

**APPEALS
SETTLEMENT GUIDELINES**

ISSUE: IRC § 461(f) Contested Liabilities

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SETTLEMENT POSITION
I.R.C. 461(f) CONTESTED LIABILITIES TRANSACTIONS

GENERAL ISSUE

Whether taxpayers entering into I.R.C. § 461(f) Contested Liabilities Transactions that are the same as or similar to those described in Notice 2003-77, 2003-49 I.R.B. 1182, are entitled to a deduction under I.R.C. § 461(f).

The issue to be considered has several components, which may be summarized as follows:

ISSUE 1

Whether the taxpayer contests an asserted liability:

- a) Tax and interest on taxes; and
- b) Determining whether there is a contest of an asserted liability.

ISSUE 2

Whether the liability was contested at the time of the transfer:

ISSUE 3

Whether the transfer of property to a trust provides for the satisfaction of the contested liabilities.

- a) Related party notes

ISSUE 4

Whether the taxpayer has set an accurate value on property transferred to the trust:

- a) Related party notes;
- b) Taxpayer's own stock or related party stock;
- c) Valuation of Stock; and
- d) Cash, mortgage-backed securities.

ISSUE 5

Whether taxpayer retains control over amounts transferred to contested liabilities trusts:

- a) Power to substitute assets transferred to trust with other assets;
- b) Validity of trust;
- c) Disclosure of trust's existence to claimant;

- d) Claimant's assent to escrows and trusts in § 461(f) transactions;
- e) Limitations on trustee's ability to sell trust assets and enforce rights related to the trust property;
- f) Power to Pay Claimants with Funds Outside of the Trust
- g) Edison Brothers Stores as a Benchmark for Analyzing § 461(f) Trust Agreements; and
- h) Manner of transfer must not be open to tax abuse.

ISSUE 6

Whether, but for the contest, a deduction would be allowed in the taxable year of transfer:

- a) Liability must be otherwise deductible; and
- b) Economic performance.

ISSUE 7

Whether any of the following components of the accuracy-related penalty under I.R.C. § 6662 should be asserted: negligence or disregard of rules or regulations, substantial understatement of income tax, and/or valuation misstatement.

- a) The Accuracy-Related Penalty;
- b) The Reasonable Cause Exception; and
- c) Disclosure Initiative Under Announcement 2002-2

APPENDIX I

The I.R.C. § 461(f) Contested Liabilities Transaction described in Notice 2003-77 is a change in method of accounting to which §§ 446 and 481 apply. Normally, Rev. Proc. 97-27, 1997-1 C.B. 680, permits a taxpayer to change from an impermissible method of accounting to a proper method by filing a Form 3115. Instead, the Service has issued Rev. Proc. 2004-31, 2004-22 I.R.B. 1, as the procedure to be followed by taxpayers wanting to change from the impermissible method of accounting used in I.R.C. § 461(f) Contested Liabilities Transactions. The Appendix explains how Appeals should administer requests to resolve cases using Rev. Proc. 2004-31.

OVERVIEW OF COMPLIANCE'S POSITION

I.R.C. § 461(f) provides an exception to the general rules of tax accounting by allowing a taxpayer to deduct a contested liability in a year prior to the resolution of the contest if certain conditions are satisfied.

Under I.R.C. § 461(f) an accrual basis taxpayer may claim a deduction for a contested liability if:

- (1) the taxpayer contests an asserted liability,
- (2) the taxpayer transfers money or other property to provide for the satisfaction of the asserted liability,
- (3) the contest with respect to the asserted liability exists after the time of the transfer, and
- (4) but for the fact that the asserted liability is contested, a deduction would be allowed for the taxable year of the transfer (or for an earlier taxable year) determined after application of I.R.C. § 461(h).

I.R.C. § 461(h) provides that an accrual method taxpayer may not deduct a liability until economic performance has occurred with respect to the liability. Therefore, IRC § 461(f)(4) requires that economic performance must occur before a contested liability deduction may be allowed under § 461(f).

I.R.C. § 461(f) does not provide an independent basis for a deduction. Instead, the provision merely affects a deduction's timing. The taxpayer must be entitled to a deduction under some other Code provision.

"Payment" vs. "Nonpayment" Liabilities

Shorthand terms are frequently used throughout this discussion to reflect the different economic performance standards that I.R.C. § 461(f) applies to two categories of contested liabilities, the so-called "payment liabilities" and "nonpayment liabilities."

Payment liabilities are workers compensation and tort liabilities, as well as liabilities listed in Treas. Reg. § 1.461-4(g) for which economic performance occurs when payment has been made to a person (i.e., the claimant) to which the liability is owed.

Nonpayment liabilities are those falling outside this definition.

Notice of Listed Transactions

Certain transactions described in Notice 2003-77, 2003-49 I.R.B 1182 ("listing notice") purporting to generate deductions for contested liabilities under I.R.C. § 461(f) are designated as listed transactions ("I.R.C. § 461(f) Contested Liabilities Transaction"). The I.R.C. § 461(f) Contested Liabilities Transaction involves transfers to trusts that purport to comply with I.R.C. § 461(f).

Generally, a corporation ("taxpayer") creates a trust to which it transfers a related party note or its own stock or that of a related party (and sometimes cash or other property), ostensibly to provide for the satisfaction of selected contested liabilities which have been asserted against the taxpayer by third parties.

The taxpayer then deducts the fair market value of the property that was transferred to the trust, despite maintaining such a degree of control over the property that the transfer does not comply with the requirements of I.R.C. § 461(f)(2).

In transactions involving the transfer of a related party note, typically the note does not represent a genuine liability and/or the parties do not intend to enforce the obligation. There may also be an issue whether the fair market value of the note is less than the claimed deduction.

In transactions involving torts, workers compensation, and other payment liabilities designated in Treas. Reg. § 1.461-4(g), the transfer by an accrual basis taxpayer to a trust does not constitute payment to the parties asserting the liabilities, under the economic performance requirements of I.R.C. § 461(h)(2)(C) and the related regulations.

Fact Patterns Determine the Selection of Legal Arguments

Unlike some shelters that have uniform fact patterns, the I.R.C. § 461(f) Contested Liabilities Transactions vary widely in the number and types of contested liabilities included in the transactions, the types of property transferred to the trusts, the degree of control the taxpayer retains over the trust property, and the limitations on the powers of the trustees.

Various statutory and judicial grounds may be used to challenge the taxpayers' deductions under I.R.C. § 461(f), but not all arguments are applicable to each case. Also, the legal arguments are fact sensitive, therefore extensive factual development is necessary in order to evaluate the appropriate legal position for each transaction.

Compliance's position is that the accuracy-related penalty under I.R.C. § 6662 should be asserted where applicable on a case-by-case basis, depending on the specific facts and circumstances of each case.

OVERVIEW OF TAXPAYER'S POSITION

The taxpayer contends that it has satisfied all four elements required under I.R.C. § 461(f) to deduct a contested liability.

- I.R.C. § 461(f) (1): The taxpayer contests an asserted liability.

The taxpayer typically contends (1) that there is evidence of the asserted liability, and (2) that it has established that a contest exists because of a bona fide dispute over the interpretation of the law or the facts necessary to determine the existence or correctness of the amount of the asserted liability.

- I.R.C. § 461(f) (2): The taxpayer transfers money or other property to provide for the satisfaction of the asserted liability.

A taxpayer will generally argue that although some early cases on the issue found that the regulations required a taxpayer to sign a § 461(f) trust agreement, more recent and persuasive cases have held otherwise.

A taxpayer will state that the terms of its § 461(f) trust agreement establish that the assets transferred to the § 461(f) trust have irrevocably passed beyond control of the taxpayer, and that amounts transferred to the trust may only be used to satisfy claims for which such trust is established. Some will argue that money or other property of equivalent value may be substituted later for the property contributed to a § 461(f) trust. This argument has not been tested in the courts.

Where applicable, a taxpayer will argue that its contribution of a promissory note to a § 461(f) trust should be considered a transfer of “other property” in satisfaction of the asserted liability. The taxpayer may argue that although there are some court decisions discussing what constitutes a transfer of “other property” for purposes of satisfying the asserted liability, there are no cases that specifically address the exact facts in the promoted I.R.C. § 461(f) Contested Liabilities Transaction.

- I.R.C. § 461(f) (3): The contest with respect to the asserted liability exists after the time of the transfer.

The taxpayer generally contends that the liability continues to be contested after the tax year of the transfer. Its position is that the liability ceases to be contested when the taxpayer has executed a settlement agreement or there has been a legally final determination, such as a court decision. Also, negotiation and compromise on factual issues in settlement correspondence does not rise to that level.

- I.R.C. § 461(f) (4): But for the fact that the asserted liability is contested, a deduction would be allowed for the taxable year of the transfer (or for an earlier taxable year) determined after application of I.R.C. § 461(h), which provides that an accrual method taxpayer may not deduct a liability until economic performance has occurred with respect to the liability.

The taxpayer interprets the economic performance requirements of § 461(f)(4) as if there is no contest. The taxpayer argues that but for the contest, the claimant would be viewed as being in actual or constructive receipt of money or other property at the time of its transfer to the trust, and the economic performance

rules would be satisfied pursuant to § 1.461-4(g)(1)(ii)(B).¹ Section 461(f)(4) is therefore satisfied in the taxable year in which the taxpayer transfers money or other property to the trust.

The determination of whether economic performance has occurred varies by type of liability.

Where applicable, the taxpayer argues that although its contested liability arises from a tort action and is subject to the economic performance requirements of §§ 461(f) and 461(h), the decision in *Maxus Energy Corporation v. United States*, 31 F.3d 1135 (Fed. Cir. 1994) supports its deduction in the year of transfer to a trust since such a transfer is equivalent to paying the person who asserted the liability (even though the liability remains contested.)

- Accuracy-Related Penalty

In cases where the accuracy-related penalty is being proposed, the taxpayer's first defense is that the deduction is correct as a matter of law. Alternatively, the taxpayer argues that it meets the reasonable cause and good faith exception of I.R.C. § 6664 and should be relieved of the penalty. The taxpayer may also argue for a lenient resolution of the penalty on grounds that the tax treatment of the promoted § 461(f) Contested Liabilities Transaction is a novel question.

DISCUSSION

FACTS

Four Steps in the Contested Liabilities Transaction

In the first of the four steps in an I.R.C. § 461(f) Contested Liabilities Transaction, the taxpayer reviews the liabilities that have been asserted against it by third parties and selects the specific contested liabilities to be funded in the contested liabilities trust. The liabilities may be formal or informal in nature, e.g. lawsuits, claims asserted in letters, and adjustments proposed by Federal or state auditors, including Internal Revenue Service ("IRS") examiners. Taxpayers generally fund the trust for the full amount of the liability as asserted by the third party, even though a much lower estimate of the ultimate liability is used for purposes of the taxpayers' financial statements. As a result, I.R.C. § 461(f) Contested Liabilities Transactions usually require a Schedule M-1 adjustment on the tax return.

¹ This section of the economic performance regulations provides that payment is effected if the person to which the liability is owed would be treated as having actually or constructively received the amount of the payment as gross income under § 451.

In the second step of an I.R.C. § 461(f) Contested Liabilities Transaction, the taxpayer selects the type of property to be transferred to the contested liabilities trust. In many cases the property is a related party note. The taxpayer typically requests the related party to issue a note for existing inter-company payables. If existing balances are not large enough, funds may be transferred within the consolidated group to create enough inter-company balances and related notes to support the predetermined amount of the deduction to be claimed under I.R.C. § 461(f). In some cases the subsidiary has been asked to declare a dividend and then issue a note payable to the parent in the amount of the dividend. In other cases a pre-existing note has been used, or a pre-existing note has been canceled and reissued for use in the I.R.C. § 461(f) Contested Liabilities Transaction. In a few cases, notes have been issued without any cash or other consideration being transferred. Taxpayers have sometimes used their own stock, or related party stock, instead of a related party note. Infrequently, cash or some other property, such as marketable securities, may also be used. Regardless of the type of property being used, the taxpayer claims that the purported fair market value of the property is equal to the amount of the contested liabilities being funded in the trust.

In the third step of an I.R.C. § 461(f) Contested Liabilities Transaction, the taxpayer forms a trust and transfers the property to the trust, purportedly to provide for the satisfaction of the contested liabilities. In most cases identified to date, the trusts are represented to be grantor trusts that generally do not file separate tax returns; instead, the income and expenses of the trust are included on the taxpayer's return. The taxpayer often selects a bank recommended by the promoter to serve as the trustee. The transaction is usually completed shortly before the end of the tax year. However, some taxpayers have completed the transaction at the end of a calendar quarter, in order to reduce the amount of the quarterly estimated tax payment. At year-end the taxpayer will take a deduction for the purported fair market value of the property that was transferred to the trust. The taxpayer may repeat the I.R.C. § 461(f) Contested Liabilities Transaction in future tax years using the same trust or a new trust, in order to generate additional deductions.

The final step of an I.R.C. § 461(f) Contested Liabilities Transaction occurs when a contested liability that was funded in the trust is resolved or settled in a future tax year. The taxpayer will either pay the claimant directly, or transfer cash into the trust so that the trustee can make the payment. In some cases the liability will be resolved without any payment being required from the taxpayer. The note or stock of the taxpayer or a related party and other trust assets (if any) generally remain in the trust until all of the contested liabilities are resolved, at which point the trust property will be returned to the taxpayer.

Whenever a contested liability is resolved, the taxpayer is required to recognize taxable income equal to the difference between the amount actually paid to the claimant and the amount that was previously deducted. However, some

taxpayers have improperly delayed the recognition of income into future tax years. Other taxpayers have repeated the I.R.C. § 461(f) Contested Liabilities Transaction in the year of settlement or resolution, using new contested liabilities, in order to offset the income that has to be recognized from a prior I.R.C. § 461(f) Contested Liabilities Transaction.

Evidence Showing Retention of Control over Trust Assets

Although the terms of the trust agreements vary, in most I.R.C. § 461(f) Contested Liabilities Transactions the taxpayer retains one or more powers that allow the taxpayer to maintain control over the trust property. For example, the taxpayer may have the power to substitute cash or other assets for the property in the trust or the power to pay the contested liabilities out of assets other than those in the trust. The taxpayer will generally be able to control the timing of the distribution of trust assets because the trust agreements prohibit the trustee from making any payments to the claimants until instructed by the taxpayer. In some cases the trust agreements limit the trustee's ability to sell the trust assets or to exercise rights relating to the assets. In cases where the property in the trust is a related party note or stock, the taxpayer may control whether the note will ultimately be collectible or whether the stock will ultimately have any value, by exercising control over the assets of the issuer of the note or stock. A taxpayer may also exercise control over the trustee's ability to collect on the notes or to sell the stock transferred to the trust.

In most cases the claimants named as beneficiaries of the trust will not be informed of the existence of the trust, and the trustee will also be prohibited from providing any notification to the claimants. In cases where the claimant is notified that a trust exists, the notice generally occurs after the trust has already been formed and the claimant will not be informed of the location of the trust, the name of the trustee, or the terms of the trust agreement. Thus the claimants are not given any opportunity to agree with the trust arrangements, and they do not have the ability to enforce their rights under the trust agreement.

A small number of trust agreements allow the trustee to retain an independent accounting firm to examine the taxpayer's books, records, and non-privileged litigation files to monitor the taxpayer's compliance with such terms of the trust agreement as notification of the trustee of the amount to be paid to the claimant and the identity of the claimant, as well as the timing and manner of payment to the claimant.

Transfers to Trust of Notes or Stock of the Taxpayer or a Related Party

In many of the I.R.C. § 461(f) Contested Liabilities Transactions, the property transferred to the trust is a related party note from an entity that is included in the taxpayer's consolidated financial statements. Since the off-setting receivable and payable will be eliminated in the inter-company adjustments, the taxpayer

will be able to omit any mention of the I.R.C. § 461(f) Contested Liabilities Transaction in its audited financial statements. The parent corporation may take a deduction under I.R.C. § 461(f) based on a note issued by a subsidiary, or a subsidiary may take a deduction based on a note issued by the parent. In a few instances notes from related partnerships and disregarded entities have also been used. Use of a related party note allows the taxpayer to claim a deduction for the “payment” of a contested liability without using any cash.

In some cases the facts indicate that the liability underlying the note is not genuine, or that there is no intent between the parties to enforce the obligation. For example, notes have been issued in circumstances where the note issuer is insolvent, or the notes have an interest rate that is not reasonable considering the balance sheet and credit history of the note issuer. The notes are generally valued at face value; even in situations where it is clear that a third party would not be willing to acquire the note at face value in an arm’s length transaction. For example, some of the notes being used in the I.R.C. § 461(f) Contested Liabilities Transactions state that the note is collectible “to the extent of the finally determined liability,” making it difficult or impossible to determine the exact fair market value of the note at the time it was transferred to the trust.

In general, no payments of interest or principal will be required on the related party note until such time as the underlying contested liabilities are resolved. Interest income accruing in the trust will generally be offset by interest expense for the entity that issued the note, so that the note being used in the I.R.C. § 461(f) Contested Liabilities Transaction will have no net effect on taxable income for the consolidated entity.

In a few cases taxpayers have used their own stock or related party stock to fund a contested liabilities trust. In one of these cases the taxpayers issued treasury stock that was not registered, did not have voting rights, and did not pay dividends. In addition, the taxpayers retained control over the trustee’s ability to sell the stock. For purposes of the I.R.C. § 461(f) Contested Liabilities Transaction, the stock was valued at the fair market value for publicly traded, registered stock. The use of unregistered stock in a contested liabilities trust may present a valuation problem similar to the related party notes.

