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INCOME TAXATION

DEDUCTIBILITY OF FUNDS TRANSFERRED INTO TRUST TO SATISFY CONTESTED LIABILITY

Poirier & McLane Corp. v. Commissioner

Enacted to ensure the realistic reporting of income by accrual basis taxpayers,¹ section 461(f) of the Internal Revenue Code affords a deduction for money or other property transferred to provide for the satisfaction of a contested liability.² Although the statute is

¹ Accrual basis taxpayers report income and deductions in the year in which the items accrue. STANLEY & KILCULLEN, *THE FEDERAL INCOME TAX* § 451, at 202 (4th ed. 1961). The distinction between the accrual basis taxpayer and the cash basis taxpayer is that "the right to receive and not the actual receipt . . . determines the inclusion of . . . [an] amount in gross income . . ." for the accrual basis taxpayer. 2 J. MERTENS, *LAW OF FEDERAL INCOME TAXATION* § 12.60 (1942) (emphasis in original). An accrual basis taxpayer generally may deduct an expense in the year in which "all events . . . occur [to] fix the amount of the [item] and determine the liability of the taxpayer to pay it." *United States v. Anderson*, 269 U.S. 422, 441 (1926); see, e.g., *Trinity Constr. Co. v. United States*, 424 F.2d 302 (5th Cir. 1970); *Eastman Kodak Co. v. United States*, 534 F.2d 252 (Ct. Cl. 1976); *Putoma Corp. v. Commissioner*, 66 T.C. 652 (1976). For a discussion of this "all events" test, see Freeman, *Tax Accrual Accounting For Contested Items*, 56 MICH. L. REV. 727, 747 (1958) [hereinafter cited as Freeman]; Grubich, *Further Erosion of "All Events" Test?*, 6 TAX ADVISOR 145 (1975); Oshatz, *Accrual and Deductions of Contested and Contingent Liabilities*, 26th N.Y.U. INST. OF FED. TAX. 747, 750 (1968) [hereinafter cited as Oshatz].

The accrual taxpayer may not claim a deduction unless the amount of the expense can be determined with a fair degree of certainty. *Continental Tie & Lumber Co. v. United States*, 286 U.S. 290 (1932), discussed in Freeman, *supra*, at 734-35. See generally 2 J. MERTENS, *LAW OF FEDERAL INCOME TAXATION* § 12.60-90 (1942 & Supp. 1954). Traditionally, where the liability was contingent and contested by the taxpayer, the all events test was not satisfied. See *Dixie Pine Prods. Co. v. Commissioner*, 320 U.S. 516 (1944). The Internal Revenue Service nonetheless allowed accrual basis taxpayers to deduct the payment of a contested liability. See Oshatz, *supra*, at 755. Despite the position adopted by the Service, in *United States v. Consolidated Edison Co.*, 366 U.S. 380 (1961), the Supreme Court held that an accrual basis taxpayer "might claim a deduction only for the taxable year in which its liability for the [expense] was finally adjudicated," irrespective of whether payment of the contested liability had been made in an earlier year. *Id.* at 386 (quoting *Dixie Pine Prods. Co. v. Commissioner*, 320 U.S. 516, 519 (1944)). It has been observed that the *Consolidated Edison* decision, in effect, "thwart[ed] the objective of matching receipts and disbursements attributable to specific taxable years." *Poirier & McLane Corp. v. Commissioner*, 63 T.C. at 575 (1975), *rev'd*, 547 F.2d 161 (2d Cir. 1976), *cert. denied*, 97 S. Ct. 2925 (1977). In response to the decision, Congress enacted section 461(f) of the Internal Revenue Code, in order to ensure that deductions and income are more realistically matched. See S. REP. NO. 830, 88th Cong., 2d Sess. 100-01 (1964), reprinted in [1964] U.S. CODE CONG. & AD. NEWS 1673, 1773.

