INTERNAL REVENUE SERVICE

October 3, 2000

Number: **200106005**
Release Date: 2/9/2001
CC:IT&A:01

UILC: 165.00-00
461.02-00
461.07-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR: District Counsel, District

ATTN:

FROM: Heather C. Maloy
Associate Chief Counsel (Income Tax & Accounting)

SUBJECT: Timing of Foreign Currency Loss Deductions by Cash Method Taxpayer

This Field Service Advice responds to your memorandum dated June 29, 2000 requesting reconsideration of the Field Service Advice issued on June 23, 2000 regarding the case of Tax Court case. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

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LEGEND

= Tax Court case

= District Court case

= Appeals Court case

= Circuit Z

= A

= B

= C

= D

= E

= F

= Currency X

= Currency Y

= Date i

= Date ii

= Date iii

= Date iv

=	Date v
=	Date vi
=	Date vii
=	Date viii
=	Date ix
=	Date x
=	Date xi
=	Date xii
=	Date xiii
=	Date xiv
=	Date xv
=	Month I
=	Month II
=	Month III
=	Month IV
=	Year 1
=	Year 2
=	Year 3
=	Year 4
=	Year 5
=	Year 6

$	=	Amount A
$	=	Amount B
$	=	Amount C
$	=	Amount D
$	=	Amount E
$	=	Amount F
$	=	Amount G
$	=	Amount H
$	=	Amount I
$	=	Amount J
$	=	Amount K
$	=	Amount L
$	=	Amount M
$	=	Amount N
$	=	Amount O
$	=	Amount P

ISSUES

1. Whether Petitioners may deduct losses from foreign currency trading in Year 3, when the foreign currency transactions matured, or in Year 5, when Petitioners paid to their broker the amounts owed on the foreign currency losses.

2. Whether Petitioners may deduct losses from foreign currency trading in Year 4 pursuant to I.R.C. § 461(f).

CONCLUSIONS

1. Petitioners may deduct losses from the foreign currency transactions in Year 5 when the loss amounts were paid.

2. Petitioners have not met their burden of proving that they have satisfied all of the requirements for a deduction under section 461(f) in Year 4.

FACTS

The following facts are based on your memorandum, telephone conversations, the documentation you provided, and the District Court case and Appeals Court case opinions.

A is an individual investor in foreign currency. B is A's spouse, and is a party to this action due solely to the couple's filing of joint returns for the tax years at issue. All subsequent references will be to A. C is a foreign currency broker. C and A engaged in nearly three thousand foreign currency transactions between Year 1 and Year 3. A, D (a partnership in which A was the managing partner), and C entered into several written agreements from Year 1 - Year 3 concerning these transactions. The transactions were of three types: futures, options, and cash forwards. All of the transactions were executory in nature and were unregulated. No margin account arrangement existed between C and A.

The transactions which generated the losses at issue stemmed from A's agreement to purchase from or to sell to C specific quantities of Currency X or Currency Y at a specific price for delivery in Month III and Month IV of Year 3. Pursuant to agreements between the parties dated Date i, A was required to render punctual payment of all amounts due to C and to provide collateral to cover potential losses to his account resulting from fluctuations in the foreign currency markets. In two agreements dated Date ii, A promised to provide as collateral to C a security interest in all securities and property, as well as letters of credit issued by an entity acceptable to C. C had the right to request additional collateral from A. If A defaulted on his obligations, C reserved the right to sell the collateral in its possession, draw on the letters of credit, and cancel or liquidate any or all transactions with A. The amount of collateral which A was required to post varied according to the amount of his total exposure, as the foreign currency values would increase or decrease in value on a daily basis. This amount was to be valued each month.

Foreign currency prices decreased significantly in Year 2 and Year 3, placing A in a negative trading position. C demanded that A provide additional collateral to cover his exposure to potential losses. On Date iii A acknowledged in writing that his exposure was approximately Amount A, and promised to provide additional collateral to protect C. By letter dated Date iv A agreed that any new foreign currency transactions would not increase C's exposure, and that he would provide real estate as interim collateral for any new transactions until Date vi. A failed to provide the collateral, and in Month I of Year 3 C ceased all trading with A. Another agreement, dated Date v, provided for the transfer of specific assets to C as collateral.

In Month III and Month IV of Year 3, foreign currency transactions matured. Upon their maturity (i.e. the date on which A was obligated to purchase the foreign currency), the transactions happened to come up short (i.e. the agreed-upon price for the transactions turned out to be higher than the market price on the trading date) and there was insufficient collateral to cover the losses. As a result, a balance of approximately Amount B became due and payable in A's account. C applied approximately Amount C in collateral to this amount, but no additional collateral existed to absorb the remainder. C requested A to pay the remaining Amount D balance.

