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## Beyond Frustration: Section 162(f) and the Deductibility of Fines, Penalties, and Settlement Payments

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## BEYOND FRUSTRATION: SECTION 162(f) AND THE DEDUCTIBILITY OF FINES, PENALTIES, AND SETTLEMENT PAYMENTS

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## FORWARD

The Merriam-Webster online dictionary defines frustration as a deep chronic sense or state of insecurity and dissatisfaction arising from unresolved problems or unfulfilled needs. It lists as synonyms: aggravation, bother, botheration, bugbear, exasperation, annoyance, hairshirt, hassle, headache, inconvenience, irk, irritant, nuisance, peeve, pest, rub, ruffle, thorn, trial, and vexation. It has been said that to conquer frustration one must remain intensely focused on the outcome, not the obstacles.<sup>1</sup>

This Article owes its existence to frustration on two counts. The substantive topic is section 162(f). It was Congress’s response in 1969 to certain deductions claimed by taxpayers that were thought to frustrate public policy. That is one count. The other is that the vagaries of section 162(f) have frustrated taxpayers, the Internal Revenue Service, and the courts ever since its enactment. That second count is the primary focus of this Article. The first count is described in more detail below, primarily as background.

## I. BACKGROUND

### *A. Section 162(f) and the Treasury Regulations Thereunder*

A corporation taxed under Subchapter C of the Internal Revenue Code,<sup>2</sup> very cleverly referred to by most tax professionals as a “C-corporation,” is subject to income tax as an entity separate and apart from its shareholders.<sup>3</sup> A corporation begins its tax computation by aggregating gross income from all sources for a taxable year and subtracting therefrom deductible items for that year. The net amount, if positive, is taxed at the applicable corporate tax rate, subject to any allowable credits that reduce the corporation’s tax liability otherwise due, dollar for dollar. Among the deductible items are any “ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business,” under section

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1. T.F. HODGE, FROM WITHIN I RISE: SPIRITUAL TRIUMPH OVER DEATH AND CONSCIOUS ENCOUNTERS WITH “THE DIVINE PRESENCE” (2009).

2. Except as otherwise indicated, references to “sections” are to the Internal Revenue Code of 1986, as amended (the “Code”) and references to “Regulations” are to the Treasury Regulations promulgated thereunder.

3. Unless stated otherwise, references herein to a corporation or corporations are references to entities that are taxed under Subchapter C of the Code.

162(a). Some typical examples are salaries, wages, purchased materials and inputs, costs of advertisements, commissions, incidental repairs, insurance premiums, and rental expenses.<sup>4</sup>

To be deductible under section 162(a), an expense must be “ordinary and necessary.” Ordinary and necessary expenses are those expenses that are common or that occur frequently in the business, and which are appropriate and helpful in carrying out the trade or business.<sup>5</sup> Much of the case law under section 162(a) reflects disagreements between taxpayers and the IRS about whether expenses are “ordinary and necessary.” Ultimately, the burden of proof in establishing that an expense is ordinary and necessary rests on the taxpayer, as will be discussed in further detail below.<sup>6</sup>

If a business expense is ordinary and necessary, then it is deductible unless deduction of the expense is barred by another provision of the Code. Section 162(f) is such a provision. It is very short. It provides that “no deduction shall be allowed under subsection (a) for any fine or similar penalty paid to the government for the violation of any law.”

It has become commonplace to hear or read in the news that a corporation or other business entity has agreed to pay to a government a significant amount of money as a fine, a penalty, or in settlement of claims relating to alleged civil or criminal violations of law. Some examples are described below. Regardless of the context or the label attached to a given payment, if the payment otherwise would qualify as an ordinary and necessary business expense to the payor under section 162(a), it is necessary to analyze the payment to determine whether it is a “fine” or a “similar penalty” under section 162(f).

Regulation section 1.162–21 adds some flesh to the bones of section 162(f). It provides that

[n]o deduction shall be allowed under section 162(a) for any fine or similar penalty paid to—(1) the government of the United States, a State, a territory or possession of the United States, the District of Columbia, or the Commonwealth of Puerto Rico; (2) the government of a foreign country; or (3) a political subdivision serving as an agency or instrumentality of, any of the above.<sup>7</sup>

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4. Reg. § 1.162–1(a). Expenses referred to or discussed herein are items paid in the conduct of a trade or business that are not required to be capitalized under section 263 or otherwise under the Code.

5. *Deputy v. Dupont*, 308 U.S. 488 (1940).

6. *See, e.g., Norgaard v. Commissioner*, 939 F.2d 874, 878 (9th Cir. 1991).

7. Reg. § 1.162–21(a).

The Regulations add that a fine or similar penalty includes an amount:

- (i) Paid pursuant to conviction or a plea of guilty or *nolo contendere* for a crime (felony or misdemeanor) in a criminal proceeding;
- (ii) Paid as a civil penalty imposed by Federal, State, or local law, including additions to tax and additional amounts and assessable penalties imposed by chapter 68 of the Internal Revenue Code of 1954;
- (iii) Paid in settlement of the taxpayer's actual or potential liability for a fine or penalty (civil or criminal);<sup>8</sup> or
- (iv) Forfeited as collateral posted in connection with a proceeding which could result in imposition of such a fine or penalty.<sup>9</sup>

Legal fees and related expenses paid in defense of a prosecution or a civil action arising from an alleged violation of law are not covered by section 162(f).<sup>10</sup> Furthermore, and very importantly, section 162(f) does not include amounts paid as compensatory damages.<sup>11</sup>

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8. This provision of the Regulations reflects the origin of the claim test, a doctrine that looks to the origin and character of the liability or claim in issue to determine the true characterization of an expense incurred to satisfy such liability or claim. The doctrine has been applied by the IRS and the courts to determine whether fines, penalties, and settlement costs are deductible under section 162(f). *See, e.g.*, G.C.M. 38,547 (Oct. 24, 1980) (payment made by corporate officer to reimburse corporation for illegal political campaign contributions made with officer's approval was a nondeductible fine under section 162(f)); F.S.A. 2001-46-008 (Apr. 30, 2001) (settlement agreement relating to state law claims was not binding as to characterization or allocation of the payments where settlement was not a product of bona fide, arm's-length, adversarial negotiations).

9. Reg. § 1.162-21(b)(1). In *Adolf Meller Co. v. United States*, 600 F.2d 1360 (Ct. Cl. 1979), a taxpayer challenged the validity of Regulation section 1.162-21(b)(1)(iii), claiming that Congress did not intend for civil forfeitures to be covered by section 162(f), especially if the amount paid was mutually agreed to by the parties in settlement. The court rejected the taxpayer's arguments, determining that legislative history indicated that section 162(f) was not intended to be limited to fines or penalties paid in relation to criminal proceedings. The court held that Regulation section 1.162-21(1)(b)(iii) was valid.

10. Reg. § 1.162-21(b)(2).

11. *Id.* Compensatory damages paid under section 4A of the Clayton Act (15 U.S.C. § 15(a)) are specifically carved out of section 162(f) by the Regulations.

The Regulations provide eight clarifying examples in various contexts that include law violations relating to price fixing, oil spills, and safety standards.<sup>12</sup> The first example describes a corporation's criminal fine of \$50,000 under the Sherman Anti-Trust Act for price fixing activities, and an additional \$100,000 in civil damages resulting from a related suit brought by the government under section 4A of the Clayton Act.<sup>13</sup> The example concludes that section 162(f) precludes the deduction of the criminal fine, but does not preclude the taxpayer from deducting the damages awarded to the government under the civil suit. The second example concludes that section 162(f) precludes the deduction of a civil penalty assessed against a corporation for oil discharged into a navigable waterway.<sup>14</sup> The remaining example in the regulations illustrates that fines and penalties are not deductible because of section 162(f), but economic damages or remedial amounts that relate to correcting a transgression are outside the scope of section 162(f).<sup>15</sup> Apart from drawing that black-letter distinction, the examples are not particularly helpful. Payments discussed in the examples are relatively easily classified as nondeductible fines or penalties on the one hand, or as deductible penalties or compensatory or remedial damages on the other. The punch lines in the examples are easy to predict and there are few surprises, if any. There is not any guidance to help taxpayers and the IRS analyze ambiguous contexts to determine what portion of a payment, if any, constitutes a non-deductible payment under section 162(f).