² I.R.C. § 461(f) provides in pertinent part:

- If— (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 the transfer, and

silent on the point, the applicable regulation requires that a transfer in the form of an escrow or trust arrangement be made pursuant to a written agreement among the escrowee or trustee, the taxpayer, and the person asserting the liability.³ Recently, in *Poirier & McLane Corp. v. Commissioner*,⁴ the Second Circuit literally construed this regulation, holding that a transfer to a trustee for payment of a contested liability is not deductible when the persons asserting the liability have not assented to the trust agreement.⁵

Poirier & McLane Corporation, a New York construction firm reporting income on an accrual basis, was a named defendant in various suits arising from two distinct construction contracts.⁶ On December 31, 1964, the corporation entered into an agreement with the Manufacturer's Hanover Trust Company under which a trust fund was created to provide for payment of any obligations Poirier & McLane might incur as a result of the pending litigation.⁷ Although the claimants were named as trust beneficiaries,⁸ they neither signed the agreement nor were aware of its existence.⁹ Poirier & McLane, pursuant to section 461(f), claimed a deduction for the

(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), then the deduction shall be allowed for the taxable year of the transfer.

³ Treas. Reg. § 1.461-2(c) (1964) provides in part:

A taxpayer may provide for the satisfaction of an asserted liability by transferring money or other property beyond his control (i) to the person who is asserting the liability, (ii) to an escrowee or trustee pursuant to a written agreement (among the escrowee or trustee, the taxpayer, and the person who is asserting the liability)

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⁴ 547 F.2d 161 (2d Cir. 1976), *cert. denied*, 97 S. Ct. 2925 (1977), *rev'g* 63 T.C. 570 (1975).

⁵ 547 F.2d at 162.

⁶ 63 T.C. at 571-72. In 1956, Poirier & McLane had contracted with the New York City Transit Authority to reconstruct a subway tunnel and station. *Id.* at 571. The corporation was obligated under the contract to indemnify the Transit Authority for all damage claims resulting from the work performed. *Id.* In 1958, Poirier & McLane contracted with the State of New York to construct a parkway; the contract included a similar indemnification provision. Actions for negligence and trespass arising from the performance of the contracts were commenced against the corporation. *Id.* at 571-72. The aggregate damages sought in these actions totaled more than \$14,000,000. *Id.* A \$1,100,000 trust was established in 1964 naming the claimants as the beneficiaries, to provide for the payment of claims adjudicated in favor of the claimants. *Id.* Litigation began in 1960 and resulted in a judgment in 1969 against Poirier & McLane for more than \$11,600. *See* *Bronxville-Palmer Ltd. v. State*, 34 App. Div. 2d 714, 309 N.Y.S.2d 672 (3d Dep't 1970), *vacated*, 36 App. Div. 2d 10, 318 N.Y.S.2d 57 (3d Dep't 1971), *modified mem.*, 30 N.Y.2d 760, 284 N.E.2d 577, 333 N.Y.S.2d 422 (1972).

⁷ 63 T.C. at 572. The trust instrument stated that the "sole purpose" of the trust was to satisfy any liability of the settlor to the claimant-beneficiaries arising from the pending actions. *Id.* It went on to identify each claimant and to provide that the trust was created pursuant to § 461(f) of the Internal Revenue Code. 67 T.C. at 573.

⁸ *Id.*

⁹ 547 F.2d at 163-64.

transferred funds on its 1964 income tax return. Finding that the trust did not comply with requirements of the Code, the Commissioner of Internal Revenue disallowed the deduction.¹⁰ The Tax Court upheld the deduction, however, noting that nothing in section 461(f) or its legislative history requires that the claimants be signatories to the transfer agreement.¹¹

A divided Second Circuit panel reversed the Tax Court's decision, holding that the trust created by Poirier & McLane did not qualify for a 461(f) deduction.¹² Judge Kaufman, writing for the

¹⁰ 63 T.C. at 574. The Commissioner determined that the deduction complied with neither § 461(a) nor with § 461(f) of the Code. 63 T.C. at 574. I.R.C. § 461(a) provides that "[t]he amount of any deduction or credit allowed by . . . [the income tax laws] shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income."

¹¹ 63 T.C. at 579. The Tax Court found:

Initially, it is pertinent that section 461(f) allows the deduction where, among other things, "the taxpayer transfers money or other property to provide for the satisfaction of the asserted liability." Nothing in this language or its legislative history . . . suggests that the person asserting the liability need sign the transfer agreement.

63 T.C. at 579. (quoting I.R.C. § 461(f)) (citation omitted). The court determined that a trust may be created without the knowledge of the beneficiaries and that it is rare for a beneficiary to sign such an agreement. 63 T.C. at 579. Nonetheless, the court did not consider it necessary to declare invalid Treas. Reg. § 1.461-2(c). See 63 T.C. at 579. Rather, the regulation was construed as not requiring the signatures of the beneficiaries. See *id.* A concurring opinion pointed out that a contrary interpretation would lead to an invalidation of the regulation. *Id.* at 581 (Forrester, J., concurring).

