

Effective Date: November 17, 2004

**COORDINATED ISSUE
ALL INDUSTRIES**

**IRC § 461(f) CONTESTED LIABILITIES
UIL: 9300.30-00**

ISSUES:

Whether taxpayers entering into IRC § 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 IRC § 461(f). The issue to be considered has several components, which may be summarized as follows:

- 1) Whether there is an asserted liability;
- 2) Whether the taxpayer has contested the asserted liability;
- 3) Whether the liability was contested at the time of the transfer;
- 4) Whether the transfer of property to a trust provides for the satisfaction of the contested liabilities:
 - a) Related party notes;
 - b) Taxpayer's own stock or related party stock; and
 - c) Cash, mortgage-backed securities.
- 5) Whether taxpayers retain control over amounts transferred to contested liabilities trusts:
 - a) Power to pay claimant with funds outside of trust;
 - b) Power to substitute assets transferred to trust with other assets;
 - c) Disclosure of trust's existence to claimant;
 - i) Claimant's execution of trust agreement; and
 - ii) Claimant's knowledge of trust's establishment.
 - d) Limitations on trustee's ability to transfer the assets to the claimants;
 - e) Limitations on trustee's ability to sell trust assets and enforce rights related to the trust property; and
 - f) Manner of transfer must not be open to tax abuse.
- 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;
 - i) Payment liabilities; and
 - ii) Interest liabilities.
- 7) Whether the accuracy-related penalty under IRC § 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

CONCLUSIONS:

The legal arguments to be used by the Service in challenging deductions claimed under IRC § 461(f) in connection with Contested Liabilities Transactions must be determined on a case-by-case basis depending on the specific facts and circumstances of each case. The accuracy-related penalty under IRC § 6662 should be asserted where applicable.

OVERVIEW:

The transaction described below purports to generate deductions for contested liabilities under IRC § 461(f) and is designated as a listed transaction under Notice 2003-77, 2003-49 I.R.B. 1182 ("IRC § 461(f) Contested Liabilities Transaction"). 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 certain conditions are satisfied. The IRC § 461(f) Contested Liabilities Transaction involves a transfer of money or other property that purports to comply with IRC § 461(f).

In an IRC § 461(f) Contested Liabilities Transaction, generally a corporation ("taxpayer") transfers a note or stock of the taxpayer or a related party (and sometimes cash or other property) to a trust, purportedly to provide for the satisfaction of certain contested liabilities that have been asserted against the taxpayer by third parties. The taxpayer then takes a current deduction for the fair market value of the property that was transferred to the trust, even though the facts and circumstances indicate that the taxpayer has maintained control over the property. In transactions involving the transfer of a note of the taxpayer or a related party, typically the note does not represent a genuine liability, the parties do not intend to enforce the obligation, or 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 IRC § 461(h)(2)(C) and the related regulations.

IRC § 461(f) Contested Liabilities Transactions differ with respect to the details of the transactions, the number and types of contested liabilities included in the transactions, and the types of property transferred to the trusts. There are various statutory and judicial bases that may be used to challenge the taxpayer's claim to a deduction under § 461(f), but not all arguments are applicable to each case. Since many of the legal arguments are fact sensitive, extensive factual development is necessary for each transaction in order to evaluate the appropriate legal positions.

FACTS:

In the first step of an IRC § 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. In determining the amount of liabilities to be funded in the trust, taxpayers generally use the full amount of the liability as asserted by the third party, even though a much lower estimate of the ultimate liability will be used for purposes of the taxpayers’ financial statements. As a result, IRC § 461(f) Contested Liabilities Transactions usually require a Schedule M-1 adjustment on the tax return.

In the second step of an IRC § 461(f) Contested Liabilities Transaction, the taxpayer selects the type of property to be transferred to the contested liabilities trust, purportedly to provide for the satisfaction of the asserted liability. In most cases the property will be 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 IRC § 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 IRC § 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. 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 IRC § 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 all cases identified to date, the trusts are purported to be grantor trusts that generally do not file separate tax returns; instead, the income and expenses of the trust will be included on the taxpayer’s return. The taxpayer will often select a bank recommended by the promoter to serve as the trustee. The transaction will usually be 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 IRC § 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 IRC § 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 supposed 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 IRC § 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 IRC § 461(f) Contested Liabilities Transaction.

Retention of Control over Trust Assets

Although the terms of the trust agreements vary, in most IRC § 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.

Notes or Stock of the Taxpayer or a Related Party

In many of the IRC § 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 IRC § 461(f) Contested Liabilities Transaction in its audited financial statements. The parent corporation may take a deduction under IRC § 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 IRC § 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 IRC § 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 IRC § 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

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

a. Contested Tort, Workers Compensation, and Other Payment Liabilities

IRC § 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 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 IRC § 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.

b. Contested Interest Liabilities

Treas. Reg. § 1.461-4(e) provides that economic performance occurs as the interest cost economically accrues. Accordingly, IRC § 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 IRC § 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 Service Center." Not surprisingly, some of the notices addressed to the service centers 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 provides various effective dates for listed transactions involving IRC § 461(f) Contested Liabilities Transactions. The effective dates are based on the types of powers retained by the taxpayer over the trust property, the type

of property transferred to the trust, and the economic performance rule pertaining to the contested liabilities. One or more effective dates may apply to an IRC § 461(f) Contested Liabilities Transaction. The effective dates are as follows:

- 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 (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 IRC § 267(b)), the listing notice applies to transfers on or after November 19, 2003.