*B. Section 162(f) Contexts: Recent Corporate Settlements*

It is clear from the examples in the Regulations that section 162(f) affects taxpayers in virtually every industry. Indeed, section 162(f) cuts across all industries. Relatively recently, corporations and other business entities

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12. Reg. § 1.162-21(c).

13. Reg. § 1.162-21(c), Ex. 1.

14. Reg. § 1.162-21(c), Ex. 2.

15. For more illustrative guidance, see Reg. § 1.162-21(c), Ex. 3 (section 162(f) precludes the deduction of a \$10,000 civil penalty for a manufacturer's sale of a new motor vehicle without the required certificate of conformity, but does not preclude the deduction of remedial expenses required by statute), Ex. 4 (section 162(f) precludes the operator of a coal mine from deducting a \$10,000 civil penalty assessed under the Federal Coal Mine Health and Safety Act for violating a mandatory safety standard contained therein), Ex. 5 (section 162(f) precludes the deduction of a \$250 penalty for a common carrier's violation under 45 U.S.C. § 11 for failure to operate a railroad car with efficient handbrakes), Ex. 6 (section 162(f) precludes a trucking company from deducting an \$85 fine for operating a truck in excess of weight limit under state law), Ex. 7 (section 162(f) precludes the deduction of a \$500 fine assessed by the state board for a corporation's air emissions in violation of the limit set forth in a state regulation), Ex. 8 (section 162(f) precludes the deduction of a \$200 fine for operating an apartment building which did not conform to a city housing code).

engaged in healthcare, finance, accounting, defense, manufacturing, trucking, technology, communications, natural resources and energy, banking, and insurance businesses have been subject to large fines and penalties for actual or alleged statutory and regulatory violations.<sup>16</sup> In 2000, a healthcare company, HCA Inc., pleaded<sup>17</sup> guilty to criminal conduct with fines and repayments totaling just over \$1.7 billion and settled a related civil suit involving allegations under the False Claims Act and other federal laws for a variety of alleged unlawful practices including cost report fraud and the payment of kickbacks to physicians.<sup>18</sup> A pharmaceutical company, Pfizer Inc., pleaded guilty in 2009 to a felony violation of the Food, Drug, and Cosmetic Act for drug misbranding.<sup>19</sup> The criminal suit resulted in a criminal fine and forfeiture, totaling \$1.3 billion. Pfizer settled, for \$1 billion, related civil False Claims Act allegations with the federal government for the illegal promotion of certain drugs.<sup>20</sup> Tenet Healthcare Corporation, the operator of one of the largest hospital chains in the United States, agreed to pay more than \$900 million to the federal government for alleged unlawful billing practices in a 2006 civil settlement.<sup>21</sup> In 2011, Merck & Co. Inc. reached a civil settlement with the federal government for \$628 million to resolve allegations of off-label

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16. Historically, section 162(f) has been applied by the IRS and the courts to prohibit deductions in a wide range of contexts, involving amounts both large and small, and reaching beyond criminal fines imposed by courts. *See, e.g.*, *Cohen v. Commissioner*, 60 T.C.M. (CCH) 135, 1990 T.C.M. (RIA) ¶ 90,358 (disallowing deduction of \$65 for traffic and parking violations under section 162(f)); *Foxworthy, Inc. v. Commissioner*, 98 T.C.M. (CCH) 177, 2009 T.C.M. (RIA) 2009-203 (determining that a payment made to satisfy fines imposed on the taxpayer for violating the Investment Advisers Act of 1940 was nondeductible under section 162(f)); *Tucker v. Commissioner*, 69 T.C. 675 (1978) (finding that a penalty imposed on a teacher for engaging in an illegal strike was nondeductible under section 162(f)). To be sure, the deduction of a federal criminal tax penalty is barred by section 162(f). *Triplett v. Commissioner*, 82 T.C.M. (CCH) 1005, 2001 T.C.M. (RIA) 2001-320 (holding that a fine paid pursuant to a conviction for filing a false tax return was nondeductible under section 162(f)).

17. Readers should note the raging debate over whether the proper verb is “pleaded” or “pled.” Since either apparently is acceptable, “pleaded,” is used herein although when speaking “pled” seems better.

18. Press Release, U.S. Dep’t of Justice, Largest Health Care Fraud in U.S. History Settled HCA Investigation Nets Record Total of \$1.7 Billion (June 26, 2003), [http://www.justice.gov/ops/pr/2003/June/03\\_civ\\_386.htm](http://www.justice.gov/ops/pr/2003/June/03_civ_386.htm).

19. Press Release, U.S. Dep’t of Justice, Justice Department Announces Largest Health Care Fraud Settlement in Its History (Sept. 2, 2009), <http://www.justice.gov/opa/pr/2009/September/09-civ-900.html>.

20. *Id.*

21. Press Release, U.S. Dep’t of Justice, Tenet Healthcare Corporation to Pay U.S. more than \$900 Million to Resolve False Claims Act Allegations (June 29, 2006), [http://www.justice.gov/opa/pr/2006/June/06\\_civ\\_406.html](http://www.justice.gov/opa/pr/2006/June/06_civ_406.html).

marketing of Vioxx and false statements regarding the safety of the drug.<sup>22</sup> In 2012, Glaxo Smith Klein settled with the federal government Food, Drug, and Cosmetic Act charges for allegedly introducing misbranded drugs into interstate commerce, failing to report safety data with respect to certain drugs to the Food and Drug Administration, and price fraud.<sup>23</sup> The company agreed to pay \$1 billion in criminal fines and \$2 billion in civil fines.<sup>24</sup> As recently as 2013, Johnson and Johnson agreed to pay over \$2.2 billion in civil and criminal fines relating to off-label marketing and the payment of kickbacks to physicians and pharmacists.<sup>25</sup>

The financial services industry has not been immune. Several sizable settlements have been entered into between the federal government and financial and banking companies. In 2003, the Securities and Exchange Commission (SEC) reached a \$1.4 billion settlement with ten financial institutions accused of allowing their investment banking interests to exert undue influence on their securities research operations.<sup>26</sup> In response to the settlement, Senators Charles Grassley, Max Baucus, and John McCain introduced the Government Settlement Transparency Act, which would have clarified that payments made in settlement of actual or potential violations of law would be nondeductible.<sup>27</sup> The legislation was not enacted. In 2003, however, the SEC “adopted a policy of requiring settlement agreements with civil penalties to include language stating that the settling parties would not deduct civil penalties for tax purposes.”<sup>28</sup> The Goldman Sachs Group, Inc. settled a federal civil fraud case for \$550 million in 2009 relating to allegations

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22. Press Release, U.S. Dep’t of Justice, U.S. Pharmaceutical Company Merck Sharp and Dohme Sentenced in Connection with Unlawful Promotion of Vioxx (Apr. 19, 2012), <http://www.justice.gov/opa/pr/2012/July/12-civ-842.html>.

23. Press Release, U.S. Dep’t of Justice, GlaxoSmithKline to Plead Guilty and Pay \$3 Billion to Resolve Fraud Allegations and Failure to Report Safety Data (July 2, 2012), <http://www.justice.gov/opa/pr/2012/April/12-civ-497.html>.

24. *Id.*

25. Press Release, U.S. Dep’t of Justice, Johnson & Johnson to Pay More Than \$2.2 Billion to Resolve Criminal and Civil Investigations (Nov. 4, 2013), <http://www.justice.gov/opa/pr/2013/November/13-ag-1170.html>.

26. Press Release, U.S. Securities and Exchange Commission, Ten of Nation's Top Investment Firms Settle Enforcement Actions Involving Conflicts of Interest Between Research and Investment Banking (Apr. 28, 2003), <http://www.sec.gov/news/press/2003-54.htm>.

27. Press Release, U.S. Senator Chuck Grassley, Grassley, Baucus Introduce Bill to Toughen Corporate Settlements (Apr. 28, 2003), <http://www.grassley.senate.gov/releases/2003/p03r04-28.htm>.