Types of Liabilities and Economic Performance

I.R.C. § 461(f) was amended in 1984 to provide that deductions after July 18, 1984, are subject to the economic performance rules. In the I.R.C. § 461(f) Contested Liabilities Transactions, the liabilities being funded and deducted typically fall into two categories:

- Contested tort, workers compensation, and other payment liabilities (such as state taxes or employment taxes and many breach of contract claims)

- designated in Treas. Reg. § 1.461-4(g), for which economic performance requires payment to the claimant; and
- Contested interest liabilities, including interest owed to the IRS and state governments, and pre or post-judgment interest for which economic performance occurs as the interest cost economically accrues.

Some I.R.C. § 461(f) Contested Liabilities Transactions include a combination of the two categories of liabilities, such as trusts formed to satisfy liabilities for both state taxes and interest on the taxes.

The two categories of liabilities and the applicable economic performance rules are discussed separately below.

Contested Tort, Workers Compensation, and Other Payment Liabilities

I.R.C. § 461(h)(2)(C), effective after July 18, 1984, provides that economic performance does not occur with respect to tort and workers compensation liabilities until payment is made to the person to which the liability is owed. Treas. Reg. § 1.461-4(g), effective for taxable years beginning after December 31, 1991, designated additional liabilities for which economic performance does not occur until payment is made to the person to which the liability is owed (“payment liabilities”). These additional payment liabilities include liabilities arising out of breach of contract, violation of law (for example, anti-trust, discrimination, or sexual harassment laws), rebates and refunds, awards and prizes, insurance, warranty or service contracts on property purchased or leased by the taxpayer, taxes, licensing and permit fees owed to government authorities, and other liabilities not specifically addressed elsewhere in the economic performance rules, other IRS regulations, or in other published guidance. However, for this purpose a taxpayer’s liability to make payments for services, property, or other consideration provided to the taxpayer under a contract is not considered a liability arising out of a breach of contract unless the payments are in the nature of incidental, consequential, or liquidated damages.

Final regulation § 1.461-2(e)(2), issued on July 20, 2004, provides that economic performance does not occur when a taxpayer transfers money or other property to a trust, an escrow account, or a court to provide for the satisfaction of a contested workers compensation, tort, or other liability designated in § 1.461-4(g) unless §468B or the regulations thereunder apply, the trust, escrow account, or court is the claimant, or the taxpayer’s payment to the trust, escrow account, or court discharges the taxpayer’s liability to the claimant. Rather, economic performance occurs in the taxable year in which the taxpayer transfers money or other property to the person actually asserting the contested liability or in the taxable year in which payment from the trust, escrow account, or court registry is made to the person to which the liability is owed.

The majority of the I.R.C. § 461(f) Contested Liabilities Transactions involve payment liabilities. It is not unusual to have a single lawsuit alleging damages for a combination of grievances, including tort, breach of contract, and violation of law. In the transactions involving payment liabilities, the third party claimants are generally not informed of the existence of the trust. Taxpayers apparently choose not to inform the claimants because disclosure of the trust might have a negative impact on the on-going lawsuit and/or related settlement negotiations (a risk explicitly commented upon in some cases in promotional material.)

Contested Interest Liabilities

Treas. Reg. § 1.461-4(e) provides that economic performance occurs as the interest cost economically accrues. Accordingly, I.R.C. § 461(f) Contested Liabilities Transactions involving a deduction of interest expense will generally not be challenged under the economic performance rules. (Other legal arguments will be used to disallow the deductions in these transactions.) Most of the I.R.C. § 461(f) cases with contested interest liabilities involve interest owed to the IRS or to state governments in connection with income and other tax liabilities. A few cases involve pre-judgment or post-judgment interest relating to lawsuits.

In cases involving interest owed to the IRS, many taxpayers sent a letter notifying the IRS of the trust's existence. However, the circumstances surrounding the notice differ from case to case. Some taxpayers gave the letter to the IRS audit team assigned to their case, while others merely addressed a notice to the "IRS Campus." Not surprisingly, some of the notices addressed to the campuses have not reached IRS personnel assigned to the taxpayers' income tax examinations.

In cases involving interest owed to state governments, the taxpayers have generally not informed the state governments of the existence of the trust. Similarly, claimants in lawsuits requesting pre-judgment or post-judgment interest have also not been informed of the existence of the trust.

Effective Dates for Listing Notice

Notice 2003-77 lists effective dates for various kinds of transactions involving I.R.C. § 461(f) Contested Liabilities Transactions.² The transactions affected by

² The complete information about the effective dates in the Notice is: (1) With respect to transactions in which a taxpayer retains certain powers over the money or other property transferred, the listing notice applies to transfers of money or other property in taxable years beginning after December 31, 1953, and ending after August 16, 1954; (2) With respect to transactions in which a taxpayer transfers any indebtedness of the taxpayer or any promise by the taxpayer to provide services or property in the future, the listing notice applies to transfers in taxable years beginning after December 31, 1953, and ending after August 16, 1954; (3) With respect to transactions in which a taxpayer using an accrual method of accounting transfers money or other property to provide for the satisfaction of a workers compensation or tort liability

the notice have an effective date of 1992 or prior, except those in which a taxpayer transfers stock issued by the taxpayer, or indebtedness or stock issued by a party related to the taxpayer (as defined in I.R.C. § 267(b)), and the listing notice applies to such transfers made on or after November 19, 2003. More than one effective date may cover a transaction. For instance, a transaction occurring prior to November 19, 2003, involving a related party note or stock, may still be treated as a listed transaction if the taxpayer retained certain powers in the trust agreement over the property.

Other § 461(f) Factual Issues

The facts and circumstances may indicate additional issues that would be applicable to any deduction claimed under I.R.C. § 461(f), regardless of whether the transaction is the listed transaction described in Notice 2003-77.

A potential issue arises when taxpayers claim deductions for liabilities that were never contested, or liabilities that are no longer being contested.

Taxpayers may overstate the amount of the liability by claiming deductions for liabilities that are covered in full or in part by insurance or other indemnity arrangements. Taxpayers have also deducted the full amount of claims in situations where multiple unrelated parties are being sued for the same liabilities and a right of contribution or indemnification may be asserted against the unrelated parties.

The sections below examine the requirements of I.R.C. § 461(f) deductions set forth by the statute, regulations and court decisions and analyze the associated shelter transactions.

(unless the trust is the person to which the liability is owed, or payment to the trust discharges the taxpayer's liability to the claimant), the listing notice applies to transfers after July 18, 1984; (4) With respect to transactions in which a taxpayer using an accrual method of accounting transfers money or other property to provide for the satisfaction of a liability for which payment is economic performance under Treas. Reg. §1.461-4(g) (unless the trust is the person to which the liability is owed, or payment to the trust discharges the taxpayer's liability to the claimant), other than a liability for workers compensation or tort, the listing notice applies to transfers in taxable years beginning after December 31, 1991; and (5) With respect to transactions in which a taxpayer transfers stock issued by the taxpayer, or indebtedness or stock issued by a party related to the taxpayer (as defined in I.R.C. § 267(b)), the listing notice applies to transfers on or after November 19, 2003.

ISSUE 1

WHETHER THE TAXPAYER CONTESTS AN ASSERTED LIABILITY

Law and Analysis

I.R.C. § 461(f)(1) requires that a taxpayer contest an asserted liability. An asserted liability is an item with respect to which, but for the existence of any contest in respect of such item, a deduction would be allowable under an accrual method of accounting.³ The regulations provide as examples of asserted liabilities a notice of local real estate tax assessment and a bill received for services.

a) Tax and Interest on Taxes:

Taxpayers may transfer amounts to contested liabilities trusts for liabilities that have not actually been asserted. In some cases, the taxpayer claimed interest owed to the IRS on an examination issue in a tax year for which an adjustment had yet to be proposed.

The Service has taken the position that the issuance of a 30-day letter accompanied by a revenue agent's or examiner's report results in an asserted liability for federal tax and related interest within the meaning of § 461(f)(1).⁴ Also, the Tax Court has held that the Service's issuance of a statutory notice of deficiency constitutes an assertion of a liability against a taxpayer for purposes of § 461(f)(1).⁵

The issue of whether a liability has been asserted for purposes of § 461(f)(1) has arisen in the context of federal and state tax liabilities and interest relating to prior or subsequent tax years. In transactions involving contested tax liabilities and related interest, taxpayers have transferred to contested liabilities trusts amounts representing estimates of federal tax deficiency interest for tax years in which the Service has not asserted a liability, and/or estimated state tax deficiencies and deficiency interest for which no audit has been commenced by the state tax authorities. No precedent has addressed these issues in the context of § 461(f). However, a similar issue has been examined in the context of the all events test for accruals under § 461.

In deciding under the all events test whether the liability for a state tax is asserted and contested by virtue of a taxpayer's active contest of a federal tax liability for the same year, courts have examined the extent to which the state tax liability is related to and dependent on the federal determination of the tax liability.

³ Treas. Reg. § 1.461-2(b)(1).

⁴ Rev. Rul. 89-6, 1989-1 C.B. 119.

⁵ Perkins v. Commissioner, 92 T.C. 749, 758 (1989), acq. in result only, 1990-2 C.B. 1

Consolidated Industries, Inc. v. Commissioner, 82 T.C. 477, 481 (1984), aff'd, 767 F.2d 41 (2^d Cir. 1985); Hollingsworth v. U.S., 568 F.2d 192, 203 (Ct. Cl. 1977) (contest of state tax liability was not contest of federal tax liability, as investigations and determinations on each level were independent).

In Consolidated Industries, the Tax Court observed that the state had a “piggy back” system which imposed a state franchise tax dependent on the taxpayer’s federal taxable income. Under the “piggy back” system the state required a taxpayer to file an amended state return if the Service made any adjustment to the taxpayer’s federal taxable income. There, the Court held that by virtue of the “piggy back” tax system,” a liability asserted by the Federal Government is asserted ‘mutatis mutandis’ by the State government. It follows that when petitioners dispute an adjustment to the federal deduction, they are in effect contesting two deductions,” namely federal and state. Based on the Tax Court’s reasoning in Consolidated Industries, where the state tax liability is inextricably related to and dependent upon the determination of the federal tax liability, a state tax liability may have been asserted even where no audit has been commenced by the state authorities. The Court in Consolidated Industries acknowledged, on the other hand, that if the determinations on the federal and state levels are “substantially independent, contest of one liability ought not to constitute a contest of the other liability.”⁶ As there have been no cases addressing these issues in the context of § 461(f), a court may look to this precedent to interpret and apply § 461(f)(1).

Finally, taxpayers may make computational errors that result in an overstatement of the deductible amount. For example, in calculating interest owed to the IRS, some taxpayers have omitted certain examination adjustments, advance payments, and other credits that may be available to reduce the amount of the deficiency interest. In some cases taxpayers may have ignored, for example, all examination adjustments that were in their favor and deducted interest expense for a tax year that actually had a net over-assessment of tax when all adjustments were considered.

b) Determining Whether There Is a Contest of an Asserted Liability

Many I.R.C. § 461(f) Contested Liabilities Transactions involve a lawsuit commenced against a taxpayer that the taxpayer is contesting. In those situations, there is clearly a contest of an asserted liability for § 461(f) purposes.

In some other transactions involving federal and state tax liabilities and interest, taxpayers have funded the contested liabilities trust for multiple federal tax years, but only filed a protest with the Service for one taxable year. Alternatively, taxpayers have funded the contested liabilities trust to provide for the satisfaction of federal deficiency interest and state tax liabilities and related interest, but have

⁶ Consolidated Industries, 82 T.C. at 481, citing Hollingsworth v. U.S., 568 F.2d 192, 203 (Ct. Cl. 1977).

filed a protest only with respect to the federal tax liabilities. The issue of whether a contest of an asserted liability exists arises in these latter instances.

Treas. Reg. § 1.461-2(b)(2) provides that any contest which would prevent the accrual of a liability under § 461(a) shall be considered to be a contest for purposes of satisfying the requirements of § 461(f). The Regulations refer to an affirmative act “sufficient to commence a contest.” While a written protest is certain documentation of a contested liability, the Regulations do not require that, stating:

It is not necessary that the affirmative act denying the validity or accuracy, or both, of an asserted liability be in writing if, upon examination of all of the facts and circumstances, it can be established to the satisfaction of the Commissioner that a liability has been asserted and contested.

In Exxon Corporation and Affiliated Companies v. Commissioner, T.C. Memo. 1999-247, the Tax Court concluded that the facts and circumstances of each case must be examined to determine if the tax adjustments and related interest should be treated as uncontested or contested. The Court went on to find a contest existed until that taxpayer executed a Form 870 since (1) the taxpayer used other figures on its return; (2) the adjustments were raised on Forms 5701; (3) the taxpayer did not indicate an agreement to the Forms 5701 adjustments; (4) the taxpayer provided no written statement of agreement to the adjustments prior to executing the Form 870; and (5) the taxpayer’s Tax Court petition challenged certain of the adjustments. Similar objective evidence should be reviewed to determine if a contest exists in I.R.C. § 461(f) Contested Liabilities Transactions.

In deciding if the liability for a state tax is asserted and contested by virtue of the taxpayer’s active contest of the federal tax for the same year, the Tax Court has examined the extent to which the state tax liability is related to and dependent on the federal determination of the tax issue. In Consolidated Industries, the Tax Court rejected the taxpayer’s argument that Treas. Reg. § 1.461-2(b)(2) requires the filing of a protest with the person who is asserting the liability, and stated that the regulation merely lists examples of what is sufficient to commence a contest. The Court emphasized the close dependency of the state income determination on the federal taxable income determination in concluding that in contesting the federal tax determination, the taxpayer, in effect, was also contesting the income determination on the state level.⁷ The Court acknowledged, on the other hand, that if the determinations on the federal and state levels are “substantially independent, contest of one liability ought not to constitute a contest of the other liability.”⁸ In determining whether a taxpayer has contested liabilities and/or

⁷ Consolidated Industries, 82 T.C. at 483.

⁸ Consolidated Industries, Id. at 481, citing Hollingsworth v. U.S., 568 F.2d 192, 203 (Ct. Cl. 1977) (contest of state tax liability was not a contest of federal tax liability, as investigations and

related interest from either multiple tax years or multiple jurisdictions, it is recommended that Appeals Officers consider the extent to which the state tax determination is dependent on the federal tax determination, or the extent to which the federal tax determination of one taxable year is dependent on that of a prior or subsequent federal tax year.

ISSUE 2

WHETHER THE LIABILITY WAS CONTESTED AT THE TIME OF THE TRANSFER

Law and Analysis

In several of the transactions involving tax deficiencies or deficiency interest, the issue has arisen as to whether a taxpayer continued to contest a tax adjustment after establishing a contested liabilities trust under § 461(f) and transferring money or other property to the trust to provide for the satisfaction of the asserted liabilities. In some instances, taxpayers overstate the amount of a deduction for contested liabilities by including in the deduction tax adjustments that they are not contesting. Taxpayers have attempted to accelerate the deduction for liabilities that were already informally resolved, but which will not be paid until a future tax year. Taxpayers also have misrepresented the date when a contested liability was settled, in order to delay income recognition into a future tax year.

I.R.C. § 461(f)(3) requires that the taxpayer contest the liability after the time of the transfer. Similarly, Treas. Reg. § 1.461-2(d) provides that a contest with respect to an asserted liability must be pursued subsequent to the time of the transfer of money or property to provide for the satisfaction of the asserted liability. The contest must have been neither settled nor abandoned at the time of the transfer. The regulation describes the settlement of a contest to include a decision, judgment, decree, or other final order of any court of competent jurisdiction, or an oral or written agreement between the parties.

The Tax Court is inclined to consider unprotested tax adjustments as contested for purposes of I.R.C. § 461 because it does not regard the lack of an explicit protest as equivalent to an implied admission of liability.⁹

Making a formal agreement to a tax adjustment would permit an accrual method taxpayer to take a deduction of the associated interest. Thus, it is taxpayers who contest part or all of an asserted tax adjustment and related interest who can

determinations on each level were independent).

⁹ Phillips Petroleum Co. and Affiliated Subsidiaries v. Commissioner, T.C. Memo. 1991-257; Exxon Corporation and Affiliated Companies v. Commissioner, T.C. Memo. 1999-247

gain an advantage by engaging in an I.R.C. § 461(f) Contested Liabilities Transaction.

The facts and circumstances of each case must be carefully examined to determine whether a taxpayer continued to contest an asserted liability at the time it transferred money or other property to provide for the satisfaction of the asserted liability. In the context of tax liabilities, it is important to examine whether the taxpayer relinquished its right to protest the adjustments. A taxpayer's indication that an adjustment is "agreed" on a Form 5701 does not prevent a taxpayer from later contesting it, and does not grant the Service the rights of assessment and collection.¹⁰ Other facts, such as a document reflecting the taxpayer's written agreement to or settlement of the adjustments or the taxpayer's execution of a Form 870, will determine if a contest actually existed after the time of the transfer.

ISSUE 3

WHETHER THE TRANSFER OF PROPERTY TO A TRUST PROVIDES FOR THE SATISFACTION OF THE CONTESTED LIABILITIES

Law and Analysis

I.R.C. § 461(f)(2) requires the taxpayer to transfer money or other property to provide for the satisfaction of an asserted liability. There is no definition of what constitutes "money or other property" in either the statute or the regulations. The examples provided in the regulations and the legislative history only involve transfers of cash.

