92 T.C. 1116 (1989)

A letter of credit placed in trust to satisfy a contested liability does not constitute a transfer of money or other property under Section 461(f)(2) of the Internal Revenue Code, and therefore, does not allow for the deduction of the contested liability in the year the letter of credit is issued.

Summary

Willamette Industries, an accrual method taxpayer, sought to deduct a contested liability in 1981 by placing a letter of credit in trust. The liability stemmed from antitrust litigation related to plywood pricing. The Tax Court disallowed the deduction, holding that the letter of credit was not a transfer of money or other property as required by IRC Section 461(f)(2). The court reasoned that a letter of credit is merely a promise to pay, not an actual transfer of funds or property, and thus does not meet the statutory requirements for deducting contested liabilities. This case clarifies that a mere promise to pay, even if secured, is insufficient for the "transfer" requirement under Section 461(f)(2).

Facts

Willamette Industries faced numerous private antitrust lawsuits related to its plywood pricing practices. In 1981, after an unfavorable appellate court ruling, Willamette sought to deduct $20 million for this contested liability under IRC Section 461(f). To do so, on December 28, 1981, Willamette obtained a $20 million letter of credit from Bank of America and placed it into an irrevocable trust. The letter of credit was payable to the trustee on December 31, 1986, or earlier upon a draw. Willamette entered into a loan agreement with the bank to cover any draws on the letter of credit. The antitrust litigation was eventually settled in 1983, and payments were made to plaintiffs using funds partly from draws on the letter of credit and partly from Willamette directly.

Procedural History

The Commissioner of Internal Revenue disallowed Willamette's $20 million deduction for the 1981 tax year. Willamette petitioned the Tax Court, contesting the deficiency. The Tax Court severed the Section 461(f) issue for partial trial. This case represents the Tax Court's decision on that severed issue.

Issue(s)

1. Whether the placement of a letter of credit in trust to provide for the satisfaction of a contested liability constitutes a "transfer of money or other property" within the meaning of Internal Revenue Code Section 461(f)(2), thereby allowing for a deduction of the contested liability in the year of the transfer.

Holding

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1. No, because a letter of credit is not considered a transfer of money or other property under Section 461(f)(2). The deduction is disallowed for the 1981 tax year.

Court's Reasoning

The Tax Court analyzed Section 461(f), which allows for the deduction of contested liabilities in the year of transfer if certain conditions are met, including the "transfer of money or other property." The court distinguished cases cited by Willamette, such as *Griffith v. Commissioner* and *Watson v. Commissioner*, which held that a letter of credit could be considered "property" under Section 1001(b) for determining gain upon the sale of an asset. The court emphasized that Section 1001(b) is not in pari materia with Section 461(f)(2). The court stated, "Section 1001(b), however, does not stand in pari materia with section 461(f)(2)."

The court reasoned that a letter of credit is merely a commitment by a bank to provide funds if certain conditions are met; it is not an actual transfer of money or property by the taxpayer. Referencing *Chase Manhattan Bank v. Equibank* and *Chapman v. United States*, the court highlighted that a letter of credit is a commitment to make a loan, not a loan itself, and no money is transferred until the specified events occur. The court used hypothetical balance sheets to illustrate that obtaining a letter of credit merely substitutes a contingent liability to the bank for the contested liability, without any actual diminution of the taxpayer's assets, except for the fees paid for the letter of credit itself. The court stated, "Petitioner thus exchanged a contingent liability to the antitrust plaintiffs for a contingent liability to the bank."

The court distinguished *Chem Aero v. United States*, where the Ninth Circuit allowed a deduction when a letter of credit was collateralized by a certificate of deposit. In *Chem Aero*, the actual funds from the certificate of deposit ultimately paid the liability. However, in Willamette's case, there was no such pledge of property. The court concluded that the arrangement was akin to a surety bond, which does not constitute a transfer under Section 461(f). The court stated, "In sum, the trust arrangement here amounts to nothing more than the bank bonding the liability. This does not satisfy the requirements of section 461(f)."

Practical Implications

Willamette Industries establishes that merely securing a contested liability with a letter of credit is insufficient to meet the "transfer" requirement of IRC Section 461(f)(2) for deduction purposes. Taxpayers seeking to deduct contested liabilities in the year of transfer must ensure an actual transfer of cash or other tangible property beyond their control. This case highlights the importance of the specific language of Section 461(f)(2) and the need for a genuine economic outlay to secure a deduction for contested liabilities. Legal practitioners should advise clients that simply obtaining a letter of credit, without an actual transfer of funds or property, will not suffice for a current deduction under Section 461(f) when utilizing a letter of

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credit to satisfy contested liabilities. Subsequent cases have consistently followed *Willamette Industries* in requiring an actual transfer of assets, not just a promise to pay, for deductibility under Section 461(f)(2).

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