taxable on the basis of net income."[114]

A loss deduction would mitigate the inequity of taxing bad gambling debts, but it would not eliminate it. Unlike bad debts,[115] losses cannot be deducted on the reserve method.[116] As the regulations indicate, a loss must be "evidenced by closed and completed transactions, fixed by identifiable events, and . . . actually sustained during

F.2d 893 (1931), involved an accrual basis taxpayer and accrued accounts receivable. In that case, however, the taxpayer received the amount due from a third party. This receipt was nontaxable. Permitting a bad debt deduction would have given the taxpayer a double benefit.

107. *See* notes 84-95 *supra* and accompanying text.

108. *See* note 85 *supra* and accompanying text.

109. *Cf.* Lykes Bros. S.S. Co. v. United States, 513 F.2d 1342 (Ct. Cl. 1975) (Treasury Regulation interpreted so as to be consistent with statutory purpose).

110. Income that will not be received cannot be taxed. *See* North Am. Oil Consol. v. Burnet, 286 U.S. 417, 423 (1932); Long Poultry Farms v. Commissioner, 249 F.2d 726, 731 (4th Cir. 1957); Farrell v. Commissioner, 134 F.2d 193, 194 (5th Cir. 1943). It would be inequitable to tax income when there is no reasonable expectancy of its receipt. Corn Exch. Bank v. United States, 37 F.2d 34 (2d Cir. 1930).

111. 31 T.C.M. (CCH) 22 (1972).

112. 31 T.C.M. at 24-25.

113. 31 T.C.M. at 25.

114. 31 T.C.M. at 26.

115. I.R.C. § 166(c).

116. Treas. Reg. § 1.165-1(d) (1960).

the taxable year" to be deductible.[117] Losses, moreover, must be wholly worthless before deducted;[118] bad debts may be deducted when partially so.[119] These differences permit a taxpayer taking the bad debt deduction on the reserve method to recover tax paid on income never received sooner than a taxpayer taking the loss deduction, who loses the time value of money.[120] To deny the casino the full benefit of a bad debt reserve and afford it to other businesses would, therefore, violate the principle that "similarly situated taxpayers [should] pay the same tax."[121] Although denial of a bad debt deduction may have been justifiable in *Tharp* where the transactions were proscribed by statute, courts should afford the full benefit of the bad debt reserve to casinos who comply with the law in extending credit to gamblers.[122]

Opponents of the bad debt reserve might also deny the deduction because it frustrates Nevada's public policy against gambling on credit.[123] The Supreme Court has denied federal income tax deductions that would severely and immediately[124] undermine a clearly articulated national or state policy;[125] however, allowing the bad

117. Treas. Reg. § 1.165-1(b) (1960).

118. Treas. Reg. § 1.165-1(a) (1960).

119. I.R.C. § 166(a)(2).

120. The Supreme Court recognized this inequity in Commissioner v. Sullivan, 356 U.S. 27 (1958). The Court held expenditures, themselves illegal, deductible in computing taxable income of an illegal gambling enterprise. The Court stated that disallowing the deductions would come close to making the business taxable on its gross receipts, whereas other businesses are taxed on net income. 356 U.S. at 29. While a 1971 congressional amendment to I.R.C. § 162(c)(2) may have overturned *Sullivan*, the case's reasoning and policy still apply to gambling markers. *See* Herbert E. Tharp v. Commissioner, 31 T.C.M. (CCH) 22, 23 & n.5 (1972) (concluding that the public policy prohibition is precluded by § 162(c) as to loss deductions but not bad debt deductions); Note, *The Judicial Public Policy Doctrine in Tax Litigation*, 74 MICH. L. REV. 131 (1975).