When A failed to pay the negative balance, C sued him and D in the United States District Court. In its complaint of Date vii C asserted causes of action for breach of contract for failing to pay the amounts due to it and failing to post security pursuant to their agreements. A asserted numerous counterclaims challenging the validity of his transactions with C. The District Court held that the transactions between A and C were valid and enforceable, and entered a judgment in favor of C for Amount E, which included Amount D plus interest. District Court case.

A appealed the judgment to the United States Court of Appeals for the Circuit Z. On Date ix, A and C entered into an Agreement for Stay Pending Appeal [hereinafter "the agreement"]. The purpose of the agreement was to allow A to stay the execution of the District Court's judgment pending the determination of A's appeal. The agreement provided that if the Court of Appeals affirmed the District Court's judgment then A would pay C the amount of the judgment plus interest and costs. Agreement, clause 1 at 2. The agreement provided for the establishment of a trust into which A was required to deposit various liquid and non-liquid assets to be held by the E, the designated trustee for the benefit of C, as security for payment of the judgment, interest, and costs. Agreement, clause 2 at 3. A, C, and E entered into a separate agreement establishing the trust.

The stay agreement required that within three business days after its execution by the parties and its submission to the court, A deposit the following liquid and non-liquid assets into the trust: Amount F in cash plus interest earned while in the trust, pledges of A's interests in four joint ventures and two partnerships which totaled approximately Amount G, a pledge of stock in F, owned 100% by A, the assets of which totaled approximately Amount H, deeds of trust in A's personal residence and real property, sums garnished by

C, including Amount I, and cash equal to the difference between Amount J and the total garnished amounts. Agreement, clause 3 at 4. C was granted a priority security interest in the trust assets. Agreement, clause 2 at 3. A was also required to deliver assignments from the trustee to C of the various non-liquid assets for the trustee's execution in the event the judgment was affirmed. Agreement, clause 3(g) at 8.

In addition, if there were insufficient liquid assets to satisfy the judgment, then A was required to make the following quarterly cash deposits into the trust: Amount K from Date viii through Date x, and Amount L from Month II through Date xi. Agreement, clause 3(i) at 8-9. Once the level of liquid assets in the trust was sufficient to secure full payment of the judgment, interest and costs, then A would no longer be required to pay any sums to the trust, and would be entitled to receive from the trustee releases for the non-liquid assets. Id.

The agreement allowed A to withdraw certain sums from the trust with the written consent of C. C could not unreasonably condition, withhold, or delay its consent to said withdrawals. Agreement, clause 5(b) at 15. These sums included a monthly allowance of Amount N, amounts for payment of state and federal income taxes from current or prior tax years, including amounts due from payment plans, up to Amount O in attorney's fees which had already been accrued to the date of the agreement, and reasonable amounts for attorney's fees to be incurred in the future. Id. Absent the consent of C, A could not withdraw any amount from the trust if such withdrawal would reduce the amount of liquid assets in the trust below the sum of the following amounts: 1. Amount F in cash plus interest earned while in the trust; 2. any sums garnished or attached by C in any jurisdiction prior to Date viii; 3. cash in the amount of the difference between Amount J and the total garnished or attached amounts in 2; and 4. the sums of the aforementioned cash deposits to be made between Date viii and Date xi. Agreement, clause 5(c) at 15. A was required to furnish C with a monthly accounting of all assets received or disbursed by him. Id.

Until the trust had sufficient liquid assets to pay the judgment and other related costs, such as interest, A was precluded from engaging in any new foreign currency transactions, entering into any transactions which involved material financial liabilities, and encumbering or transferring his assets. Agreement, clause 9 at 18. If the Court of Appeals rendered a final decision affirming the judgment, then A was directed to pay the judgment in full with the liquid assets in the trust. Agreement, clause 10(b) at 19. If the trust did not contain sufficient liquid assets to fully satisfy the judgment, then the trustee would deliver to C executed assignments for the remaining non-liquid trust assets, or A could pay the remainder of cash into the trust or directly to C. Id.

The judgment of the District Court was affirmed by the Circuit Z. Appeals Court case. In Year 5 A paid the judgment in full to C.

The Commissioner issued a statutory notice of deficiency for tax Year 3 on Date xii in which it denied charitable contribution deductions taken in that tax year. A filed a Tax Court suit on Date xiii. The losses at issue were first raised by A in an amended Tax Court petition filed on Date xiv, in which A contended that they should be deducted in Year 3. A has argued in the alternative that pursuant to I.R.C. § 461(f) he is entitled to the loss deduction in Year 4 based on his entry into the trust agreement. [1]

LAW AND ANALYSIS

Issue 1

Section 165(a) allows a deduction for any loss sustained during the taxable year and not compensated for by insurance or otherwise. Such losses include those incurred in a trade or business or a transaction entered into for profit. I.R.C. § 165(c). The amount of the loss deduction is equivalent to the taxpayer's adjusted basis in the property, as prescribed in section 1011. I.R.C. § 165(c), I.R.C. § 1011(a); Treas. Reg. § 1.165-1(c).