Finding that the regulation should be construed to require the claimant's assent to the trust agreement, the Tax Court dissent reasoned that the regulation was designed to prevent purely tax-motivated transfers effected without the knowledge or consent of the persons asserting the liability. *Id.* at 583 (Hall, J., dissenting). The dissent observed:

The issue facing the Treasury in drafting its regulations was whether the statute should also be construed to permit a taxpayer to thrust himself artificially within its protection through a formalistically perfect arrangement designed for no apparent purpose except qualifying for the deduction, while avoiding the collateral litigation consequences of disclosure to the opponent.

Id. at 584 (Hall, J., dissenting). See generally Horvitz, *Creating a Trust to "Pay" Contested Liabilities Has Tax Planning Potential*, 44 J. TAX. 14, 14-15 (1976).

¹² 547 F.2d at 161. The Tax Court is likely to follow the Poirier court's holding only in cases appealable to the Second Circuit. See *Golsen v. Commissioner*, 54 T.C. 742, 756-58 (1970), *aff'd*, 445 F.2d 985 (10th Cir.), *cert. denied*, 404 U.S. 940 (1971). In *Golsen*, the Tax Court explained this unique feature of the federal tax system:

Section 7482(a), I.R.C. 1954, charges the Court of Appeals with the primary responsibility for review of our decisions, and we think that where the Court of Appeals to which appeal lies has already passed upon the issue before us, efficient and harmonious judicial administration calls for us to follow the decision of that court. . . . [This] practice . . . does not jeopardize the Federal interest in uniform application of the internal revenue laws We shall remain able to foster uniformity by giving effect to our own views in cases appealable to courts whose views have not yet been expressed, and, even where the relevant Court of Appeals had already made its view known, by explaining why we agree or disagree with the precedent that we feel constrained to follow.

54 T.C. at 757 (footnotes omitted).

majority,¹³ found that section 461(f) was enacted to avoid the unreasonable application of accrual rules,¹⁴ and that Congress intended the section to be applied only to situations where an actual payment was made to satisfy a contested liability.¹⁵ The court determined that the applicable regulation was designed to permit deductions for payment into trusts resembling escrow accounts, as the latter were specifically mentioned in the legislative history underlying section 461(f).¹⁶ Noting that when funds are transferred to an ordinary trust the timing and amount of the transfer are solely within the taxpayer's discretion, the majority found that such a transfer is not the equivalent of payment to an escrowee.¹⁷ The Second Circuit therefore construed the regulation as requiring the assent of the claimant-beneficiaries to the trust agreement.¹⁸ Determining this "requirement to be an integral means of effectuating the legislative intent of 461(f),"¹⁹ the court reasoned that only where the claimants are parties to the agreement is there assurance that the assets in the trust remain beyond the control of the taxpayer.²⁰ Judge Kaufman concluded that since the trust established by Poirier & McLane did not comply with the requirements of the regulation, it did not qualify for a deduction under section 461(f).²¹

¹³ 547 F.2d at 161. Judge Meskill joined in the majority opinion authored by Chief Judge Kaufman. Judge Mansfield dissented.

¹⁴ See note 1 *supra*.

¹⁵ 547 F.2d at 165. The Second Circuit was of the opinion that "[i]t is apparent from the legislative history that Congress envisioned the application of §461(f) to instances . . . where payment has been 'actually made.' By satisfying the asserted claim, the taxpayer fixed the fact and amount of its liability in that taxable year. Thus, accrual of the liability was warranted." 547 F.2d at 165 (footnote omitted).

¹⁶ *Id.* at 166. In enacting section 461(f), Congress stated that "[a] taxpayer may provide for the satisfaction of an asserted liability by transferring money or other property to the person who is asserting the liability, or by a transfer to an *escrow agent* . . ." S. SUPP. REP. No. 830, 88th Cong., 2d Sess., reprinted in [1964] U.S. CODE CONG. & AD. NEWS 1868, 1913 (emphasis added).

¹⁷ 547 F.2d at 167. In deciding that the transfer of funds into a trust is not the equivalent of payment into escrow, the court observed that the mere transfer of assets beyond the immediate control of the taxpayer does not necessarily effectuate the purpose of section 461(f), *viz.*, to "realistically match receipts and disbursements for specific taxable years . . ." 547 F.2d at 167.

