
Transfers to Trusts to Provide for the Satisfaction of Contested Liabilities

Notice 2003-77

The Internal Revenue Service and Treasury Department are aware of certain transactions that use contested liability trusts improperly to attempt to accelerate deductions for contested liabilities under § 461(f) of the Internal Revenue Code. This notice alerts taxpayers and their representatives that these transactions are tax avoidance transactions and identifies these transactions, and substantially similar transactions, as listed transactions for purposes of § 1.6011-4(b)(2) of the Income Tax Regulations and §§ 301.6111-2(b)(2) and 301.6112-1(b)(2) of the Procedure and Administration Regulations. This notice also alerts parties involved with these transactions of certain responsibilities that may arise from their involvement with these transactions.

Section 461(f) provides an exception to the general rules of tax accounting by allowing a taxpayer to deduct a contested liability in a year prior to the resolution of the contest if the following conditions are satisfied: (1) the taxpayer contests an asserted liability; (2) the taxpayer transfers money or other property to provide for the satisfaction of the asserted liability; (3) the contest with respect to the asserted liability exists after the time of transfer; and (4) but for the fact that the asserted liability is contested, a deduction would be allowed for the taxable year of the transfer (or for an earlier taxable year) determined after the application of the economic performance rules. If these requirements are satisfied, a taxpayer may deduct the liability in the taxable year of the transfer.

On November 19, 2003, the Service and Treasury Department filed with the Federal Register proposed (REG-136890-02) and temporary (T.D. 9095) regulations under § 461(f). Section 1.461-2T(c)(1) of these temporary regulations, which replaces and restates § 1.461-2(c)(1), provides that a transfer for the satisfaction of an asserted liability is a transfer of money or property beyond the taxpayer's control to: (1) the person asserting the liability; (2) an escrowee or trustee pursuant to a written agreement (among the escrowee or trustee, the taxpayer, and the person who is asserting the liability) providing that the money or other property be delivered in accordance with the settlement of the contest; (3) an escrowee or trustee pursuant to an order of a court or government entity providing that the money or other property be delivered in accordance with the settlement of the contest; or (4) a court with jurisdiction over the contest. An account is in the taxpayer's control unless the taxpayer has relinquished all authority over the money or other property transferred.

Section 1.461-2T(c)(1)(iii) provides that the following actions are not transfers to provide for the satisfaction of an asserted liability: (1) the purchase of a bond to guarantee payment of the asserted liability; (2) an entry on the taxpayer's books of account; and (3) a transfer to an account in the taxpayer's control. The temporary regulations clarify that a transfer in taxable years beginning after December 31, 1953,

and ending after August 16, 1954, of any indebtedness of a taxpayer or any promise by the taxpayer to provide services or property in the future is not a transfer to provide for the satisfaction of an asserted liability. In addition, the temporary regulations provide the express rule that a transfer (other than to the person asserting the liability) of a taxpayer's stock, or the indebtedness or stock of a person related to the taxpayer (as defined in section 267(b)), is not a transfer to provide for the satisfaction of an asserted liability.

Section 461(h)(2)(C) provides that, if a workers compensation or tort liability requires a payment to another person, then economic performance occurs as payments to the person are made. The Conference Report accompanying enactment of § 461(h) states:

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

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

Section 461(h)(2)(D) provides that in the case of other liabilities, economic performance occurs at the time determined under regulations prescribed by the Secretary. Section 1.461-4(g)(2) through (7) describes other liabilities for which payment is economic performance.

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

Section 1.461-4(g)(1)(i) provides that, for certain liabilities for which payment is economic performance, economic performance does not occur as a taxpayer makes payments in connection with the liability to any other person, including a trust, escrow account, court-administered fund, or any similar arrangement, unless the payments constitute payment to the person to which the liability is owed. In *Maxus Energy Corporation and Subsidiaries v. United States*, 31 F.3d 1135, 1144, 1145 (Fed. Cir. 1994), the taxpayer's payment to a settlement fund effectively constituted

payment to the person to which the liability was owed because the claimants agreed to look solely to the fund to satisfy their claims and, therefore, the taxpayer's payment to the fund discharged its liability to the claimant.

