

Section 461.—General Rule for Taxable Year of Deduction

26 CFR 1.461-2T: Contested liabilities (temporary).

T.D. 9095

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Transfers to Provide for Satisfaction of Contested Liabilities

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains regulations relating to transfers of money or

other property to provide for the satisfaction of contested liabilities. The regulations affect taxpayers that are contesting an asserted liability and that transfer their own stock or indebtedness, the stock or indebtedness of a related party, or a promise to provide services or property in the future, to provide for the satisfaction of the liability prior to the resolution of the contest. The regulations also affect taxpayers that transfer money or other property to a trust, an escrow account, or a court to provide for the satisfaction of a liability for which payment is economic performance. The text of these temporary regulations also serves as the text of the proposed regulations (REG-136890-02) set forth in the notice of proposed rulemaking on this subject in this issue of the Bulletin.

DATES: *Effective Date:* These regulations are effective November 19, 2003.

Applicability Dates: For dates of applicability, see §1.461-2T(g).

FOR FURTHER INFORMATION CONTACT: Norma Rotunno, (202) 622-7900 (not a toll free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to the Income Tax Regulations (26 CFR Part 1) under section 461(f) of the Internal Revenue Code (Code) relating to the transfer of money or other property to provide for the satisfaction of an asserted liability that a taxpayer is contesting. Section 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 the following conditions are met: (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 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 the application of the economic performance rules. If these requirements are satisfied, a taxpayer may deduct the liability in the taxable year of the transfer.

Section 461(f)(2) requires the taxpayer to transfer money or other property to provide for the satisfaction of the asserted liability. Neither the statute nor the regulations specifically define *money or other property*. The examples in the regulations and the legislative history involve only transfers of cash.

Under §1.461-2(c)(1) of the Income Tax Regulations, a transfer for the satisfaction of an asserted liability is a transfer of money or other property beyond the taxpayer's control to: (1) the person asserting the liability, (2) an escrowee or trustee pursuant to a written agreement (among the escrowee or trustee, the taxpayer, and the person who is asserting the liability) providing that the money or other property be delivered in accordance with the settlement of the contest, (3) an escrowee or trustee pursuant to an order of a court or government entity providing that the money or other property be delivered in accordance with the settlement of

the contest, or (4) a court with jurisdiction over the contest. The taxpayer must relinquish all authority over the money or other property transferred.

To qualify for a deduction, section 461(f)(4) provides that a deduction is allowed in the taxable year of the transfer only if, 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 subsection (h)." Congress added the quoted language to section 461(f)(4) when Congress enacted section 461(h), which provides, for amounts with respect to which a deduction would be allowable after July 18, 1984, that the all events test is not met any earlier than when economic performance has occurred with respect to the liability. Section 461(h)(2)(C) provides that payment to another person is required to satisfy economic performance for liabilities arising out of any workers compensation act or any tort. The Conference Report accompanying enactment of section 461(h) explains the impact of the economic performance requirement on trusts established under section 461(f):

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 (1984).

For transfers in taxable years beginning after December 31, 1991, §1.461-4(g)(2)-(7) expands the list of liabilities for which payment "to the person to which the liability is owed" constitutes economic performance (payment liabilities). The additional payment liabilities listed in §1.461-4(g)(2)-(6) include liabilities for breach of contract (to the extent of incidental, consequential, and liquidated damages) or violation of law, rebates and refunds, awards, prizes, jackpots, insurance, warranty and service contracts, and taxes. In addition, §1.461-4(g)(7) characterizes as payment

liabilities other liabilities for which other specific rules are not provided.

Section 1.461-4(g)(1)(ii)(A) provides that payment does not include the furnishing of a note or other evidence of indebtedness of the taxpayer.

Section 1.461-4(g)(1)(i) provides that, for liabilities for which payment is economic performance, economic performance does not occur as a taxpayer makes payments in connection with a liability to any other person, including a trust, escrow account, court-administered fund, or any similar arrangement, unless the payments constitute payment to the person to which the liability is owed under paragraph (g)(1)(ii)(B). Section 1.461-4(g)(1)(ii)(B) states that payment is accomplished if a cash basis taxpayer in the position of 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 section 451.