Change in Method of Accounting

Some taxpayers have sought to correct their erroneous IRC § 461(f) Contested Liabilities Transaction deductions by filing an amended return for the first taxable year in which an IRC § 461(f) Contested Liabilities Transaction occurred and for any subsequent years impacted by the IRC § 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 IRC § 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 IRC § 481(a) adjustment to be spread over a period of years. The procedures under Rev. Proc. 2004-31 differ depending on whether the IRC § 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.

If the transaction was required to be disclosed under § 1.6011-4, 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 IRC § 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 IRC § 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.

In some instances, compliance may discover an IRC § 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 IRC § 461(f) Contested Liabilities Transactions is an impermissible method, compliance may require the taxpayer to change under IRC § 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 IRC § 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 several open years thereafter.

Other Issues

The facts and circumstances may indicate additional issues that would be applicable to any deduction claimed under § 461(f), regardless of whether the transaction is the listed transaction described in Notice 2003-77. For example, taxpayers may transfer amounts to contested liabilities trusts for liabilities that have not actually been asserted. In one case, the taxpayer claimed interest owed to the IRS on an examination issue in a tax year for which no adjustment had been proposed yet. Another potential issue arises when taxpayers claim deductions for liabilities that were never contested, or liabilities that are no longer being contested. For example, taxpayers may attempt to accelerate the deduction for liabilities that have already been informally resolved, but which will not be paid until a future tax year. Taxpayers may also misrepresent the date when a contested liability was settled, in order to delay income recognition into a future tax year.

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. 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 one case the taxpayer ignored all examination adjustments that were in its favor and deducted interest expense for a tax year that actually had a net over-assessment of tax when all adjustments were considered.

DISCUSSION

The sections below examine the requirements of § 461(f), the regulations thereunder, as well as precedent, and discuss them in reference to the facts of the transactions described above.

1) Whether there is an asserted liability

Section 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. Treas. Reg. § 1.461-2(b)(1). The regulations provide as examples of asserted liabilities a notice of local real estate tax assessment and a bill received for services. Id.

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). Rev. Rul. 89-6, 1989-1 C.B. 119. 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). Perkins v. Commissioner, 92 T.C. 749, 758 (1989), acq. in result only, 1990-2 C.B. 1.

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. 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. Consolidated Industries, 82 T.C. at 479. 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. Id. at 483. 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. Id. at 480-483. 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 constitute a contest of the other liability.” Id. at 481, citing Hollingsworth v. U.S., 568 F.2d 192, 203 (Ct. Cl. 1977). 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).

2) Whether the taxpayer has contested the asserted liability

Most of the IRC § 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 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.

Section 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). Under Treas. Reg. § 1.461-2(b)(2):

[a] contest arises when there is a bona fide dispute as to the proper evaluation of the law or the facts necessary to determine the existence or correctness of the amount of an asserted liability. It is not necessary to institute suit in a court of law in order to contest an asserted liability. An affirmative act denying the validity or accuracy, or both, of an asserted liability to the person who is asserting such liability, such as including a written protest with payment of the asserted liability, is sufficient to commence a contest. Thus, lodging a protest in accordance with local law is sufficient to contest an asserted liability for taxes. 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.

The Tax Court has interpreted this regulation in the context of whether federal tax deficiency interest was fixed and determinable in Exxon Corporation and Affiliated Companies v. Commissioner, T.C. Memo. 1999-247. There, the Court

observed that commencing a contest does not require “a particular affirmative act of protest or litigation to a proposed tax adjustment in order for the adjustment to be regarded as unsettled and contested. The language of the regulation indicates only what is ‘sufficient’ to commence a contest and does not purport to be exhaustive.” 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. Id. In Exxon, 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. Id. Similar objective evidence should be reviewed to determine if a contest exists in IRC § 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. Consolidated Industries, Inc. v. Commissioner, 82 T.C. at 483. In Consolidated Industries, the Tax Court rejected the taxpayer’s argument that § 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. Id. 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. Id. 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 constitute a contest of the other liability.” 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 determinations on each level were independent). In determining whether a taxpayer has contested liabilities and/or related interest from either multiple tax years or multiple jurisdictions, it is recommended that you 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.

3) Whether the liability was contested at the time of the transfer

In several of the transactions involving tax deficiencies or deficiency interest, the issue has arisen as to whether a taxpayer has 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, a taxpayer overstates the amount of

its deduction for contested liabilities by including in the deduction tax adjustments that it is not contesting.

Section 461(f)(3) requires that the taxpayer contest the liability after the time of the transfer. To fulfill this requirement, 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 as including a decision, judgment, decree, or other final order of any court of competent jurisdiction, or an oral or written agreement between the parties.