Treas. Reg. § 1.446-1(c)(1)(i) provides that a taxpayer may use the cash receipts and disbursements method of accounting to compute taxable income. If a taxpayer chooses this method of accounting then any expenditures are to be deducted for the taxable year in which they are paid. Treas. Reg. § 1.461-1(a)(1). No loss deduction may be reported until the taxpayer has satisfied the obligation arising from the transaction. Helvering v. Price, 309 U.S. 409 (1940). Payment occurs when the taxpayer suffers an economic detriment, i.e. an actual depletion of his money or property. Jergens v. Commissioner, 17 T.C. 806, 809 (1951), acq., 1952-1 C.B. 2. In Jergens, a corporate employee was entitled to deduct business expenses in the year in which they were debited to his personal account. Id. Because a sufficient credit balance existed in the account, the employee suffered economic detriment and thus was entitled to a deduction. Id. See also P.G. Lake, Inc. v. Commissioner, 148 F.2d 898, 900 (5th Cir.), cert. den., 326 U.S. 732 (1945) (describing payment as a liquidation of a liability in cash); Reynolds v. Commissioner, 44 B.T.A. 342, 355 (1941), acq., 1941-2 C.B. 11 (deduction of expenses charged to personal account in year 1 that exceeded amount of funds in account should be disallowed since expenses not paid during taxable year 1); Shutly v. Commissioner, T.C. Memo. 1968-24 (business expense incurred in 1963 could not be deducted that year in absence of payment).

A taxpayer may not deduct a loss if he or she provides a note or other form of promise to pay. Williams v. Commissioner, 429 U.S. 569, 582-583 (1977). A note, even if secured by collateral, represents a promise to pay and does not constitute cash or its equivalent.

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[1] [redacted]

Id. at 578; Helvering v. Price, 309 U.S. at 413 (giving of collateral to secure note did not transform promise to pay into payment).

Where a taxpayer borrows money to purchase property and then loses or disposes of the property for less than his or her adjusted basis, the taxpayer may take a deduction in the year of the loss or disposition regardless of whether he or she has paid the loan. Larkin v. Commissioner, 46 B.T.A. 213, 220 (1942). Accordingly, a deduction is allowed in the year in which a taxpayer pays a creditor with cash borrowed from a third party. Battelstein v. Commissioner, 631 F.2d 1182, 1184 (5th Cir. 1980), cert. den., 451 U.S. 938 (1981); Crain v. Commissioner, 75 F.2d 962, 964 (8th Cir. 1935); Granan v. Commissioner, 55 T.C. 753, 755 (1971); Blumeyer v. Commissioner, T.C. Memo. 1992-647. The deduction may not be deferred until the year in which taxpayer repays the third party loan since the obligation between the taxpayer and the original creditor has been extinguished. Battelstein, 631 F.2d at 1184. To allow a deduction when the third party loan is ultimately repaid would permit taxpayers to elect the year in which to deduct their expenses. Keenan v. Commissioner, 20 B.T.A. 498, 499 (1930); McDonald v. Commissioner, T.C. Memo. 1991-54. Courts have viewed these transactions as consisting of two distinct steps, namely the purchase of property from one party, with a loss sustained upon either sale or worthlessness of the property, and the borrowing of funds from a separate party to pay for the property with an independent obligation to that party to repay the loan. Weis v. Commissioner, 13 B.T.A. 1284, 1289 (1928).

If, however, the cash used to pay the obligation is loaned by the person or entity from whom the property is purchased, then a taxpayer may not deduct the expense until such time as the taxpayer has paid back that creditor. Weis v. Commissioner, 13 B.T.A. at 1288; Barber v. Commissioner, 4 T.C.M. 104, 108 (1945), aff'd, 152 F.2d 930 (2nd Cir. 1946). In this situation, a taxpayer has not paid any money, but merely promised to pay back the same creditor. Wilkerson v. Commissioner, 655 F.2d 980, 982 (9th Cir. 1981) (taxpayer cannot deduct payment if money obtained for payment was borrowed from creditor in same transaction). The obligation between the taxpayer and the lender has not been extinguished. Battelstein v. Commissioner, 631 F.2d at 1184.

These principles were applied in the following cases involving securities transactions in which the timing of taxpayers' loss deductions was at issue. Page v. Rhode Island Hospital Trust Co., 88 F.2d 192, 193 (1st Cir. 1937) involved a cash basis taxpayer who had a margin account with his broker in which he was required to maintain a set amount of collateral to apply to settle any losses sustained. The account became grossly under-margined. Id. Rather than paying the broker the shortfall in collateral, the taxpayer merely gave the broker notes. Id. Upon the taxpayer's death, the remaining stock in the account was sold at a loss, and the estate paid the remaining amounts due on the notes to the broker. Id. The estate was not allowed a deduction until the year the proceeds from the sale of the remaining stock were applied to the satisfy the notes and the estate paid the remaining balance due. Id. at 194. The under-margined account was, in effect, a debt due to the broker. Id. Taxpayer did not suffer a loss until the broker was paid, at which time there was an actual depletion of the taxpayer's property. Id. at 193 (citing Eckert v. Burnet, 283 U.S. 140, 141 (1931)). Accord Gross v. Commissioner, 36 B.T.A. 759, 761, 762 (1937).