Explanation of Provisions

Transfers of Property to Provide for the Satisfaction of an Asserted Liability

The regulations remove §1.461-2(c)(1) and add §1.461-2T(c)(1). The temporary regulations restructure the provisions of current §1.461-2(c)(1) for greater clarity but retain all of the rules in §1.461-2(c)(1), including the requirement that the taxpayer must transfer money or other property beyond the taxpayer's control and relinquish all authority over the money or other property transferred. The temporary regulations clarify that the transfer of the indebtedness of a taxpayer or of any promise by the taxpayer to provide services or property in the future is not a transfer to provide for the satisfaction of an asserted liability. See *Eckert v. Burnet*, 283 U.S. 140 (1931); *Willamette Industries, Inc., v. Commissioner*, 92 T.C. 1116 (1989), *aff'd*, 149 F.3d 1057 (9th Cir. 1998). In addition, the temporary regulations provide the express rule that a transfer (other than to the person asserting the liability) of a taxpayer's stock, or the indebtedness or stock of a person related to the taxpayer (as defined in section 267(b)), is not a transfer to provide for the satisfaction of an asserted liability. These rules are consistent with section 468B(d)(1)(B), which excludes as

a qualified payment to a designated settlement fund the transfer of any stock or indebtedness of the taxpayer (or any related person). See §1.461-4(g)(1)(ii)(A), which provides that payment does not include the furnishing of a note or other evidence of indebtedness of the taxpayer or a promise of the taxpayer to provide services or property in the future.

Economic Performance Rules for Payment Liabilities

Section 1.461-4(g) provides that economic performance occurs in the case of a liability requiring payment to another person arising out of a workers compensation act, tort, or other designated liability as payments are made to the person to which the liability is owed. Therefore, the temporary regulations provide in §1.461-2T(e)(2) that, except as provided in section 468B or the regulations thereunder, economic performance does not occur when a taxpayer transfers money or other property to a trust, escrow account, or court to provide for the satisfaction of a contested workers compensation, tort, or other liability designated in §1.461-4(g) unless 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. See *Maxus Energy Corporation and Subsidiaries v. United States*, 31 F.3d 1135 (Fed. Cir. 1994). Rather, economic performance occurs in the taxable year in which the taxpayer transfers money or other property to the person asserting the liability that the taxpayer is contesting, 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.

Effective Date

In general, the temporary regulations apply to transfers made in taxable years beginning after December 31, 1953, and ending after August 16, 1954. However, the temporary regulations apply to transfers of any stock of the taxpayer or any stock or indebtedness of a related person on or after November 19, 2003. Section 1.461-2T(e)(2)(i) applies to transfers of money or other property after July 18,

1984, the effective date of section 461(h). Similarly, §1.461-2T(e)(2)(ii) applies to transfers of money or other property after July 18, 1984, to satisfy workers compensation or tort liabilities, and applies to 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).

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. Please refer to the cross-referenced notice of proposed rulemaking (REG-136890-02) published elsewhere in this issue of the Bulletin for applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6). Pursuant to section 7805(f) of the Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these regulations is Norma Rotunno of the Office of the Associate Chief Counsel (Income Tax & Accounting). However, other personnel from the IRS and Treasury participated in their development.

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Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1— INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.461-2 is amended by:

1. Removing paragraph (a)(5).
2. Revising paragraph (c)(1).
3. Redesignating paragraph (e)(2) as paragraph (e)(3) and revising it.

4. Adding new paragraph (e)(2).

The addition and revisions read as follows:

§1.461-2 Contested liabilities.

* * * * *

(c) * * *

(1) [Reserved]. For further guidance, see §1.461-2T(c)(1).

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(e) * * *

(2) [Reserved]. For further guidance, see §1.461-2T(e)(2).

(3) *Examples.* The provisions of this paragraph are illustrated by the following examples:

Example 1. A, an individual, makes a gift of certain property to B, an individual. A pays the entire amount of gift tax assessed against him but contests his liability for the tax. Section 275(a)(3) provides that gift taxes are not deductible. A does not satisfy the requirement of paragraph (a)(1)(iv) of this section because a deduction would not be allowed for the taxable year of the transfer even if A did not contest his liability to the tax.

