

subdivision. Nothing set forth in this subdivision shall be construed as permitting the allowance of a credit or refund for any year which is barred by the limitations on credit or refund provided by section 6511.

(iii) If the total of the amounts, if any, allowed under subdivisions (i) and (ii) of this subparagraph before the taxable year in which the taxpayer liquidates or otherwise ceases to engage in trade or business is less than the amount not allowed under subparagraph (1), there shall be allowed a deduction in such taxable year for the difference between the amount not allowed under subparagraph (1) and the amounts allowed, if any, as deductions under subdivisions (i) and (ii) unless the circumstances under which the taxpayer ceased to do business constitute an acquisition described in section 381(a) (relating to carryovers in certain corporate acquisitions). If the circumstances under which the taxpayer ceased to do business constitute an acquisition described in section 381(a), the acquiring corporation shall succeed to and take into account the balance of the amounts not allowed on the same basis as the taxpayer, had it not ceased to engage in business.

[T.D. 6500, 25 FR 11720, Nov. 26, 1960, as amended by T.D. 6520, 25 FR 13692, Dec. 24, 1960; T.D. 6710, 29 FR 3473, Mar. 18, 1964; T.D. 6735, 29 FR 6494, May 19, 1964; T.D. 6772, 29 FR 15753, Nov. 24, 1964; T.D. 6917, 32 FR 6682, May 2, 1967; T.D. 8408, 57 FR 12420, Apr. 10, 1992; T.D. 8482, 58 FR 42233, Aug. 9, 1993; T.D. 8554, 59 FR 36360, July 18, 1994; T.D. 8820, 64 FR 26851, May 18, 1999]

#### § 1.461-2 Contested liabilities.

(a) *General rule*—(1) *Taxable year of deduction.* If—

(i) The taxpayer contests an asserted liability,

(ii) The taxpayer transfers money or other property to provide for the satisfaction of the asserted liability,

(iii) The contest with respect to the asserted liability exists after the time of the transfer, and

(iv) But for the fact that the asserted liability is contested, a deduction would be allowed for the taxable year of the transfer (or, in the case of an accrual method taxpayer, for an earlier

taxable year for which such amount would be accruable),

then the deduction with respect to the contested amount shall be allowed for the taxable year of the transfer.

(2) *Exception.* Subparagraph (1) of this paragraph shall not apply in respect of the deduction for income, war profits, and excess profits taxes imposed by the authority of any foreign country or possession of the United States, including a tax paid in lieu of a tax on income, war profits, or excess profits otherwise generally imposed by any foreign country or by any possession of the United States.

(3) *Refunds includible in gross income.* If any portion of the contested amount which is deducted under subparagraph (1) of this paragraph for the taxable year of transfer is refunded when the contest is settled, such portion is includible in gross income except as provided in § 1.111-1, relating to recovery of certain items previously deducted or credited. Such refunded amount is includible in gross income for the taxable year of receipt, or for an earlier taxable year if properly accruable for such earlier year.

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

*Example (1).* X Corporation, which uses an accrual method of accounting, in 1964 contests \$20 of a \$100 asserted real property tax liability but pays the entire \$100 to the taxing authority. In 1968, the contest is settled and X receives a refund of \$5. X deducts \$100 for the taxable year 1964, and includes \$5 in gross income for the taxable year 1968 (assuming § 1.111-1 does not apply to such amount). If in 1964 X pays only \$80 to the taxing authority, X deducts only \$80 for 1964. The result would be the same if X Corporation used the cash method of accounting.

*Example (2).* Y Corporation makes its return on the basis of a calendar year and uses an accrual method of accounting. Y's real property taxes are assessed and become a lien on December 1, but are not payable until March 1 of the following year. On December 10, 1964, Y contests \$20 of the \$100 asserted real property tax which was assessed and became a lien on December 1, 1964. On March 1, 1965, Y pays the entire \$100 to the taxing authority. In 1968, the contest is settled and Y receives a refund of \$5. Y deducts \$80 for the taxable year 1964, deducts \$20 for the taxable year 1965, and includes \$5 in gross income for the taxable year 1968 (assuming § 1.111-1 does not apply to such amount).

(b) *Production costs*—(1) *In general; asserted liability.* For purposes of paragraph (a)(1) of this section, the term “asserted liability” means 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. For example, a notice of a local real estate tax assessment and a bill received for services may represent asserted liabilities.