Whether an accrual basis taxpayer is contesting a liability must be determined by examining all of the relevant facts and circumstances. Phillips Petroleum Co. and Affiliated Subsidiaries v. Commissioner, T.C. Memo. 1991-257. The Tax Court has addressed the issue of when tax adjustments and related interest should be treated as uncontested for purposes of determining when they are fixed and determinable under IRC § 461 in Exxon Corporation and Affiliated Companies v. Commissioner, T.C. Memo. 1999-247, and Phillips Petroleum Co. and Affiliated Subsidiaries v. Commissioner, T.C. Memo. 1991-257. In both cases the Tax Court held that the taxpayers' liability for tax deficiencies was not sufficiently fixed in the year the taxpayers proposed to deduct related deficiency interest.

In Exxon, the Service sent Forms 5701 (Notices of Proposed Adjustment) to the taxpayer and requested that it indicate whether it agreed, agreed in part, or disagreed with each proposed adjustment. The taxpayer did not indicate on these forms or in any other written manner whether it agreed or disagreed with the adjustments. The taxpayer claimed that it informally or orally communicated to the Service its intent not to protest some of the specific adjustments, and argued that the Service should assume that all adjustments it did not specifically protest were agreed. The Court noted that before either the end of the audits (when revenue agent reports were issued and taxpayer executed Forms 870 that waive the Service's restrictions on assessment and collection) or when the Service made assessments, the tax adjustments were not fixed and definite, since the taxpayer provided "insufficient specific communication" to the Service reflecting its agreement to the proposed adjustments. The Tax Court explained that a taxpayer's liability is fixed when agreements regarding the tax adjustments are entered into in a clear and formal manner. Exxon, T.C. Memo. 1999-247.

In Phillips, the taxpayer protested certain adjustments the Service raised in revenue agent reports, orally claimed that it agreed with the adjustments it chose not to protest, and performed no other affirmative acts to deny the validity of the allegedly agreed adjustments. Examining the facts and circumstances, the Court held that the taxpayer's unprotested adjustments were not sufficiently settled to allow the taxpayer to accrue deductions for related interest prior to the point at which taxpayer signed Forms 870-AD or Forms 866 ("Agreement as to Final

Determination of Tax Liability”) both of which gave the Service permission to assess. The Court observed that prior to signing these forms, the taxpayer neither explicitly agreed to the proposed adjustments nor explicitly contested them, and reserved its right to protest all of the adjustments. The Court thus concluded that the adjustments “were sufficiently challenged by [the taxpayer’s] nonacquiescence to render them contested.” Phillips, T.C. Memo. 1991-257, citing General Communication Co. v. Commissioner, 33 T.C. 640, 654 (1960) (“A taxpayer may resist payment of an asserted claim in more subtle ways than express denial of liability or adoption of a litigious attitude.”)

The facts and circumstances of each case must be carefully examined to determine whether a taxpayer continues to contest an asserted liability at the time the taxpayer transfers 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 Forms 5701 does not prevent a taxpayer from later contesting it, and does not grant the Service the rights of assessment and collection. Sara Lee Corp. & Subs. v. United States, 29 Fed. Cl. 330, 335 (1993). 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.

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

Section 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. 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).

In these 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, in one instance, accounts receivable.

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.¹ 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 payor is not required to make interest payments over the course of the note. The notes generally do not require the payor to provide any security. In some instances, the parties did not report the notes for book purposes.

Some of the trust agreements funded with demand notes prohibit the trustee from demanding payment on the note until certain events occur within the taxpayer's control. Some agreements provide that the trustee may demand payment on the note only when cash is needed to satisfy the contested liabilities, or when the contest is resolved. In other trust agreements, the taxpayer retains the right to fund the trust with cash prior to allowing the trustee to demand payment from the payee on the note. These limitations are also present in some of the contested liabilities trusts funded with promissory notes.

The related party notes that taxpayers have used to fund the 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." Gilbert v. Commissioner, 248 F.2d 399, 402 (2^d Cir. 1957), cert. denied, 359 U.S. 1002 (1959). Courts have applied greater scrutiny in examining whether notes between related parties represent valid debt. As one court observed:

Claim to a debt relationship in a parent-subsidary transaction merits particular scrutiny because the control element suggests the opportunity to contrive a fictional debt, an opportunity less present in an arms-length transaction between strangers. This is not to preclude the possibility that a parent-subsidary transaction may constitute a bona fide indebtedness; it is merely a warning to be wary. The term indebtedness must be strictly construed. 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 (2^d

¹ In one instance, the taxpayer transferred to the trust premiums receivable, consisting of various obligations payable to the taxpayer by policyholders and third parties.

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). 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. Calumet Industries, Inc. v. Commissioner, 95 T.C. 257, 286 (1990); Irbco Corp v. Commissioner, T.C. Memo. 1966-67. 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 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. Cuyuna Realty Co. v. United States, 180 Ct. Cl. at 885. See also Hardy v. Commissioner, T.C. Memo. 1972-230.

Courts have determined related party debt to be valid where the facts and circumstances showed that there was a reasonable expectation of repayment, the debtor had the ability to obtain loans from a third party lender, the loan had a business purpose, the debtor corporation was operating at a profit, the related parties treated the obligation for book purposes as a loan to be repaid, and some repayments were made shortly after the note was issued. Irbco Corp. v. Commissioner, T.C. Memo. 1966-67. See also Troop Water Heater Co. v. Bingler, 234 F.Supp. 642, 648, 649 (W.D. Pa. 1964).

