

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM
August 10, 1999

Number: **199947007**
Release Date: 11/26/1999
CC;DOM;IT&A:B6
Third Party Contact:
Index (UIL) No.: 461.09-01
CASE MIS No.: TAM-109572-99

Appeals

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:
Date of Conference:

LEGEND:

Taxpayer =

X =

Y =

Z =

D =

Year 1 =

Case 1 =

ISSUE:

Does section 461(h) of the Internal Revenue Code prevent Taxpayer from deducting the amount of a judgment entered against him, prior to its payment?

CONCLUSION:

Section 461(h) of the Code prevents Taxpayer from deducting the amount of a judgment entered against him, prior to its payment.

FACTS:

Taxpayer has engaged in the oil and gas business and used the accrual method of accounting to report his income from such business. In this case, he claims a deduction in Year 1 in the amount of a judgment entered against him in that year. The appeals officer has tentatively determined that the economic performance requirement found in section 461(h) of the Code bars deduction of the judgment prior to its payment. As explained below, resolution of this issue requires us to determine the nature of Taxpayer's liability.

According to the court's Findings of Fact and Conclusion of Law, a binding contract was reached for the sale of certain royalty interests in an oil lease. Plaintiffs were the owners of the interests and were represented by X. Another party acting as agent, Y, represented the buyer. As explained below, the identity of the buyer (or buyers) is not entirely clear from the court's findings. Portions of the findings suggest Taxpayer was a buyer, while other portions indicate that Taxpayer employed a corporate entity, Z, to enter into the contract. In any event, the court found that the buyer had failed to perform its obligations under the sale contract and that, as a result, plaintiffs had suffered damages in the amount of D dollars, the amount by which the fair market value of the royalty interests had declined between the date of the contract and the time the buyer failed to perform.

The court further found that Taxpayer never intended to perform (or cause to be performed) the buyer's obligation under the contract unless he was able to resell the royalty interests for a profit. Because Taxpayer was unable to resell the interests for a profit, the default occurred. The court found Taxpayer "guilty of fraud, both actual and constructive."

The court entered a separate Final Judgment in the amount of D dollars. The record in this case indicates that Taxpayer has not paid any portion of the judgment.

LAW AND ANALYSIS:

Section 1.461-1(a)(2) of the Income Tax Regulations provides that under an accrual method of accounting, a liability is incurred, and generally is taken into account for Federal income tax purposes, 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.

Section 461(h)(2)(C) of the Code provides that if the liability of the taxpayer requires a payment to another person and arises under any worker's compensation act, or arises out of any tort, economic performance occurs as the payments to such person are made.

The legislative history of Code section 461(h) suggests that Congress imposed the economic performance requirement because of a concern that permitting taxpayers to deduct otherwise incurred liabilities that are to be paid in the future results in an overstatement of deductions, given the time value of money:

Allowing a taxpayer to take deductions currently for an amount to be paid in the future overstates the true cost of the expense to the extent the time value of money is not taken into account; the deduction is overstated by the amount the face value exceeds the present value of the expense.

Staff of the Joint Committee on Taxation, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 260 (1984). It also appears that Congress viewed worker's compensation and tort liabilities as presenting special problems due to the lapse of time between accrual and payment. Reference is made to case law permitting deductions of amounts to be paid at uncertain future dates:

[T]he Ninth Circuit held that the fact of the liability under workmen's compensation laws is determined in uncontested cases in the year in which injury occurs, even though medical services may be rendered and disability may occur at a future time.

Id. at 259.

In drafting regulations interpreting the economic performance requirement, Treasury extended the payment requirement to certain liabilities arising from the breach of contract. The preamble to the regulations indicates a concern that drawing a distinction between tort and other liabilities may prove difficult in some cases:

The payment rule was chosen because of the nature of the liabilities and the difficulty in applying the statutory rules to these liabilities. For example, in the case of liabilities arising out of the breach of contract or violation of law, it is often difficult to distinguish among actions based on breach of contract, violation of law, and tort because many such actions are brought on alternative grounds and settled without any objective determination of the prevailing theory.

T.D. 8408, 1992-1 C.B. 158, 159. This regulatory extension of the payment requirement has no bearing on this case, however, because it applies only to liabilities otherwise incurred in taxable years beginning after December 31, 1991. Treas. Reg. § 1.461-4(k)(3).

Thus, the economic performance rules prohibit Taxpayer from deducting the amount of the judgment prior to its payment, if the judgment represents a liability arising out of a tort. We conclude that it does. The court's Findings of Fact and Conclusion of Law refute Taxpayer's assertion that the liability is based on a simple breach of contract. Taken as a whole, the document indicates that Taxpayer was not a party to the contract and that Taxpayer's personal liability is premised on his fraud. True, the court did state

that Taxpayer was “a principal or buyer as well as an agent.” But the court also stated that “The corporate fiction, if any, of [Z] was used as a sham by [Taxpayer] to perpetrate a fraud by [Taxpayer] and should be disregarded.” If Taxpayer were a party to the contract and his liability were based on simple breach of that contract, there would be no need to disregard the corporate entity.

Correspondence referenced by the court in its findings also indicates that Z, not Taxpayer, was the contracting party. Y indicates in an offer letter to X that it will purchase the royalty interests for the account of Z. Another letter, one from Y to Taxpayer, confirms the existence of a sale agreement between the sellers and Z. It also contains a signature line for Z that appears to be signed by Taxpayer in a representative capacity, as an officer of the corporation.

Moreover, the Final Judgment of the court emphasizes Taxpayer’s fraud, not any breach of contract, in finding Taxpayer liable: “[Taxpayer] was guilty of such false pretenses, or false representations, as to be liable to Plaintiffs in this transaction.”

Taxpayer points out that the amount of the judgment represents the difference between the contract price of the royalty interests and the fair market value of the interests upon default and that these are the type of benefit of the bargain damages that are traditionally awarded in contract cases. But benefit of the bargain damages are also awarded in fraudulent inducement cases, so this point is not conclusive. Case 1.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the Taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.