In Wilson v. Commissioner, 5 T.C.M. 592, 598 (1946), aff'd, 161 F.2d 556 (4th Cir.), cert. den., 332 U.S. 769 (1947), a case factually similar to Page, taxpayer's brokers extended a cash method taxpayer credit to engage in commodity transactions. Taxpayer sustained losses on these transactions in 1927 and 1928, and, as a result, became indebted to his brokers. Id. In 1941, taxpayer repaid the brokers. Id. The court held that a loss deduction was proper in 1941, the year in which taxpayer discharged his indebtedness to the brokers by making cash payments. Id.

In Bramer v. United States, 259 F.2d 717 (3rd Cir. 1958), a cash method taxpayer's brokerage account was under-margined. A third party loaned taxpayer stock to post on the account as security. Id. at 719. When taxpayer failed to pay any of the shortfall in collateral, the third party bought back the stock from the broker, who, in turn, used the money to pay the taxpayer's debt. Id. The taxpayer gave a note to the third party for the value of the redeemed stock. Id. The court held that the taxpayer was not entitled to a loss deduction until he fully paid the note to the third party, who, in effect, had been substituted for the broker as the lender. Id. at 721. The court reasoned that the loss on worthless securities is deductible when paid, if securities are paid for after the purchase date, even though payment may occur after the year of actual worthlessness. Id.

The following cases, in contrast, involved a taxpayer who borrowed funds from a third party to purchase securities which were either subsequently sold at a loss or became worthless. In Larkin v. Commissioner, 46 B.T.A. 213, 215 (1942), a cash basis taxpayer borrowed money from a bank to purchase securities. Taxpayer pledged the securities as collateral for the bank's loan. Id. at 217. The securities became worthless before the 1935 tax year. Id. at 215. Taxpayer was unable to repay the bank, and in 1934 it sold the stock for a nominal amount. Id. Taxpayer repaid a portion of the loan to the bank in 1936, and deducted the amount on his 1936 return. Id. Disallowing the taxpayer a deduction in 1936, the court held that it should have been taken in 1934 when the stock became worthless, rather than when taxpayer repaid the bank. Id. at 220. The court reasoned that where a cash basis taxpayer purchases securities with funds borrowed from a third party, a taxpayer may deduct the loss in the year when the stock becomes worthless or is sold, even though the borrowed monies may not have been repaid to the third party at that time. Id. (citing Helvering v. Price, 309 U.S. 409 (1940); Eckert v. Burnet, 283 U.S. 140 (1931)). The court distinguished this situation from one in which a cash basis taxpayer purchases stock for which payment is due at a future date and which subsequently becomes worthless. Id. at 218. In that scenario, taxpayer would not be allowed a loss deduction at the time the stock becomes worthless, but when taxpayer pays the debt with cash or its equivalent. Id. The court distinguished its facts from those of Page in that the purchase of the stocks and the borrowing of money through the margin account in Page were integral parts of the same transaction. Id. at 216. Unlike Page, the money used to purchase the securities in Larkin was borrowed from a third party and thus there were two distinct transactions, a borrowing transaction and a purchase transaction.

The Tax Court relied on Larkin in Estate of Hirsch v. Commissioner, T.C. Memo. 1983-371, 46 T.C.M. 559. A cash basis taxpayer borrowed money from a third party to engage in commodity transactions with his broker on which he sustained losses. Id. at 564. The court allowed the losses in the year in which he sustained them. Id. Relying on Larkin, the court reiterated the distinction between the gain or loss sustained on the commodity transactions and the borrowing of funds used to finance the transactions. Id. at 563-564. Distinguishing Page and Bramer, the court noted that in the facts before it, taxpayer did not borrow the funds from the brokers with whom taxpayer entered into the transactions, but from a separate entity. Id. at 564. Accord Brenner v. Commissioner, 62 T.C. 878, 883 (1974) (cash basis taxpayers who borrowed money from third parties to acquire partnership interest entitled to deduction at time of loss from failure of partnership, rather than at time of loan repayment).

In the present case, A is entitled to deduct his foreign currency losses in Year 5, the year in which he paid C the loss amounts. The foreign currency transactions were executory. A was not required to pay for the foreign currency until a future maturity date. When the contracts matured in Month III and Month IV of Year 3, A sustained losses which resulted in indebtedness to C due to his failure to post adequate collateral. Though A sustained these losses in Year 3, he chose not to liquidate the losses through payment to C in that year. A deferred payment until the conclusion of the legal proceedings. As a cash basis taxpayer, A may not deduct the losses in Year 3, when they were sustained, but rather in Year 5 when he actually discharged them through payment to C.