28. U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-05-747, TAX ADMINISTRATION: SYSTEMATIC INFORMATION SHARING WOULD HELP IRS DETERMINE THE DEDUCTIBILITY OF CIVIL SETTLEMENT PAYMENTS (2005).



that it misled investors in a subprime mortgage product.<sup>29</sup> The entire amount was characterized in the settlement as a penalty paid to the government, for all purposes including tax purposes.<sup>30</sup> JP Morgan Chase & Co. settled with the SEC charges that it misled investors in a complex mortgage securities transaction before the collapse of the housing market.<sup>31</sup> The settlement payment totaled over \$150 million, \$133 million of which was designated as a penalty.<sup>32</sup> More recently, in 2011, the SEC announced that Citigroup, Inc. agreed to a civil settlement requiring it to pay \$285 million for allegedly misleading investors about a \$1 billion collateralized debt obligation tied to the U.S. housing market.<sup>33</sup> The U.S. Attorney filed lawsuits against Wells Fargo and Bank of America in late 2012 for faulty mortgage practices,<sup>34</sup> and Bank of America released a settlement figure totaling near \$13 billion.<sup>35</sup> In 2013, J.P. Morgan Chase & Co. reached a settlement of approximately \$5.1 billion with the Federal Housing Finance Agency, as conservator of Fannie Mae and Freddie Mac.<sup>36</sup> That settlement resolved claims of alleged violations of federal and state securities laws in connection with private-label, residential

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29. Press Release, U.S. Securities and Exchange Commission, Goldman Sachs to Pay Record \$550 Million to Settle SEC Charges Related to Subprime Mortgage CDO (July 15, 2010), <http://www.sec.gov/news/press/2010/2010-123.htm>.

30. A copy of the settlement is available at <http://www.sec.gov/litigation/litreleases/2010/consent-pr2010-123.pdf>.

31. Press Release, U.S. Securities and Exchange Commission, J.P. Morgan to Pay \$153.6 Million to Settle SEC Charges of Misleading Investors in CDO Tied to U.S. Housing Market (June 21, 2011), <http://www.sec.gov/news/press/2011/2011-131.htm>.

32. *Id.*

33. Press Release, U.S. Securities and Exchange Commission, Citigroup to Pay \$285 Million to Settle SEC Charges for Misleading Investors About CDO Tied to Housing Market (Oct. 19, 2011), <http://www.sec.gov/news/press/2011/2011-214.htm>.

34. Peter Lattam, *U.S. Sues Wells Fargo, Accusing It of Lying About Mortgages*, N.Y. TIMES (Oct. 11, 2012), <http://dealbook.nytimes.com/2012/10/09/u-s-sues-wells-fargo-alleging-mortgage-deceit/>; Press Release, U.S. Attorney's Office for the Southern District of New York, Manhattan U.S. Attorney Sues Bank of America For Over \$1 Billion For Multi-Year Mortgage Fraud Against Government Sponsored Entities Fannie Mae and Freddie Mac (Oct. 24, 2012), <http://www.justice.gov/usao/nys/pressreleases/October12/BankofAmericanSuit.php>.

35. Press Release, Bank of America, Bank of America Announces Settlement with Fannie Mae to Resolve Agency Mortgage Repurchase Claims on Loans Originated and Sold Directly to Fannie Mae Through December 31, 2008 (Jan. 7, 2013), <http://newsroom.bankofamerica.com/press-release/corporate-and-financial-news/bank-america-announces-settlement-fannie-mae-resolve-agen>.

36. Press Release, Federal Housing Finance Agency, FHFA Announces \$5.1 Billion in Settlements with J.P. Morgan Chase & Co. (Oct. 25, 2013), <http://www.fhfa.gov/webfiles/25649/FHFAJPMorganSettlementAgreement.pdf>.

mortgage-securities purchased by Fannie Mae and Freddie Mac.<sup>37</sup> Similarly, in 2013, UBS reached a settlement with the Federal Housing Finance Agency for its alleged violations of federal and state securities laws in connection with private-label residential mortgage-backed securities purchased by Fannie Mae and Freddie Mac, agreeing to pay \$885 million,<sup>38</sup> and in 2014, Goldman Sachs settled for \$1.2 billion to resolve its own alleged violations.<sup>39</sup> In what has become the “largest insider trading penalty” in history, in late 2013, SAC capital reached a plea agreement with the Department of Justice (DOJ) imposing a fine of \$1.184 billion that related both to criminal and civil proceedings.<sup>40</sup> In addition to that fine, SAC Capital reached an agreement with the SEC, obligating it to pay \$616 million to settle claims arising from the same conduct.<sup>41</sup> In early 2014, Royal Bank of Scotland and its wholly owned subsidiary, Royal Bank of Scotland Japan Limited, settled regulatory and criminal charges relating to its alleged manipulation of benchmark interest rates for an amount totaling \$612 million, \$137 million of which was payable to British authorities, with the remainder payable to the U.S.<sup>42</sup> In July of 2014, Sun Trust agreed to pay \$320 million to resolve a criminal investigation relating to its administration of the Home Affordable Modification Program (HAMP) in 2009 and 2010.<sup>43</sup> Also in 2014, BNP Paribas signed a plea agreement, agreeing to pay \$8.9 billion to settle a criminal case relating to its alleged violation of U.S. economic sanctions under the International Emergency Economic Powers Act and the Trading with the Enemy Act by processing more than \$8.8 billion of transactions through the U.S. financial system for sanctioned Sudanese, Iranian, and Cuban entities. As a part of the plea agreement, BNP agreed not to claim a deduction of any U.S. federal, state,

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37. *Id.*

38. Press Release, Federal Housing Finance Agency, FHFA Announces Settlement with UBS, (July 25, 2013), <http://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Announces-Settlement-with-UBS.aspx>.

39. Press Release, Federal Housing Finance Agency, FHFA Announces Settlement with Goldman Sachs (Aug. 22, 2014), <http://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Announces-Settlement-with-Goldman-Sachs.aspx>.

40. Press Release, U.S. Attorney’s Office for the Southern District of New York, SAC Capital Management Companies Plead Guilty To Insider Trading Charges In Manhattan Federal Court, (Nov. 8, 2013), <http://www.justice.gov/usao/nys/pressreleases/November13/SACCapitalPleaPR.php?print=1>.

41. *Id.*

42. Press Release, Federal Bureau of Investigation, RBS Securities Japan Ltd Sentenced for Manipulation of Yen LIBOR, (Jan. 6, 2014), <http://www.fbi.gov/washingtondc/press-releases/2014/rbs-securities-japan-ltd-sentenced-for-manipulation-of-yen-libor>.

43. Press Release, U.S. Dep’t of Justice, Sun Trust Mortgage Agrees to \$320 Million Settlement (July 3, 2014), <http://www.justice.gov/opa/pr/2014/July/14-ag-697.html>.

or local tax for any fine or forfeiture under the plea agreement.<sup>44</sup> Citigroup entered into a \$7 billion settlement with the DOJ in July 2014 to resolve federal and state claims relating to the packaging, securitization, marketing, sale, and issuance of residential mortgage-backed securities (RMBS) prior to Jan. 1, 2009.<sup>45</sup> In August, 2014, Bank of America similarly entered into a \$16.6 billion settlement with the DOJ to resolve claims relating to residential mortgage backed securities, the largest civil settlement with a single entity in American history.<sup>46</sup>

Regulatory violations in the natural resources and energy industries have garnered much attention over the years. Exxon Mobil Corporation, known then as Exxon Corporation, paid a total of \$1.1 billion in a settlement with the federal government for its March 24, 1991 Valdez oil spill.<sup>47</sup> In 2001, Koch Industries Inc. agreed to pay a \$30 million civil fine to resolve claims brought by the Environmental Protection Agency (EPA) and the DOJ for more than 300 oil spills from its pipelines and oil facilities in six states.<sup>48</sup> The 2010 Deepwater Horizon oil spill has already resulted in BP plc's agreement to pay more than \$30 billion in fines, settlements, and cleanup costs, and with a trial looming to resolve allegations brought under the Clean Water Act, BP could be facing additional payments to resolve the matter.<sup>49</sup> When asked if any of BP's fines would be tax deductible, then Assistant Attorney General Lanny Breuer stated that, "[t]hey are not. The Attorney General was very clear that

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44. Press Release, U.S. Dep't of Justice, BNP Paribas Agrees to Plead Guilty and to Pay \$8.9 Billion for Illegally Processing Financial Transactions for Countries Subject to U.S. Economic Sanctions (June 30, 2014), <http://www.fbi.gov/news/pressrel/press-releases/bnp-paribas-agrees-to-plead-guilty-and-to-pay-8.9-billion-for-illegally-processing-financial-transactions-for-countries-subject-to-u.s.-economic-sanctions>.