On the other hand, courts have held that a valid debtor-creditor relationship was not established between related parties where repayment was contingent on the debtor's successful operation, the creditor participated in the management of the related party debtor, other creditors had priority over the related party creditor, due dates for repayment were routinely extended, and the debtor could not have obtained similar unsecured loans from outside lenders. Old Dominion Plywood Corp. v. Commissioner, T.C. Memo. 1966-135. See also Development Corp. of America v. Commissioner, T.C. Memo. 1988-127 (parent's advances to subsidiary were not valid loans since minimal repayments were made and loan terms were not those a third party lender would have imposed given the subsidiary's poor financial condition).

The terms of the related party notes and trust agreements should be examined to determine whether a valid debtor-creditor relationship exists. In addition to examining the terms of the notes, the actions of the payor and payee during the life of the note, including whether principal and interest were paid, and, if not, whether a demand for payment of principal or interest was made, whether security was provided by the payor, whether the parties recorded the debt on their books and records, and whether the payor subordinated the debt to other third party debt, are important in determining whether the parties intended the note to represent valid debt. 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. As one court observed, even though a provision for a maturity date is an important characteristic of debt, “this factor loses its importance when it is observed in form only. While a reasonable extension of the time for payment is not fatal in itself . . . an extension for an inordinate period gravitates against the presence of a debt.” Sayles Finishing Plants, Inc. v. United States, 185 Ct. Cl. 196, 207 (1968). Similarly, repeated and routine renewals of the due date for payment set forth in the original notes was considered by one court to be an important factor in concluding that the advances the taxpayer made to its subsidiary were not valid debt. See Old Dominion Plywood Corporation v. Commissioner, T.C. Memo. 1966-135. 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).

Another important factor to examine is whether, at the time the note was issued, an independent lender would have loaned funds to the payor under the same terms and conditions. This inquiry involves investigating the payor’s financial condition at the time of the issuance of the related party note, as well as comparing the terms of the related party notes to the terms of notes between the payor and unrelated third parties.

As stated above, a number of the related party notes 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. See 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). 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. Another agreement requires 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. At least one trust agreement prohibits the trustee from bringing an action to enforce the note. Such trust provisions are contrary to the requirement under Treas. Reg. § 1.461-2(c)(1)(ii) that the taxpayer relinquish all authority over the money or property transferred. 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.

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 deduction. In Willamette Industries, Inc. v. Commissioner, the taxpayer acquired a \$20,000,000 letter of credit from a bank for \$85,000, and transferred the letter of credit to a contested liabilities trust to provide for the satisfaction of a contested liability. Willamette Industries, Inc. v. Commissioner, 92 T.C. 1116, 1119-1120 (1989), aff'd, 149 F. 3d 1057 (9th Cir. 1998). In the year of transfer, the taxpayer claimed a deduction for \$20,000,000 under § 461(f). Id. at 1121. In contending that the transfer of a letter of credit constituted a transfer of property under § 461(f)(2), the taxpayer cited prior Tax Court precedent indicating that a letter of credit is property under § 1001(b). Id. at 1124. The Tax Court noted that the issue in those cases was whether the letters of credit constituted property received for purposes of determining the amount of gain realized under § 1001, but added that this section "does not stand in pari materia with section 461(f)(2)," and stated that a letter of credit is merely a commitment by a bank to make a loan and that no money is transferred until specific events occur. Id. In transferring the letter of credit to the trust, the Court pointed out that the taxpayer exchanged a contingent liability to the claimants for a contingent liability to the bank. Id. at 1125. The Court indicated that the legislative history of IRC § 461(f) permits a deduction in the year of payment.² Id. at 1126. Noting that the term "payment" normally means to pay out 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. Id. at 1125-1126. 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. Id.

If, from examining all of the facts, there is evidence indicating 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, 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). Section 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

² 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).

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 IRC § 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 IRC § 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 IRC § 267(b)), on or after November 19, 2003, to a trust purported to be established under IRC § 461(f) to provide for the satisfaction of any asserted liability.

i. 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.³ However, the note may not actually be worth this amount.

Fair market value has been defined by courts for income tax purposes as the price at which property would exchange hands between a willing buyer and a willing seller, neither being under any compulsion to sell and both having reasonable knowledge of the relevant facts. United States v. Cartwright, 411 U.S. 546, 551 (1973); McDonald v. Commissioner, 764 F.2d 322, 329 (5th Cir. 1985). 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. See 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. In Marcello v. Commissioner,

³ In some instances, taxpayers have assigned a lower value to the note for book purposes.

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. 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 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. ⁴

A few of the notes provide that they are payable at the time the contest is resolved and to the extent of the liability finally determined. In valuing these notes, a third party would likely consider not only the valuation factors set forth above, but also the strength of the underlying contested claims. This probably adds an additional discount to the value of the notes.

Examiners should obtain and review financial statements and other available information relating to the issuer of the note to determine whether the fair market value of the note is equal to its face value. Examiners should also consider referrals to an IRS economist or engineer as necessary to obtain assistance in valuing the note.

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. ⁵ 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

⁴ Similar factors should be considered in valuing the insurance premiums receivable that at least one taxpayer transferred to a contested liabilities trust.