¹⁸ *Id.* at 166-67.

¹⁹ *Id.* at 167.

²⁰ *Id.* Judge Kaufman stated that "[t]here is little reason to assume solicitude by the settlor towards the beneficiary . . ." and that "[t]here may be a strong temptation for the taxpayer not to relinquish full control [of the assets], especially when the trustee is a personal friend . . ." *Id.* While there is an independent duty upon the trustee to "safeguard trust property, only the person asserting the liability is likely to be zealous in objecting to a breach of that duty." *Id.* (footnote omitted).

²¹ *Id.* at 165.

In a dissenting opinion, Judge Mansfield rejected the majority's interpretation of the treasury regulation, finding it "contrary to the plain language and purpose of the statute."²² Dismissing the distinction drawn by the court between escrow and trust accounts, the dissent reasoned that the two devices are legal equivalents for section 461(f) purposes.²³ Judge Mansfield was of the opinion that the statute was satisfied in the *Poirier* situation, as the funds placed in trust were beyond the control of the taxpayer²⁴ according to the terms of the trust instrument and applicable New York law.²⁵

Prior to the enactment of section 461(f), an accrual basis taxpayer was not entitled to deduct a contested claim until his liability was finally adjudicated.²⁶ As noted by the *Poirier* majority,²⁷ Congress intended section 461(f) to provide a more realistic reporting of income by allowing accrual basis taxpayers to deduct a payment in satisfaction of a contested liability in the year in which a transfer of funds actually is made.²⁸ In enacting the section, however, the legislature did not place any limitations upon the time at which

²² *Id.* at 168 (Mansfield, J., dissenting).

²³ *Id.* at 169-70.

²⁴ *Id.* at 171. Judge Mansfield concluded that

§ 461(f) was fully satisfied by the taxpayer's transfer of the trust fund beyond its control to satisfy . . . [the] contingent claims. This interpretation not only accords with the language and purpose of the statute but makes it unnecessary to hold, as would be required if the word "among" as used in the Regulation were construed as requiring the claimants' signatures on the trust agreement, that the Regulation to such extent is unlawful for the reason that it adds a condition and restriction not contemplated by Congress and not reasonably necessary to accomplish Congress' purpose.

Id.

²⁵ *Id.* at 169. The judge noted that under New York law, the trustee must administer the trust "with due regard to the respective interests of income beneficiaries and remaindermen," N.Y. EST., POWERS & TRUSTS LAW § 11-2.1(a)(1) (McKinney 1967), and the trust instrument may not be revoked without the written consent of the beneficiaries. *Id.* § 7-1.9(a) (McKinney Supp. 1977-1978).

²⁶ See note 1 *supra*.

²⁷ 547 F.2d at 165.

²⁸ The Senate found that

it is unfortunate to deny taxpayers a deduction with respect to an item where the payment has actually been made, even though the liability is still being contested either as to amount or as to the item itself. The objective of the reporting of items of income and deduction under the internal revenue laws generally is to realistically and practically match receipts and disbursements attributable to specific taxable years. The internal revenue laws contain a number of adjustments designed to accomplish this result. . . . [A]llowing the deduction of items in the year paid, even though they are still being contested . . . , more realistically matches these deductions up with the income to which they relate than would the postponement of the deduction, perhaps for several years, until the contest is settled.

such a transfer properly could be effected.²⁹ Consequently, the taxpayer seems to have been afforded a measure of discretion in timing the payment of the contested claim.³⁰ The *Poirier* court's emphasis upon preventing the taxpayer from unilaterally determining the year of the 461(f) deduction thus appears contrary to the statutory scheme.³¹

While the Senate Report accompanying section 461(f) specifically mentions only transfers to a claimant or escrowee,³² the majority's finding, that payment into escrow more closely comports with legislative intent than payment into a unilateral trust, appears to be without support.³³ Moreover, as observed by the *Poirier* dissent, under circumstances where payment is made to an escrowee, the taxpayer would still have the same discretion over the timing and amount of the transfer as he would have in transferring funds into trust. The similarity of escrow and trust accounts is further suggested by the treasury regulation's interchangeable use of the two terms.³⁴ Finally, the fact that the claimant-beneficiaries of a trust

²⁹ See I.R.C. § 461(f); S. REP. No. 830, 88th Cong., 2d Sess. 100-01 (1964), *reprinted in* [1964] U.S. CODE CONG. & AD. NEWS 1673, 1773.