Section 1.461-2T(e)(2) provides that, except as provided in § 468B or the regulations thereunder, economic performance does not occur when a taxpayer transfers money or other property to a trust, escrow account, or court to provide for the satisfaction of a contested workers compensation, tort, or other liability designated in § 1.461-4(g) unless the trust, escrow account, or court is the claimant or the taxpayer's payment to the trust, escrow account, or court discharges the taxpayer's liability to the claimant.

ANALYSIS

The Service and Treasury Department have become aware of transactions in which taxpayers have established trusts purported to qualify under § 461(f), but that fail to comply with the requirements of § 461(f) or the regulations by reason of: (1) retention of powers over the trust assets (such as the power to substitute assets, to pay the contested liabilities out of assets other than those in the trust, or to limit the trustee's ability to sell the taxpayer's assets that the taxpayer transferred to the trust), contrary to the requirement that the taxpayer relinquish control over the property transferred; (2) transfer to the trust of related party notes under circumstances indicating the liability is not genuine or that there is no intent between the parties to enforce the obligation, which is not a valid transfer to provide for the satisfaction of an asserted liability; or (3) establishment of trusts for contested tort, workers compensation, or other liabilities designated in § 1.461-4(g), for which economic performance requires payment to the claimant.

Transactions that are the same as, or substantially similar to, the following transactions are identified 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 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 retains 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;

(2) 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 § 461(f) to provide for the satisfaction of an asserted liability;

(3) transactions in which a taxpayer using an accrual method of accounting transfers money or other property after July 18, 1984, to a trust purported to be established under § 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);

(4) transactions in which a taxpayer using an accrual method of accounting transfers money or other property in taxable years beginning after December 31, 1991, to a trust purported to be established under § 461(f) to provide for the satisfaction of a liability for which payment is economic performance under § 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; and

(5) 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 § 267(b)), on or after November 19, 2003, to a trust purported to be established under § 461(f) to provide for the satisfaction of any asserted liability.

Independent of their classification as “listed transactions,” transactions that are the same as, or substantially similar to, the transactions described in this notice may already be subject to the disclosure requirements of § 6011 (§ 1.6011-4), the tax shelter registration requirements of § 6111 (§§ 301.6111-1T, 301.6111-2), or the list maintenance requirements of § 6112 (§ 301.6112-1). Persons required to register these tax shelters under § 6111 who have failed to do so may be subject to the penalty under § 6707(a). Persons required to maintain lists of investors under § 6112 who have failed to do so (or who fail to provide such lists when requested by the Service) may be subject to the penalty under § 6708(a). In addition, the

Service may impose penalties on parties involved in these transactions or substantially similar transactions, including the accuracy-related penalty under § 6662.

Transactions that are the same as, or substantially similar to, the transactions described in this notice are identified as “listed transactions” for purposes of §§ 1.6011-4(b)(2), 301.6111-2(b)(2) and 301.6112-1(b)(2) effective November 19, 2003, the date this notice is released to the public. The references to specific taxable years and dates in the description of transactions covered by this notice are intended to provide consistency with the temporary and proposed regulations under § 461(f) filed with the Federal Register on November 19, 2003. Only those

transactions covered by the provisions (including the effective date provisions) of the disclosure, tax shelter registration, and list maintenance requirements under §§ 6011, 6111, and 6112 and the regulations thereunder will be subject to those requirements.

DRAFTING INFORMATION

The principal author of this notice is Norma Rotunno of the Office of the Associate Chief Counsel (Income Tax & Accounting). For further information regarding this notice, contact Ms. Rotunno at (202) 622-7900 (not a toll-free number).

26 CFR 601.602: Tax forms and instructions.

(Also, Part I, §§ 1, 23, 24, 25A, 32, 42, 59, 62, 63, 68, 132, 135, 137, 146, 151, 170, 179, 213, 220, 221, 512, 513, 685, 877, 2032A, 2503, 2523, 4261, 6033, 6039F, 6323, 6334, 6601, 7430, 7702B)