Treas. Reg. § 1.461-2(c)(1)(iii) contains examples of transfers that do not provide for the satisfaction of an asserted liability. These transfers include: the purchase of a bond to guarantee payment of the asserted liability, an entry on the taxpayer's books of account, and a transfer to an account in the taxpayer's control.

In promoted I.R.C. § 461(f) Contested Liabilities Transactions, the property that taxpayers have typically transferred to the contested liabilities trusts is a related party note. Some taxpayers have transferred cash, their own stock, related party stock, marketable securities, or accounts receivable.

Whether the property is intended to be used to pay the liability (or is even capable of being used for that purpose) is another aspect to this issue, reflected

¹⁰ Sara Lee Corp. & Subs. v. United States, 29 Fed. Cl. 330, 335 (1993).

by some I.R.C. § 461(f) Contested Liabilities Transactions in trust agreement language restricting the trustee's power to invest, liquidate, and otherwise independently administer the trust property.

Lastly, if any part of the contested amount which is deducted for the taxable year of the transfer is refunded to the taxpayer when the contest is settled, the taxpayer must include the refunded amount in gross income for the taxable year of receipt, or for an earlier taxable year if properly accruable for such earlier year. Treas. Reg. § 1.461-2(a)(3).

a) Related party notes

Taxpayers have transferred and assigned to the trust a note issued by a member of their consolidated group or a related party owned or controlled directly or indirectly by the same interests as the taxpayer (within the meaning of § 267(b)), and have taken a deduction for the face value of the note in the year of transfer. A number of the related party notes are demand notes. Others are promissory notes, some of which mature at a specified future date, while others are due and payable at the time the contested liabilities are settled or finally determined. The notes typically provide for the payment of interest, but in many cases the payer is not required to make interest payments over the course of the note. The notes generally do not require the payer to provide any security. In some instances, the parties did not report the notes for book purposes.

The related party notes that taxpayers have used to fund the § 461(f) contested liabilities trusts should be examined to ensure that these instruments represent valid debt obligations. Courts have defined debt as "an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage of interest payable regardless of the debtor's income or lack thereof."¹¹ Courts have applied greater scrutiny in examining whether notes between related parties represent valid debt.¹²

The fact that common ownership and control exists between borrower and lender when the loan is made does not, alone, preclude the existence of a valid debtor-creditor relationship.¹³ The question of whether a valid debtor-creditor relationship exists between related parties is highly factual. Some factors courts have examined in determining whether the related parties intended to create a

¹¹ Gilbert v. Commissioner, 248 F.2d 399, 402 (2^d Cir. 1957), cert. denied, 359 U.S. 1002 (1959).

¹² Cuyuna Realty Co. v. United States, 180 Ct. Cl. 879, 883, 884 (1967). See also Troop Water Heater Co. v. Bingler, 234 F.Supp. 642, 649 (W.D. Pa. 1964) (advances to parent by subsidiary are closely scrutinized); Ludwig Baumann & Co. v. Commissioner, T.C. Memo. 1961-271, aff'd, 312 F.2d 557 (2d Cir. 1963) (close scrutiny is warranted in debtor-creditor transaction where there is common ownership to determine whether the transaction would have been entered into between parties at arm's length).

¹³ Calumet Industries, Inc. v. Commissioner, 95 T.C. 257, 286 (1990); Irbco Corp v. Commissioner, T.C. Memo. 1966-67.

true debtor-creditor relationship at the time of the issuance of the note include: whether the advances were repayable on a fixed maturity date, whether repayment terms were enforced, whether outside lenders would have made or continued loans on the same terms and conditions, and the financial condition of the debtor.¹⁴

The terms of the related party notes and trust agreements should be examined to determine whether a valid debtor-creditor relationship exists. Even though nearly all of the notes in these transactions contain provisions for the payment of interest and a maturity date, there may be other evidence indicating that the parties had no intention of enforcing the terms of the note.¹⁵ When the facts and circumstances indicate that the notes either do not represent valid debt or that the parties did not intend to enforce the note, the taxpayer has not transferred property to provide for the satisfaction of the contested liability, as required by § 461(f)(2).

Although there is no precedent involving the transfer of related party notes to trusts established under § 461(f), there is precedent addressing a taxpayer's failure to transfer property to the trust of equal value to the amount of its claimed I.R.C. § 461(f) deduction. In Willamette Industries, Inc. v. Commissioner, 92 T.C. 1116 (1989), the taxpayer acquired a \$20,000,000 letter of credit from a bank for \$85,000, transferred the letter of credit to a contested liabilities trust to provide for the satisfaction of a contested liability, and claimed a deduction for \$20,000,000 under § 461(f). The Tax Court pointed out that in transferring the letter of credit to the trust the taxpayer exchanged a contingent liability to the claimants for a contingent liability to the bank. The Court indicated that the legislative history of I.R.C. § 461(f) permits a deduction in the year of payment.¹⁶ Noting that the term "payment" normally means to payout an amount in cash or its equivalent in satisfaction of a liability, the Court observed that the taxpayer's assets were not diminished in the amount of \$20,000,000, but only \$85,000. The Court concluded that the taxpayer's transfer of a letter of credit was not a transfer of money or other property under § 461(f)(2), but rather a transfer of a promise to pay the bank that issued the letter of credit.

If, upon examining all of the facts, the evidence indicates that the related party debt was not valid, the parties did not intend to enforce the note, or the taxpayer did not relinquish control over the note after its transfer to the fund, then the transfer of a related party note does not represent a transfer of valuable property,

¹⁴ Cuyuna Realty Co. v. United States, 180 Ct. Cl. at 885; Hardy v. Commissioner, T.C. Memo. 1972-230.

¹⁵ Sayles Finishing Plants, Inc. v. United States, 185 Ct. Cl. 196, 207 (1968); Old Dominion Plywood Corporation v. Commissioner, T.C. Memo. 1966-135.

¹⁶ The legislative history discusses § 461(f) as follows: "The amendment provides that if a taxpayer contests an asserted liability . . . but makes a payment in satisfaction of this liability and the contest with respect to the liability exists after the payment, then the item involved is to be allowed as a deduction or credit in the year of payment." S. Rep. No. 830, Part 2, 88th Cong., 2d Sess. 100 (1964).

but rather, as in Willamette, merely a substitution of one obligation (the asserted claim) for another (the related party note).

On July 19, 2004, the Service and Treasury Department filed with the Federal Register final regulations under § 461(f). Treas. Reg. § 1.461-2(c)(1)(iii) of these regulations provides that a transfer of any indebtedness of the taxpayer or any promise of the taxpayer to provide services or property in the future is not a transfer to provide for the satisfaction of an asserted liability. This provision applies to transfers made in taxable years beginning after December 31, 1953, and ending after August 16, 1954. The final regulations also provide in §1.461-2(c)(1)(iii) that the transfer to a person (other than the person asserting the liability) of any stock of the taxpayer or any stock or indebtedness of a related person (as defined in I.R.C. § 267(b)), is not a transfer to provide for the satisfaction of an asserted liability, effective for transfers on or after November 19, 2003.

As mentioned above, Notice 2003-77 identifies transactions that are the same as, or substantially similar to, the following transactions as listed transactions for purposes of §§ 1.6011-4(b)(2), 301.6111-2(b)(2) and 301.6112-1(b)(2):

(1) transactions in which a taxpayer transfers any indebtedness of the taxpayer or any promise by the taxpayer to provide services or property in the future in taxable years beginning after December 31, 1953, and ending after August 16, 1954, to a trust purported to be established under I.R.C. § 461(f) to provide for the satisfaction of an asserted liability; and

(2) transactions in which a taxpayer transfers stock issued by the taxpayer, or indebtedness or stock issued by a party related to the taxpayer (as defined in I.R.C. § 267(b)), on or after November 19, 2003, to a trust purported to be established under I.R.C. § 461(f) to provide for the satisfaction of any asserted liability.

ISSUE 4

WHETHER THE TAXPAYER HAS SET AN ACCURATE VALUE ON PROPERTY TRANSFERRED TO THE TRUST

Law and Analysis

a) Valuation of notes

Even if there are sufficient indicia of valid debt between the related parties and the taxpayer has not retained control over the note, there may be facts that indicate a discount of the note from its face value is warranted. The taxpayer assigns a value to the note equivalent to the amount of the asserted liability, and

deducts the face value of the note in the year it is transferred to the trust.¹⁷ However, the note may not actually be worth this amount.

The factors used in valuing a note are similar to those used to determine whether the note represents valid debt. Courts have considered the following in determining whether the fair market value of a note is equivalent to its face value: the payer's financial condition, the likelihood of repayment, the existence and value of collateral, as well as the terms of the note, including length of maturity, existence and length of repayment schedule, rate of interest, and payee protections in the event of default.¹⁸ The facts and circumstances of each transaction must be carefully examined to determine whether the notes would have been purchased at face value by third parties in an arm's length transaction.

b) Taxpayer's own stock or related party stock

In a few instances, taxpayers have funded the contested liabilities trust with their own stock or the stock of an affiliate. The stock typically transferred consists of treasury shares of the taxpayer's own common stock that are subject to the registration requirements of the Securities Act of 1933.¹⁹ The taxpayers have deducted in the year of transfer the amount of the closing stock exchange price near the date on which the trust agreements were executed. Although the trust agreements provide that the trust has legal title to the shares after their transfer, the agreements significantly limit the trust's ownership rights with respect to the shares. After their transfer, the shares are still characterized as treasury shares in the trust agreements. The agreements indicate that since the shares being transferred to the trust are treasury shares, they have no voting or dividend rights. The agreements provide that the trustee must hold the stock until either the trust needs cash to pay the claimants, or the trust returns the shares to the taxpayer. The agreements also allow the taxpayer to retain a right of first refusal to purchase the stock held in the trust. The marketability restrictions are compounded by the fact that the transferred shares are unregistered. To dispose of the shares, the trustee must have the taxpayer file a registration statement with the Securities and Exchange Commission or must otherwise comply with the securities registration laws.

¹⁷ In some instances, taxpayers have assigned a lower value to the note for book purposes.

¹⁸ Evelyn T. Smith v. United States, 923 F.Supp. 896, 903, 904 (S.D. Miss. 1996); Estate of Morton B. Harper v. Commissioner, T.C. Memo. 2002-121; Tietig v. Commissioner, T.C. Memo. 2001-190; Estate of Meyer B. Berkman v. Commissioner, T.C. Memo. 1979-46; Allison v. Commissioner, T.C. Memo. 1976-248; Marcello v. Commissioner, 43 T.C. 168, 181 (1964), aff'd in part and remanded in part, 380 F.2d 499 (5th Cir. 1967), cert. denied, 387 U.S. 1044 (1968) (the Tax Court concluded that notes had a fair market value of 33 1/3% of their face values based on the thin capitalization of the payors, default in payment of principal and interest, low value of collateral, and the poor condition of the guarantor of the notes.).

¹⁹ Treasury shares are generally defined as shares of a corporation's own stock held by the corporation. Delaware Corporation Law and Practice § 33.02 (2002).

These trust provisions allow the taxpayer to exercise substantial control over the shares transferred to the trust, contrary to the requirement under § 1.461-2(c)(1)(ii) that the taxpayer relinquish all authority over the money or property transferred. In addition, there has not been a transfer to provide for the satisfaction of a liability for purposes of § 461(f)(2), as the transferred shares are unregistered treasury shares over which the trust has few ownership rights.

As noted above, the final regulations provide that the transfer of any stock of the taxpayer or any related person (as defined in I.R.C. § 267(b)), except a transfer to the person asserting the liability, does not qualify as a transfer of property to provide for the satisfaction of liabilities under I.R.C. § 461(f). These regulations are effective for transfers of stock on or after November 19, 2003.

c) Valuation of stock

As an alternative to the argument denying a deduction for a transfer of stock under the facts and circumstances described above, a position may be asserted that the fair market value of the stock should not be set at the trading price on the stock exchange. Generally, the fair market value of publicly traded stock is determined by the market price for which the stock is actually traded on the valuation date.²⁰ However, restrictions on marketability of the shares reduce their value.²¹

The transfer of unregistered treasury shares, the restrictions in the trust agreements on the trustee's ability to sell the stock, as well as the lack of voting and dividend rights, are factors that substantially affect the marketability and, therefore, the value of the transferred stock. The amount of the deduction should be discounted to recognize these restrictions.

²⁰ Zanuck v. Commissioner, 149 F.2d 714, 715, 719 (9th Cir. 1945); W.T. Grant Co. v. Duggan, 94 F.2d 859, 861 (2^d Cir. 1938). Revenue Ruling 59-60 provides specific guidelines for valuing closely-held stock. Rev. Rul. 59-60, 1959-1 C.B. 237. See also Estate of William J. Desmond, T.C. Memo. 1999-76.

²¹ Shackleford v. United States, 262 F.3d 1028, 1032 (9th Cir. 2001) (if an asset's marketability is restricted, it is less valuable than an identical marketable asset). The value of unregistered shares is generally lower than the market price for freely tradable shares. See Trust Services of America, Inc. v. United States, 885 F.2d 561, 569 (9th Cir. 1989) (stock subject to restrictions under federal securities laws precluding free sale in public market may require discount from the mean to set accurate value); Estate of Elizabeth O'Herron Sullivan v. Commissioner, T.C. Memo. 1983-185 (discount normally applied to the publicly traded value to determine the private placement value of unregistered stock). Rev. Rul. 77-287, describes various factors to consider in valuing unregistered stock. Rev. Rul. 77-287, 1977-2 C.B. 319. The lack of voting and dividend rights may also affect the value of the stock. See generally Brown v. McLanahan, et al., 148 F.2d 703, 708 (4th Cir. 1945) ("voting strength attaching to shares of stock is as much a property right as any element of dominion possessed by an owner of realty"); DuVall v. Moore, et al., 276 F. Supp. 674, 679 (N.D. Iowa 1967) ("Deprivation of a stockholder's right to vote takes away an essential attribute of his property"); Rev. Rul. 83-120, 1983-2 C.B. 170; Rev. Rul. 81-15, 1981-1 C.B. 457.

d) Cash, mortgage-backed securities

In a few transactions, taxpayers have transferred to the trust either cash or mortgage-backed securities. Such transfers do not necessarily present the same opportunities for retention of control or valuation abuses as compared to transfers of related party notes and the taxpayer's stock or related party stock. Rather, taxpayers have transferred assets of readily ascertainable value. However, even with transfers of cash or readily marketable securities, issues may exist as to the taxpayer's control over the assets after the transfer to the trust.

ISSUE 5

WHETHER TAXPAYER RETAINS CONTROL OVER AMOUNTS TRANSFERRED TO CONTESTED LIABILITIES TRUSTS

Law and Analysis

Pursuant to Treas. Reg. § 1.461-2(c)(1)(i), a taxpayer may provide for the satisfaction of an asserted liability by transferring money or other property beyond his control to: (i) the person who is asserting the liability, (ii) an escrowee or trustee pursuant to a written agreement (among the escrowee or trustee, the taxpayer, and the person who is asserting the liability) that the money or other property be delivered in accordance with the settlement of the contest, or (iii) an escrowee or trustee pursuant to an order of the United States, any State or political subdivision thereof, or any agency or instrumentality of the foregoing, or a court that the money or other property be delivered in accordance with the settlement of the contest. Another permissible transfer under this section includes the transfer of money or other property beyond the taxpayer's control to a court with jurisdiction over the contest.

The Regulations before and after the 2003 amendment were essentially the same with respect to this requirement for a written agreement.²²

²² Prior to the 2003 amendment, Treas. Reg. § 1.461-2(c)(1) read:

A taxpayer may provide for the satisfaction of an asserted liability by transferring money or other property beyond his control (i) to the person who is asserting the liability, (ii) to an escrowee or trustee pursuant to a written agreement (among the escrowee or trustee, the taxpayer, and the person who is asserting the liability) that the money or other property be delivered in accordance with the settlement of the contest, or (iii) to an escrowee or trustee pursuant to an order of the United States, any State or political

Treas. Reg. § 1.461-2(c)(1)(ii) further provides that in order for money or other property to be transferred beyond the taxpayer's control, the taxpayer must relinquish all authority over such money or other property. In interpreting this provision, courts have held that before a deduction may be taken, money or other property transferred to provide for the satisfaction of a contested liability must be "irrevocably parted with, provided that the manner of transfer is not open to the possibility of tax abuse." Chem Aero, Inc. v. United States, 694 F.2d 196, 200 (9th Cir. 1982).

While any of the issues discussed in this guideline can have a major impact on an individual case, the control issue is critical to almost all the cases coming to Appeals.

The issue of whether a taxpayer relinquished control over the assets transferred to a trust as part of its I.R.C. § 461(f) transaction arises for the simple reason pointed out by the court in Poirier & McLane Corp. v. Commissioner, 547 F.2d 161 (2^d Cir. 1976):

There may be a strong temptation for the taxpayer not to relinquish full control, especially when the trustee is a personal friend rather than a disinterested bank.

Indeed, promoters of § 461(f) Contested Liabilities Transactions also found ostensibly "disinterested" banks who were willing to facilitate the transactions by serving as a trustee for a comparatively nominal fee.