³⁰ See 547 F.2d at 170 (Mansfield, J., dissenting); I.R.C. § 461(f)(4).

³¹ In *Gregory v. Helvering*, 293 U.S. 465, 469 (1935), the Supreme Court pointed out that a taxpayer is entitled to decrease his taxes to the extent that the law permits. The question to be determined in allowing or disallowing a deduction is whether the taxpayer's situation comports with the intent underlying the statute. *Id.*; see *Dravo Corp. v. United States*, 348 F.2d 542 (Ct. Cl. 1965); *Woodmont Terrace, Inc. v. United States*, 261 F. Supp. 789 (M.D. Tenn. 1966).

³² See S. SUPP. REP. No. 830, 88th Cong., 2d Sess. 100-01, *reprinted in* [1964] U.S. CODE CONG. & AD. NEWS 1868, 1913; note 16 *supra*.

³³ See S. SUPP. REP. No. 830, 88th Cong., 2d Sess., *reprinted in* [1964] U.S. CODE CONG. & AD. NEWS 1868, 1913. Escrow is a widely used term referring to a number of different arrangements. Under certain circumstances, a delivery into escrow may create a trust. RESTATEMENT (SECOND) OF TRUSTS § 32, comment d (1959). Escrow is most commonly defined as:

A written instrument which by its term imports a legal obligation, and which is deposited by the grantor, promisor, or obligor, or his agent, with a stranger or third party, to be kept by the depository until the performance of a condition or the happening of a certain event, and then to be delivered over to the grantee, promisee, or obligee.

Home-Stake Royalty Corp. v. McClish, 187 Okla. 352, 355, 103 P.2d 72, 75 (1940) (quoting *BALLENTINE'S LAW DICTIONARY* 445); see *McGriff v. McGriff*, 74 N.E.2d 619 (Ohio Ct. App. 1947). The escrow holder is governed by the escrow agreement and "is charged with the performance of an express trust . . ." *Nash v. Normandy State Bank*, 201 S.W.2d 299, 301 (Mo. 1947). The essential difference, therefore, between rights arising from an escrow agreement and those arising from a trust agreement are that the parties have contractual rights in the former, see, e.g., *Home-Stake Royalty Corp. v. McClish*, 187 Okla. 352, 355, 103 P.2d 72, 75 (1940), and statutory rights in the latter, see, e.g., N.Y. EST., POWERS & TRUSTS LAW arts. 7, 11 (McKinney 1967).

³⁴ See note 4 *supra*. It is interesting to note that in a discussion of the *Poirier* case in the *Journal of Taxation*, the word "escrow" was used to describe the account that the corporation had established. 46 J. TAX. 103, 103 (1977).

are vested with equitable interests and legally enforceable rights,³⁵ notwithstanding the absence of their assent to the trust instrument, militates in favor of recognizing unilateral trust payments as transfers under section 461(f).

It is submitted, therefore, that Judge Mansfield was correct in concluding that the treasury regulation requiring the inclusion of the claimants in the trust agreement should be interpreted to mean that the persons asserting the liability must be the named beneficiaries of the trust.³⁶ The literal interpretation adopted by the *Poirier* majority is based to some degree on the assumption that the assent of the claimants to the trust is the equivalent of direct payment of the liability, in effect fixing its fact and amount in a single taxable year.³⁷ The legislative history of section 461(f), however, indicates

³⁵ The Tax Court found the trust to be irrevocable, pointing to the "sole purpose" clause in the trust instrument, *see note 7 supra*, and the authorization given the trustee to make payments only to claimants. 63 T.C. at 577. According to New York law, a trust may not be revoked without the written consent of "all the persons beneficially interested" therein. N.Y. EST., POWERS & TRUSTS LAW § 7-1.9 (McKinney Supp. 1977-1978). It is only when the settlor specifically reserves the "power to alter or amend . . . in the trust instrument" that the trust may be revoked without obtaining the consent of the beneficiaries. N.Y. EST., POWERS & TRUSTS LAW § 7-1.9, commentary at 69 (McKinney Supp. 1977-1978); *see City Bank Farmers Trust Co. v. Cannon*, 291 N.Y. 125, 51 N.E.2d 674 (1943); N.Y. EST., POWERS & TRUSTS LAW § 10-10.6 (McKinney 1967). Upon request, the beneficiaries of a trust are entitled to "complete and accurate information concerning the trust" and inspection of the underlying agreement. *Davidson v. Blaustein*, 247 F. Supp. 225, 227-28 (D. Md. 1965) (citing *G. BOGERT, TRUSTS AND TRUSTEES* § 961 (2d ed. 1962); 2 A. SCOTT, TRUSTS § 173 (2d ed. 1956)), *cited in* 63 T.C. at 580 n.11. One of the principal duties of a trustee is to ensure that the interests of the beneficiaries of a trust are protected. *See In re Bond & Mortgage Guar. Co.*, 303 N.Y. 423, 430, 103 N.E.2d 721, 725 (1952).