45. Press Release, U.S. Dep't of Justice, Justice Department, Federal and State Partners Secure Record \$7 Billion Global Settlement with Citigroup for Misleading Investors About Securities Containing Toxic Mortgages (July 14, 2014), <http://www.justice.gov/opa/pr/2014/July/14-ag-733.html>.

46. Press Release, Dep't of Justice, Bank of America to Pay \$16.65 Billion in Historic Justice Department Settlement for Financial Fraud Leading up to and During the Financial Crisis (Aug. 21, 2014), <http://www.justice.gov/opa/pr/2014/August/14-ag-884.html>.

47. Press Release, Environmental Protection Agency, Exxon to Pay Record One Billion Dollars in Criminal Fines and Civil Damages in Connection with Alaskan Oil Spill (Mar. 13, 1991), <http://www.epa.gov/history/topics/valdez/02.html>.

48. Press Release, Environmental Protection Agency, Koch Industries to Pay Record Fine for Oil Spills in Six States (Jan. 13, 2000), <http://yosemite.epa.gov/opa/admpress.nsf/016bcfb1deb9fec8525aca005d74df981d17e5ab07246f8525686500621079?OpenDocument>.

49. Tom Fowler, *BP Faces New Boat of Spill Liability*, WALL ST. J. (Feb. 18, 2013), <http://online.wsj.com/article/SB10001424127887323764804578312363372704012.html>.

nothing in the criminal settlement could be tax deductible nor could it be an offset to any further civil resolution, and that was a very explicit term of these agreements at the request of the Attorney General.”<sup>50</sup> Transocean Deepwater, Inc., the rig owner also implicated in the 2010 Deepwater Horizon oil spill, entered into its own settlement agreement with the DOJ totaling \$1.4 billion, \$400,000 of which was for criminal fines.<sup>51</sup> French oil and gas company, Total S.A., agreed in May 2013 to pay \$254 million to resolve alleged violations of the Foreign Corrupt Practices Act (FCPA) relating to illegal payments made to Iranian government officials in exchange for oil and gas concessions.<sup>52</sup> In November 2013, Weatherford International and its subsidiaries, a publicly traded Swiss oil services company, pleaded guilty to FCPA violations and export control violations, agreeing to pay \$252 million in penalties and fines.<sup>53</sup>

Several other industries have made headlines for high-dollar settlements. In defense contracting, The Boeing Company agreed to pay \$615 million to “resolve criminal and civil allegations that the company improperly used competitors’ information to procure contracts for launch services worth billions of dollars from the Air Force and the National Aeronautics and Space Administration.”<sup>54</sup> Senators Charles Grassley, John McCain, and John Warner wrote a letter to the then Attorney General, Alberto Gonzalez, saying that it would be unacceptable if Boeing were permitted to deduct the costs “thereby leaving the American taxpayer to effectively subsidize its misconduct.”<sup>55</sup> Deductibility of the settlement payment apparently was not resolved in the

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50. Videotape: Justice Dep’t Officials Answer Questions About BP at 3:07 (Nov. 15, 2012) (on file with The Wall Street Journal), <http://live.wsj.com/video/justice-dept-officialsanswer-questions-about-bp/153BD9BD-2852-4524-B6CC-91F1D2C932F7.html#!153BD9BD-2852-4524-B6CC-91F1D2C932F7>.

51. Press Release, U.S. Dep’t of Justice, Transocean Agrees to Plead Guilty to Environmental Crime and Enter Civil Settlement to Resolve U.S. Clean Water Act Penalty Claims from Deepwater Horizon Incident, (Jan. 3, 2013), <http://www.justice.gov/opa/pr/2013/January/13-ag-004.html>.

52. Press Release, U.S. Dep’t of Justice, French Oil and Gas Company, Total, S.A., Charged in the United States and France in Connection with an International Bribery Scheme, (May 29, 2013), <http://www.justice.gov/opa/pr/2013/May/13-crm-613.html>.

53. Press Release, U.S. Dep’t of Justice, Three Subsidiaries of Weatherford International Limited Agree to Plead Guilty to FCPA and Export Control Violations, (Nov. 26, 2013), <http://www.justice.gov/opa/pr/2013/November/13-crm-1260.html>.

54. Press Release, U.S. Dep’t of Justice, Boeing to Pay United States Record \$615 Million to Resolve Fraud Allegations (June 30, 2006), [http://www.justice.gov/opa/pr/2006/June/06\\_civ\\_412.html](http://www.justice.gov/opa/pr/2006/June/06_civ_412.html).

55. Letter from Charles Grassley, Chairman, Senate Finance Committee et al., to the Honorable Alberto Gonzales, Attorney General, (June 29, 2006) (on file with the Senate Finance Committee), <http://www.finance.senate.gov/newsroom/chairman/download/?id=087bf16e-8d77-4fcf-af4b-38cb4f8c5798>.

settlement agreement. Nonetheless, shortly after the settlement, Boeing announced that it would not seek to deduct the payments even though it believed they should have been deductible.<sup>56</sup> Notwithstanding the “high-road” taken by Boeing, Senator Grassley accused DOJ lawyers of being “asleep at the switch.” The automotive company, Daimler AG reached a settlement with the SEC and DOJ in 2010 for alleged violations of the FCPA. Under the settlement, Daimler paid over \$180 million in fines and civil disgorgement.<sup>57</sup>

Members of the insurance industry have also been parties to settlements of this sort. For example, in 2005, Marsh & McLennan Companies, Inc. agreed to pay \$850 million to settle civil fraud charges brought by New York State for allegedly steering business to other insurance companies in exchange for payoffs.<sup>58</sup>

With settlement payments totaling billions of dollars, the tax implications to the fisc and to taxpayers alike are obviously enormous. To the extent that the settlement payments are not “fines” or “similar penalties” contemplated by section 162(f), the amounts are deductible for U.S. federal taxpayers as long as they otherwise meet the requirements of section 162. The result in most cases likely would be federal tax savings of more than a third of the deductible settlement payment. With the exception of settlement agreements entered into with the SEC, many settlement agreements do not prohibit a tax deduction for amounts paid thereunder or characterize payments in a way that resolves tax deductibility under section 162(f). In fact, many government agencies involved in negotiating settlement agreements apparently are reluctant to characterize the payments for tax purposes because of a perceived lack of expertise in tax law, and a preference that the IRS instead handle such matters.<sup>59</sup> The IRS, however, has expressed the hope that characterization of settlement payments as punitive, *i.e.*, nondeductible payments, or compensatory, *i.e.*, deductible payments, would be addressed by

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56. Peter Lattman, *Boeing Doesn't Take Tax Deduction; Grassley Still Slams DOJ*, WALL ST. J. (July 27, 2006), <http://blogs.wsj.com/law/2006/07/27/boeing-doesnt-take-tax-deduction-grassley-still-slams-doj/> [hereinafter Lattman, *Boeing Tax Deduction*].

57. Press Release, U.S. Dep't of Justice, Daimler AG and Three Subsidiaries Resolve Foreign Corrupt Practices Act Investigation and Agree to Pay \$93.6 Million in Criminal Penalties (Apr. 1, 2010), <http://www.justice.gov/opa/pr/2010/April/10-crm-360.html>.

58. Press Release, New York State Ins. Dep't, Insurance Broker Agrees to Sweeping Reforms; Marsh to Pay \$850 Million in Restitution and Ban Contingent Commissions (Jan. 31, 2005), <http://www.dfs.ny.gov/insurance/press/2005/p0501311.htm>.

59. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-05-747, SYSTEMATIC INFORMATION SHARING WOULD HELP IRS DETERMINE THE DEDUCTIBILITY OF CIVIL SETTLEMENT PAYMENTS (2005).

the governmental agencies negotiating the settlement.<sup>60</sup> It is not inconceivable that the agencies would rather not, because doing so would complicate the settlement process which is difficult enough. Many taxpayers might agree and prefer to sort it out with the IRS after the fact.

From an operational or administrative standpoint, as a general matter, it is hard not to conclude that something is wrong with the system as it relates to federal settlements. It is, after all, one government. A federal deduction for a federal settlement payment, in fiscal terms, is a “give back” to the payor, borne by all taxpayers. Ideally, left hand and right hand would coordinate.