In I.R.C. § 461(f) Contested Liabilities Transactions, taxpayers established contested liabilities trusts purporting to comply with Treas. Reg. § 1.461-2(c)(1)(i)(B). Most of the trust agreements contain provisions that allow the taxpayers to retain control over the money or property after its transfer to the contested liabilities trust. The trust agreements generally contain one or more of the following retained powers: paying liabilities ultimately due to the claimant out

subdivision thereof, or any agency or instrumentality of the foregoing, or a court that the money or other property be delivered in accordance with the settlement of the contest. Subsequent to the amendment, the contents of Treas. Reg. § 1.461-2(c)(1) were renumbered but still read essentially the same:

In general. (i) A taxpayer may provide for the satisfaction of an asserted liability by transferring money or other property beyond his control to-- (A) The person who is asserting the liability; (B) An escrowee or trustee pursuant to a written agreement (among the escrowee or trustee, the taxpayer, and the person who is asserting the liability) that the money or other property be delivered in accordance with the settlement of the contest; (C) An escrowee or trustee pursuant to an order of the United States or of any State or political subdivision thereof or any agency or instrumentality of the foregoing, or of a court, that the money or other property be delivered in accordance with the settlement of the contest; or (D) A court with jurisdiction over the contest.

of assets other than those transferred to the trust, substituting money or other property for property transferred to the trust, prohibiting payment to the claimant by the trustee until instructed by the taxpayer, prohibiting notification to the claimant of the trust's establishment, and, as discussed in Issue 3, restricting the trustee's ability to sell the stock and to enforce the related party notes.²³

Notice 2003-77 identifies as a listed transaction a taxpayer's transfer of money or other property in taxable years beginning after December 31, 1953, and ending after August 16, 1954, to a trust purported to be established under § 461(f) to provide for the satisfaction of an asserted liability and the retention of any one or more of the following powers over the money or other property transferred: to pay any liabilities ultimately due to the claimant out of assets other than those transferred to the trust; to substitute money or other property for property transferred to the trust; to prohibit payment to the claimant by the trustee until instructed by the taxpayer; to prohibit notification to the claimant of the trust's establishment; to limit the trustee's ability to sell the property after it is transferred to the trust; and to limit the trustee's ability to enforce notes or rights relating to other property transferred to the trust.

a) Power to substitute assets transferred to trust with other assets

Several of the trust agreements allow the taxpayer to substitute money or other property for property initially transferred to the trust to provide for either existing liabilities, additional liabilities, or both. A number of the trust agreements also allow the taxpayer to substitute assets by providing the taxpayer with a right of first refusal to purchase the assets with which it funded the trust.

The power to substitute assets for those transferred to the contested liabilities trust is contrary to the requirement of Treas. Reg. § 1.461-2(c)(1)(ii) that the taxpayer relinquish all authority over the money or other property transferred. Allowing the taxpayer to substitute money or other property for the property it transferred to the contested liabilities trust, or to retain a right of first refusal to purchase the property it transferred to the trust, does not place the property beyond the taxpayer's control. As noted above, for a transfer to be deductible under § 461(f)(2), the taxpayer must intend that the transfer provide for the satisfaction of an asserted liability, and any other reason for the transfer does not satisfy the statutory requirement.²⁴

b) Validity of Trust

²³ A few of the trust agreements contain a provision allowing the trustee to monitor the taxpayer's compliance with the terms of the agreement by hiring an independent accounting firm to audit the taxpayer's books, records, and non-privileged litigation files. It is not certain whether the trustee invoked this provision in these agreements. It should be noted, however, that in none of these transactions were the claimants (who are the parties most likely to invoke this provision) informed of the trust's establishment.

²⁴ Consolidated Freightways, Inc. v. Commissioner, 708 F.2d 1385, 1394 (9th Cir. 1983).

It is rare for the taxpayer's trust agreement in the I.R.C. § 461(f) Contested Liabilities Transaction to vitiate the powers of the trustee to such a degree that it becomes an issue whether the trust is valid under state law. However, if the trust is not valid this is obviously a significant hazard to the taxpayer because it likely would clinch the government's argument that property was not transferred beyond the taxpayer's power.

The trusts in the I.R.C. § 461(f) Contested Liabilities Transaction may be legally valid under state law, a fact that is not a hazard to the government's case in its own right. It is possible for there to be a valid trust under state law which, nevertheless, is governed by an agreement or is restricted by other circumstances which allow the taxpayer to exercise an unacceptable degree of control over the trust property, contrary to Treas. Reg. § 1.461-2(c). The terms of the trust agreement and the taxpayer's actions must be considered together in determining whether the requirements of § 461(f) have been satisfied. When there is disagreement (as there usually is) that the taxpayer intended for the trust agreement to allow a trustee to perform only ministerial acts, one can observe whether the taxpayer honored the notification duties placed upon it by terms of the trust agreement. In several trusts used for these § 461(f) transactions, the taxpayer is obligated to notify the trustee "as soon as practicable" of the resolution of the contested liabilities. In some cases, it is documented that this notification happened months after the settlement, and after funds from outside the trust were used to pay whatever the settlement amount. The trustee's apathetic acceptance of that negligence is a further indicator that the true nature of the relationship between taxpayer and trustee is to allow the taxpayer to keep an unacceptably high degree of control over the trust property.

c) Disclosure of trust's existence to claimant

Although nearly all of the trust agreements in these transactions designate the claimant as a beneficiary in the trust agreement, none of the trust agreements contain the claimant's signature. In addition, some of the trust agreements specifically direct the trustee not to inform the claimant of the trust at any time, and not to transfer any trust assets to the claimant until the trustee has received written notice from the taxpayer that the contest has been resolved.

Trust agreements used in I.R.C. § 461(f) Contested Liabilities Transactions often require the trustee to await notification from the taxpayer that the liabilities are resolved. This effectively allows the taxpayer to dictate when the trustee can direct and transfer all or part of the trust property to the claimant to satisfy the liabilities. Under such terms, the trustee may not act independently to determine that the contest has been resolved, nor act upon notification from the third party claimant. This power is often accompanied by the failure to inform the claimant of the trust's existence. In transactions involving federal tax and related interest liabilities, however, the taxpayer is more likely to inform the claimant of the trust's

existence, usually by letter, but the taxpayer still does not provide the claimant with any information regarding the terms of the trust or the identity of the trustee.

No court has directly discussed this type of provision in a case involving a trust established under § 461(f) for contested liabilities. Even the trust agreement from Edison Brothers, so widely emulated in these shelters, allowed the trustee to act upon notice provided by either the taxpayer or the claimant.²⁵ The Edison Brothers court did not comment on this provision in its analysis of why it determined the funds were transferred beyond the taxpayer's control for purposes of § 461(f).

The Tax Court, in Specialized Services Inc. v. Commissioner, 77 T.C. 490, 505 (1981), addressed a contested liabilities escrow trust fund that did not specifically authorize the escrow agent to transfer the funds to the claimants after the settlement of the contested claims. The Tax Court observed that absent such a provision, the escrow agent would have to rely on the taxpayer to determine when and how to transfer the funds to the claimants, and this would provide the taxpayer with control over the transferred funds.

The trust agreements in § 461(f) transactions usually provide the trustee with the power to transfer any trust funds ultimately due to the claimants, but many of the agreements prevent the trustee from distributing the funds to the claimant until the trustee is notified in writing by the taxpayer, and, as mentioned above, expressly prohibit the trustee from disclosing the trust's existence to the claimant. The trustee is thus forced to look to the taxpayer for instruction as to when it may transfer the trust assets.

Can a deductible § 461(f) transaction occur under Treas. Reg. § 1.461-2(c)(1)(i)(B) without the claimant's knowledge of the trust? The Tax Court in Edison Brothers Stores v. Commissioner, T.C. Memo, 1995-262 takes a more equivocal approach to the regulations' requirement for claimants to be a party to an escrow or trust for purposes of § 461(f).

In Edison Brothers, the taxpayer contested its liability for countervailing duties asserted by the Department of Commerce. The taxpayer created a trust and transferred cash into it for the purpose of satisfying the liability if the government prevailed. The taxpayer did not notify the government of the trust's existence when it was formed in 1985 (the year in which the taxpayer took the § 461(f) deduction). However, the following year (1986) the taxpayer did send a letter to the agency informing it of the trust. The contested liability was resolved by a court ruling in 1994. The Tax Court noted that the absence of the claimant's signature on the trust agreement was not conclusive as to whether the taxpayer was entitled to a deduction under § 461(f). The Court concluded that based on

²⁵ Edison Brothers Stores v. Commissioner, T.C. Memo. 1995-262.

all the facts, the funds were transferred irrevocably beyond the taxpayer's control.

Edison Brothers permitted a § 461(f) deduction without the claimant signing the trust agreement, and without even requiring contemporaneous notification of the claimant that a contested liabilities trust has been created. Some taxpayers have cited Edison Brothers as authority for § 461(f) transactions kept entirely secret from the beneficiaries, usually claimants in a tort action where it is feared that the taxpayer's creation of a 461(f) trust for the face amount of the liability would hamper efforts to settle for much less if the amount transferred to the trust became known.

Some taxpayers have attempted to increase the resemblance of their I.R.C. § 461(f) Contested Liabilities transactions to the fact pattern in Edison Brothers by sending a bare notice to the claimant that the trust had been created. The text of the notice involved in Edison Brothers is not reproduced in the decision, but the Tax Court mentions that the letter informed the Government that it was a beneficiary of the trust and that the trust was established to satisfy any liability owed to it as a result of the appeal. It is open to debate what information would have to be conveyed for a court to agree that a claimant has been empowered to protect its interests. Taxpayers may send a notice to an IRS Campus stating a § 461(f) trust had been formed to satisfy contested income tax deficiency liabilities, without identifying the trustee or any other information about the trust or its assets. Such a notice appears to beg the question of what the Service could possibly do to collect from the trust if it prevailed. (While the government would not be legally limited to collecting from the trust, for purposes of a deduction under § 461(f) one relevant question is whether the claimant is empowered to protect its interest in the trust property.)

Taxpayers may also argue in Appeals that due to the audit triggered by an Announcement 2002-2 disclosure, the government ultimately received every bit of information available about the trust. Therefore, if the letter by itself was lacking anything, the government still ended up possessing all possible information needed to protect its interests with respect to the § 461(f) trust. This is a novel idea for taking the government's sword (inadequate information for the claimant to protect its interests in trust property) and turning it into the taxpayer's shield. The courts, of course, have not considered whether the government's receipt of information about a § 461(f) trust through an audit (e.g., the Announcement 2002-2 situation) is synonymous with the notice given in Edison Brothers.

The Tax Court, and the Eighth and Ninth Circuits have examined factors that demonstrate that the money or other property has been irrevocably transferred beyond the taxpayer's control and the manner of transfer is not open to the possibility of tax abuse. However, both the Tax Court, in Edison Brothers, and the Ninth Circuit, in Chem Aero, cited the claimant's knowledge of the trust

agreement as a factor in allowing the deduction. In Chem Aero, Inc. v. United States, 694 F.2d 196 (9th Cir. 1982) the Ninth Circuit distinguished its facts from the “secret trust” in Poirier & McLane Corp. v. Commissioner, 547 F.2d 161 (2^d Cir. 1976). If the sum of all actions taken by the taxpayer to relinquish control over the trust assets does, indeed, result in the property being transferred beyond its control, the transaction satisfies I.R.C. § 461(f)(2). Notification to the claimant of the trust’s existence is arguably a fact that enhances the taxpayer’s case because it decreases the taxpayer’s opportunity to exercise control over trust assets and provides the claimant with the ability to enforce its rights under the trust.

The Second Circuit, in Poirier & McLane, and the Claims Court, in Rosenthal v. United States, 11 Cl. Ct. 165, 171 (1986), specifically focused on the importance of the claimant’s awareness of the trust agreement as a means of ensuring that the transferred assets are beyond the taxpayer’s control. In both cases the claimants were notified of the trust agreement.

In general, Appeals considers it highly unlikely that a court will find taxpayers have irrevocably transferred property beyond their control if the claimant lacks sufficient awareness of the § 461(f) trust to create power of enforcement in the beneficiary. The exception would be in cases where state law and/or the court functions to provide notice to the claimant (as in Chem Aero and Varied Investments v. United States, 31 F.3d 651 (8th Cir. 1994)).

d) Claimant’s Assent to Escrows and Trusts in § 461(f) Transactions

When an escrow or trust is the recipient of property in a § 461(f) transaction, the regulations require a “written agreement (among the escrowee or trustee, the taxpayer, and the person who is asserting the liability) that the money or other property be delivered in accordance with the settlement of the contest....” Treas. Reg. § 1.461-2(c)(1)(i)(B). One controversy over § 461(f) Contested Liabilities Transactions arises from attempts to create deductible transactions without the claimant’s participation in the arrangement or, in many instances, without the claimant’s knowledge that the escrow or trust exists.

The requirement for transfers to escrows or trusts to be subject to a written agreement is explained by the court in Poirier & McLane Corp. v. Commissioner, 547 F.2d 161 (2^d Cir. 1976) as serving an important purpose in addition to upholding the matching principle of accounting:

If the claimants are aware of the trust arrangement, as they are required to be under the Regulation, they can ensure that its assets remain beyond the taxpayer's control. While it is true that the trustee has an independent duty to safeguard trust property, only the person asserting the liability is likely to be zealous in objecting to a breach of that duty. Id. at 167.

Treasury Regulation § 1.461-2(c)(2) gives the following example of a qualifying § 461(f) transaction (the text was the same before and after the 2003 amendment):

Example (2): M Corporation contests a \$5,000 liability asserted against it by L Company for services rendered. To provide for the contingency that it might have to pay the liability, M transfers \$5,000 to an irrevocable trust pursuant to a written agreement among the trustee, M (the taxpayer), and L (the person who is asserting the liability) that the money shall be held until the contest is settled and then disbursed in accordance with the settlement. Such transfer qualifies as a transfer to provide for the satisfaction of an asserted liability.

The regulations thus appear to require the claimant to be a party to the trust or escrow agreement. However, not all circuits which have considered the issue interpret Treas. Reg. § 1.461-2(c)(1)(i)(B) to require that the claimant sign the trust agreement in order for a valid transfer to provide for the satisfaction of an asserted liability to occur.

A literal requirement that the claimant sign the trust agreement has been sustained in only two jurisdictions, the Second Circuit and Court of Claims: Poirier & McLane Corp. v. Commissioner, 547 F.2d 161, 165, 166 (2^d Cir. 1976) (in reversing the Tax Court, stated that a regulation requiring the claimant to be a party to the trust agreement was a reasonable interpretation of the statute); Rosenthal v. United States, 11 Cl. Ct. 165, 172 (requirement in Treas. Reg. § 1.461-2(c) that the claimant agree in writing to the formation of the trust is a reasonable interpretation of I.R.C. § 461(f)(2)).

In contrast, the Tax Court (Edison Brothers Stores v. Commissioner, T.C. Memo. 1995-262), Eighth Circuit (Varied Investments v. United States, 31 F.3d 651 (8th Cir. 1994)), and Ninth Circuit (Chem Aero, Inc. v. United States, 694 F.2d 196 (9th Cir. 1982)) have ruled that Reg. § 1.461-2(c) does not require the claimant to sign the trust or escrow agreement.

Therefore, it is of great interest how these three courts analyzed the facts and determined there to be satisfactory alternatives to written agreements with the claimants, and how these alternatives achieved the Regulations' purpose: to ensure that money or other property is irrevocably transferred beyond the taxpayer's control to provide for the satisfaction of the asserted liability.

In Chem Aero, the Ninth Circuit stated that the claimant's assent to the trust agreement need not be reflected by the claimant's signature, but may be implied where the claimant is named as a beneficiary of a trust.

A sales agent for Chem Aero brought a state court action against the corporation for unpaid commissions, and in 1974 was awarded a judgment in the amount of \$54,082. In order to appeal, the losing party in an action

of this kind is required by state law to post a bond for one and one-half times the amount of the award. Chem Aero posted such a bond in the amount of \$80,900. Id. at 197.

The Ninth Circuit specifically noted that the claimant was aware of the appeal bond. Id. at 199. State law required the bond as a condition for the appeal. Moreover, since the court system was holding the bond, the claimant was certain of being paid if he prevailed.

As did the trial court before it, the Ninth Circuit refuted the government's interpretation of then-numbered Reg. § 1.461-2(c)(1)(ii):

The government further contends that there was no agreement because the claimant did not assent to the bonding agreement. However, the trial court found that if assent was required here in addition to notice, it could be implied, as the claimant had not only a judgment but also a bond collateralized with the cash necessary to satisfy it. Id. at 199.

Subsequently, in Varied Investments v. United States, 31 F.3d 651 (8th Cir. 1994), the Eighth Circuit chose to adopt the Ninth Circuit's view of (then-numbered) Reg. §1.461-2(c)(1)(ii), but agreed that the claimant's assent to the arrangement still mattered:

We have already concluded that the judgment creditor's signature is not required on a trust or escrow agreement. The related issue of whether the judgment creditor has 'assented' to the transfer of property, however, may be relevant to the inquiry of whether the judgment debtor has relinquished control over the property for purposes of section 461(f). Id. at 655.