³⁶ *See* 547 F.2d at 171. If the regulation is read as requiring the signature of the claimant-beneficiaries it must be then determined whether the Commissioner exceeded his power in promulgating it. In *Morrill v. Jones*, 106 U.S. 466 (1882), the Supreme Court held that regulations cannot alter a revenue law or "put into the body of the statute a limitation which Congress did not think it necessary to prescribe." *Id.* at 467. The Ninth Circuit, in *Smith v. Commissioner*, 332 F.2d 671, 673 (9th Cir. 1964), stated that the Commissioner may not prescribe regulations that are inconsistent with or restrictive of a Code provision. *See, e.g., Manhattan Gen. Equip. Co. v. Commissioner*, 297 U.S. 129, 134 (1936); *United States v. Whitney Land Co.*, 324 F.2d 33, 38 (8th Cir. 1963); *Boykin v. Commissioner*, 260 F.2d 249, 254 (8th Cir. 1958); *Scofield v. Lewis*, 251 F.2d 128, 132 (5th Cir. 1958). Thus, regulations modifying or limiting the terms of a statute to the taxpayer's detriment cannot be given effect by the courts. *Miller v. Commissioner*, 237 F.2d 830, 836 (5th Cir. 1956). It has been stated that "[t]he Commissioner has no more power to add to the Act what he thinks Congress may have overlooked than he has to supply what Congress has deliberately omitted." *General Elec. Co. v. Burton*, 372 F.2d 108, 111 (6th Cir. 1967) (quoting *Arkansas-Oklahoma Gas Co. v. Commissioner*, 201 F.2d 98, 102 (8th Cir. 1953)). Based on this well-established line of authority, the *Poirier* dissent intimated that, under the majority's reading of the regulation, it should be declared invalid. 547 F.2d at 171 (Mansfield, J., dissenting). A similar view was expressed by the concurring judges in the Tax Court. 63 T.C. at 581.

³⁷ *See* 547 F.2d at 167. The question whether the amount of the taxpayer's liability has been sufficiently fixed has been of continual concern. In *Lucas v. American Code Co.*, 280

that a taxpayer is to be permitted a deduction for a payment made to satisfy a liability, irrespective of whether its amount is contingent or fixed.³⁸ Moreover, the court's concern for the rights of the claimant-beneficiaries³⁹ will not be assuaged by the signature requirement, since such a requirement confers no additional rights upon the beneficiaries.⁴⁰ The imposition of an assent requirement instead might operate to place the taxpayer in an unfair litigation position, inasmuch as the claimant could interpret the amount transferred as an assessment by the taxpayer of its liability.⁴¹ At the very least, it is suggested that the assent requirement may serve to increase the amount of 461(f) deductions, as claimants will be in a position to seek an increase in the amount transferred to the trust or to obtain a settlement beneficial to their interests.⁴²

The broad language of Internal Revenue Code section 461(f) appears to allow a deduction upon a taxpayer's unilateral transfer of funds purported to be in satisfaction of a contested liability. Such a transfer, however, may bear little relationship to an actual assessment or final settlement of a claim, thereby presenting the opportunity for abuse of the section. By placing a literal construction upon the applicable treasury regulation, an interpretation apparently in conflict with the plain language of the statute and the relevant legislative history,⁴³ the Second Circuit has clearly limited the availability of 461(f) deductions. In reaching this result, the majority relied heavily upon the notion that a taxpayer may not unilaterally determine the year of a deduction.⁴⁴ In effect, therefore,

U.S. 445 (1930), money ostensibly deposited to pay a contingent liability was held not deductible because it did not adequately reflect the potential liability. See *Gillis v. United States*, 402 F.2d 501 (5th Cir. 1968), discussed in 83 HARV. L. REV. 1452 (1970); *Clevite Corp. v. United States*, 386 F.2d 841 (Ct. Cl. 1967) (per curiam); *United Control Corp. v. Commissioner*, 38 T.C. 957 (1962).