Example 2. [Reserved]. For further guidance, see §1.461-2T(e)(3), Example 2.

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Par. 3. Section 1.461-2T is added to read as follows:

§1.461-2T Contested liabilities (temporary).

(a) and (b) [Reserved]. For further guidance, see §1.461-2(a) and (b).

(c) *Transfer to provide for the satisfaction of an asserted liability—(1) 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.

(ii) 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.

(iii) The following are not transfers to provide for the satisfaction of an asserted liability—

(A) Purchasing a bond to guarantee payment of the asserted liability;

(B) An entry on the taxpayer's books of account;

(C) A transfer to an account that is within the control of the taxpayer;

(D) A transfer of any indebtedness of the taxpayer or of any promise by the taxpayer to provide services or property in the future; and

(E) A transfer to a person (other than the person asserting the liability) of any stock of the taxpayer or of any stock or indebtedness of a person related to the taxpayer (as defined in section 267(b)).

(c)(2) through (d) [Reserved]. For further guidance, see §1.461-2(c)(2) through (d).

(e) *Deduction otherwise allowed*—(1) [Reserved]. For further guidance, see §1.461-2(e)(1).

(2) *Application of economic performance rules to transfers under section 461(f)*. (i) A taxpayer using an accrual method of accounting is not allowed a deduction under section 461(f) in the taxable year of the transfer unless economic performance has occurred.

(ii) Economic performance occurs for liabilities requiring payment to another person arising out of any workers compensation act or any tort, or any other liability designated in §1.461-4(g), as payments are made to the person to which the liability is owed. Except as provided in section 468B or the regulations thereunder, 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 an asserted workers compensation, tort, or other liability designated under §1.461-4(g) that the taxpayer is contesting unless the trust, escrow account, or court is the person to which the liability is owed 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 the taxpayer transfers money or other property to the person that is asserting the workers compensation, tort, or other liability designated under §1.461-4(g) that the taxpayer is contesting or in the taxable year that payment is made from a trust, an escrow account, or a court registry funded by the taxpayer to the person to which the liability is owed.

(3) *Examples*. The provisions of this paragraph (e) are illustrated by the following examples:

Example 1. [Reserved]. For further guidance, see §1.461-2(e)(3), *Example 1*.

Example 2. Corporation X is a defendant in a class action suit for tort liabilities. In 2002, X establishes a trust for the purpose of satisfying the asserted liability and transfers \$10,000,000 to the trust. The trust does not satisfy the requirements of section 468B or the regulations thereunder. In 2004, the trustee pays \$10,000,000 to the plaintiffs in settlement of the litigation. Under paragraph (e)(2) of this section, economic performance with respect to X's liability to the plaintiffs occurs in 2004. X may deduct the \$10,000,000 payment to the plaintiffs in 2004.

(f) [Reserved]. For further guidance, see §1.461-2(f).

(g) *Effective date*. (1) Except as otherwise provided, this section applies to transfers of money or other property in taxable years beginning after December 31, 1953, and ending after August 16, 1954.

(2) Paragraph (c)(1)(iii)(E) of this section applies to transfers of any stock of the taxpayer or any stock or indebtedness of a person related to the taxpayer on or after November 19, 2003.

(3) Paragraph (e)(2)(i) of this section applies to transfers of money or other property after July 18, 1984.

(4) Paragraphs (e)(2)(ii) and (e)(3) of this section apply to—

(i) Transfers after July 18, 1984, of money or other property to provide for the satisfaction of an asserted workers compensation or tort liability; and

(ii) Transfers in taxable years beginning after December 31, 1991, of money or other property to provide for the satisfaction of asserted liabilities designated in §1.461-4(g) (other than liabilities for workers compensation or tort).

Mark E. Matthews,
*Deputy Commissioner for Services
and Enforcement.*

Approved November 12, 2003.

Pamela F. Olson,
Assistant Secretary of the Treasury.