Although Page, Wilson, and Bramer are not factually identical to the present case, the principles set forth therein are relevant in analyzing the facts of this case. In those cases taxpayers were not permitted to deduct losses in the year sustained where they had failed to pay the underlying debt owed to brokers as a result of their under-funded margin accounts. In a margin account, there is generally a formal monitoring of losses and gains so that an investor's account balance can be debited or credited as necessary. Any loss is immediately charged against the investor's account, resulting in an actual depletion of the investor's money. In these cases, however, the taxpayers did not periodically recoup the losses to their margin accounts to cover the effect of market fluctuations. Taxpayers' deductions were disallowed since they had not paid the debt to their margin accounts. Similarly, in the present case, there was insufficient collateral to absorb the losses sustained upon the maturity of the foreign currency transactions. If sufficient collateral had been present in A's account to absorb the losses, then C would have been able to apply the collateral to the losses in Month III and Month IV of Year 3, resulting in an actual depletion of A's account and entitling him to a deductible loss in that year.

The facts of the present case are distinguishable from the third party borrowing cases cited above, namely Larkin, Hirsch, and Brenner. A did not borrow money from a third party to finance the foreign currency transactions. Rather, the transactions which A entered into required payment on a future maturity date. Though A sustained losses in Month III and Month IV of Year 3, he did not suffer an actual depletion of his funds until Year 5, at which time he paid C the loss amounts.

Section 165(b) limits A's loss deduction to the amount of his adjusted basis in the currency. In Year 3, A only paid for the foreign currency to the extent of approximately Amount P, the amount of collateral in his account on the Year 3 maturity dates. Therefore, A is not entitled to take a deduction under section 165 for the remaining Amount D in losses until he paid this amount in Year 5.

Issue 2

Section 461(f) allows a taxpayer to deduct contested liabilities if the following requirements are met: (1) the taxpayer contests an asserted liability, (2) the taxpayer transfers money or other property to provide for the satisfaction of the asserted liability, (3) the contest with respect to the asserted liability exists after the time of transfer, and (4) but for the fact that the asserted liability is contested, a deduction would be allowed for the taxable year of the transfer (or for an earlier taxable year). If these four requirements are satisfied, then a deduction shall be allowed for the taxable year of the transfer. I.R.C. § 461(f). A taxpayer has the burden of proving that each of the requirements has been satisfied. T.C. Rule 142(a); Barnette v. Commissioner, T.C. Memo. 1992-371, 63 T.C.M. 3201, 3201-24.

Section 461(f) was enacted to allow "deductions of items in the year paid, even though they are still being contested in the courts . . . to more realistically match[ ] these deductions up with the income to which they relate [rather] than . . . postpon[ing] the deduction, perhaps for several years, until the contest is settled." S. REP. NO. 830, at 100 (1964). The section therefore allows payments of contested liabilities to be deducted in the year actually paid even though they are still being contested.

Section 461(f) applies to cash basis taxpayers. Poirier & McLane Corporation v. Commissioner, 547 F.2d 161, 164 (2nd Cir. 1976), cert. den., 431 U.S. 967 (1977); Weber v. Commissioner, 70 T.C. 52, 55 (1978); Barnette, 46 T.C.M. at 3201-24; S. REP. NO. 830 at 100 (1964). Section 461(f) does not authorize deductions but relates solely to their timing. Treas. Reg. § 1.461-2(e)(1).

With respect to the first requirement, Treas. Reg. § 1.461-2(b)(2) describes the term "contest" as 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. Treas. Reg. § 1.461-2(b)(2). The filing of a lawsuit falls within the definition of a contest.

See Treas. Reg. § 1.461-2(b)(3), Example.

In the present case, A contested the liability which C asserted against him in its District Court suit by filing numerous counterclaims challenging the validity of their foreign currency agreements. Once the District Court rendered a judgment against A, he continued to contest the liability by filing an appeal. A bona fide dispute existed between C and A, namely whether A was obligated to pay the loss amount. This dispute involved an evaluation of the agreements entered into between the parties to ascertain whether they violated federal statutes relating to commodities trading. Thus, A has satisfied the first requirement.

Section 461(f)(2) requires the taxpayer to transfer money or other property to provide for the satisfaction of the asserted liability beyond his or her control. Treas. Reg. § 1.461-2(c)(1) provides that a transfer may be made to (i) to the person who is asserting the liability, (ii) to an escrowee or trustee pursuant to a written agreement (among the escrowee or trustee, the taxpayer, and the person who is asserting the liability) that the money or other property be delivered in accordance with the settlement of the contest, or (iii) to an escrowee or trustee pursuant to an order of the United States, any State or political 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. In order for money or property to be beyond the control of a taxpayer, the taxpayer must relinquish all authority over the money or property.