The policy behind section 162(f), of course, is that no payment for violating or allegedly violating the law should be deductible. It has been noted that the harm to the public from matters relating to settlements are four-fold, and some of the harms may be encouraged by, or relate to, tax deductibility.<sup>61</sup> First, the initial violation giving rise to the deduction is usually a direct harm to the public.<sup>62</sup> Second, as mentioned above, the public bears the cost of the tax deduction.<sup>63</sup> Third, the deterrence against future violations is thwarted when violations of laws give rise to a tax benefit.<sup>64</sup> Finally, the use of a settlement rather than a public trial may deny the public of the full disclosure of the violation.<sup>65</sup>

In at least one instance described above, the potential public outcry was so strong that the taxpayer, Boeing, decided to forego a tax deduction that it believed could have saved as much as \$215 million in federal taxes.<sup>66</sup> It was reported that in a quarterly earnings call, Boeing’s CEO stated that

[w]hile the decision not to deduct the \$615 million will be costly in the short run, it is an important long-term move to improve Boeing’s reputation and move the company in a new direction. Without question, the short-term impact of the tax issue is significant. However, the long-term value of Boeing’s reputation is even more significant. I feel strongly that the

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60. See, e.g., Internal Revenue Service, *Coordinated Issues—All Industries—False Claims Act Settlements With Department of Justice (DOJ)* (Sept. 5, 2008), <http://www.irs.gov/Business/Coordinated-Issue---All-Industries---FalseClaimsAct-Settlements-With-Department-Of-Justice-%28DOJ%29>.

61. U.S. PIRG Education Fund, *Subsidizing Bad Behavior: How Corporate Legal Settlements for Harming the Public Become Lucrative Tax Write Offs, with Recommendations for Reform* (Jan. 2013), <http://www.uspirg.org/sites/pirg/files/reports/Subsidizing%20Bad%20Behavior%20USPIRG%20EF.pdf>.

62. *Id.*

63. *Id.*

64. *Id.*

65. *Id.*

66. Lattman, *Boeing Tax Deduction*, *supra* note 56.

right thing for Boeing to do is not to seek tax deductibility for the settlement charges.<sup>67</sup>

Given the obligation of corporate management to minimize taxes in any way that is lawful, the perceived economic risk to Boeing's business must have been immense. Given the amount of federal business done by Boeing, perhaps that is not surprising. Companies in many industries are not so constrained.

While the list of settlements, above, is no doubt incomplete, what was described is a total of over \$65 billion in payments made by 25 companies. With so much at stake both in the public and private sectors, the issue of whether section 162(f) applies to fines, penalties, and settlement payments is an important one. The Code and the Regulations thereunder do not adequately address it. In many cases, taxpayers and the IRS will be left to fight it out.<sup>68</sup> An understanding of the origins of section 162(f), and its scope as determined by the courts, is crucial.

C. *Prior Law, the Frustration Doctrine, and the Enactment of Section 162(f)*

Reflected throughout the discussion that follows are the competing goals that both Congress and the courts have been faced with in addressing the issue of deductibility of amounts paid as a result of actual or potential legal transgressions, that is, balancing the tax goal of taxing net income with the broader policy goal of encouraging compliance with state and federal laws. It has long been Congress's intent in enacting the income tax laws, as a general matter, to tax net and not gross income, *i.e.*, to tax receipts less expenses.<sup>69</sup> However, the ability to deduct expenses from gross income in order reach net or taxable income has been premised on the requirement that such expenses be both ordinary and necessary to carrying on a taxpayer's business.<sup>70</sup> While no precise definition of the terms "ordinary" and "necessary" exists, the Supreme Court has stated that

[o]rdinary has the connotation of normal, usual, or customary.  
To be sure, an expense may be ordinary though it happens but

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67. *Id.*

68. *Guardian Indus. Corp. v. Commissioner*, 143 T.C. 1 (2014) (upholding the IRS's determination under section 162(f) that the taxpayer was not entitled to deduct a €20 million penalty paid to the Commission of the European Community after the Commission determined that the taxpayer participated in prohibited price fixing).

69. *McDonald v. Commissioner*, 323 U.S. 57 (1944); *Higgins v. Smith*, 308 U.S. 473 (1940).

70. *Deputy v. Dupont*, 308 U.S. 488 (1940).

once in the taxpayer's lifetime. Yet the transaction which gives rise to it must be of common or frequent occurrence in the type of business involved. Hence, the fact that a particular expense would be an ordinary or common one in the course of one business and so deductible under [section 162] does not necessarily make it such in connection with another business. . . . One of the extremely relevant circumstances is the nature and scope of the particular business out of which the expense in question accrued. The fact that an obligation to pay has arisen is not sufficient. It is the kind of transaction out of which the obligation arose and its normalcy in the particular business which are crucial and controlling.<sup>71</sup>

The term "necessary" has been said to include those expenses which are "appropriate and helpful" in carrying on a trade or business.<sup>72</sup> Broad as that definition may be, necessity cannot be established where the allowance of the deduction would frustrate sharply defined public policy reflected by a governmental declaration thereof.<sup>73</sup> *Textile Mills Securities Corporation v. Commissioner*,<sup>74</sup> one of the first in its line of cases, involved the deductibility of lobbying expenses in the form of payments to lawyers and publicists. The Court held that such expenses were not deductible as "ordinary and necessary" business expenses because of the existence of an analogous Regulation prohibiting deductions for lobbying expenses as charitable contributions.<sup>75</sup> To have allowed the deduction under section 162, in the Court's view, would have been to ignore a clear general policy established by the Department of the Treasury.<sup>76</sup>

Two years later, in 1943, the Supreme Court drew a line and held that legal fees were deductible where they were paid by a dentist to defend his

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71. *Id.* at 495–96 (citations omitted).

72. *Welch v. Helvering*, 290 U.S. 111, 113 (1933).

73. *Textile Mills Sec. Corp. v. Commissioner*, 314 U.S. 326 (1941); *Commissioner v. Heininger*, 320 U.S. 467 (1943); *Lilly v. Commissioner*, 343 U.S. 90 (1952). *See also* *Faulk v. Commissioner*, 26 T.C. 948 (1956) (finding that forfeiture and double damages payments to the government, assessed for committing fraud against the government, were nondeductible, because deducting such payments would frustrate sharply defined public policy). *Cf.* *Commissioner v. Tellier*, 383 U.S. 687 (1966) (the frustration doctrine did not bar the taxpayer's deduction of legal fees incurred to defend against criminal charges he faced as a securities dealer; there was no articulated and identifiable national or state policy which would be frustrated by such a deduction).

74. 314 U.S. 326 (1941).

75. *Id.*

76. *Id.*



business against a finding by the Postmaster General that the dentist's mail advertisements were misleading and fraudulent.<sup>77</sup> The Court reasoned that expenses incurred in defending the business from threatened impairment or destruction were ordinary and necessary, as much so as would be expenses incurred in defense of a damage suit based on malpractice, fraud, or breach of fiduciary duty, expenses which are deductible.<sup>78</sup> The Court stated that while the deductibility of ordinary and necessary expenses has been narrowed where the deduction might frustrate public policy:

It has never been thought, however, that the mere fact that an expenditure bears a remote relation to an illegal act makes it non-deductible advertising [through mail]. It is not [the] policy [of the laws at issue] to impose personal punishment on violators; such punishment is provided by separate statute . . . . It follows that to allow the deduction of respondent's litigation expenses would not frustrate the policy of these statutes . . . .<sup>79</sup>

The Court added that to hold the expenses nondeductible on account of being extraordinary or unnecessary "would be to ignore the ways of conduct and the forms of speech prevailing in the business world."<sup>80</sup>

In *Lilly v. Commissioner*, another frustration doctrine case, an optical company that supplied and fit frames for eye glasses prescribed by eye doctors, made payments to those eye doctors to compensate them for the loss of profit they would have earned if the doctors had fit the frames themselves.<sup>81</sup> The optical companies then deducted the payments as ordinary and necessary business expenses.<sup>82</sup> The IRS (then referred to as the Bureau of Revenue) disallowed the deductions on the grounds that the payments were contrary to public policy.<sup>83</sup> The Supreme Court, however, held that the payments were ordinary and necessary in the generally accepted meaning of the phrase, and that there was no sharply defined state or national public policies against the payments.<sup>84</sup> The Court stated that while customs and actions of organized

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77. *Heininger*, 320 U.S. at 467.

78. *Id.* at 472.

79. *Id.* at 474.

80. *Id.* at 472.