(2) *Definition of the term “contest”.* Any contest which would prevent accrual of a liability under section 461(a) shall be considered to be a contest in determining whether the taxpayer satisfies paragraph (a)(1)(i) of this section. 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 the facts and circumstances, it can be established to the satisfaction of the Commissioner that a liability has been asserted and contested.

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

*Example:* O Corporation makes its return on the basis of a calendar year and uses an accrual method of accounting. O receives a large shipment of typewriter ribbons from S Company on January 30, 1964, which O pays for in full on February 10, 1964. Subsequent to their receipt, several of the ribbons prove defective because of inferior materials used by the manufacturer. On August 9, 1964, O orally notifies S and demands refund of the full purchase price of the ribbons. After negotiations prove futile and a written demand is rejected by S, O institutes an action for the full purchase price. For purposes of para-

graph (a)(1)(i) of this section, S has asserted a liability against O which O contests on August 9, 1964. O deducts the contested amount for 1964.

(c) *Transfer to provide for the satisfaction of an asserted liability*— (1) [Reserved]. For further guidance, see § 1.461-2T(c)(1).

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

*Example (1).* M Corporation contests a \$5,000 liability asserted against it by L Company for services rendered. To provide for the contingency that it might have to pay the liability, M establishes a separate bank account in its own name. M then transfers \$5,000 from its general account to such separate account. Such transfer does not qualify as a transfer to provide for the satisfaction of an asserted liability because M has not transferred the money beyond its control.

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

(d) *Contest exists after transfer.* In order for a contest with respect to an asserted liability to exist after the time of transfer, such contest must be pursued subsequent to such time. Thus, the contest must have been neither settled nor abandoned at the time of the transfer. A contest may be settled by a decision, judgment, decree, or other order of any court of competent jurisdiction which has become final, or by written or oral agreement between the parties. For example, Z Corporation, which uses an accrual method of accounting, in 1964 contests a \$100 asserted liability. In 1967 the contested liability is settled as being \$80 which Z accrues and deducts for such year. In 1968 Z pays the \$80. Section 461(f) does not apply to Z with respect to the transfer because a contest did not exist after the time of such transfer.

(e) *Deduction otherwise allowed*—(1) *In general.* The existence of the contest with respect to an asserted liability

must prevent (without regard to section 461(f)) and be the only factor preventing a deduction for the taxable year of the transfer (or, in the case of an accrual method taxpayer, for an earlier taxable year for which such amount would be accruable) to provide for the satisfaction of such liability. Nothing in section 461(f) or this section shall be construed to give rise to a deduction since section 461(f) and this section relate only to the timing of deductions which are otherwise allowable under the Code.

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

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

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

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

(f) *Treatment of money or property transferred to an escrowee, trustee, or court and treatment of any income attributable thereto.* [Reserved]

(g) *Effective dates.* Paragraphs (a) through (e) of this section apply to transfers of money or property made in taxable years beginning after December 31, 1953, and ending after August 16, 1954.

[T.D. 6772, 29 FR 15753, Nov. 24, 1964, as amended by T.D. 8408, 57 FR 12421, Apr. 10, 1992; T.D. 9095, 68 FR 65636, Nov. 21, 2003]

**§ 1.461-2T Contested liabilities (temporary).**

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

(c) *Transfer to provide for the satisfaction of an asserted liability—(1) In general.* (i) A taxpayer may provide for the satisfaction of an asserted liability by transferring money or other property beyond his control to—

(A) The person who is asserting the liability;

(B) An escrowee or trustee pursuant to a written agreement (among the escrowee or trustee, the taxpayer, and the person who is asserting the liability) that the money or other property be delivered in accordance with the settlement of the contest;

(C) An escrowee or trustee pursuant to an order of the United States or of any State or political subdivision thereof or any agency or instrumentality of the foregoing, or of a court, that the money or other property be delivered in accordance with the settlement of the contest; or

(D) A court with jurisdiction over the contest.

(ii) In order for money or other property to be beyond the control of a taxpayer, the taxpayer must relinquish all authority over the money or other property.

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

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

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

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

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

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

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

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

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

(ii) Economic performance occurs for liabilities requiring payment to another person arising out of any workers compensation act or any tort, or any other liability designated in § 1.461-4(g),