Example (2) under Treas. Reg. § 1.461-2(c)(2) provides that a transfer of $5,000 to an irrevocable trust pursuant to a written agreement among a trustee, the taxpayer, and the person who is asserting the liability, is one that qualifies as a transfer to provide for the satisfaction of an asserted liability.

In the present case, A and C entered into a written agreement providing for the creation of a trust to receive and hold assets transferred by A to secure payment of the judgment, interest and costs. This is one of the accepted means of transfer of funds under Treas. Reg. § 1.461-2(c)(1)(ii). The agreement provided for the creation of a trust into which A was required to transfer both money and property in amounts sufficient to satisfy the judgment. The money and property was to be transferred to and held by the trustee during the pendency of the appeal for the benefit of C as security for payment of the judgment and would be delivered to C within ten business days of a final decision affirming the judgment. Agreement, clause 2 at 3; clause 3 at 4. The agreement required that within three business days after its execution by the parties and its delivery to the court, A deposit the following liquid and non-liquid assets in the trust to be held by the trustee: Amount F in cash plus interest earned while in the trust, pledges and assignments of A's interests in four joint ventures and two partnerships which totaled approximately Amount G, a pledge of A’s 100% stock interest in F, the assets of which totaled approximately Amount H, deeds of trust for A's personal residence and real property conveying title in trust to the trustee, sums garnished by C, including Amount I, and cash equal to the difference between Amount J and the garnished amounts. Agreement, clause 3 at 4-8. These amounts appear to exceed the amount required to satisfy the asserted liability. Thus, if A transferred these amounts in the time required under the agreement, A has satisfied the requirement of transferring money and property sufficient to satisfy the asserted liability.

With respect to whether money or property has been relinquished beyond a taxpayer's control, the regulations have been interpreted to require that the money or other property for a contested liability be "irrevocably parted with" before a deduction may be taken. Chem Aero, Inc. v. United States, 694 F.2d 196, 200 (9th Cir. 1982). See also Williamette Industries, Inc. v. Commissioner, 92 T.C. 1116, 1126 (1989), aff'd, 149 F.3d 1057 (9th Cir. 1998) (no deduction allowed in 1981 under section 461(f) as taxpayer suffered no diminution of assets to satisfy liability); Edison Brothers Stores, Inc. v. Commissioner, T.C. Memo. 1995-262 (funds placed in trust administered by independent trustee and dedicated solely and irrevocably to payment of contested liability held deductible in year of transfer). In determining whether a taxpayer has relinquished control over money or property, courts have examined the following: the extent to which an agreement allows the taxpayer influence over the use of the funds, whether the taxpayer has access to the funds, and whether the timing and amount of transfers are within the taxpayer's discretion. Poirier & McClane, 547 F.2d at 165; Specialized Services, Inc. v. Commissioner, 77 T.C. 490, 502, 503 (1981).

Several cases have arisen involving transfers of money or property to trusts in which courts analyzed the control issue. In Rosenthal v. United States, 11 Cl. Ct. 165 (Cl. Ct. 1986), two partners were sued. While the litigation was pending, they executed a trust indenture with a bank providing that the bank would hold trust property to pay any obligation pending the outcome of the litigation. Id. at 166. The party asserting the liability was not informed of the trust arrangement. Id. at 168. Taxpayers made three transfers to the trust in 1975, 1976, and 1977, and deducted each of these amounts in the respective tax years. Id. at 166. The case was settled in 1981, and taxpayers paid plaintiff the settlement amount from funds outside of the trust. Id. The court held that taxpayers exerted control over the assets transferred to trust for the following reasons: the party asserting the liability had no knowledge of the trust, taxpayers were the sole beneficiaries of the trust, the timing and amount of taxpayers' payments was arbitrary, as they did not know at the time of their payments what the amount of the liability would be, the amount of their payments bore no relationship to the potential liability, and the taxpayers had the right to revoke the trust at any time. Id. at 169-171. The court concluded that since taxpayers set up the trust solely for purposes of taking advantageous tax deductions, the deduction should be allowed in 1981, the year of payment. Id. at 172.

The Tax Court similarly denied a deduction for failure to meet the control requirement in Specialized Services, Inc. v. Commissioner, 77 T.C. 490 (1981). Pursuant to an agreement with a bank, taxpayer set up a bank-managed escrow trust fund in which it deposited money for liabilities for which its subsidiary was responsible. Id. at 493. The agreement permitted taxpayer to withdraw money from the escrow fund without the consent of any of the claimants, as long as it determined that the trust contained a sufficient balance at all times to cover 100% of the claims. Id. at 504. The claimants had the right to inspect taxpayers' files to determine whether there were sufficient funds to cover the claims. Id. The court held that the agreement violated section 461(f)(2), as it allowed taxpayer to control the funds by failing to require any cosignature for withdrawals, and to independently determine if sufficient funds existed to fully pay the claims (in spite of the claimants' right to inspection). Id. at 505. The agreement also failed to authorize the bank to distribute settlement funds to the claimants. Id. at 505, 506.