81. *Lilly v. Commissioner*, 343 U.S. 90 (1952).

82. *Id.* at 92.

83. *Id.* at 93. Note that the "public policy" relied upon by the court, and seemingly the IRS, was merely standards of professional conduct and the "very high degree of trust and confidence existing between those doctors and their patients." *See* *Thomas B. Lilly*, 14 T.C. 1066 (1950).

84. *Lilly*, 343 U.S. at 96-97.

professional organizations may be admissible to establish what is ordinary and necessary, they do not themselves constitute sharply defined national or state policies the frustration of which, may, as a matter of law, preclude the deductibility of an expense.<sup>85</sup>

Prior to the enactment of section 162(f), case law specifically addressing the deductibility of fines was also generally based on the principle that deductions for the payment of fines should be disallowed where such deductions would frustrate public policy and “remove some part of the sting” of the fine or penalty.<sup>86</sup> *Tank Truck Rentals v. United States* addressed the deductibility of payments for fines made by a trucking company for the violation of weight limitation laws of eight states.<sup>87</sup> Having concluded that the cost of compliance with the laws of each state would be far more costly than the punishment for violations of such laws, the trucking company took the calculated risk of noncompliance.<sup>88</sup> Ultimately, the Court held that payments were nondeductible because to allow the deduction would “encourage continued violations of state or federal law by increasing the odds in favor of noncompliance, destroying the effectiveness of those laws.”<sup>89</sup> In reaching its decision, the Court relied on the frustration doctrine that was considered, and sometimes followed, in the abovementioned cases. It clarified that the frustration doctrine is not to be applied in an absolute sense, but rather where the deduction of fines and penalties would reduce “the sting of the penalty prescribed by the state legislature.”<sup>90</sup> In applying the frustration doctrine, the Court stated that

the test of nondeductibility always is the severity and immediacy of the frustration resulting from allowance of the deduction. The flexibility of such a standard is necessary if we are to accommodate both the congressional intent to tax

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85. *Id.* at 97.

86. *Tank Truck Rentals, Inc. v. United States*, 356 U.S. 30, 36 (1958). *See also* *Hoover Motor Express Co., Inc. v. United States*, 356 U.S. 38 (1958); *A.D. Julliard & Co., Inc. v. Johnson*, 259 F.2d 837 (2d. Cir. 1958) (deduction of fine for violation of World War II Maximum Price Regulation would frustrate public policy in the absence of taxpayer proving that violations were the product of inadvertent error); *Tunnel R.R. v. Commissioner*, 61 F.2d 166 (8th Cir. 1932) (payment of fines by terminal corporation and affiliates for violation of Federal Safety Appliance Acts and Twenty-Eight Hour Live Stock Acts were nondeductible because such fines arose from unlawful activity and Congress could not have intended that such violations should result in any advantage, direct or indirect).

87. *Tank Truck Rentals, Inc.*, 356 U.S. at 36.

88. *Id.* at 33.

89. *Id.* at 35.

90. *Id.* at 36.

only net income, and the presumption against congressional intent to encourage violation of declared public policy.<sup>91</sup>

In 1969, Congress codified the principles underlying *Tank Trunk Rentals* by amending section 162(c) to prohibit the deduction of amounts paid for illegal bribes, illegal kickbacks, and other illegal payments, and by enacting section 162(f), providing that payments of fines and similar penalties are nondeductible.<sup>92</sup> The legislative history suggests, however, that Congress intended to set limits on the extent to which the frustration doctrine would trump the competing tax goal of taxing net income. The accompanying Senate report for the section 162(c) amendments states that

[t]he provision added by the committee amendments denies deductions for four types of expenditures: fines or similar penalties paid to a government for the violation of any law, a portion of treble damage payments under the antitrust laws following a related criminal conviction (or plea of equity or nolo contendere), deductions for bribes paid to public officials (whether or not foreign officials), and other unlawful bribes or “kickbacks.” The provision for the denial of the deduction for payments in these situations which are deemed to violate public policy is intended to be all inclusive. Public policy, in other circumstances, generally is not sufficiently clearly defined to justify the disallowance of deductions.<sup>93</sup>

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91. *Id.* at 35.

92. As an aside, the frustration doctrine underlying section 162, including section 162(f), has been considered relevant in determining whether a taxpayer could claim a charitable contribution under section 170, basis under sections 263A and 1012, and a deduction under section 165. *See, e.g.*, Rev. Rul. 79-148, 1979-1 C.B. 93 (court-ordered charitable transfer in a criminal case was not deductible under section 162(f) because it was a substitute for a fine or penalty, and as such, was also not deductible as a charitable contribution under section 170); T.A.M. 2006-29-030 (Mar. 31, 2006) (applying principles of section 162(f), IRS denied basis to taxpayer under sections 1012 and 263A for construction costs incurred by taxpayer’s voluntary participation in environmental remediation program in connection with taxpayer’s Clean Air Act violation); P.L.R. 1980-31-098 (Feb. 22, 1980) (payment made by vice-chairman to reimburse corporation for illegal political contributions made with vice-chairman’s approval was nondeductible under sections 162, 212, and 165 because payment retained illegal nature of the campaign contributions); P.L.R. 1980-31-078 (Feb. 22, 1980) (same); F.S.A. 1992-904 (May 27, 1992) (where section 162(f) did not technically apply, an argument could be raised that payments were deductible under section 165, but the frustration doctrine codified in section 162(f) was highly relevant in determining whether the payments were deductible under section 165).

93. S. REP. NO. 91-552, at 2972 (1969).

The Senate report goes on to say that with respect to the first type mentioned, fines or similar penalties paid to a government for the violation of any law (that is, section 162(f)), “[t]his provision is to apply in any case in which the taxpayer is required to pay a fine because he is convicted of a crime (felony or misdemeanor) in a full criminal proceeding in an appropriate court. This represents a codification of the general court position in this respect.”<sup>94</sup>

Two years later, after sections 162(c) and (f) were enacted, Congress became concerned that

these provisions, enacted in 1969, may in some cases unduly restrict the denial of deductions . . . for example, in the case of fees paid to individuals for referring patients under the Medicare and Medicaid programs. The committee continues to believe that the determination of when a deduction should be denied should remain under the control of Congress. However, the committee has concluded that the area in which deductions are denied should be expanded somewhat beyond the limits set in 1969.<sup>95</sup>

In its then form, section 162(c) denied deductions for illegal bribes, illegal kickbacks, or other illegal payments where there was either a criminal proceeding conviction or a *nolo contendere* plea with regard to the illegality of the payment.<sup>96</sup> Moreover, section 162(f) was applied in such a way that civil fines that were penal in nature were not subject to disallowance because they were not incurred in connection with a criminal proceeding.<sup>97</sup>

In response to perceived gaps in the statute, in 1971, Congress expanded the scope of section 162(c) by providing that a payment would be nondeductible if the payment would “subject the payor to a criminal penalty or the loss of license or privilege to engage in a trade or business.”<sup>98</sup> Congress did not amend section 162(f) to address civil penalties but it did clarify its

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94. *Id.*

95. S. REP. NO. 92-437, at 1979 (1971).

96. Prior to amendment in 1971, section 162(c)(2) read as follows: “(2) Other bribes or kickbacks. If in a criminal proceeding a taxpayer is convicted of making a payment (other than a payment described in paragraph (1)) which is an illegal bribe or kickback, or his plea of guilty or *nolo contendere* to an indictment or information charging the making of such a payment is entered or accepted in such a proceeding, no deduction shall be allowed under subsection (a) on account of such payment or any related payment made prior to the date of the final judgment in such proceeding.”

97. S. REP. NO. 92-437, at 1979.

98. *Id.*

scope. The legislative history to the 1971 amendments to section 162(c) indicates that section 162(f) was intended to capture civil penalties that serve the same purpose as criminal fines, but that it was not intended to capture penalties aimed at encouraging prompt compliance with the laws. The Senate report for the amendments provides that

[i]n connection with the proposed regulations relating to the disallowance of deductions for fines and similar penalties (sec. 162(f)), questions have been raised as to whether the provision applies only to criminal “penalties” or also to civil penalties as well. In approving the provisions dealing with fines and similar penalties in 1969, it was the intention of the committee to disallow deductions for payments of sanctions which are imposed under civil statutes but which in general terms serve the same purpose as a fine exacted under a criminal statute. The provision was intended to apply, for example, to penalties provided for under the Internal Revenue Code in the form of assessable penalties (subchapter B of chapter 68) as well as to additions to tax under the internal revenue laws (subchapter A of chapter 68) in those cases where the government has the fraud burden of proof (i.e., proof by clear and convincing evidence). It was also intended that this rule should apply to similar type payments under the laws of a State or other jurisdiction.