The facts in Varied included strong parallels to Chem Aero, such as the taxpayer having filed a bond in order to appeal an adverse lower court decision.²⁶

The Varied court also applied Chem Aero's logic in determining that a claimant's assent could be inferred from a set of facts showing its interests were protected:

A claimant's assent can be inferred when the claimant is the beneficiary of a trust or escrow because such arrangements in effect carry the same power of enforcement... Varied's escrow agreement expressly provides that [the claimant] is the beneficiary of the agreement, stating that the securities were placed in escrow 'to provide for the satisfaction of any liability of [Varied] or [the surety] to [[the claimant]] under the terms of the

²⁶ In Varied, the bond was subject to an indemnification arrangement secured by government securities placed by the taxpayer in an escrow account pursuant to an agreement signed with a third party bank, but not by the claimant. Id. at 652.

Bond...’ [The claimant] also possessed enforceable rights under equitable subrogation principles. Id. at 655.

Since the contested tort liabilities which the taxpayers deducted in Chem Aero and Varied were litigated in states whose laws required the posting of a bond as a prerequisite to appealing a lower court ruling, the claimants in each of these cases could have deduced the existence of a bond whether or not they were notified. Therefore, the comment in Varied should be interpreted in light of these facts and should not be read as an endorsement of the idea that a trust arrangement can satisfy § 461(f) even if the claimant is unaware of it.

e) Limitations on trustee’s ability to sell trust assets and enforce rights related to the trust property

A number of the related party notes in these transactions are identified as demand notes. Generally a demand note is due and payable at the time of execution, and full payment may be demanded by the holder at any time regardless of the holder’s motivation.²⁷ Although a demand note affords the payee the power to collect the amount owed at any time, several of the trust agreements limit the trustee’s ability to enforce these notes.

Some of the trust agreements prohibit the trustee from demanding payment on the note until certain events occur within the taxpayer’s control, such as when the taxpayer notifies the trustee that cash is needed to pay the beneficiaries. In other trust agreements, the taxpayer retains the right to fund the trust with cash before allowing the trustee to demand payment from the payee on the note. Others require the trustee to purchase promissory notes issued by the taxpayer’s subsidiaries if the level of cash and investments in the trust exceeds a certain dollar amount or prohibit the trustee from bringing an action to enforce the note.

The trust agreement should also be examined for other provisions that allow a taxpayer to exercise control over the notes after their transfer to the contested liabilities trust and their assignment to the trustee. As discussed in Issue 4, a number of trust agreements limit the trustee’s ability to sell property, such as the taxpayer’s own or related party stock, and to enforce payment of related party notes or rights relating to other transferred property.²⁸ Restrictions on the availability of trust property to satisfy contested liabilities (when the liability is finally determined) are contrary to the requirement under Treas. Reg. § 1.461-

²⁷ U.C.C. § 3-108(a) (1990); Johnson v. Commissioner, 86 F.2d 710, 712 (2^d Cir. 1936) (“It is inherent in a demand note that the payee has the power to decide when to call the loan, or to determine not to enforce his rights at all”); Litton Business Systems, Inc. v. Commissioner, 61 T.C. 367, 378 (1973), acq. 1974-2 C.B. 3 (demand obligations have been upheld as having due dates within the creditors’ control).

²⁸ This provision also exists in the trust agreement funded with premiums receivable. The agreement provides the taxpayer with further control over the receivables by allowing the taxpayer to serve as a collection agent for the receivables on behalf of the trustee.

2(c)(1)(ii) that the taxpayer relinquish all authority over the money or property transferred.

f) Power to pay claimant with funds outside of trust

Many of the trust agreements provide the taxpayer the option of paying the claimants directly, rather than paying the claimants from the assets transferred to the contested liabilities trust, provided that the taxpayer furnishes written notice to the trustee. The payments made by the taxpayer out of other funds are offset against amounts that would have been paid by the trustee to the claimant. This provision is frequently accompanied by another provision directing the trustee not to inform the claimant at any time of the trust's establishment. This retained power directly contravenes the requirement in Treas. Reg. § 1.461-2(c)(1)(ii) that the taxpayer must relinquish all control over and irrevocably part with the money or other property transferred to the trust. It allows the taxpayer to circumvent the contested liabilities trust by satisfying any liability ultimately due to the claimant with funds outside of the trust.

I.R.C. § 461(f)(2) requires a transfer of money or other property in order to provide for the satisfaction of the asserted liability. As noted by the Ninth Circuit in Consolidated Freightways v. Commissioner, 708 F.2d 1385 (1980), for a transfer to be deductible under I.R.C. § 461(f)(2), the taxpayer must intend that the transfer provide for the satisfaction of an asserted liability, and any other reason for the transfer does not satisfy the statutory requirement. In Consolidated Freightways, the payments that the taxpayer made to the contested liabilities reserve were not intended to satisfy a contested liability, but to provide security needed for the taxpayer to qualify as a common carrier. The Ninth Circuit further noted that although § 461(f) and the legislative history do not impose a same money requirement, (i.e. the money transferred to the contested liabilities trust must be used to ultimately satisfy the contested liabilities) such a requirement would diminish the possibility of taxpayers using I.R.C. § 461(f) trusts to accelerate tax deductions. Commenting in *dicta* on its opinion in Consolidated Freightways, the Tax Court observed that I.R.C. § 461(f) “was designed to enable taxpayers to deduct payments to funds set aside to meet contested liabilities; because the payments [in Consolidated Freightways] were not made in respect of contested liabilities, we held them to be not deductible.”²⁹

In Rosenthal v. United States, 11 Cl. Ct. 165, 171 (1986), the taxpayer set up a trust to which it transferred cash over several years in connection with a lawsuit filed against the taxpayer's partnership. In concluding that the amounts the taxpayer transferred were not deductible in the year of transfer and were chiefly dictated by tax reasons, the Claims Court considered evidence that the claimant

²⁹ Sebring v. Commissioner, 93 T.C. 220, 225 (1989), citing Consolidated Freightways, Inc. v. Commissioner, 74 T.C. 768, 804 (1980). See also Specialized Services, Inc. v. Commissioner, 77 T.C. 490, 506 (1981) (transfer requirement of I.R.C. § 461(f) is not satisfied where there is no intent to pay claims out of the escrow fund set up to provide for the contested liabilities).

was never informed of the trust and that none of the trust assets were used to satisfy the liability to the claimant.

By retaining the power to pay the claimant with non-trust funds, the taxpayer has not made a transfer for the purpose of providing for the satisfaction of the contested liabilities under I.R.C. § 461(f)(2), but rather for the acceleration of its tax deductions. This is particularly true where the taxpayer has transferred to the trust its own stock or related party stock subject to various marketability restrictions, as well as related party notes that may not represent valid debt, which it has no intention to enforce, or over which the taxpayer has imposed limitations on enforcement. In these situations, a taxpayer may pay any liability ultimately due to the claimant out of assets over which it had full use and control throughout the trust's existence.

g) Edison Brothers Stores as a Benchmark for Analyzing § 461(f) Trust Agreements

The Edison Brothers opinion quotes from its taxpayer's § 461(f) trust agreement at length, providing a window onto the evidence available to the court. Doubtless as a direct result of the taxpayer prevailing in that case, other taxpayers engaged in promoted § 461(f) Contested Liabilities Transactions generally include somewhat similar conditions and wording in their trust agreements. It is always important to consider whether anything distinguishes the taxpayer's degree of control over property placed in its § 461(f) trust from the control evident in the trust agreement and other facts of Edison Brothers. When there are significant distinctions between them there is greater reason to anticipate that a court will be persuaded that too great a degree of control is exercised for there to have been an irrevocable transfer of property to the trust.

i. Purpose

The name of the trust in Edison Brothers was "The Brazilian CVD Trust." Item 2 of the Brazilian CVD Trust specified that the funds shall be held solely for the purpose of paying the specified contested liability. The § 461(f) Contested Liabilities Transaction trust agreements do likewise. It must be considered in each case whether this was the principal purpose of the transaction. As the court stated in Consolidated Freightways v. Commissioner, 708 F.2d 1385:

For the transfer to be deductible, it must have been made 'to provide for the satisfaction of the asserted liability.' Any other reason for the transfer fails to satisfy the statute. Id. at 1394.

Whether the property in the trust could be, or ever was, used to pay the liabilities is a separately considered question, as is the question of whether other terms of the trust agreement restrict the trustee from accomplishing the stated purpose.

ii. Independence of Trustee

Item 3 of the Brazilian CVD Trust instructed the Trustee to make the payments required to satisfy and discharge the finally determined liability amount. Significantly, it permitted the Trustee to make payments after it had received written notice from either the taxpayer or the defendant (the third party claimant). Typically, the I.R.C. § 461(f) Contested Liabilities Transaction trust agreements provide that the Trustee may pay liabilities only after receiving notification from the taxpayer. In most instances, the claimant is not informed of the trust. This distinction represents a greater degree of control by the taxpayer over trust property.

iii. Residual Assets

Item 4 of the Brazilian CVD Trust sets terms upon which the residual amount of the trust will be returned to the taxpayer, after the final judgment or settlement. There is no problem with a provision that permits return of trust property to the taxpayer after a final resolution of the contested liability. Any lesser restriction on returning the property should be analyzed for hazards to the taxpayer.

Returning the property is distinguished from paying out income earned by the property, evidently, because in Varied Investments the taxpayer actually arranged to withdraw interest income when the fund exceeded a certain minimum and the court found that to be no obstacle to allowing the § 461(f) deduction:

The fact that Varied retained the right to withdraw accumulated interest so long as the value of the escrow fund was at least \$7,035,000 is not the equivalent of retaining control over the property. Nor did the existence of interest render 'indeterminate' in any important way the value of the transferred property and therefore the amount of Varied's tax deduction. Id. at 655.

iv. Management of Trust Funds

Item 7 of the Brazilian CVD Trust states, “* * * [Petitioner], by virtue of the Trust, relinquishes all control over the funds contributed to the Trust. The Trustee shall have exclusive authority and complete discretion with respect to the investment * * *, management and control of the Fund.” Many of the trust agreements in the I.R.C. § 461(f) Contested Liabilities Transaction contain similar language even though there are other provisions in the trust that permit the taxpayer to exercise control over the trust property. This is strong language to carry out the regulations' requirement in § 1.461-2(c)(ii) that “In order for money or other property to be beyond the control of a taxpayer, the taxpayer must relinquish all authority over the money or other property.” If the taxpayer in an I.R.C. § 461(f)

Contested Liabilities Transaction retains some power to govern the investment of the trust assets that would sufficiently distinguish the fact pattern of that case from Edison Brothers, then this would affect the taxpayer's litigating hazards unfavorably. The facts of each case, including the terms of the trust and the taxpayer's actions, must be examined to determine whether the taxpayer has truly relinquished control over the transferred amounts.

v. No Power to Amend

Item 11 of the Brazilian CVD Trust states the trust is irrevocable and cannot be amended by the taxpayer. Any ability explicitly retained by a taxpayer to amend the trust should be analyzed for hazards to the taxpayer.

h) Manner of transfer must not be open to tax abuse

Although the avoidance of "tax abuse" is always a concern of tax administrators, I.R.C. § 461(f) litigation has turned the phrase into a specific test of the allowability of the deduction.

The Ninth Circuit stated in Chem Aero, Inc. v. United States, 694 F.2d 196, 200 (9th Cir. 1982), that the transfer requirement of § 461(f)(2) is satisfied "whenever the money for the settlement of the contested liability is irrevocably parted with, provided that the manner of transfer is not open to the possibility of tax abuse."

The Eighth Circuit, Court of Federal Claims and Tax Court have also adopted this test. See, e.g., Chernin v. United States, 149 F.3d 805, 810 (8th Cir. 1998); Varied Investments v. United States, 31 F.3d 651, 653-654 (8th Cir. 1994); Edison Brothers Stores, Inc. v. Commissioner, T.C. Memo. 1995-262; Rosenthal v. United States, 11 Cl. Ct. 165 (1986).

The Rosenthal court went so far as to say that "the key to allowance of the deduction in Chem Aero, Inc. is the absence of the possibility of tax abuse..." Id. at 172, n. 11.

Two considerations noted by the Second Circuit in Poirier & McLane Corp. v. Commissioner, 547 F.2d 161 (2^d Cir. 1976) included (1) how Congress intended the statute to fit together with the existing rules for accruing expenses, and (2) whether the taxpayer's unilateral transfer of money to an escrow account established without the claimant's knowledge, fits within the purpose of § 461(f). The Poirier court sustained the Government's position on both grounds, the latter also discussed under Issue 5(e).

Poirier & McLane has failed to offer any reason to regard 1964 as the year its liability accrued. The claims against it had been filed more than four years earlier. The only significant event occurring in that year was the Corporation's unilateral decision to establish a contingency reserve. By

transferring funds to a trust, rather than an ordinary bank account, it has asserted that a deductible 'payment' was made under § 461(f). Unlike the taxpayer in Consolidated Edison, however, Poirier & McLane was not required to make any payment in 1964. Nor did the exigencies of litigation compel the company to establish the trust. Its decision to do so was totally voluntary, unilateral and principally dictated by tax motives. Id. at 166.

Chem Aero paid close attention to the timing concerns raised by the Poirier court before rendering a decision in favor of the taxpayer:

Payments pursuant to an escrow agreement, in most instances, are made after the parties have disposed of many of the contested aspects in the case and only a limited legal issue remains for resolution. Often, such settlements are made after a nisi prius determination of liability and damages, where all that remains open to the losing party is the right to appeal. In such circumstances, we can see little to distinguish a payment to an escrow account from an advance payment of a contested tax liability. Id. at 199.

Nisi prius is Latin for "unless first," usually indicating the original trial court which heard a case as distinguished from a court of appeals. The Ninth Circuit is observing that in its experience escrow agreements for settling claims tend to be arranged after the parties have only a limited legal issue left unresolved, such as after an adverse lower court decision.

In making this observation the Court is not requiring a lower court decision before a § 461(f) deduction is allowed, rather, the Court is stating that in its experience business-motivated financial commitments follow events that define a contested claim as likely to be resolved in favor of the claimant, and show how much of the claimed amount will be owed if the claimant prevails. The Ninth Circuit believed in these circumstances the payment to the escrow account had a comparable identity to the advance payment of a contested tax liability.

The Appeals Officer must assign appropriate weight to whether the I.R.C. § 461(f) Contested Liabilities Transaction was entered into by the taxpayer pursuant to the "exigencies of litigation." In nearly all of the I.R.C. § 461(f) Contested Liabilities transactions, a lawsuit has been commenced against a taxpayer or, in the case of federal tax liabilities, a 30-day letter has been issued. It is important to examine on a case-by-case basis whether the amounts the taxpayer deducted exceed the amounts asserted by the claimant or the amounts that the taxpayer is contesting. In general, cases where the courts determined there was not tax abuse, such as Chem Aero, Varied Investments, Chernin, and Edison Brothers are distinguishable from the promoted transactions discussed in this guideline. (Note: As discussed earlier, Rosenthal was decided in the Government's favor.)

First, cash, a letter of credit backed by a certificate of deposit, or government securities were used to fund the trusts in these four cases. The transfer of comparatively liquid and valuable assets does not present the same possibility of tax abuse or potential valuation problems as compared to the transfers of property in the promoted I.R.C. § 461(f) Contested Liabilities Transactions. For example, related party notes were used to fund the trusts in the majority of the promoted transactions. The related party notes must be examined to ensure they represent valid debt that the parties intend to enforce. Similarly, transactions in which taxpayers transferred their stock or related party stock to contested liabilities trusts must be examined to ascertain whether there are trust provisions such as those as described in Issue 4 that affect the trust's ownership rights and the stock's value.

Second, some of the trust agreements do not allow the claimants to be informed of the trust's existence, whereas in Edison Brothers the claimant was informed of the trust by letter. As noted above, a prohibition against informing the claimant of the trust's establishment raises the potential for tax abuse by the taxpayer, as it provides the taxpayer with the opportunity to exercise control over the money or property transferred to the trust.

Third, the Edison Brothers trust provided that the trustee shall make payments out of the trust after it receives written notice from the claimant or the taxpayer that the liability has been finally determined. A number of the trusts either explicitly or effectively provide only the taxpayer with this power.

Fourth, the opinions in these four cases give no indication of any terms in the trust agreements authorizing the taxpayer to pay amounts to the claimant with funds other than those in the trust, or to substitute money or other property for property transferred to the trust, as is the case with a number of the trust agreements relating to the promoted I.R.C. § 461(f) Contested Liabilities Transactions.

The transfer of the taxpayer's stock or related party stock over which the taxpayer retains ownership rights, or the transfer of related party notes that do not represent valid debt and/or that the parties do not intend to enforce, as well as multiple provisions in the trust agreement allowing the taxpayer to exercise control over the stock or related party notes after their transfer through the powers described above, together represent a strong potential for tax abuse under the Chem Aero test. On the other hand, the transfer of cash or marketable securities to the trust, together with the retention of one or two of the above-mentioned powers in the trust agreement, do not represent as strong a potential for tax abuse. The facts of each transaction, in particular, the type of property the taxpayer transfers and the extent to which the taxpayer retains control over the property after its transfer, must be carefully examined to determine whether the manner of transfer is open to the possibility of tax abuse.

ISSUE 6

WHETHER, BUT FOR THE CONTEST, A DEDUCTION WOULD BE ALLOWED IN THE TAXABLE YEAR OF TRANSFER

Law and Analysis

I.R.C. § 461(f)(4) provides that but for the fact that the asserted liability is contested, a deduction would be allowed for the taxable year of the transfer (or for an earlier taxable year), determined after the application of I.R.C. § 461(h).

a) Liability must be otherwise deductible

I.R.C. § 461(f) does not provide an independent basis for a deduction. Instead, the provision merely affects a deduction's timing. The taxpayer must be entitled to a deduction under some other Code provision.