The court allowed a taxpayer to deduct in 1986 amounts transferred to an escrow account to collateralize an appeal bond for 125% of the lower court judgment in Varied Investments v. United States, 31 F.3d 651, 652, 654 (8th Cir. 1994). Taxpayer deducted the amount of the appeal bond on its 1986 return. Id. at 652. In 1988 the appellate court affirmed the lower court judgment, and taxpayer paid the monies to the claimant. Id. The court concluded that a transfer had occurred, and that the taxpayer retained no control over the transferred amounts, even though it had the right to withdraw accumulated interest as long as the value of the escrow fund principal did not fall below 125% of the judgment. Id. at 655.

In the present agreement, the provision allowing A to withdraw sums from the trust must be examined to determine whether the funds he transferred to satisfy the judgment were beyond his control. As noted above, A had the ability to withdraw sums from the trust for a number and variety of expenditures. Agreement, clause 5(b) at 15. C's written consent was required to make the withdrawals, but the agreement provided that C's consent should not be unreasonably conditioned, withheld or delayed. Id. The agreement imposed specific limits on the amount of liquid assets which A could withdraw. Absent the consent of C, A could not withdraw any amount from the trust if such withdrawal would reduce the amount of liquid assets in the trust below the sum of the following amounts: 1. Amount F in cash plus interest earned while in the trust; 2. any sums garnished or attached by C in any jurisdiction prior to Date viii; 3. cash in the amount of the difference between Amount J and the total garnished or attached amounts in 2; and 4. the sums of the aforementioned cash deposits of up to Amount M to be made between Date ix and Date xi. Agreement, clause 5(c) at 15. It is not clear whether the amount of liquid assets below which A could not withdraw added up to the amount required to satisfy the judgment. It is also not clear whether A needed C's consent to make withdrawals other than those specified in clause 5(b). Under clause 5(c), A was not allowed to withdraw any amount from the trust without C's consent if the withdrawal resulted in a decrease in liquid assets below a specified level. Clause 5(c) could be construed to allow A to withdraw any sum (other than those listed in 5(b)) from the trust without C's consent as long as the amount withdrawn did not fall below the sum of the specified amounts in clause 5(c). If A was permitted to withdraw sums below the amount required to pay the judgment, then this shows that he retained control over the funds after their transfer. If, on the other hand, A's withdrawals did not fall below the amount required to satisfy the judgment, as in Varied Investments, then A did not maintain control over this amount.

It must be noted, however, that unlike the agreements in Rosenthal and Specialized Services, the present agreement provided several safeguards for C to ensure that the amounts in the trust did not fall below those required to pay the judgment. These included the need for C's written approval for all of A's withdrawals, C's right to a monthly accounting of all liquid assets received and disbursed by the trust, the granting to C of a priority security interest in the trust assets, the designation of C as a beneficiary of the agreement, and C's right to report any breach or default of the agreement to the court. Agreement, clause 2 at 3-4, clause 5(b) at 8, clause 18 at 23. The present agreement does not appear to allow A to revoke the trust at his own initiative, unlike the agreement in Rosenthal. Thus, although A had the authority to make withdrawals from the trust, the amount of withdrawals was limited by the agreement and was subject to approval and monitoring by C, unlike Specialized Services, where the taxpayer did not need the consent of the party asserting the liability to withdraw sums from the trust.

In addition, the clause containing limitations on the amounts to be withdrawn refers to the amounts of liquid assets in the trust. Agreement, clause 5(b) at 15. As noted above, the trust contained a number of non-liquid assets, such as deeds of trust to A's residence and real property, stock pledges, pledges of A's interest in joint ventures and partnerships, all of which could be used to satisfy the judgment if it was affirmed. The agreement states that A did not take any action within the past six months of its execution to encumber or transfer the non-liquid assets. It further provides that releases for the non-liquid assets could only be delivered to A when there existed sufficient liquid assets to secure full payment of the judgment, interest, and costs. Agreement, clause 6 at 16. Even if the amount below which A could not withdraw liquid assets was less than the amount of the judgment, it appears that sufficient non-liquid assets would have still existed in the trust to satisfy the judgment.

With respect to the non-liquid assets, however, it is not clear whether A relinquished complete control over them after he transferred them into the trust. Regarding A's personal residence, the agreement required A to transfer good and marketable title in trust to the trustee for the benefit of C. The Tax Court has held that as long as the taxpayer does not have the legal right to sell, lease, encumber or prevent the sale, lease or encumbrance of his home, taxpayer has effectively transferred the property beyond his control for purposes of section 461(f)(2) even if the taxpayer continues to reside in the home. Davies v. Commissioner, 101 T.C. 282, 290 (1993). Accordingly, if A continued to reside in his home, this would not constitute sufficient control to violate section 461(f)(2).

