Continental Nut Co. v. Commissioner, 62 T. C. 771 (1974)

A 'sale' of property to the state for unpaid taxes does not constitute a payment under section 461(f) of the Internal Revenue Code if the taxpayer retains control over the property during the redemption period.

Summary

In Continental Nut Co. v. Commissioner, the U. S. Tax Court ruled that a 'sale' of property to the State of California due to unpaid taxes did not allow the taxpayer to accrue and deduct the tax liability under section 461(f) of the Internal Revenue Code. The company, operating on an accrual basis, had received additional property tax assessments for prior years, which were sold to the state, but the company retained possession and use of the property during the redemption period. The court found that the 'sale' did not transfer control of the property away from the taxpayer, thus not satisfying the requirements of section 461(f) for a deductible contested liability.

Facts

Continental Nut Company, a California corporation, faced additional property tax assessments for 1963-1965, which it appealed. Despite a reduced assessment, the taxes remained unpaid, leading to a 'sale' of the property to the State of California on June 30, 1966, under California law. The company continued to use the property without restriction during a five-year redemption period. In 1969, further assessments were levied, and the company accrued these as liabilities on its books for the fiscal year ending June 30, 1970, but did not pay them until July 1, 1971.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Continental Nut's 1970 federal income tax return due to the deduction of the contested property taxes. Continental Nut petitioned the U. S. Tax Court for a redetermination of the deficiency, arguing that the 'sale' to the state constituted a payment under section 461(f).

Issue(s)

1. Whether the 'sale' of property to the State of California for unpaid taxes constitutes a transfer of money or other property to provide for the satisfaction of an asserted liability under section 461(f) of the Internal Revenue Code.

Holding

1. No, because the 'sale' did not effectively place the property beyond the control of the taxpayer as required by section 461(f)(2). The taxpayer retained possession and unrestricted use of the property during the redemption period.

Court’s Reasoning

The court reasoned that for a contested liability to be deductible under section 461(f), there must be a transfer of money or property beyond the taxpayer’s control. The court highlighted that the ‘sale’ to the State of California under section 3436 of the California Revenue and Taxation Code did not divest the taxpayer of title or control over the property during the five-year redemption period. It cited California case law, stating that the ‘sale’ merely started the redemption period and established a lien, but did not transfer ownership or control to the state. The court emphasized that only after the redemption period would the state gain title and control over the property. Therefore, the court concluded that the ‘sale’ did not meet the criteria of section 461(f)(2), as the taxpayer did not relinquish control over the property.

Practical Implications

This decision clarifies that for taxpayers on an accrual basis, a ‘sale’ of property to the state due to unpaid taxes does not qualify as a payment of a contested liability under section 461(f) if the taxpayer retains control and use of the property during the redemption period. This ruling affects how taxpayers should account for contested tax liabilities and underscores the importance of the transfer of control in determining the deductibility of such liabilities. Legal practitioners must advise clients that only a transfer that effectively removes the property from the taxpayer’s control will satisfy section 461(f). This case has been referenced in subsequent cases involving contested tax liabilities and the application of section 461(f).