On the other hand, it was not intended that deductions be denied in the case of sanctions imposed to encourage prompt compliance with requirements of law. Thus, many jurisdictions impose “penalties” to encourage prompt compliance with filing or other requirements which are really more in the nature of late filing charges or interest charges than they are fines. It was not intended that this type of sanction be disallowed under the 1969 action. Basically, in this area, the committee did not intend to liberalize the law in the case of fines and penalties.<sup>99</sup>

## II. AMBIGUITY AND FRUSTRATIONS UNDER SECTION 162(f)

Since the enactment of section 162(f), an extensive body of case law has emerged that addresses the application of section 162(f) to various payments taxpayers have claimed as deductible under section 162(a). The Tax Court and other federal courts across the country have addressed issues

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99. S. REP. NO. 92-437, at 1979-80.

associated with applying section 162(f) and determining whether various payments are deductible.<sup>100</sup> In analyzing the applicability of section 162(f), courts have considered multiple factors.

Before considering more specific matters discussed below, it may be helpful to summarize the scope of section 162(f) based on the statute and Regulations thereunder. Those rules (1) extend nondeductibility under section 162(f) to fines and similar penalties paid to the government of the United States, the District of Columbia, Puerto Rico, or a foreign government, as well as to a political subdivision, corporation, agency, or other entity that is an instrumentality of any of them, (2) define as proscribed payments “fines” and “similar penalties,” meaning an amount paid pursuant to a criminal conviction or plea (including *nolo contendere*), as well as civil penalties paid under federal, state, local, or foreign law, including as additions to tax or tax penalties, and, amounts paid to settle a taxpayer’s liability for a civil or criminal fine or penalty, and (3) confirm that section 162(f) does not apply to compensatory payments or changes intended to ensure prompt compliance with the law.<sup>101</sup>

Two more points are important to keep in mind. First, it should be noted, as the discussion of cases below will demonstrate, that not all civil payments labeled a fine or a penalty are subject to section 162(f). The courts have shown a willingness to look beyond what a payment is called to determine whether section 162(f) applies, that is, whether the payment is punitive or deterrent on the one hand, or compensatory on the other. That inquiry is invited by the use of the term “similar” to modify the word “penalties” in the law, and also by the interchangeable use of the terms “fines” and “penalties.”<sup>102</sup> Moreover, extending a tax rule to any item based simply on what the item is called tends to cede the item’s tax treatments to whoever creates the label, which usually is not a good idea.

The second thing to remember is that the analysis of whether section 162(f) applies to a settlement payment adds a level of inquiry to the exercise.

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100. As was stated above, the taxpayer has the burden of proving it is entitled to a deduction. Therefore, the taxpayer has the burden of proving section 162(f) does not prohibit a deduction that has been claimed. *Talley Indus., Inc. v. Commissioner*, 116 F.3d 382, 387 (9th Cir. 1997) (citing *Norgaard v. Commissioner*, 939 F.2d 874, 877 (9th Cir. 1991)).

101. Pursuant to the Regulations, forfeited amounts are also nondeductible under section 162(f). Reg. § 1.162–21(b).

102. *See S. Pac. Transp. Co. v. Commissioner*, 75 T.C. 497, 650 (1980) (questioning the taxpayer’s distinction between a fine and a penalty). It could be argued based on the plain wording of section 162(f) and Regulations thereunder that every fine should be nondeductible. That reading of the word “fine” may be reinforced by the use of the word “similar” to describe penalties to which section 162(f) applies. Nonetheless, courts look beyond labels in applying section 162(f), as they do in applying other parts of the Code.

Not only must the purpose of the underlying statute that provides for a fine or penalty be determined, but a determination of whether any of the payment is in settlement of potential liability for a nondeductible fine or penalty, or is for something else, must be determined.<sup>103</sup>

A. *Basic Section 162(f) Analysis*

As a general rule, in order to decide whether section 162(f) applies to a fine or a penalty, a court must first determine whether the statute imposing the fine is an enforcement tool that is intended to be penal. It is generally safe to assume that any criminal fine or penalty is subject to disallowance under section 162(f).<sup>104</sup> Civil fines and penalties, however, may or may not be subject to section 162(f), and that is where the analysis comes in. The question of the nondeductibility of civil penalties under section 162(f) was addressed in *Southern Pacific Transportation Company v. Commissioner*.<sup>105</sup> In that case, the Tax Court found that the penalties at issue were intended to enforce the law and punish violations thereof. As a result, they were held to be nondeductible under section 162(f). The case is often cited in section 162(f) analyses, so it is worth considering in more detail here.

Southern Pacific Transportation Company (“Southern Pacific”) was a Delaware corporation with its principal office in California. Southern Pacific filed consolidated federal income returns for tax years 1959, 1960, and 1961, and claimed deductions therein for certain penalties incurred for violating two federal laws, the Safety Appliance Act and the Twenty-Eight Hour Act. The Safety Appliance Act required railroad companies, like Southern Pacific, engaged in interstate commerce to ensure that their trains contained specific

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103. For an example of IRS analysis relating to whether a payment was in settlement of potential liability for a fine or penalty, see F.S.A. 2002–10–011 (Nov. 19, 2001). It illustrates the IRS’s analysis in two situations: one where the settlement agreement relating to the taxpayer’s Sherman Act violation was explicit as to the compensatory nature of the settlement payment, and another where the settlement agreement relating to the taxpayer’s FCA and Lanham Act violations was silent as to the nature of the settlement payment and the underlying statutes served both punitive and compensatory purposes.

104. Note that it is possible for a payment made in a criminal context to be characterized not as a section 162(f) fine or penalty, but rather as a compensatory payment. See P.L.R. 1977–36–040 (May 31, 1977) (taxpayer’s payment of a fine after entering a plea of *nolo contendere* to alleged violations of Wisconsin anti-trust law was deductible where the settlement agreement characterized the payment as compensatory). In a Tax Court case addressing the violation of an Illinois anti-trust law a different outcome was reached. *Robinson v. Commissioner*, 48 T.C.M. (CCH) 508, 1984 T.C.M. (RIA) ¶ 84,358 (taxpayer’s payment in lieu of a penalty under the Illinois anti-trust act was nondeductible under section 162(f) because it was in the place of a penalty which would have been nondeductible under section 162(f)).

105. 75 T.C. 497 (1980).

operating and safety equipment and that the equipment was maintained in good operating condition. The law imposed a \$250 civil penalty for each violation of the statute. The law, and the penalties thereunder, were intended to protect those who came in contact with the train from injuries that could result from defective equipment. The Safety Appliance Act imposed a strict liability standard, and various mechanical issues with trains' operating and safety equipment caused Southern Pacific to repeatedly violate the statute. The Twenty-Eight Hour Act was enacted to prevent cruelty to animals in transit. It prohibited animals being transported in interstate commerce by rail from being confined for a period longer than 28 hours without having at least five hours to rest, drink water, and eat in a pen. It was a violation of that statute to continuously confine an animal in a railroad car beyond the specified statutory time limit willfully and knowingly. Apparently, Southern Pacific exercised due care in attempting to comply with the statutory requirements, however, operational complications made it difficult to meet the requirements. A penalty of between \$100 and \$500 was imposed on Southern Pacific for each violation.