³⁸ The Senate Report noted that any portion of the transferred funds in excess of the finally determined amount of liability is includable in gross income in the year it is returned. S. REP. No. 830, 88th Cong., 2d Sess. 100, reprinted in [1964] U.S. CODE CONG. & AD. NEWS 1673, 1773; see *Treas. Reg. § 1.461-2(a)(3)* (1964).

³⁹ See 547 F.2d at 167.

⁴⁰ See notes 25 and 35 *infra*.

⁴¹ Arrangements for depositing money in trust without the claimant's knowledge are especially valuable to a taxpayer who is reluctant to acknowledge any liability or reveal his own estimation of his liability to his adversary. See *Bushman, Contested Liabilities: No Necessity for Claimants to Sign Trust Agreement*, 6 TAX ADVISOR 676-77 (1975); 4 TAX. FOR LAW. 42 (1975).

⁴² See 547 F.2d at 170-71 (Mansfield, J., dissenting).

⁴³ See notes 31-35 *supra*.

⁴⁴ 547 F.2d at 166. The Second Circuit stated that it did not "believe Congress ever intended § 461(f) to permit taxpayers to unilaterally decide when and in what amount to 'manufacture' tax deductions." 547 F.2d at 166 n.10. The court went on to find that the

the *Poirier* court has invoked a general tax principle to circumscribe the operation of an overly broad section of the Code. While this approach arguably might reduce the potential for misuse of the statute, its utilization raises serious questions as to the proper bounds of the judicial function.⁴⁵ Perhaps a more desirable solution lies in legislative reevaluation of the statutory scheme, and, should Congress so conclude, amendment of the Code.

Lois C. Rubin

funds transferred created only a contingent-liability reserve, *id.*, which is "in reality a species of self-insurance." 2 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 12.69 (1942). Moreover, the majority noted that the deduction taken by the corporation resembles "anticipatory accrual"—that is, anticipation of a future liability. 547 F.2d at 167 n.11 (citing *Overlakes Corp. v. Commissioner*, 348 F.2d 462 (2d Cir. 1965) (per curiam), *cert. denied*, 382 U.S. 988 (1966)). Such a practice has been widely disapproved: "Because anticipated casualty losses are contingent in nature, present tax accounting principles will prevent an accrual basis taxpayer from deducting amounts it adds to a reserve for insuring its own future risks." Horvitz, *Creating a Trust to "Pay" Contested Liabilities Has Tax Planning Potential*, 44 J. TAX. 14, 14, 16 (1976) (footnote omitted). The trust established by *Poirier & McLane*, as Judge Mansfield pointed out, created legal rights in favor of the beneficiaries and responsibilities in the trustee, 547 F.2d at 168-69 (Mansfield, J., dissenting); see notes 25 and 35 *supra*, and thus differed from a simple reserve fund or anticipatory accrual.

⁴⁵ Considerable discussion has been devoted to the proper role of the judiciary in interpreting legislative enactments. When courts construe statutes, the fundamental rule is that "words are to be given their usual and ordinary meaning." *United States v. First Nat'l Bank*, 234 U.S. 245, 258 (1914). The meaning given must be "in accord with the general purpose which the statute was intended to accomplish." *Keppel v. Tiffin Sav. Bank*, 197 U.S. 356, 361 (1905). Qualifications cannot be read into a statute which would cause it "to be in conflict with the purpose which it was intended to accomplish." *Id.* at 362. Although tax deductions are not available unless specifically granted by the legislature, see I.R.C. § 161, where Congress has specifically granted a deduction, it is not within the discretion of the judiciary to limit the availability of that deduction. See *Holden v. Stratton*, 198 U.S. 202 (1905), wherein the Court stated that "it would not be construction but legislation to restrict the meaning of [a] statute . . . , because in the judgment of a court it might be deemed equitable to do so." *Id.* at 210. As has been often emphasized by the Court, in no case can "amendment . . . be substituted for construction." *Yu Cong Eng v. Trinidad*, 271 U.S. 500, 518 (1926).