⁵ 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).

with the Securities and Exchange Commission or must otherwise comply with the securities registration laws.

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 IRC § 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 IRC § 461(f). These regulations are effective for transfers of stock on or after November 19, 2003.

i. 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 should 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.⁶ 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). However, restrictions on marketability of the shares reduce their value. See 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.

⁶ 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.

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.

Referrals to an IRS economist or engineer should be considered where necessary to obtain an accurate valuation of stock used in an IRC § 461(f) Contested Liabilities Transaction. Examiners should consider whether the taxpayer issued the new stock with the expectation that the stock would never be sold or transferred by the trustee. For example, taxpayers might incur significant additional expense to register the stock in the event of sale or transfer to outside third parties.

C. 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.

5) Whether taxpayers retain control over amounts transferred to contested liabilities trusts

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. Treas. Reg. § 1.461-2(c)(1)(i).

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).

In IRC § 461(f) Contested Liabilities Transactions, taxpayers established contested liabilities trusts purporting to comply with § 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 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 section 4, restricting the trustee’s ability to sell the stock and to enforce the related party notes.⁷

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 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

⁷ 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.

contested liabilities trust by satisfying any liability ultimately due to the claimant with funds outside of the trust.

Section 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, for a transfer to be deductible under IRC § 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. Consolidated Freightways v. Commissioner, 708 F.2d 1385, 1391 (9th Cir. 1983). 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. Id. at 1391. 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), the Ninth Circuit acknowledged that such a requirement would diminish the possibility of taxpayers using IRC § 461(f) trusts to accelerate tax deductions. Id. at 1393. Commenting in *dicta* on its opinion in Consolidated Freightways, the Tax Court observed that IRC § 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.” 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 IRC § 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).

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 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 was never informed of the trust and that none of the trust assets were used to satisfy the liability to the claimant. Id. at 171, 172.

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 IRC § 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.

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

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. 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. The taxpayer does not provide the claimant with any information regarding the terms of the trust or the identity of the trustee.

i. Claimant's execution of trust agreement

As noted above, one of the means of transfer set forth in the regulations is 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. Treas. Reg. § 1.461-2(c)(1)(i)(B). The regulations thus appear to require the claimant to be a party to the trust or escrow agreement.

However, not all courts have interpreted § 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. The Tax Court, Eighth Circuit, and Ninth Circuit have interpreted this provision as not imposing a requirement that the claimant sign the trust or escrow agreement. In Chem Aero, Inc. v. United

States, the Ninth Circuit interpreted the phrase “in general,” preceding the methods of transfer in the regulations, as an indication that the list was merely illustrative, rather than all inclusive, and the use of the term “among” in the regulations does not impose a requirement that the taxpayer sign the trust agreement. Chem Aero, Inc. v. United States, 694 F.2d 196, 198, 200 (9th Cir. 1982). The Ninth Circuit also noted 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. Id. at 199. In Varied Investments, the Eighth Circuit acknowledged that a claimant’s assent to the transfer of property to a contested liabilities trust may be relevant in deciding whether a taxpayer has relinquished control over trust assets. However, citing Chem Aero, the Eighth Circuit observed that a claimant’s assent may be implied where the claimant is designated as a beneficiary of a trust. Varied Investments v. United States, 31 F.3d 651, 652, 655 (8th Cir. 1994). The Tax Court noted that the absence of the claimant’s signature on the trust agreement as the trust beneficiary was not conclusive as to whether § 461(f)(2) was satisfied. Edison Brothers Stores v. Commissioner, T.C. Memo. 1995-262. See also Consolidated Freightways, Inc. v. Commissioner, 74 T.C. 768, 803 (1980), aff’d in part and rev’d in part, 708 F.2d 1385 (9th Cir. 1983); Poirier & McLane Corp. v. Commissioner, 63 T.C. 570, 579 (1975), rev’d, 547 F.2d 161 (2^d Cir. 1976), cert. denied, 431 U.S. 967 (1977). These cases pointed to other facts which, viewed together, demonstrated that the funds were transferred beyond the taxpayer’s control and the manner of transfer was not abusive.

In contrast, the Second Circuit and the Claims Court have held that a claimant is required to sign the trust or escrow agreement in order for the taxpayer to satisfy § 461(f)(2) and § 1.461-2(c)(1)(i)(B). Poirier & McLane Corp. v. Commissioner, 547 F.2d 161, 165, 166 (2^d Cir. 1976) (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. at 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 IRC § 461(f)(2)). As stated in Poirier, “[w]hile 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.

The Service should advance the argument that the regulations require the claimant to sign the trust agreement in order to satisfy the transfer requirements, except in cases appealable to the Eighth and Ninth Circuits.

ii. Claimant’s knowledge of trust’s establishment

In both Poirier and Rosenthal, the claimants were not informed of the trust’s existence. Poirier, 547 F.2d at 162; Rosenthal v. United States, 11 Ct. Cl. 165, 171, 172 (1986). The Second Circuit noted in Poirier that because the claimants were never informed of the trust, there was little assurance that the funds would remain beyond the taxpayer’s control, as the claimants could not act to ensure

that the assets would not fall under the taxpayer's control. Poirier, 547 F.2d at 167. Similarly, in Rosenthal, the Court of Claims observed that if the claimant had been informed of the trust's existence, the claimant's knowledge would "help to insure that the trust assets remained beyond [the taxpayers'] control." Rosenthal, 11 Ct. Cl. at 172.

