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Accrual of Deduction for Disputed Amounts

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A party against whom a claim is made may set aside an amount for payment of the claim, even as that party continues to dispute its liability. For example, the obligor may be required to make a payment in order to continue to dispute the claim under judicial or administrative requirements of a court or taxing jurisdiction; or a set-aside may be necessary as an inducement to prevent the counter-party from seeking to secure its claim through means such as filing a lien or seeking the forced sale of property. If, in the absence of a dispute, payment of the claim would give rise to a deduction for income tax purposes, the question arises whether payment with respect to a *disputed* claim, made either to the person asserting the claim or to a third party, will provide the obligor with a deduction in the year of payment.

In general, an amount may be deducted by a taxpayer using an accrual method of accounting only "in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability."[1] Accordingly, if liability with respect to a claim is contested in good faith, a deduction generally cannot be claimed under the basic "all events" test, since the existence of the contest indicates uncertainty as to whether the liability is in fact due.

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Indeed, the existence of a contest was held by the Supreme Court in *United States v. Consolidated Edison Co.* to preclude a deduction by an accrual method taxpayer, even when payment of the amounts involved (in that case, real property taxes) had already been made by the taxpayer to the claimant (the taxing governmental authority).[2] Under the rule laid down by the Supreme Court in *Consolidated Edison*, if a contest was commenced by the taxpayer in the year of payment, no deduction could be claimed before the year of entry of a final judgment by a court against the taxpayer in respect of the amount of the liability.

In order to ameliorate the harsh result of *Consolidated Edison*, section 461(f) was added to the Internal Revenue Code ("Code"). Under that provision, "[i]f (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 [section 461(h)]," then the deduction will be allowed in the year of the transfer notwithstanding the ongoing contest. The Treasury Regulations under section 461(f) have long made clear that the "transfer" described in that provision can be made to a third party trustee or escrow agent—rather than to the claimant itself—but only if a series of additional requirements is satisfied.

A recent case, *Goodrich Corporation v. United States*,[3] deals mainly with the second of the four tests under section 461(f)—namely, whether the taxpayer's actions in establishing and funding a trust were sufficient to constitute a "transfer" of money or other property to provide for the satisfaction of the asserted liability. The case is particularly interesting because the "liability" for which the taxpayer wished to claim a deduction was interest expense owed with respect to a Federal income tax deficiency, so that the creditor for whose benefit the "transfer" was allegedly made and the taxing authority asserting that no deduction was available as a result of that transfer were one and the same—the Internal Revenue Service.

Facts in Goodrich Corp.

Goodrich Corp. ("Goodrich"), the parent of a group which has been involved in other reported tax cases in recent years,[4] acquired Rohr, Inc. and its subsidiaries ("Rohr") in 1997. A tax examination of Rohr for the years 1986 through 1989 was underway at the time of the acquisition.

The IRS issued a notice of deficiency to Rohr during 2000 (three years after the acquisition), asserting that an additional $85,000,000 of tax was due from Rohr with respect to the tax years

1986 through 1989. As eleven to fourteen years had already passed since the years to which the notice of deficiency related, the interest then claimed by the IRS to be owed with respect to the asserted tax deficiencies was $230,000,000, an amount almost three times the underlying tax liability.

Goodrich contested that Rohr owed the asserted underlying tax obligations, but also sought advice from the accounting firm of Arthur Andersen with respect to "trust strategies" that might give rise to tax benefits for contested liabilities. Under a strategy described by Arthur Andersen in a PowerPoint presentation and ultimately implemented by Goodrich and Rohr with Bank One Trust Company, N.A., as trustee, Rohr established a trust in December 2001 for the stated purpose of holding property to be used for the payment of its then-contingent interest liabilities to the IRS; amounts were apparently not set aside with respect to the tax liabilities themselves.

Rohr transferred to the newly formed trust unsecured promissory notes with a face value of $250,000,000 that Rohr had received from Goodrich; these notes allegedly evidenced amounts owed to Goodrich by other subsidiaries on account of funds advanced to them by Goodrich and by reason of intercompany sales of goods and services.[5] Goodrich notified the IRS by certified mail that the trust had been established.

Goodrich characterized the transfer of the bulk of the notes ($229,000,000) as attributable to interest that had accrued with respect to the alleged tax deficiencies of Rohr from 1986 through the date of creation of the trust in December 2001. That amount was claimed as an interest expense deduction on Goodrich's consolidated Federal income tax return for 2001. The Internal Revenue Service ultimately disallowed that deduction, but the deductibility of the amount claimed on Goodrich's 2001 return is being disputed by Goodrich in a separate case in the Tax Court and was not considered by the District Court in its recent decision.

Interest continued to accrue on the asserted tax deficiencies, and Goodrich characterized a further $13,600,000 portion of the contributed notes as relating to interest on the asserted tax deficiencies that accrued from December 20, 2001 (the date the trust was created) through June 30, 2002. Goodrich asserted that it was allowed a deduction during 2002 for this interest expense, and that this deduction gave rise to a net operating loss carryover for that year that could be carried back to 1997. On the basis of this carryback, Goodrich claimed a refund of its 1997 Federal income tax. When that claim for refund was denied by the IRS, Rohr brought this suit in the District Court.

One of the notes contributed to the trust was ultimately paid after the settlement with the IRS in 2006 of the underlying asserted tax liabilities, with the proceeds of payment of the note being used by the trustee to make payment to the IRS with respect to those liabilities. The other notes were returned by the trustee to Rohr.

