Warnock Davies v. Commissioner, 101 T. C. 282 (1993)

A taxpayer can deduct contested liabilities under section 461(f) if they meet all statutory requirements, even if the liability is not yet finalized or formally asserted in writing.

Summary

Warnock Davies, former CEO of bankrupt Newbery Corp. , settled potential bankruptcy claims by transferring $80,000 and his residence into escrow in 1987. The issue was whether these transfers qualified as deductions under section 461(f). The court ruled that Davies met all requirements for a deduction: an asserted liability existed, control over the transferred assets was relinquished, and the contest prevented an otherwise allowable deduction. This decision clarifies that a liability can be 'asserted' without being in writing and expands the understanding of what constitutes relinquishment of control in the context of contested liabilities.

Facts

Warnock Davies was the president and CEO of Newbery Corp. until his resignation in 1987. Newbery faced financial difficulties and filed for bankruptcy. Davies was informed of potential claims against him for preferential transfers. To settle these claims, Davies and Newbery agreed to a settlement in December 1987, where Davies deposited $80,000 and a deed to his residence into escrow. Davies continued to live in the residence post-settlement. The settlement required bankruptcy court approval, which was not granted until 1990 after multiple attempts.

Procedural History

Davies filed his 1987 tax return claiming deductions for the $80,000 and the fair market value of his residence. The Commissioner disallowed these deductions, leading Davies to petition the U. S. Tax Court. The court heard the case and issued its opinion in 1993, ruling in favor of Davies and allowing the deductions under section 461(f).

Issue(s)

1. Whether Davies contested an 'asserted liability' under section 461(f)(1).
2. Whether Davies transferred money or property beyond his control to provide for the satisfaction of the asserted liability under section 461(f)(2).
3. Whether, but for the contest, a deduction would have been allowed under section 461(f)(4).

Holding

1. Yes, because Newbery's oral threats and subsequent actions constituted an asserted liability, even without a formal written claim.

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2. Yes, because Davies relinquished control over the $80,000 and the residence by placing them in escrow, despite continued occupancy of the residence.
3. Yes, because absent the contest, Davies would have been entitled to a deduction for returning previously included income to Newbery.

Court’s Reasoning

The court applied section 461(f) and its regulations to determine if Davies met the criteria for deducting the escrowed items. It rejected the Commissioner’s argument that an asserted liability must be in writing, citing the absence of such a requirement in the statute or its legislative history. The court also found that Davies relinquished control over the transferred assets, drawing parallels to cases where assets were secured to satisfy a liability. The court emphasized that the contest over the liability prevented a deduction that would otherwise be allowable under the claim of right doctrine, as established in *North American Oil Consol. v. Burnet*. The decision underscores the policy of matching income and deductions to the appropriate tax year.

Practical Implications

This ruling expands the scope of what constitutes an ‘asserted liability’ for tax deduction purposes, allowing for deductions of contested liabilities without a formal written claim. It clarifies that control over property can be relinquished by placing it in escrow, even if the taxpayer continues to use the property. Practitioners should consider this when advising clients on the deductibility of settlement payments in bankruptcy or similar situations. The decision also reinforces the application of the claim of right doctrine in contested liability scenarios. Subsequent cases may cite Davies to support deductions for payments made to settle contested liabilities, especially in bankruptcy contexts.

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