Even though the Ninth Circuit in Chem Aero and the Tax Court in Edison Brothers concluded that the claimant need not sign the trust agreement for purposes of meeting the regulations' control test, in both cases the claimants were informed of the trust. This was one of the facts each court relied upon to conclude that the manner of the transfer to the contested liabilities trust lacked abuse. The Ninth Circuit noted that "the arrangement was not secret; the district court explicitly found that the claimant knew of the appeal bond" and distinguished Poirier as involving a "secret trust." Chem Aero, Inc. v. United States, 694 F.2d at 199, 200. The taxpayer's letter notifying the claimant of the trust's existence was one fact which the Tax Court in Edison Brothers cited in concluding that the taxpayer was entitled to an IRC § 461(f) deduction. Edison Brothers Stores v. Commissioner, T.C. Memo. 1995-262.

It is not entirely clear from the Eighth Circuit or District Court opinion in Varied Investments whether the claimant was informed of the escrow agreement. However, the escrow agreement was formed to hold collateral supporting an appeal bond following a state trial court judgment. Varied Investments, Inc. v. United States, 31 F.3d at 652. The taxpayer was required by state law to file an appeal bond for 125% of the judgment. Id. The escrow arrangement collateralized the bonding company's obligations with government securities. Id. From these facts, the Eighth Circuit inferred the claimant's assent to the escrow arrangement. Id. at 655. Further, the Eighth Circuit found no tax abuse, as the taxpayer's liability was fixed by the state court judgment against it, and it irrevocably transferred 125% of the judgment beyond its control pursuant to the escrow agreement. Id.

The failure to inform the claimant of the trust's establishment raises the potential for tax abuse, as it provides the taxpayer with the opportunity to exercise control over the transferred funds. This is particularly true if the taxpayer has also retained other powers in the trust agreement, such as those described above, and transferred related party notes to the trust that may not represent valid debt or which it has no intention to enforce. The claimant's knowledge of the trust agreement serves as an important means of ensuring that the trust assets remain beyond the taxpayer's control after their transfer.

d) Limitations on trustee's ability to transfer the assets to the claimants

A trust provision prohibiting the trustee from transferring any trust assets to the claimants until the trustee has received written notice from the taxpayer that the contest has been resolved also affords the taxpayer the opportunity to control the

timing of the distribution of the trust assets to the claimant. This power is often accompanied by the failure to inform the claimant of the trust's existence.

No court has directly discussed this type of provision in a case involving a trust established under § 461(f) for contested liabilities. The trust agreement in Edison Brothers contained a similar provision, but, unlike the provision described above, it allowed the notice to be provided by either the taxpayer or the claimant, which, in that case, was informed of the trust's existence approximately one year after the trust was established. Edison Brothers Stores v. Commissioner, T.C. Memo. 1995-262. The Tax Court did not comment on this provision in its analysis of whether the funds were transferred beyond the taxpayer's control.

The Tax Court, in Specialized Services, Inc. v. Commissioner, 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. Specialized Services Inc. v. Commissioner, 77 T.C. 490, 505 (1981). 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. Id. Although the trust agreements in these transactions provide the trustee with the power to transfer any trust funds ultimately due to the claimants, 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. If the claimant was aware of the trust's existence, the claimant could act independently to ensure that it receives timely payment from the trust once the contest is resolved.

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

As discussed in section 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.⁸ Such provisions are contrary to the requirement in § 1.461-2(c)(1)(ii) that the taxpayer relinquish all authority over the money or other property transferred.

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

The Eighth Circuit indicated that the transfer requirement of § 461(f)(2) is satisfied "whenever the money for the settlement of the contested liability is

⁸ 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.

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). Other courts have 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. This inquiry is highly fact sensitive. The facts in the Contested Liabilities Transactions can be distinguished from those in Chem Aero, Edison Brothers, Varied Investments, and Chernin. These cases allowed an IRC § 461(f) deduction since the manner of the taxpayers’ transfer was not abusive.

In Chem Aero the taxpayer appealed a lower court judgment and filed an appeal bond for approximately one and one-half times the judgment, as required by state law. Chem Aero, 694 F.2d at 197. The bond was collateralized 90% with an irrevocable letter of credit that was backed by a pledge of a certificate of deposit. Id. The Ninth Circuit considered the following facts in concluding that the manner of transfer did not present the possibility of tax abuse: the taxpayer’s transfer of a collateralized appeal bond constituted a transfer of property under IRC § 461(f), the claimant was aware of the trust, and the funds that the taxpayer deposited in the trust were the only funds available to satisfy the contested liability and they were used for that purpose. Id. at 199, 200. The Ninth Circuit also observed that no aspect of the escrow arrangement was structured for the purpose of avoiding tax liability, but was instead established by reason of the exigencies of litigation. Id. at 199.