In the District Court, each side sought summary judgment on the question of whether the trust arrangement met the requirement of section 461(f) that there be a transfer of money or other property to provide for the satisfaction of the liability. The court ultimately agreed with the government that the arrangement did not meet that requirement. The court therefore did not reach the government's further argument that the arrangement also failed to meet the further requirement of section 461(f) that, but for the fact of the contest, a deduction would be allowed for the taxable year of the transfer; the government argued that Rohr failed to meet this requirement because the property assigned by Rohr to the trust (notes issued to Goodrich by other subsidiaries) could not be used to pay the government.

The Treasury Regulations promulgated under section 461(f) provide that a taxpayer may provide for the satisfaction of an asserted liability by transferring money beyond the taxpayer's control to "[a]n 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" (emphasis added).[6] Neither party contested the validity of the regulation.

The IRS contended that the arrangement did not meet this "written agreement" requirement because the person asserting the liability—that is, the IRS itself—was not a party to the trust agreement and did not consent to it. Goodrich responded that the IRS's failure to respond to the notice (which, by its terms, sought no response) should be interpreted as assent to the creation of the trust, or that equitable estoppel could be applied to the IRS by reason of its failure to respond.

The court referred to various cases supporting the proposition that the government's silence was more suggestive of a *refusal* to voluntarily assent; noted that courts have imposed a heavy burden on litigants attempting to asset an estoppel defense against the United States; and found that there was no case applying estoppel against the government in similar circumstances. Accordingly, the court declined to apply the equitable estoppel doctrine here.

Goodrich further argued that the IRS had been put on notice of the arrangement, because the IRS had been mailed (and had received) a description of the trust and a copy of the trust agreement; and that this alone should suffice to meet the written agreement requirement. In support of this position, Goodrich cited cases decided by the Court of Appeals for the 8th Circuit and the 9th Circuit in which the requirements of section 461(f) had been considered satisfied where the person asserting the claim had knowledge of the arrangement.[7] Cases decided by the Court of Appeals for the Second Circuit and by the Claims Court, however, supported the government's position here that affirmative assent by the claimant was needed in order for the favorable timing rule of section 461(f) to apply, and the court found this reading of the relevant regulation in those cases to be more persuasive.[8]

The court also noted that a requirement of affirmative assent was consistent with the intent underlying section 461(f) as evidenced by the legislative history under the Revenue Act of 1964 for that provision, which was intended to permit a taxpayer to claim a deduction "where the payment has actually been made."[9] Further, the court observed that, without the claimant's involvement in or consent to a written agreement, an arrangement was more likely to be devised under which a deduction was claimed for the "transfer" of funds that were not truly outside the transferor's control (inconsistent with the rationale of section 461(f)); and that the requirement of involvement of the claimant (especially where the claimant was the government in an income tax matter) made it less likely that a trust would be overfunded so as to obtain the benefit of an over-generous tax deduction while the underlying claim was being contested.

Observations

Several facts mentioned in the District Court's opinion in *Goodrich*, although not directly relevant to analysis of the section 461(f) issue, foreshadowed a decision against the taxpayer. These included that the underlying tax dispute for 1986-1989 (more than 20 years before the *Goodrich* opinion was issued!) involved an abusive tax shelter, and that a "strategy" to accelerate the claiming of interest deductions had been promoted to Goodrich by a national accounting firm using PowerPoint slides. With this background, it was sufficient for the District Court to find that no qualifying "transfer" had occurred, and it did not need to address a further argument apparently made by the government, to the effect that the arrangement here failed to meet the statutory requirements because the assets contributed to the trust were notes of affiliates of the taxpayer, rather than some more liquid and easily valued security. Perhaps that issue will be explored in other litigation relating to the same tax "strategy."

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1 Reg. §1.461-1(a)(2). The "economic performance" requirement is set out in IRC §461(h). Somewhat different rules apply to taxpayers using the cash receipts and disbursements method of accounting.

2 *United States v. Consolidated Edison Co. of New York, Inc.*, 366 U.S. 380 (1961).

3 109 AFTR 2d 2012-556 (D. Ct., Jan. 18, 2012).

4 See *Coltec Industries, Inc. v. United States*, 454 F. 3d 1340 (Fed. Cir. 2006), rev'g 94 AFTR 2d 2004-6708 (Ct. Fed. Cl. 2004). The contested liability by reason of which the trust discussed in *Goodrich* was established apparently related at least in part to Coltec Industries, because the settlement was funded through a payment made by Coltec Industries on its promissory note held by the trust.

5 The decision to fund the trust with notes evidencing obligations of other subsidiaries of Goodrich, rather than with notes of Goodrich or of Rohr itself, was no doubt made with a view to bolstering the argument that there has been a transfer of cash or other property as required by section 461(f), since the transfer of a note of an obligor with respect to the obligor's own expense is generally not viewed as equivalent to "payment" of the expense for tax accounting purposes. See, e.g., Reg. §1.461-2(c)(1)(iii)(D).

6 Reg. §1.461-2(c)(1)(i).

7 *Chem Aero, Inc. v. United States*, 694 F. 2d 196 (9th Cir. 1982); *Varied Investments, Inc. v. United States*, 31 F. 3d 651 (8th Cir. 1994).

8 *Poirier & McLane Corp. v. Commissioner*, 547 F. 2d 161 (2d Cir.); *Rosenthal v. United States*, 58 AFTR 2d 86-6125 (Cl. Ct. 1986).

9 S. Rep. No. 830, 88th Cong., 2d Sess., at 100.

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