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## FINANCIAL FOCUS



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# Interested in How to Handle Accrual of Interest?

Oftentimes it can be a difficult and complicated task to determine how interest accruals of troubled loans are handled by tax law. A quick read through of the regulations can seem complicated and intimidating with a maze of double speak and legal jargon, but upon closer inspection it may not be as difficult to understand as it initially appears. It contains some straight forward guidelines for determining how the accrual of interest of troubled loans should be reported by both the borrower as well as the lender.

## When is interest deductible to the borrower?

In order to deduct interest paid or accrued within a tax year three things requirements must be satisfied according to Treas. Reg. § 1.461-1(a)(2).

1. All events that establish the interest as a liability must have occurred.
2. The taxpayer must be able to determine the amount of interest with reasonable accuracy.
3. Economic performance must have occurred with respect to the interest. (By definition, in the Treasury Regulations, economic performance occurs as interest accrues.)

The determination of whether or not the interest for troubled loans is deductible by the borrower hinges on key points:

- The IRS ruled that a taxpayer in bankruptcy could deduct interest as it accrues even if there is no reasonable expectancy that it would ever pay said interest in full. (Rev. Rul. 70-367)
- However courts have determined that taxpayers cannot deduct interest related to pre-bankruptcy debt that accrues after the issuer enters bankruptcy when the taxpayer did not have sufficient assets to pay the interest. (Continental Vending Machine Corp., No. 63-B-663 (E.D.N.Y. 11/22/76), Kellogg, 54 F.3d 1194 (5th Cir. 1995))
- A taxpayer is permitted to deduct postpetition interest as it accrues when the creditors have a contractual right to receive postpetition interest. (re Dow Corning Corp., 270 B.R. 393 (Bankr.E.D. Mich. 2001))
- A corporation may deduct postpetition interest in its consolidated tax return on behalf of the contractual borrowings of a subsidiary member until the confirmation of the reorganization plan in the bankruptcy proceeding. (Chief Counsel Advice (CCA) 200801039 (1/4/08))

Bottom Line – Borrowers are permitted to deduct interest as it accrues even if there is uncertainty that they will actually pay said interest. The reasoning is that since the borrower still takes on a liability they are able to deduct the interest under the accrual method.

When is interest counted as income to the lender?

Interest paid or accrued within a tax year for an accrual-method taxpayer is recognized as income when two things transpire. (Treas. Reg. § 1.461-1(a))

1. All events have occurred to establish the right of the taxpayer to receive the income.
2. The amount of the interest can be determined with reasonable accuracy.

Just as there are several factors to consider when determining when a borrower can take a deduction on interest as it accrues, so too are there factors that decide when interest must be reported as income for the lender.

- If a lender can no longer reasonably expect payment of interest from a borrower, then they are no longer required to report that interest as it accrues as income. However, it is the lender’s responsibility to prove “reasonable doubt” as to the collectability of the interest and they must also provide “definite showing” that the insolvency of the debtor makes receipt of the interest improbable. (Com Exchange Bank, 37 F.2d 34 (2nd Cir. 1930) Jones Lumber Co., 404 F.2d 715 (Ct. Cl. 1970))
- Another Court went further stating: “For accrual of income to be prevented, uncertainty as to collection must be substantial, and not simply technical in nature.” (European Amer. Bank and Trust Co., 20 Cl. Ct. 594 (1990), aff’d per curiam, 940 F.2d 677 (Fed. Cir. 1991))
- A taxpayer does not need to identify interest as it accrues as income once a borrower has become insolvent. However interest as it accrues before a borrower’s insolvency must be recognized as income. If the debt proves to be uncollectable it may be subject to section 166 as a bad debt deduction. (Rev. Rul. 80-361)

For questions regarding the proper way to report interest as it accrues for troubled loans you should always contact your trusted advisor with Lane Gorman Trubitt, L.L.P. or Scott Cote, Director of Practice Growth at (214) 461-1467 or by email at [scote@lgt-cpa.com](mailto:scote@lgt-cpa.com).

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