In some instances, the taxpayer may have a reasonable expectation of or a fixed right to reimbursement of the liability from another party, including an insurer, which would prevent the taxpayer from taking a deduction for the amounts transferred to the contested liabilities trust.³⁰

b) Economic performance

In 1984 Congress added § 461(h) to the Code. This section provides that an accrual method taxpayer may not deduct a liability until economic performance has occurred with respect to the liability.³¹ I.R.C. § 461(f)(4) was similarly amended in 1984 by adding the phrase "determined after application of subsection h" to require that economic performance must occur before a deduction may be allowed under § 461(f).

I.R.C. § 461(h)(2)(C) lists workers compensation and tort liabilities as liabilities for which payment to another person is required to satisfy economic performance ("payment liabilities"). Congress gave the Treasury the authority to promulgate

³⁰ E.g., Charles Baloian Company, Inc. v. Commissioner, 68 T.C. 620, 626, 628 (1977), nonacq., 1978-2 C.B. 3 (deduction denied since petitioner's right to reimbursement was fixed and had matured without further substantial contingency when a state agency provided written authorization to pay petitioner's expenses); Webbe v. Commissioner, T.C. Memo. 1987-426, aff'd, 902 F.2d 688 (8th Cir. 1990) (deduction disallowed since written agreement specifically entitled the taxpayer to be reimbursed by another party); Rev. Rul. 80-348, 1980-2 C.B. 31 (taxpayers are not entitled to a deduction for expenses for which they have a right or expectation of reimbursement).

³¹ I.R.C. § 461(h); Treas. Reg. § 1.446-1(c)(1)(ii).

regulations specifying additional payment liabilities.³² The additional payment liabilities added by the regulations are listed in Treas. Reg. § 1.461-4(g). Payment liabilities, in addition to workers compensation and tort liabilities, include liabilities arising out of breach of contract, violation of law, rebates and refunds, awards, prizes, jackpots, insurance, warranty and service contracts on property bought or leased by the taxpayer, and taxes. However, for this purpose a taxpayer's liability to make payments for services, property, or other consideration provided to the taxpayer under a contract is not considered a liability arising out of a breach of contract unless the payments are in the nature of incidental, consequential, or liquidated damages. In addition, Treas. Reg. § 1.461-4(g)(7) is a catch-all provision characterizing as payment liabilities all other liabilities for which economic performance rules are not provided in Treas. Reg. § 1.461-4(g), other regulatory provisions, revenue rulings, or revenue procedures. In describing the phrase "payment to the person to which the liability is owed," Treas. Reg. § 1.461-4(g)(1)(i) provides that economic performance does not occur as a taxpayer makes payments in connection with such a liability to any other person, including a trust, escrow account, court-administered fund, or any similar arrangements.

The regulations originally published under § 461(f) did not address whether economic performance occurs at the time a taxpayer transfers money or other property to a trust established under § 461(f) to provide for the satisfaction of contested liabilities. The preamble to the final economic performance regulations reserved the issue of when economic performance occurs for § 461(f) funds until final guidance was provided for § 468B funds.³³

However, the Conference Report discussing the conforming amendment to § 461(f)(4) did address when economic performance occurs for money or other property transferred to § 461(f) trusts for workers' compensation and tort liabilities, as follows:

In the case of workers' compensation or tort liabilities of the taxpayer requiring payments to another person, economic performance occurs as payments are made to that person. Since payment to a section 461(f) trust is not a payment to the claimant and does not discharge the taxpayer's liability to the claimant, such payment does not satisfy the economic performance test.³⁴

i. Payment liabilities

Treas. Reg. § 1.461-2(e)(2) of the final regulations provides that economic performance does not occur when a taxpayer transfers money or other property

³² I.R.C. § 461(h)(2)(D).

³³ T.D. 8408 (1992). See also Treas. Reg. § 1.461-6(c) (payments to other funds or persons that constitute economic performance is reserved).

³⁴ H. R. Rep. No. 861, 98th Cong., 2d Sess. 871, 876 (June 23, 1984).

to a trust, escrow account, or a court pursuant to § 461(f) to provide for the satisfaction of any contested payment liability designated in Treas. Reg. § 1.461-4(g). Rather, economic performance occurs in the taxable year in which the taxpayer transfers money or other property to the person who is asserting the liability that the taxpayer is contesting, or in the taxable year in which payment from a trust, an escrow account, or a court registry is made to the person to which the liability is owed, as required under Treas. Reg. § 1.461-4(g)(1).

Three exceptions to this rule include: first, situations in which economic performance occurs under § 468B or the regulations there under;³⁵ second, the trust, escrow account, or court is the claimant; and third, the taxpayer's payment to a settlement fund (or trust, escrow account, or court), discharges the taxpayer's liability to the claimant, as in the case of Maxus Energy Corporation v. United States, 31 F.3d 1135 (Fed. Cir. 1994), described below. These regulations are effective for transfers of money or other property after July 18, 1984 to satisfy workers' compensation or tort liabilities, and transfers of money or other property in taxable years beginning after December 31, 1991 to satisfy liabilities designated in § 1.461-4(g), other than workers' compensation and tort liabilities.

Similarly, Notice 2003-77 includes the following transactions by an accrual method taxpayer as listed transactions: (1) the transfer of money or other property after July 18, 1984, to a trust purported to be established under I.R.C. §461(f) to provide for the satisfaction of a workers' compensation or tort liability (unless the trust is the person to which the liability is owed, or payment to the trust discharges the taxpayer's liability to the claimant), and (2) the transfer of money or other property in taxable years beginning after December 31, 1991, to a trust purported to be established under I.R.C. § 461(f) to provide for the satisfaction of a liability for which payment is economic performance under Treas. Reg. § 1.461-4(g) (unless the trust is the person to which the liability is owed, or payment to the trust discharges the taxpayer's liability to the claimant), other than a liability for workers compensation or tort.

These positions are supported by both the plain language of § 461(f)(4) and the legislative history. The "but for the contest" language in § 461(f)(4) applies only to the all events test, and does not apply in determining whether economic performance has occurred. Economic performance is therefore tested as if the liability is still contested. In enacting the conforming amendment to § 461(f)(4), the legislative history cited above indicates that Congress did not intend for transfers to a § 461(f) trust for workers' compensation and tort liabilities (the payment liabilities listed in § 461(h)(2)(C)) to satisfy the economic performance requirements. Based on this interpretation of the conforming amendment,

³⁵ Section 468B and the regulations thereunder contain specific rules as to when economic performance occurs for contributions to several types of funds. See, e.g., I.R.C. §468B(f); Treas. Reg. §§1.461-6(b), 1.468B-3(c) for economic performance rules regarding designated settlement funds and qualified settlement funds.

§ 461(h) limits taxpayers' ability to deduct payment liabilities when money or other property is transferred to a trust to provide for the satisfaction of an asserted liability under § 461(f).

- a. Maxus Energy Corporation v. United States as precedent for satisfaction of economic performance at time of transfer to a contested liabilities trust.

Some taxpayers have cited Maxus Energy Corporation v. United States, 31 F.3d 1135 (Fed. Cir. 1994), in contending that economic performance occurs for payment liabilities as a taxpayer transfers money or other property to a contested liabilities trust.

In Maxus, Diamond Shamrock, one of the taxpayer's affiliates ("Diamond"), was a defendant in a class action suit for personal injuries. Pursuant to a settlement agreement, Diamond agreed to pay a sum of money to a court-administered fund from which the plaintiffs would be compensated. The underlying personal injury claim continued to be contested in 1985 and through 1988, when the Supreme Court denied certiorari with respect to the fairness of the settlement agreement.

The fund did not satisfy the requirements of a designated settlement fund under § 468B. Diamond paid cash into the fund in 1985, and the consolidated group deducted the amount in that year. Citing the legislative history to the conforming amendment to § 461(f)(4), the Service attempted to disallow the deduction in 1985 because economic performance did not occur upon payment to the settlement fund. The Court allowed the deduction in 1985, reasoning that at the time of its payment to the settlement fund, Diamond's liability to the individual claimants had merged with its liability to the fund through the terms of the settlement agreement. The agreement provided that "[c]laims against the Fund shall be the exclusive remedy of all Class members against the defendants . . . , and all members of the Class are forever barred from instituting or maintaining any action against any of the defendants." Therefore, the Court determined that payment to the fund constituted payment to the claimants, since payment to the fund effectively discharged Diamond's liability to the claimants. The Court distinguished this situation from the discussion of economic performance in the legislative history by noting that in some cases a taxpayer's payment to a trust might not discharge its liability to a claimant, and thus not constitute economic performance.

Maxus is the only precedent thus far that has addressed the interaction between I.R.C. § 461(f) and the economic performance rules under § 461(h). The determination in Maxus is on point only to factually similar situations wherein a taxpayer's payment to a trust, escrow account, or court effectively discharges the taxpayer's liability to the claimant.

ii. Interest liabilities

Treas. Reg. § 1.461-4(e) provides that economic performance occurs for interest as the interest cost economically accrues, in accordance with the principles of relevant provisions of the Code. According to the legislative history of § 461(h), economic performance occurs with respect to interest “with the passage of time (that is, as the borrower uses, and the lender forgoes use of, the lender’s money) rather than as payments are made.” H. Rep. No. 861, 98th Cong., 2d Sess., 875 (1984).

Since interest accrues over time, rather than at the time of payment to the person to which the liability is owed, a trust established to provide for the satisfaction of contested interest liabilities cannot be challenged on economic performance grounds, with respect to interest that has accrued up to and including the taxable year of payment to the trust.

ISSUE 7

WHETHER THE ACCURACY-RELATED PENALTY UNDER I.R.C. § 6662 SHOULD BE ASSERTED AGAINST AN UNDERPAYMENT ATTRIBUTABLE TO: NEGLIGENCE OR DISREGARD OF RULES OR REGULATIONS, SUBSTANTIAL UNDERSTATEMENT OF INCOME TAX, AND/OR VALUATION MISSTATEMENT

Law and Argument

Whether penalties apply to deductions generated by I.R.C. § 461(f) Contested Liabilities Transactions must be determined on a case-by-case basis, depending on the specific facts and circumstances of each case. The application of a penalty must be based on a comparison of the facts developed with the legal standard for the application of the penalty.

The extent of the taxpayer’s due diligence in investigating the I.R.C. § 461(f) Contested Liabilities Transaction is an important factor to consider in connection with the negligence component of the accuracy-related penalty, as well as the reasonable cause exception. Relevant evidence includes: when and how the taxpayer found out about the § 461(f) transaction; details of meetings and correspondence with promoter personnel; the identity of the taxpayer’s advisors, and the type of advice provided; details of internal memorandums, notes, and meetings; the identity of taxpayer personnel that investigated the transaction and/or made the decision to participate; and actions that were taken by taxpayer personnel when the transaction was being considered.

The following factors affecting the consideration of penalties have been present in many of the cases with an I.R.C. § 461(f) Contested Liabilities Transaction: the promotional materials generally emphasize the tax benefits; taxpayers have been unable to provide a valid non-tax business purpose for the transactions; the transactions are proposed and accepted within a very short time frame, often just prior to the end of the tax year; the taxpayer is unable to provide any evidence that due diligence was completed prior to entering into the transaction; or the taxpayer relied solely upon information provided by the promoter, without doing any independent investigation of the purported tax benefits to determine whether the transaction complies with the requirements of § 461(f) and the related regulations.

a) The Accuracy-Related Penalty

I.R.C. § 6662 imposes an accuracy-related penalty in an amount equal to 20 percent of the portion of an underpayment attributable to, among other things: (1) negligence or disregard of rules or regulations, (2) any substantial understatement of income tax, and (3) any substantial valuation misstatement. Treas. Reg. § 1.6662-2(c) provides that there is no stacking of the accuracy-related penalty components. Thus, the maximum accuracy-related penalty imposed on any portion of an underpayment is 20 percent (40 percent in the case of a gross valuation misstatement), even if that portion of the underpayment is attributable to more than one type of misconduct (e.g., negligence and substantial valuation misstatement). See DHL Corp. v. Commissioner, T.C. Memo. 1998-461, aff'd in part and rev'd in part, 285 F.3d 1210 (9th Cir. 2002), where the IRS alternatively determined that either the 40-percent accuracy-related penalty attributable to a gross valuation misstatement under I.R.C. § 6662(h) or the 20-percent accuracy-related penalty attributable to negligence was applicable. The accuracy-related penalty provided by I.R.C. § 6662 does not apply to any portion of an underpayment on which a penalty is imposed for fraud under § 6663.³⁶

i. Negligence or Disregard of Rules and Regulations

Negligence includes any failure to make a reasonable attempt to comply with the provisions of the Internal Revenue Code or to exercise ordinary and reasonable care in the preparation of a tax return. See I.R.C. § 6662(c) and Treas. Reg. § 1.6662-3(b)(1). Negligence also includes the failure to do what a reasonable and ordinarily prudent person would do under the same circumstances. See Marcello v. Commissioner, 380 F.2d 499 (5th Cir. 1967), aff'g 43 T.C. 168 (1964). Treas. Reg. § 1.6662-3(b)(1)(ii) provides that negligence is strongly indicated where a taxpayer fails to make a reasonable attempt to ascertain the correctness

³⁶ I.R.C. § 6662(b).

of a deduction, credit or exclusion on a return that would seem to a reasonable and prudent person to be “too good to be true” under the circumstances. The accuracy-related penalty may apply if the taxpayer failed to make a reasonable attempt to properly evaluate the I.R.C. § 461(f) Contested Liabilities Transaction.

The phrase “disregard of rules and regulations” includes any careless, reckless, or intentional disregard of rules and regulations. The term “rules and regulations” includes the provisions of the Internal Revenue Code and revenue rulings or notices issued by the IRS and published in the Internal Revenue Bulletin.³⁷ Therefore, if the facts indicate that a taxpayer took a return position contrary to any published notice or revenue ruling, the taxpayer may be subject to the accuracy-related penalty for underpayments attributable to disregard of rules and regulations, if the return position was taken subsequent to the issuance of the notice or revenue ruling.

The accuracy-related penalty may not be imposed on any portion of an underpayment due to a position contrary to rules and regulations if: (1) the position is disclosed on a properly completed Form 8275 or Form 8275-R (the latter is used for a position contrary to regulations) and (2) in the case of a position contrary to a regulation, the position represents a good faith challenge to the validity of a regulation. This adequate disclosure exception applies only if the taxpayer has a reasonable basis for the position and keeps adequate records to substantiate items correctly.³⁸ Moreover, for transactions entered into after December 31, 2002, the taxpayer must also disclose the transaction in accordance with Treas. Reg. § 1.6011-4 to meet the adequate disclosure exception.³⁹

Generally, a taxpayer that takes a position contrary to a revenue ruling or a notice has not disregarded the ruling or notice if the contrary position has a realistic possibility of being sustained on its merits.⁴⁰ For reportable transactions entered into after December 31, 2002, however, taxpayers cannot rely on the realistic possibility standard to avoid the penalty for disregard of rules or regulations.⁴¹

ii. Substantial Understatement of Tax

A substantial understatement of income tax exists for a taxable year if the amount of the understatement exceeds the greater of 10 percent of the tax required to be shown on the return or \$5,000 (\$10,000 in the case of corporations other than S corporations or personal holding companies).⁴²

³⁷ Treas. Reg. § 1.6662-3(b)(2).

³⁸ Treas. Reg. § 1.6662-3(c)(1).

³⁹ Treas. Reg. §§ 1.6662-3(a); 1.6662-2(d)(5).

⁴⁰ Treas. Reg. § 1.6662-3(b)(2).

⁴¹ *Id.*

⁴² I.R.C. § 6662(d)(1). For taxable years ending after October 22, 2004, an understatement for a

Understatements are generally reduced by the portion of the understatement attributable to: (1) the tax treatment of items for which there was substantial authority for the treatment, and (2) any item if the relevant facts affecting the item's tax treatment were adequately disclosed in the return or an attached statement and there is a reasonable basis for the taxpayer's tax treatment of the item.⁴³

In the case of items of taxpayers other than corporations attributable to tax shelters, the reduction for adequate disclosure and reasonable basis, described above, does not apply and the reduction for substantial authority applies only if the taxpayer also reasonably believed that the tax treatment of the item was more likely than not the proper treatment.⁴⁴ In the case of items of corporate taxpayers attributable to tax shelters, neither reduction described above applies.⁴⁵ Therefore, if a corporate taxpayer has a substantial understatement that is attributable to a tax shelter item, the accuracy-related penalty applies to the substantial underpayment unless the reasonable cause exception applies. See Treas. Reg. § 1.6664-4(f) for special rules relating to the definition of reasonable cause in the case of a tax shelter item of a corporation.

The definition of tax shelter includes, among other things, any plan or arrangement a significant purpose of which is the avoidance or evasion of federal income tax.⁴⁶ If the facts establish that an understatement attributable to the I.R.C. § 461(f) Contested Liabilities Transaction exceeds the greater of 10 percent of the tax required to be shown on the return or \$5,000 (\$10,000 in the case of corporations other than S corporations or personal holding companies), the accuracy-related penalty may apply.

In most understatement cases, if the facts support a determination that a significant purpose of the transaction was the avoidance or evasion of federal income tax, examiners have asserted that the I.R.C. § 461(f) Contested Liabilities Transaction is a tax shelter item of a corporation under I.R.C. § 6662(d)(2)(C)(iii).