The case of uncollectible gambling markers provides even more sympathetic facts for allowing the deduction than *Sullivan*. First, although the gambling markers are unenforceable, they are not illegal. Second, whereas the business in the *Sullivan* case was itself illegal, the casino is conducting a legal enterprise under the laws of Nevada. Its credit extensions are authorized by Nevada law and regulated by the Nevada Gaming Commission and the Nevada Gaming Control Board. *See* Desert Palace, Inc. v. Commissioner, 72 T.C. 1033, 1036-37 (1979). Third, taxing nonexistent income is far different from not allowing expenses to be deducted from income admittedly received. Whereas an expense deduction is considered a matter of legislative grace, *see* Commissioner v. Tellier, 383 U.S. 687, 693 (1966); Deputy v. Dupont, 308 U.S. 488, 493 (1940), a tax on income that is not received is clearly contrary to tax policy. *See* North Am. Oil Consol. v. Burnet, 286 U.S. 417, 423 (1932); Long Poultry Farms v. Commissioner, 249 F.2d 726, 731 (4th Cir. 1957); Farrell v. Commissioner, 134 F.2d 193, 194 (5th Cir. 1943).

121. *See* note 34 *supra*.

122. *See* note 120 *supra*.

123. *See* J. SKOLNICK, *supra* note 35; note 11 *supra*.

124. Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30, 35 (1958).

125. The Court requires a governmental declaration proscribing particular forms of conduct. Commissioner v. Tellier, 383 U.S. 687, 694 (1966). *See, e.g.*, Smith v. Commissioner, 34 T.C. 1100 (1960), *affd.*, 294 F.2d 957 (5th Cir. 1961) (denial of bad debt deduction on public policy grounds); Wagner v. Commissioner, 30 B.T.A. 1099 (1934) (denial of loss deduction

debt reserve would not severely or immediately frustrate Nevada's policy against gambling on credit. The state's courts have effectuated the policy by holding the markers void.[126] Allowing the reserve does not lessen the penalty's "sting"[127] since casino profits will still fall to the extent of the penalty.[128] Disallowing the reserve would add a penalty[129] that is contrary to a goal of tax law: taxing net rather than gross income.[130] Absent a severe and immediate frustration of the state's policy, the courts must allow a bad debt reserve for accrued markers that may subsequently prove worthless.[131]

CONCLUSION

That gambling markers are not legally enforceable does not necessarily mean that they should not be included in taxable income by an accrual method taxpayer; rather, courts must evaluate all the relevant facts and circumstances at the time the debt is executed to determine its certainty. Ordinarily the casino markers are sufficiently certain to be accrued as taxable income.

Taxing accrued markers that subsequently prove worthless creates an inequity that courts can eliminate by allowing a reserve for bad debts. Treasury regulations, however, do not allow a bad debt reserve when the underlying claim is unenforceable. This Note demonstrates that when an item is accrued in taxable income, tax policy requires granting a corresponding reserve for bad debts. Thus, courts that require casinos to accrue their income from the outstanding markers should also allow a bad debt reserve.

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arising from operation of usurious loan business). This rule is an exception to the principle that the income tax does not punish wrongdoing. 383 U.S. at 691-94. Ordinarily, deductions are not limited to expenses or losses incurred in a legitimate or lawful trade or business. 383 U.S. at 691.

126. *See* note 11 *supra*.

127. *See generally* Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. at 35-36 (1958).

128. A tax deduction will not offset the amount of the penalty. It will only prevent imposition of an additional penalty equal to the amount of tax paid on income not received.

129. If the reserve is not allowed, the taxpayer is in effect taxed on its income before deductions, *i.e.*, on "gross" income. In this way, tax law will treat the casino different from other accrual basis taxpayers who are permitted a reserve for bad debts. Such a result is contrary to the tax policy that similarly situated taxpayers be treated alike even if one is conducting a lawful business and the other an unlawful one. *See* Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 544 (1979).

130. *See* note 120 *supra*; Commissioner v. Tellier, 383 U.S. 687, 691-92 (1966).

Arguably, the public policy prohibition has been precluded by amendments to § 162. I.R.C. § 162(c). The Tax Court, based on the IRS's concession, has concluded that the preclusion applies to loss deductions. *See* note 120 *supra*. There are no cases applying the same rationale to bad debt deductions.

131. The court in Travis v. Commissioner, 406 F.2d 987, 991 (6th Cir. 1969), stated that if a taxpayer is required to include a receivable in income, it is entitled to a realistic bad debt reserve. The court did not explain its holding, assuming such an entitlement and applying the "realistic" concept to the facts of the case before it.