In order to satisfy the requirements of section 461(f)(2), A must not have retained control over the various partnerships, joint ventures, and F, after he transferred pledges and assignments of his interests in these concerns to the trust. The agreement provides that during the term of the trust agreement, A may cause F and D (two of the entities in which A agreed to transfer his interests to the trust) to refinance some office buildings they owned in order to raise cash to deposit into the trust. Agreement, clauses 7, 8 at 17, 18. In addition, the agreement provides that A will not permit any of the joint ventures and partnerships in which he transferred his interests to take any action to transfer or encumber any of their assets, to threaten a material default under any deed of trust, mortgage, or other loan, to engage in new foreign exchange transactions, or to undertake material financial liabilities unless approved by C in writing. Agreement, clause 9, at 18, clause 4(i) at 12, 13. The agreement thus permits A to take actions on behalf of the entities after he transferred his interests in them to the trust, and evidences a retention of control over them contrary to the requirements of section 461(f)(2). We have not encountered any cases in which a taxpayer has transferred interests in a partnership, corporation, or other entity in satisfaction of an asserted liability under section 461(f)(2), and thus are not certain how the Tax Court would interpret the control requirement in this context.

To fulfill the third 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 in satisfaction of the asserted liability. 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.

As discussed above, the agreement provides that within three business days of its execution and delivery to the court, A was to transfer money and property to the trust. Agreement, clause 3 at 4. The agreement provides for other deposits of liquid assets into the account between Date ix and Date xi. Agreement, clause 3(i) at 8-9. A contested the liability throughout these periods. A began to contest his liability for the judgment amount from the time of the maturation of the currency transactions in Month III and Month IV, Year 3 through at least Date xv, the date of the appellate court's decision affirming the district court's judgment. Assuming that A actually transferred sufficient assets over which he did not retain control within this period, the third requirement is satisfied.

Under the fourth requirement, 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 to provide for the satisfaction of such liability. Treas. Reg. § 1.461-2(e)(1). Thus, under section 461(f)(4), but for the fact that the asserted liability is contested, a taxpayer would be allowed a deduction for either the taxable year of payment or an earlier taxable year. In Davies v. Commissioner, 101 T.C. 282, 285 (1993), taxpayer transferred cash and a deed to his residence in 1987 to an escrow account created pursuant to a settlement agreement in a bankruptcy proceeding. Taxpayer deducted the cash amount and the fair market value of his residence on his 1987 tax return. Id. at 286. The court held that under section 461(f)(4), absent the contest, the taxpayer would have been allowed the deduction based on his 1987 transfer. Id. at 293.

For an expense to be deductible under the cash method of accounting, the item must be paid. Treas. Reg. § 1.461-1(a)(1). The following example from the Senate Report illustrates the application of section 461(f)(4) to a cash method taxpayer. A corporation using the cash method of accounting contests $20 of a $100 asserted tax liability in 1964, and pays the entire $100 to the tax authority in that year. The contest is settled in 1968. The corporation is entitled to a deduction of $100 in 1964. S. REP. NO. 830, Part 2, at 211 (1964). In Weber v. Commissioner, 70 T.C. 52, 58 (1978), the Tax Court held that cash basis taxpayers were not entitled to deduct an amount they sent by certified check in 1972 to the party asserting the liability based on their failure to satisfy section 461(f)(4). Id. at 57. The court held that the transfer did not constitute a payment (as required for a deduction under the cash method) since the party asserting the liability did not accept taxpayers' certified check. Id. at 58. Because taxpayers made no payment in 1972, the deduction was not allowed under section 461(f)(4) for that year. Id. See also Rosenthal, 11 Cl. Ct. at 171, n.8 (cash method taxpayers allowed deduction only in year of actual payment, i.e. when taxpayers transferred property and money to person asserting liability).

In the present case, A was required to deposit the above-mentioned money and property into the trust within three days of the execution of the agreement and its delivery to the court. Agreement, clause 3 at 4. Once A transferred sufficient money or property to the trust beyond his control to satisfy the judgment, he would have made a payment of that amount and, as a cash method taxpayer, be entitled to deduct it on his tax return for the year of the transfer. As discussed above, it appears that the value of the money and property which A was required to deposit into the trust within the three-day period provided in the agreement was in excess of the amount needed to satisfy the judgment.

A appears to have satisfied the first requirement of section 461. More information is needed to determine whether A has satisfied the second, third, and fourth requirements. A has the burden of proving that all four elements under section 461(f) have been satisfied. With respect to the second, third, and fourth requirements in particular, A must show when he transferred money and property to the trust and the value of what he transferred. A must establish that he retained no control over the funds transferred to satisfy the judgment and did not withdraw amounts from the trust which caused the level of money or property to fall below the amount of the judgment.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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Please call if you have any further questions.

Sincerely,

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