Similarly, in Varied Investments, the taxpayer filed an appeal bond for 125% of the lower court judgment, which it collateralized with government securities. Varied Investments, 31 F.3d at 652. The taxpayer transferred the securities to an escrow account and took a deduction for the value of the securities in the year of the transfer. Id. at 653. The Eighth Circuit found no tax abuse based on the taxpayer’s collateralization of the bond with securities of equal value, as well as the fact that the taxpayer retained no control over the transferred securities. Id. at 655. As in Chem Aero, the Court pointed out that the escrow account was established due to the exigencies of litigation, rather than for the avoidance of tax liability. Id.

Chernin involved a taxpayer who was sued by his employer in state court for embezzlement. Chernin, 149 F.3d at 807. The state court issued a writ of garnishment against the taxpayer’s bank accounts. Id. The Eighth Circuit held that the issuance of the writ of garnishment satisfied the transfer requirement under § 461(f)(2), as it forced the taxpayer to transfer funds beyond his control to the garnishees, who held the funds as officers of the court. Id. at 810. The Eighth Circuit also noted that the transfer resulted from the exigencies of litigation, and there was no evidence that the taxpayer tried to effect the issuance of the writ of garnishment to avoid a tax liability. Id. at 811.

In Edison Brothers, the taxpayer was assessed duties by the Department of Commerce. Edison Brothers Stores, Inc. v. Commissioner, T.C. Memo. 1995-262. The taxpayer commenced an action in the Court of International Trade to contest the duties, and thereafter established a trust to which it contributed cash in the amount of the duties and related interest. The taxpayer deducted the amounts contributed to the trust in the year of their transfer pursuant to § 461(f). The U.S. Government was named as the beneficiary, but did not sign the trust agreement. The taxpayer informed the Government of the trust by letter approximately one year after it was established. In concluding that the transaction satisfied § 461(f) and was not abusive, the Tax Court explained that trustee was under a duty to administer the trust in the interests of the Government as a beneficiary, the trust funds were in hands of an independent trustee dedicated to paying the amount determined to be due, the taxpayer established the trust after its asserted liability for the duties was upheld by the Government, and the taxpayer informed the Government of the trust.

There are several facts that distinguish Chem Aero, Varied Investments, Chernin, and Edison Brothers from the facts of the promoted transactions discussed in the facts portion of this paper. First, cash, a letter of credit backed by a certificate of deposit, and government securities were used to fund the trusts. The transfer of such assets does not necessarily present the same possibility of tax abuse or potential valuation problems as seen with most IRC § 461(f) Contested Liabilities Transactions. In contrast, 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. As noted above, some of the trust agreements allow the taxpayer to retain control over the trustee's sale or enforcement of the related party notes. 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 section 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 Chem Aero and Edison Brothers, the claimants were informed of the trust by letter, a fact that both courts considered in their opinions. 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, there was no mention in the opinions of any provision in the agreements allowing 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 transactions discussed in the facts portion of this paper.

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.

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

Section 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 IRC § 461(h).

a) Liability must be otherwise deductible

Section 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. See, 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). In Varied Investments, the Service unsuccessfully argued that the taxpayer would not have been able to deduct as a business expense under IRC § 162(a) the amount it transferred to an escrow account to provide for the satisfaction of a contested liability, since it had a right to reimbursement of the

liability from its insurance company. Varied Investments, 31 F.3d at 653. The Eighth Circuit rejected this argument in light of evidence that the taxpayer had no fixed right to reimbursement, as the taxpayer's insurance company and two other insurers informed the taxpayer prior to and in the taxable year of the transfer that they would not pay any part of the judgment. Id.

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. IRC § 461(h); Treas. Reg. § 1.446-1(c)(1)(ii). Section 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).

Section 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 regulations specifying additional payment liabilities. IRC § 461(h)(2)(D). The additional payment liabilities added by the regulations are listed in § 1.461-4(g). In addition to workers compensation and tort liabilities, these 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 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, § 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 § 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," § 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. T.D. 8408 (1992). See also Treas. Reg. § 1.461-6(c) (payments to other funds or persons that constitute economic performance is reserved).

However, the Conference Report discussing the conforming amendment to § 461(f)(4) does 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. H. R. Rep. No. 861, 98th Cong., 2d Sess. 871, 876 (June 23, 1984).

The types of liabilities for which the contested liabilities trusts are typically established include payment liabilities for tort, workers' compensation, breach of contract, violation of law (for example, employment discrimination and patent infringement claims, and violations of state statutes), as well as state tax liabilities. The liabilities also include non-payment liabilities such as interest due on state or federal tax liabilities and pre-judgment interest.

In examining IRC § 461(f) Contested Liabilities Transactions with payment liabilities, examiners should obtain and review the lawsuit or other claim documents and related correspondence to identify the specific types of liabilities that are involved.

i. Payment liabilities

Section 1.461-2(e)(2) of the final regulations provides that economic performance does not occur when a taxpayer transfers money or other property to a trust, escrow account, or a court pursuant to § 461(f) to provide for the satisfaction of any contested payment liability designated in § 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 § 1.461-4(g)(1). Three exceptions to this rule include: first, situations in which economic performance occurs under § 468B or the regulations thereunder;⁹ 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

⁹ 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., IRC § 468B(f); Treas. Reg. §§ 1.461-6(b), 1.468B-3(c) for economic performance rules regarding designated settlement funds and qualified settlement funds.