Some taxpayers dispute whether the contested liabilities transaction is a "tax shelter" for purposes of the substantial authority standard in I.R.C. § 6662 by arguing that the transaction is only a "timing issue."

corporation (other than an S-corporation or a personal holding company), is substantial if it exceeds the lesser of (a) 10 percent of the tax required to be shown on the return (or, if greater, \$10,000), or (b) \$ 10 million. I.R.C. § 6662(d)(1)(B), as amended by section 819(a) of the American Jobs Creation Act of 2004 ("AJCA"), P.L. 108-357.

⁴³ I.R.C. §6662(d)(2)(B).

⁴⁴ I.R.C. § 6662(d)(2)(C)(i). For taxable years ending after October 22, 2004, neither corporate nor noncorporate taxpayers can reduce the amount of the understatement attributable to a tax shelter item. Thus, this component of the accuracy-related penalty would apply unless the taxpayer acted with reasonable cause and good faith, discussed below. See AJCA § 812.

⁴⁵ I.R.C. § 6662(d)(2)(C)(ii).

⁴⁶ I.R.C. § 6662(d)(2)(C)(iii).

Appeals is of the opinion that the promoted I.R.C. § 461(f) Contested Liabilities Transactions clearly fall within the definition of “tax shelter item” in I.R.C. § 6662(d)(2)(C), where a significant purpose of a partnership, entity, plan or arrangement is the avoidance or evasion of federal income tax. Demonstrably, promoted I.R.C. § 461(f) Contested Liabilities Transactions are, to a large degree, characterized by the taxpayer’s retention of control over property transferred in satisfaction of the contested liability, contrary to the specific requirements of the regulations. The transactions enable a taxpayer to obtain an accelerated deduction even though it has not complied with the statutory and regulatory requirements. Whether an issue is a timing issue is not determinative of whether a significant purpose of a transaction is the avoidance or evasion of federal income tax. Timing issues are often highly material issues, and manipulation of the time value of money is not a relevant defense.

iii. Substantial Valuation Misstatement

The Service may assert the accuracy-related penalty attributable to a substantial valuation misstatement against the portion of the underpayment exceeding \$5,000 (\$10,000 in the case of a corporation other than an S corporation or a personal holding company). A substantial valuation misstatement exists if the value or adjusted basis of any property claimed on a return is 200 percent or more of the amount determined to be the correct amount of the value or adjusted basis.⁴⁷ If the value or adjusted basis of any property claimed on a return is 400 percent or more of the amount determined to be the correct amount of the value or adjusted basis, the valuation misstatement constitutes a “gross valuation misstatement.”⁴⁸ If there is a gross valuation misstatement, then the 20 percent penalty under I.R.C. § 6662(a) is increased to 40 percent.⁴⁹

With respect to an I.R.C. § 461(f) Contested Liabilities Transaction, in most cases the “property” claimed on the return for purposes of I.R.C. § 6662(e) is the related party note or stock that was transferred to the contested liabilities trust. If the facts establish that the value of the note or stock is 200 percent or more of the correct amount, then there is a 20 percent penalty for a substantial valuation misstatement; if the facts establish that the value of the note or stock is 400 percent or more of the correct amount, then there is a 40 percent penalty for a gross valuation misstatement.

b) The Reasonable Cause Exception

The accuracy-related penalty does not apply with respect to any portion of an underpayment with respect to which it is shown that there was reasonable cause and that the taxpayer acted in good faith.⁵⁰ The determination of whether a

⁴⁷ I.R.C. §6662(e)(1)(A).

⁴⁸ I.R.C. §6662(h)(2)(A).

⁴⁹ I.R.C. §6662(h)(1).

⁵⁰ I.R.C. §6664(c)(1).

taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances.⁵¹ Generally, the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability.

For reportable transactions entered into after December 31, 2002, a taxpayer's failure to disclose the transaction in accordance with Treas. Reg. § 1.6011-4 is a "strong indication" that the taxpayer did not act in good faith.⁵² For reportable transactions entered into before that date, a taxpayer's failure to disclose the transaction in accordance with Treas. Reg. § 1.6011-4 "could indicate" a lack of good faith. See Preamble to T.D. 8877 (2/28/2000).

The same facts relevant to the substantive issues will bear on the penalty, including the taxpayer's reasons for entering into the I.R.C. § 461(f) Contested Liabilities Transaction, the extent to which the contested liabilities may have been overstated, and the extent to which the related party note or stock may have been over-valued.

i. Reliance on Advice – In General

A taxpayer may show reasonable cause and good faith by relying on the advice of a tax professional, but reliance on advice does not necessarily establish reasonable cause and good faith.⁵³ In determining whether a taxpayer has reasonably relied on professional tax advice as to the tax treatment of an item, all facts and circumstances must be taken into account.⁵⁴

The advice must be based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances. For example, the advice must take into account the taxpayer's purposes (and the relative weight of those purposes) for entering into a transaction and for structuring a transaction in a particular manner. A taxpayer will not be considered to have reasonably relied in good faith on professional tax advice if the taxpayer fails to disclose a fact it knows, or reasonably should know, to be relevant to the proper tax treatment of an item.⁵⁵

The advice must not be based on unreasonable factual or legal assumptions (including assumptions as to future events) and must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person. For example, the advice must not be based upon a representation or assumption that the taxpayer knows, or has reason to know, is unlikely to be true, such as an inaccurate representation or assumption as to the taxpayer's

⁵¹ Treas. Reg. § 1.6664-4(b)(1).

⁵² Treas. Reg. § 1.6664-4(d).

⁵³ Treas. Reg. § 1.6664-4(c).

⁵⁴ Treas. Reg. § 1.6664-4(c)(1).

⁵⁵ Treas. Reg. § 1.6664-4(c)(1)(i).

purposes for entering into a transaction or for structuring a transaction in a particular manner.⁵⁶ Accordingly, Appeals officers should evaluate the accuracy of critical assumptions contained in any opinion letter.

Reliance on tax advice may not be reasonable or in good faith if the taxpayer knew, or should have known, that the advisor lacked knowledge of the relevant aspects of the federal tax law.⁵⁷ Although the Supreme Court in United States v. Boyle, 469 U.S. 241, 250, 105 S. Ct. 687, 692 (1985), determined that requiring the taxpayer to challenge the advice of counsel “would nullify the very purpose of seeking the advice of a presumed expert in the first place,” Boyle is not a case on point about taxpayers engaging in abusive tax avoidance transactions who seek to use expert opinions as a shield against negligence. The courts have refined the way Boyle is applied in such cases as the widely-cited Neonatology Associates, P.A. v. Commissioner, 299 F.3d 221 (3d Cir. 2002):

While it is true that actual reliance on the tax advice of an independent, competent professional may negate a finding of negligence, see, e.g., United States v. Boyle, 469 U.S. 241, 250, 105 S. Ct. 687, 692 (1985), the reliance itself must be objectively reasonable in the sense that the taxpayer supplied the professional with all the necessary information to assess the tax matter **and that the professional himself does not suffer from a conflict of interest** or lack of expertise that the taxpayer knew of or should have known about. [Emphasis in the original.]

The Neonatology court added:

When, as here, a taxpayer is presented with what would appear to be a fabulous opportunity to avoid tax obligations, he should recognize that he proceeds at his own peril.... As highly educated professionals, the individual taxpayers should have recognized that it was not likely that by complex manipulation they could obtain large deductions for their corporations and tax free income for themselves.

For a taxpayer’s reliance on advice to be sufficiently reasonable so as possibly to negate an I.R.C. § 6662(a) accuracy-related penalty, the Tax Court has stated that the taxpayer must satisfy the following three-prong test:

- (1) The advisor was a competent professional, who had sufficient expertise to justify reliance,
- (2) the taxpayer gave to the advisor the necessary and accurate information, and
- (3) the taxpayer actually relied in good faith on the advisor’s judgment.⁵⁸

⁵⁶ Treas. Reg. § 1.6664-4(c)(1)(ii).

⁵⁷ Treas. Reg. § 1.6664-4(c)(1).

⁶⁰ Neonatology Associates, P.A. v. Commissioner, 115 T.C. 43, 100 (2000), aff’d, 299 F.3d 221 (3d Cir. 2002).

A taxpayer cannot merely rely on the advice of a promoter when the facts indicate that the taxpayer should have made a meaningful inquiry beyond the promotional materials or consulted an independent tax advisor.⁵⁹ The taxpayer's level of education, sophistication, and business experience is a relevant factor in determining whether reliance on advice was reasonable.⁶⁰

Since the Third Circuit's Neonatology decision held medical doctors engaging in a shelter to this standard of responsibility, surely no lesser standard would apply to a major corporation that employs a staff of trained tax professionals. Thus, corporations with highly sophisticated tax professionals in their employ should be held to a high standard in determining whether their reliance on tax advice was reasonable.

ii. Reliance on Advice – Special Rules for Tax Shelter Items

With respect to reasonable cause for the substantial understatement penalty attributable to tax shelter items of a corporation, special rules apply. The determination of whether a corporation acted with reasonable cause and good faith is based on all pertinent facts and circumstances.⁶¹ A corporation may establish that it acted with reasonable cause and in good faith in its treatment of a tax shelter item only by showing that (1) there is substantial authority within the meaning of 1.6662-4(d) for the treatment of the item and (2) the corporation reasonably believed, when the return was filed, that the treatment was more likely than not the proper treatment.⁶²

The regulations provide that in meeting the requirement of reasonably believing that the treatment of the tax shelter item was more likely than not the proper treatment, the corporation may reasonably rely in good faith on the opinion of a professional tax advisor if the opinion is based on the tax advisor's analysis of the pertinent facts and authorities in the manner described in Treas. Reg. § 1.6662-4(d)(3)(ii) and the opinion unambiguously states that the tax advisor concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the IRS.⁶³ Therefore, if the taxpayer claims reasonable cause because of reliance on tax advice, the tax advisor's opinion should be obtained to determine whether these requirements are met.

⁵⁹ See Novinger v. Commissioner, T.C. Memo. 1991-289 (taxpayer could not avoid the negligence penalty merely because his professional advisor had read the prospectus and had advised the taxpayer that the underlying investment was feasible from a tax perspective, assuming the facts presented were true).

⁶⁰ Treas. Reg. § 1.6664-4(c)(1).

⁶¹ Treas. Reg. § 1.6664-4(f)(1).

⁶² Treas. Reg. § 1.6664-4(f)(2)(i).

⁶³ Treas. Reg. § 1.6664-4(f)(2)(i)(B)(2).

Satisfaction of the “substantial authority” and “belief” requirements is necessary, but may not be sufficient, to a reasonable cause finding. Other factors may weigh against the claim of reasonable cause. For example, reasonable cause may still not exist if the taxpayer’s participation in the tax shelter lacked significant business purpose, if the taxpayer claimed benefits that were unreasonable in comparison to the initial investment in the tax shelter, or if the taxpayer agreed with the shelter promoter that the taxpayer would protect the confidentiality of the tax aspects of the structure of the tax shelter.⁶⁴

The court weighs the quality of evidence presented in support of these points. If the evidence is not strong and specific, the court will reject the reasonable cause argument, as it did in Long Term Capital Holdings v. United States,³³⁰ F.Supp.2d 122, 211 (D. Conn. 2004):

In essence, the testimony and evidence offered by Long Term regarding the advice received from King & Spalding amounted to general superficial pronouncements asking the Court to “trust us; we looked into all pertinent facts; we were involved; we researched all applicable authorities; we made no unreasonable assumptions; Long Term gave us all information.” The Court’s role as fact finder is more searching and with specifics, analysis, and explanations in such short supply, the King & Spalding effort is insufficient to carry Long Term’s burden to demonstrate that the legal advice satisfies the threshold requirements of reasonable good faith reliance on advice of counsel.

iii. Conclusion

Generally, for all reasonable cause arguments, if a taxpayer is relying on the advice of its tax advisor and is unwilling to produce a copy of its opinion letter, the taxpayer should not be relieved from penalty consideration. Moreover, an opinion letter prepared by a promoter should be accorded less weight than the opinion of an independent tax professional.⁶⁵ If a taxpayer did not obtain a legal opinion from an independent tax professional in connection with its I.R.C. § 461(f) Contested Liabilities Transaction, the taxpayer’s reliance on the opinion may not have been reasonable. In many of the I.R.C. § 461(f) Contested Liabilities Transactions, the taxpayers will have relied entirely upon the opinion of the promoter.

c) Disclosure Initiative Under Announcement 2002-2

Accuracy-related penalties will generally be waived for taxpayers that properly disclosed the I.R.C. § 461(f) Contested Liabilities Transaction as part of the Announcement 2002-2 disclosure initiative. As explained in Announcement

⁶⁴ Treas. Reg. § 1.6664-4(f)(3).

⁶⁵ See Neonatology Associates, P.A. v. Commissioner, 299 F.3d 221, 234 n.22 (3d Cir. 2002).

2002-2, however, the penalty waiver is not available in situations if the disclosed item had been raised as an examination issue before the taxpayer made the disclosure. In addition, the penalty waiver is not available for certain transactions that did not actually occur, transactions that involve fraudulent concealments, and transactions that involve deductions of personal, household, or living expenses.

SETTLEMENT GUIDELINES

SUMMARY

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It is useful to remember that all conditions of I.R.C. § 461(f) must be met in order for a taxpayer to take a contested liability deduction. #####

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SETTLEMENT GUIDELINES FOR ISSUE 1

Whether the taxpayer contests an asserted liability.

Most I.R.C. § 461(f) Contested Liability Transactions involve an asserted liability that can be readily determined from the evidence. #####

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Taxpayers usually can establish whether the asserted liability has been contested. Many I.R.C. § 461(f) Contested Liabilities Transactions involve a lawsuit commenced against a taxpayer, and in those situations there is clearly a contest of an asserted liability for § 461(f) purposes.

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It is well-settled that the Service’s issuance of a statutory notice of deficiency constitutes an assertion of a liability against a taxpayer for purposes of § 461(f)(1)⁶⁶, and that such notices are not a sham (which is why they are sometimes effective in imposing a “reality-check” upon taxpayers perceived as uncooperative with the examination process.) The Courts have shown a strong tendency to regard tax issues as still contested until a taxpayer ends the process by signing an agreement for the tax liability (Form 870 or 870-AD, a stipulation of settled issues, etc.) #####

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SETTLEMENT GUIDELINES FOR ISSUE 3

Whether the transfer of property to a trust provides for the satisfaction of the contested liabilities.

I.R.C. § 461(f)(2) requires the taxpayer to transfer money or other property to provide for the satisfaction of an asserted liability. There is no definition of what constitutes “money or other property” in either the statute or the regulations.

Many taxpayers engaged in promoted § 461(f) transactions transfer debt or stock, because one of the touted advantages of the transaction is keeping cash free for other purposes while still being able to claim a deduction for making the transfer.

a) Related party notes

The related party notes that taxpayers have used to fund the § 461(f) contested liabilities trusts should be examined to ensure that these instruments represent valid debt obligations. Some factors courts have examined in determining whether the related parties intended to create a true debtor-creditor relationship at the time of the issuance of the note include: whether the advances were repayable on a fixed maturity date, whether repayment terms were enforced, whether outside lenders would have made or continued loans on the same terms and conditions, and the financial condition of the debtor.

When the facts and circumstances indicate that the notes either do not represent valid debt or that the parties did not intend to enforce the note, the taxpayer has not transferred property to provide for the satisfaction of the contested liability, as required by § 461(f)(2).

⁶⁶ Perkins v. Commissioner, 92 T.C. 749, 758 (1989), acq. in result only, 1990-2 C.B. 1

b) Taxpayer's own stock or related party stock

In a few instances, taxpayers have funded the contested liabilities trust with their own stock or the stock of an affiliate. Any restrictions on selling the stock imposed by public law or terms of the § 461(f) trust agreement should be reviewed for their impact on whether the stock can be used to satisfy contested liabilities.

c) Power to pay claimant with funds outside of trust

Many of the trust agreements provide the taxpayer the option of paying the claimants directly, rather than paying the claimants from the assets transferred to the contested liabilities trust.

By retaining the power to pay the claimant with non-trust funds, the taxpayer has not made a transfer for the purpose of providing for the satisfaction of the contested liabilities under I.R.C. § 461(f)(2), but rather for the acceleration of its tax deductions. In these situations, a taxpayer may pay any liability ultimately due to the claimant out of assets over which it had full use and control throughout the trust's existence.

In Rosenthal v. United States, 11 Cl. Ct. 165, 171 (1986), part of the reason the court disallowed the § 461(f) deduction is that none of the trust assets were used to satisfy the liability to the claimant.

However, in Consolidated Freightways v. Commissioner, 708 F.2d 1385, 1394 the Ninth Circuit acknowledged that I.R.C. § 461(f) and the legislative history do not impose a same money requirement, (i.e. that the money transferred to the contested liabilities trust must be used to ultimately satisfy the contested liabilities).

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SETTLEMENT GUIDELINES FOR ISSUE 4

Whether the taxpayer has set an accurate value on property transferred to the trust

a) Valuation of notes

The factors used in valuing a note are similar to those used to determine whether the note represents valid debt. Courts have considered the following in determining whether the fair market value of a note is equivalent to its face value:

the payor's financial condition, the likelihood of repayment, the existence and value of collateral, as well as the terms of the note, including length of maturity, existence and length of repayment schedule, rate of interest, and payee protections in the event of default. The facts and circumstances of each transaction must be carefully examined to determine whether the notes would have been purchased at face value by third parties in an arm's length transaction.