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 IRC § 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 IRC § 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, § 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. Maxus, 31 F.3d at 1137. 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. Id.¹⁰ 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. Id. at 1143. Citing the legislative history to the conforming amendment to § 461(f)(4), the Service disallowed the deduction in 1985 because economic performance did not occur upon payment to the fund. Id. at 1144. The Court allowed the deduction in 1985 based on the fact 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. Id. at 1145. 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." Id. at 1144. Therefore, the Court reasoned that payment to the fund constituted payment to the claimants, since payment to the fund effectively discharged Diamond's liability to the claimants. Id. at 1145. 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. Id.

Maxus is the only precedent thus far that has addressed the interaction between IRC § 461(f) and the economic performance rules under § 461(h). We think that the holding in Maxus is limited only to factually similar situations in which 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.

¹⁰ 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. Id. at 1144.

7) Whether the accuracy-related penalty under IRC § 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

Whether penalties apply to deductions generated by IRC § 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. Accordingly, examination teams should ensure that the scope of factual development encompasses those matters relevant to penalties. A separate report should be prepared for the penalty issue.

The extent of the taxpayer's due diligence in investigating the IRC § 461(f) Contested Liabilities Transaction is an important factor to consider in connection with the negligence, substantial understatement of income tax, and valuation misstatement components of the accuracy-related penalty, as well as the reasonable cause exception. Facts need to be fully developed to determine 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 IRC § 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; and the taxpayer relied solely upon information provided by the promoter, without doing any independent investigation of the purported tax benefits.

a) The Accuracy-Related Penalty

Section 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 IRC § 6662(h) or the 20-percent accuracy-related penalty attributable to negligence was applicable. The accuracy-related penalty provided by IRC § 6662 does not apply to any portion of an underpayment on which a penalty is imposed for fraud under § 6663. IRC § 6662(b).

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 IRC § 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 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 IRC § 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. Treas. Reg. § 1.6662-3(b)(2). 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 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. Treas. Reg. § 1.6662-3(c)(1). 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. Treas. Reg. §§ 1.6662-3(a); 1.6662-2(d)(5).

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. Treas. Reg. § 1.6662-3(b)(2). However, for reportable transactions entered into after December 31, 2002, taxpayers cannot rely on the realistic possibility standard to avoid the penalty for disregard of rules or regulations. Id.

ii. Substantial Understatement of Tax

A substantial understatement of income tax exists for a taxable year if the amount of 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). IRC § 6662(d)(1). 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. IRC § 6662(d)(2)(B).

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. IRC § 6662(d)(2)(C)(i). In the case of items of corporate taxpayers attributable to tax shelters, neither reduction described above applies. IRC § 6662(d)(2)(C)(ii). 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. IRC § 6662(d)(2)(C)(iii). If the facts establish that an understatement attributable to the IRC § 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 should assert that the IRC § 461(f) Contested Liabilities Transaction is a tax shelter item of a corporation under § 6662(d)(2)(C)(iii).

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. IRC § 6662(e)(1)(A). 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.” IRC § 6662(h)(2)(A). If there is a gross valuation misstatement, then the 20 percent penalty under § 6662(a) is increased to 40 percent. IRC § 6662(h)(1).

With respect to an IRC § 461(f) Contested Liabilities Transaction, in most cases the “property” claimed on the return for purposes of § 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. IRC § 6664(c)(1). The determination of whether a 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. Treas. Reg. § 1.6664-4(b)(1). 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. Treas. Reg. § 1.6664-4(d). 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 IRC § 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. Treas. Reg. § 1.6664-4(c). 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. Treas. Reg. § 1.6664-4(c)(1).

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. Treas. Reg. § 1.6664-4(c)(1)(i).

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 purposes for entering into a transaction or for structuring a transaction in a particular manner. Treas. Reg. § 1.6664-4(c)(1)(ii). Accordingly, examiners 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 in the relevant aspects of the federal tax law. Treas. Reg. § 1.6664-4(c)(1). For a taxpayer's reliance on advice to be sufficiently reasonable so as possibly to negate an IRC § 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. 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, however, when the facts indicate that the taxpayer should have made a meaningful inquiry beyond

the promotional materials or consulted an independent tax advisor. 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). The taxpayer's level of education, sophistication, and business experience is a relevant factor in determining whether reliance on advice was reasonable. Treas. Reg. § 1.6664-4(c)(1). Large 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. Treas. Reg. § 1.6664-4(f)(1). 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. Treas. Reg. § 1.6664-4(f)(2)(i).

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

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.

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. Treas. Reg. § 1.6664-4(f)(3).

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. See Neonatology Associates, P.A. v. Commissioner, 299 F.3d 221, 234 n.22 (3d Cir. 2002). If a taxpayer did not obtain a legal opinion from an independent tax professional in connection with its IRC § 461(f) Contested Liabilities Transaction, the taxpayer's reliance on the opinion of the promoter may not have been reasonable. In many of the IRC § 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 IRC § 461(f) Contested Liabilities Transaction as part of the Announcement 2002-2 disclosure initiative. However, as explained in Announcement 2002-2, 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.