There may also be a traditional valuation issue for a discount in marketability. Generally, the fair market value of publicly traded stock is determined by the market price for which the stock is actually traded on the valuation date. However, restrictions on marketability of the shares reduce their value.

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SETTLEMENT GUIDELINES FOR ISSUE 5

Whether taxpayer retains control over amounts transferred to contested liabilities trusts

The extent to which a taxpayer retains control over the money or property transferred through the terms of the trust and its actions should be considered in assessing the taxpayer's litigating hazards. The trust agreements in the I.R.C. § 461(f) Contested Liabilities Transactions may permit the taxpayer to retain control over the property transferred to the trust by substituting money or other property for the property transferred to the trust, prohibiting the trustee from transferring money or property to the claimant until notified by the taxpayer, satisfying liabilities with non-trust assets, prohibiting notification of the trust to the claimant, and restricting the trustee's ability to sell trust property or to enforce related party notes.

Appeals believes that a court will give some consideration to whether a taxpayer has a legal or business purpose for establishing and transferring money or other property to a contested liabilities trust. Nearly all of the I.R.C. § 461(f) Contested Liabilities Transactions involved a lawsuit against the taxpayer or, in the case of tax liabilities, the assertion of a tax liability by the tax authorities. It is important to examine on a case by case basis whether the amounts the taxpayer deducted exceed the amounts asserted by the claimant or the amounts that the taxpayer is contesting.

Appeals generally considers it highly unlikely that a court will find taxpayers have irrevocably transferred property beyond their control if they have not informed the claimant of the creation of an I.R.C. § 461(f) escrow or trust agreement. The exception would be in cases where state law and/or the court functions to provide notice to the claimant of the trust (as in Chem Aero). If the claimant is not aware

of the trust’s existence, the claimant cannot act independently to ensure that the taxpayer has relinquished control of the trust property and that it will receive timely payment from the trust once the contest is resolved.

Appeals officers should give appropriate weight to the Regulations’ requirement that the claimant sign the trust agreement, except in cases appealable to the Eighth and Ninth Circuits. In the Eighth and Ninth Circuits, and any other jurisdiction following the reasoning of Chem Aero, the Appeals Officer must assign appropriate weight to other facts which, when viewed together, demonstrate whether or not property in the I.R.C. § 461(f) Contested Liabilities Transaction was transferred beyond the taxpayer’s control, and the manner of transfer was not open to the possibility of tax abuse.

From Poirier through Chem Aero, Rosenthal and Varied Investments, the “key to allowance of the deduction” has been the absence of tax abuse (discussed under Issue 5(h)). However, Edison Brothers allowed the taxpayer more latitude: it did not require the taxpayer to have the claimant sign the trust agreement, or even notify the claimant in the year the deduction was claimed (notification was made a year later).

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SETTLEMENT GUIDELINES FOR ISSUE 6

Whether, but for the contest, a deduction would be allowed in the taxable year of transfer.

Appeals believes that the economic performance requirement imposed by I.R.C. § 461(f)(4) causes a division of cases into two general types of contested liabilities:

- Contested tort, workers compensation, and other “payment liabilities” (such as state taxes or employment taxes) designated in Treas. Reg. § 1.461-4(g), for which economic performance requires payment to the claimant; and
- Contested “nonpayment liabilities,” including interest owed to the IRS and state governments, and pre or post-judgment interest for which economic performance occurs as the interest cost economically accrues.

Payment Liabilities

The economic performance rules of I.R.C. § 461(f) and (h) allow no deduction for payment liabilities, such as taxes, until the persons asserting the claims are actually paid. This position is supported by the plain language of § 461(f)(4) and also the legislative history.

I.R.C. § 461(f)(4) provides that “but for the fact that the asserted liability is contested, a deduction would be allowed for the taxable year of the transfer (or for an earlier taxable year) determined **after** application of [the economic performance rules of I.R.C. § 461(h)].” (Emphasis added).

The phrase in § 461(f)(4) “but for the fact that the asserted liability is contested,” applies only to the all events test, and not to the economic performance requirement. This interpretation of § 461(f)(4) is supported by the legislative history. The Conference Report for the conforming amendment in 1984 to IRC § 461(f)(4) makes it clear that no economic performance occurs when money or other property is transferred to an I.R.C. § 461(f) trust for workers’ compensation or tort liabilities:

In the case of workers’ compensation or tort liabilities of the taxpayer requiring payments to another person, economic performance occurs as payments are made to that person. Since payment to a section 461(f) trust is not a payment to the claimant and does not discharge the taxpayer’s liability to the claimant, such payment does not satisfy the economic performance test. H. R. Rep. No. 861, 98th Cong., 2d Sess. 871, 876 (June 23, 1984). (*emphasis added*).

The same principle would apply for other types of payment liabilities (such as taxes) as designated in Treas. Reg. § 1.461-4(g), effective for taxable years beginning after December 31, 1991.

As discussed above, Treas. Reg. § 1.461-2(e)(2)(ii), issued on July 20, 2004, applies to: (1) transfers of money or other property after July 18, 1984, to satisfy workers compensation or tort liabilities, and (2) transfers of money or other property in taxable years beginning after December 31, 1991, the effective date of § 1.461-4(g), to satisfy payment liabilities designated under § 1.461-4(g) (other than liabilities for workers compensation or tort). In evaluating whether a court will agree that § 1.461-2(e)(2)(ii) should be retroactively applied, the standard is whether the Commissioner abused his discretion in applying the regulation retroactively. Tate & Lyle, Inc. v. Commissioner, 87 F.3d 99, 107 (7th Cir. 1996). Under this standard, an abuse of discretion may be found where a retroactive regulation: (1) alters settled prior law or policy upon which the taxpayer justifiably relied, and (2) the change causes the taxpayer to suffer inordinate harm. Other factors courts have applied in considering whether there has been an abuse of discretion are: the extent to which prior law or policy has been implicitly approved by Congress, whether retroactivity would advance or frustrate the interest in equality of treatment among similarly situated taxpayers, and whether according retroactive effect would produce an inordinately harsh result. Anderson, Clayton & Co. v. U.S., 562 F.2d 972, 981 (5th Cir. 1977), cert. denied, 436 U.S. 944 (1978).

None of these standards would apply to prohibit retroactive application. No change in established law or policy occurred. Prior to the issuance of the regulations, this area of law was unsettled, and the Service had not issued any public or private guidance addressing when economic performance is satisfied for transfers to trusts established pursuant to § 461(f) on which taxpayers could have relied. Moreover, the regulations do not result in an inequality of treatment among similarly situated taxpayers.

In the excerpt of the Conference Report quoted above, Congress expressed its intent to limit taxpayers' ability to obtain a deduction for contested payment liabilities when they transfer money or other property to a § 461(f) trust. Taxpayers that engaged in a promoted I.R.C. § 461(f) Contested Liabilities Transaction were aware of this Congressional intent since they received opinions from the promoter that quoted and discussed the legislative history.

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The Maxus case is the only precedent thus far that has addressed the interaction between I.R.C. § 461(f) and the economic performance rules under § 461(h). It is often cited when payment liabilities are at issue because the court allowed a deduction for property transferred to a court-administered settlement fund, #####

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Maxus, the taxpayer, had subsidiaries including Diamond Shamrock Chemical Corporation. To settle a class action lawsuit, Diamond agreed to contribute to a court-administered settlement fund. Pursuant to the terms of the settlement agreement, the claimants' recovery was limited to the settlement fund. Its first step in making the contribution was providing an irrevocable letter of credit, later it made the necessary cash payment.

The government argued that even the cash payment to the settlement fund failed the I.R.C. § 461(h)(2)(C) economic performance requirement for tort liabilities since it was not made to a person (i.e., the claimant). The Maxus court said that the government's citation of the Conference Report⁶⁷ was pertinent but distinguished the settlement fund in Maxus from the type of trust referred to in the Conference Report:

In some cases the taxpayer's payment to a trust might not discharge that party's liability to the individual claimants under the trust, and thus would not constitute 'economic performance'. In the present case, in which Diamond's liability to the individual claimants was merged with or superseded by its liability to the fund, Diamond's payment to the fund did discharge its liability to the individual claimants, and thus did constitute 'economic performance'.

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For such a discharge of liability to occur, there would need to be an agreement providing that the settlement fund is the claimants' exclusive remedy for all claims against the taxpayer.

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A review of several legal opinions provided to taxpayers by the main promoter of this transaction shows a common approach to analyzing when economic performance occurs for transfers to contested liabilities trusts established for payment liabilities. The opinions interpret the economic performance

⁶⁷ "Since payment to a § 461(f) trust is not a payment to the claimant and does not discharge the taxpayer's liability to the claimant, such payment does not satisfy the economic performance test." H.R. Conf. Rep. No. 98-861, 98th Cong., 2d Sess. 876 (1984), reprinted in 1984 U.S.C.C.A.N. 1445, 1564.

requirements of § 461(f)(4) as if there is no contest. Citing § 1.461-4(g)(1)(ii)(B), which states that payment is effected if the person to which the liability is owed would be treated as having actually or constructively received the amount of the payment as gross income under § 451, the opinions contend that economic performance would be satisfied at the time of the transfer to a contested liabilities trust since at that time the claimant would be in actual or constructive receipt of the money or other property but for the existence of the contest.

To support this position, the opinions point out that the Maxus decision allowed taxpayers a deduction under § 461(f) for their transfer of cash to a settlement fund in 1985, even though the liability continued to be contested until 1988. This argument ignores the facts of Maxus and the reasoning of the Federal Circuit. Even though the liabilities continued to be contested after the transfer, the taxpayer's transfer of cash to the settlement fund discharged its liability to the claimants since the claimants agreed to look solely to the settlement fund for payment. The Federal Circuit distinguished this factual situation from the discussion of economic performance in the Conference Report by noting that in some cases a taxpayer's payment to a trust might not discharge the party's liability to the claimant and thus would not constitute economic performance. Thus far, these facts are absent from the promoted transactions. The facts do not correspond closely enough to benefit from any exception Maxus may have created, #####.

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It is not clear how a court would interpret the economic performance requirements with respect to a trust established pursuant to § 461(f) in factual circumstances other than those presented in Maxus. It is possible that a court could determine that economic performance under § 461(f)(4) should be analyzed in the absence of the contest. #####
However, even if a court agreed with this contrary interpretation of § 461(f)(4), in the case of most of the I.R.C. § 461(f) Contested Liabilities Transactions, economic performance would not be satisfied at the time of the taxpayer's transfer of related party notes or other property to the trust since the claimants have no knowledge of the trust and/or the taxpayers have retained such powers as the right to pay the claimants with funds outside of the trust, as well as discretion concerning the time to notify the trustee that the contested liabilities have been resolved and payment should be made to the claimants. Under these circumstances, the claimants would not be treated as being in actual or constructive receipt of the transferred amounts.

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Nonpayment Liabilities

Compliance generally concedes that economic performance has been satisfied for nonpayment liabilities. If the issue has been raised, a settlement position should be discussed with the Technical Guidance Coordinator.

SETTLEMENT GUIDELINES FOR ISSUE 7

Whether any of the following components of the accuracy-related penalty under I.R.C. § 6662 should be asserted: negligence or disregard of rules or regulations, substantial understatement of income tax, and/or valuation misstatement.

Introductory Notes: (1) The penalty base for Issue 7 settlements is the underpayment remaining after taking into account mutual concessions made in settling the tax adjustment.

(2) Accuracy-related penalties will generally be waived for taxpayers that properly disclosed the I.R.C. § 461(f) Contested Liabilities Transaction as part of the Announcement 2002-2 disclosure initiative. Ordinarily, Appeals would not expect to see any penalty issues involving taxpayers that participated in this initiative.

(3) Appeals believes that if taxpayer does not qualify for “audit protection” under Notice 2003-77 (see Appendix I), its expressed desire or actual attempts to amend its returns using that provision have no effect on the hazards of litigation for penalties.

Penalty Discussion: Some taxpayers have raised the specter of the government’s defeats in several district court cases, such as Coltec Industries, Inc. v. United States, 62 Fed. Cl. 716 (2004), in which it argued the economic substance doctrine. They argue there is a trend for courts to approve tax shelter deductions, making it correspondingly unlikely the courts will sustain penalties. However, the government is not making economic substance doctrine arguments in § 461(f) transaction cases, so if Coltec has any bearing on § 461(f) cases, its focus on the satisfaction of statutory requirements should strengthen the government’s case, for it is the government that is on the side of strict construction in the I.R.C. § 461(f) arena. In any event, these cases do not analyze the penalty issue because the government’s tax adjustment was not sustained.

Payment Liabilities

Under the economic performance rules no deduction is allowed for “payment” liabilities such as taxes until the persons asserting the claims are actually paid. This position is supported by the plain language of § 461(f) and also the legislative history.

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APPENDIX I

Change in Method of Accounting

Some taxpayers have sought to correct their erroneous I.R.C. §461(f) Contested Liabilities Transaction deductions by filing an amended return for the first taxable year in which an I.R.C. § 461(f) Contested Liabilities Transaction occurred and for any subsequent years impacted by the I.R.C. § 461(f) Contested Liabilities Transaction. Others have sought to file a request for a change of accounting method using a Form 3115.

A change in the treatment (such as the taxable year of deduction) of the transfer of money or other property to a trust described in Notice 2003-77 constitutes a change in method of accounting to which §§ 446 and 481 apply. Normally, Rev. Proc. 97-27, 1997-1 C.B. 680, permits a taxpayer to change from an impermissible method of accounting to a proper method by filing a Form 3115. Rev. Proc. 97-27 also typically permits a taxpayer filing a Form 3115 to take any positive § 481(a) adjustment into account on a prospective basis ratably over four years. However, the Service has determined that it is not in the best interest of sound tax administration to permit taxpayers to use the normal Rev. Proc. 97-27 procedures to change from the impermissible methods of accounting described in Rev. Proc. 2004-31.

Instead, Rev. Proc. 2004-31, 2004-22 I.R.B. 1, issued on May 6, 2004, provides special procedures for taxpayers that desire to change their method of accounting for I.R.C. § 461(f) Contested Liabilities Transactions. Rev. Proc. 2004-31 permits a prospective change in method of accounting only in limited circumstances. Rev. Proc. 2004-31 does not permit a positive I.R.C. § 481(a) adjustment to be spread over a period of years. The procedures under Rev. Proc. 2004-31 differ depending on whether the I.R.C. § 461(f) Contested

Liabilities Transaction was required to be disclosed under Treas. Reg. § 1.6011-4. The § 1.6011-4 disclosure requirements generally apply to returns filed after February 28, 2000. Almost all of the identified I.R.C. § 461(f) Contested Liabilities Transactions are subject to the § 1.6011-4 disclosure requirements.

If the transaction was required to be disclosed under § 1.6011-4, and the taxpayer has an I.R.C. § 461(f) Contested Liabilities Transaction outstanding in the current year (the year of change), the Service will not process applications for changes in method of accounting using Form 3115. But, these taxpayers may change their method of accounting by filing an amended return in accordance with section 4.04 of the revenue procedure. Normally, the amended return must be filed for the first taxable year in which the taxpayer used the impermissible method involving an I.R.C. § 461(f) Contested Liabilities Transaction. However, if the assessment statute has expired for the first taxable year in which the impermissible method was used, the amended return may be filed for the first open taxable year. In the latter case, the full I.R.C. § 481(a) adjustment must be taken in the first open taxable year. In either case, the amended return must reflect at the top of the return that it is filed pursuant to Rev. Proc. 2004-31. The taxpayer must attach the disclosure statements required by § 1.6011-4(a), and otherwise comply with the requirements of § 1.6011-4.

If the transaction was not required to be disclosed under § 1.6011-4, a taxpayer may change its method of accounting by filing a Form 3115 using the advance consent procedures of Rev. Proc. 97-27, as specifically modified by Rev. Proc. 2004-31; i.e., the taxpayer must take any positive § 481(a) adjustment into account entirely in the year of change. This differs from the normal four-year spread allowed by Rev. Proc. 97-27 for other method of accounting changes. Alternatively, a taxpayer not required to disclose may change its method of accounting by filing an amended return in accordance with section 4.04 of Rev. Proc. 2004-31. However, if a taxpayer's I.R.C. § 461(f) Contested Liabilities Transaction is under examination or under consideration in Appeals, any request to change its method of accounting is without audit protection. This means that the examination adjustments are preserved for earlier years and cannot be avoided simply by filing a Form 3115 or an amended return for a later year. See the modifications made to Rev. Proc. 97-27 made by Rev. Proc. 2002-19.

In some instances, compliance may discover an I.R.C. § 461(f) Contested Liabilities Transaction after the statute of limitations has expired for the first taxable year in which a deduction was claimed. Since the method of accounting used in the I.R.C. § 461(f) Contested Liabilities Transactions is an impermissible method, compliance may require the taxpayer to change under I.R.C. § 446(b) from the taxpayer's impermissible method of accounting to the permissible method. The taxpayer would have to recognize any positive § 481(a) adjustment in the year of the required change. It is appropriate to consider making an

§ 446(b) change of accounting method adjustment for I.R.C. § 461(f) Contested Liabilities Transactions where: (1) the statute of limitations has expired for the first taxable year in which a deduction was claimed; and (2) the trust remains in existence with unresolved liabilities for any open years after the earliest year under examination.