Section 162(f) was enacted in 1969, and Congress specifically made it retroactive to all years to which the 1954 Internal Revenue Code applied.<sup>106</sup> In *Southern Pacific*, the court first determined that the penalties incurred and paid by Southern Pacific for taxable years 1959 through 1961 were ordinary and necessary business expenses under section 162(a). It reached this finding based on a belief that (1) Southern Pacific exercised due care in attempting to comply with both statutes, (2) the violations were unavoidable in the course of Southern Pacific's daily operations, and (3) violations of both statutes commonly occurred throughout the railroad industry. These findings were not the end of the court's analysis, however. Next, the court determined that the penalties paid by Southern Pacific served to enforce the law and protect employees from injury due to defective safety equipment and to prevent cruelty to animals in transit. The court analogized to the fines in *Tank Truck Rentals* in finding the civil penalties to be punitive or penal in nature. In both cases, the taxpayers violated laws that were intended to ensure safety and protect people or, in the case of the Twenty-Eight Hour Act, animals from harm. As was mentioned above, section 162(f) prohibits the deduction of expenses under section 162(a) for "any fine or similar penalty paid to a government for the violation of any law." Regulations define a "fine or similar penalty" as including an amount "paid as a civil penalty imposed by Federal,

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106. *S. Pac. Transp. Co.*, 75 T.C. at 646–47. The taxpayer challenged the retroactive application of section 162(f). The court upheld it. The court also said that the challenge to the retroactivity of section 162(f) was moot because allowing a deduction for the penalties in question also would have violated public policy. A retroactive statutory effective date for a tax statute is unusual today absent a perceived abuse. Earlier on, however, it was more common for Congress to adopt retroactive effective dates. Perceived unfairness was outweighed by the goal of resolving controversies without costly and time-consuming litigation.



State, or local law.”<sup>107</sup> Based on this definition, and referencing Example 5 in the Regulations, which describes a penalty imposed by the Safety Appliance Act, the court decided that the type of penalty at issue was intended to be covered by section 162(f).<sup>108</sup> The court reached the same conclusion about penalties under the Twenty-Eight Hour Act.

One reason *Southern Pacific* is often cited by other courts is the depth of the court’s analysis. For example, the court explicated Congress’s prescription to “disallow deductions for payments of sanctions which are imposed under civil statutes but which in general terms serve the same purpose as a fine exacted under a criminal statute.”<sup>109</sup> Such a penalty was distinguished from sanctions intended to encourage prompt compliance with the law. The court reasoned that when Congress used the word “similar,” it was not distinguishing between civil and criminal sanctions. Rather, it was differentiating between different types of civil penalties. The court said:

If a civil penalty is imposed for purposes of enforcing the law and as punishment for the violation thereof, its purpose is the same as a fine exacted under a criminal statute and it is “similar” to a fine. However, if the civil penalty is imposed to encourage prompt compliance with a requirement of the law, or as a remedial measure to compensate another party for expenses incurred as a result of the violation, it does not serve the same purpose as a criminal fine and is not “similar” to a fine within the meaning of section 162(f).<sup>110</sup>

In those two sentences, the court explained the framework that today is the foundation of section 162(f) analyses in civil contexts. It distinguished criminal monetary sanctions and civil impositions like them from civil ones that are intended merely to encourage prompt compliance rather than punish or that are compensatory or remedial and in the nature of economic damages. Because the court believed the penalties paid by the taxpayer in *Southern Pacific* were intended to punish, it determined that section 162(f) applied and the payments could not be deducted.

Another important case in the development of the law under section 162(f) is *Colt Industries, Inc. v. United States*.<sup>111</sup> In *Colt Industries*, the U.S. Court of Appeals for the Fifth Circuit determined that the payment at issue was

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107. Reg. § 1.162–21(b)(1)(ii).

108. Reg. § 1.162–21(c), Ex.5.

109. *S. Pac. Transp. Co.*, 75 T.C. at 651 (quoting S. REP. NO. 92–437, at 600 (1971)).

110. *Id.* at 652.

111. 880 F.2d 1311 (5th Cir. 1989).

penal in nature and, therefore, was nondeductible under section 162(f). The facts were that Crucible, Inc. (“Crucible”), a subsidiary of Colt Industries, Inc. (“Colt”) that joined in the filing of Colt’s consolidated federal income tax return, manufactured steel products in Midland, Pennsylvania. In the course of its business, Crucible was subject to the Federal Clean Air Act, the Federal Clean Water Act, and several other federal and state environmental protection laws and regulations. In 1976, the EPA discovered that several state regulations had been violated by Crucible and, pursuant to the Clean Air Act, issued notices of such violations to Crucible. Crucible failed to eliminate the violations by the required dates, and so in April 1978, the EPA rejected the compliance plan Crucible had proposed. At the EPA’s request, DOJ instituted a civil lawsuit against Crucible, seeking an injunction and \$25,000 in civil penalties for each day Crucible violated the law. The EPA also alleged that Crucible discharged pollutants into the Ohio River in excess of authorized amounts and, therefore, recommended additional civil penalties of \$10,000 per day of violation. The parties entered into negotiations and ultimately filed a consent decree in June 1979, under which Crucible paid \$1.6 million to the Pennsylvania Clear Air and Clean Water Funds. Colt deducted this payment as an ordinary and necessary business expense in its federal consolidated return for 1979, the year Colt incurred the expense. The IRS disallowed the deduction, asserting that the payments constituted fines or similar penalties under section 162(f).

The court found that the payments were civil penalties prohibited under the plain language of section 162(f). Colt conceded that the payments were “civil penalties,” as denominated in the consent decree and acknowledged that the checks Colt remitted to satisfy the penalties contained the notation “E.P.A. Penalty.” Nonetheless, Colt argued that only civil penalties serving “a punitive or criminal purpose” were barred from deduction under section 162(f) and that the penalties it paid did not serve such a purpose. Colt also argued that the penalties were compensatory because they were intended “essentially [to return Crucible] to the financial position in which it would have been had it complied with those laws,” and, therefore, that such payments were outside the ambit of section 162(f).<sup>112</sup> The statutes under which Colt paid the penalties, however, did not authorize the collection of compensatory payments, only injunctive relief and monetary penalties, and Colt failed to explain to the satisfaction of the court a connection between the

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112. *Id.* at 1313 (alteration in original).

payments and compensation.<sup>113</sup> Therefore, the court rejected Colt's arguments and sustained the IRS's position under section 162(f).<sup>114</sup>

The IRS's position was also sustained in *True v. United States*.<sup>115</sup> In *True*, the U.S. Court of Appeals for the Tenth Circuit determined that the penalties paid by the taxpayers were intended to serve a deterrent purpose, similar to a criminal fine. The taxpayers involved in this case were individuals who owned True Oil Company, a Wyoming general partnership, and also were the shareholders of Belle Fourche Pipeline Company ("Belle Fourche"), a subchapter S corporation. Belle Fourche paid a civil penalty under the Federal Water Pollution Control Act, which was imposed because oil leaked from some of the company's pipelines in violation of the act. Belle Fourche deducted the payment under section 162(a), and the IRS disallowed the deduction pursuant to section 162(f).

In determining whether the disallowance was proper, the court began by citing Regulation section 1.162-21, which defines "fine or similar penalty" to include payments made "as a civil penalty imposed by Federal, State, or local law."<sup>116</sup> An example in the Regulations concluded that a civil penalty imposed on a taxpayer under the same Water Pollution Control Act at issue in the case was nondeductible under section 162(f). Therefore, in the court's view, as long as the Regulation was valid, the court would be required to hold for the IRS and find the civil penalty assessed on Belle Fourche to be nondeductible under section 162(f).

Relying on Congressional intent and citing the public policy doctrine enforced by courts prior to the enactment of section 162(f), the court found that the Regulation was reasonable and consistent with the statute and, therefore, was valid.<sup>117</sup> The court said:

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113. Analyses of underlying statutes were applied by the Tax Court in *Jenkins v. Commissioner*, 72 T.C.M. (CCH) 1470, 1996 T.C.M. (RIA) ¶ 96,539, to reach the opposite conclusion regarding deductibility. In that case the taxpayer made payments to the North Carolina and Virginia Departments of Agriculture because it violated their state fertilizer laws. The court said the character of the payments would be determined by looking at the purpose of the underlying statutes and establishing what the payments were intended to accomplish. It analyzed the two statutory schemes and found that the payments were aimed at compensating consumers of deficient fertilizer who were harmed by the violations. Therefore, even though payments were made to the government in instances where individual victims could not be identified, the purpose of the laws was to compensate for actual losses, not to penalize violators. Therefore, deductibility was not barred by section 162(f).

114. *Colt Indus.*, 880 F.2d at 1314.

115. 894 F.2d 1197 (10th Cir. 1990).

116. *Id.* at 1201-02 (quoting Reg. § 1.162-21(b)(1)(ii)).

117. *Id.* at 1202-04.

[S]ection 162(f) encompasses fines and penalties exacted to sanction or punish conduct which some well-defined state policy seeks to proscribe. Whether the statute is determined to be “criminal” or “civil” is not conclusive. Rather, the nondeductibility exception for “fines and similar penalties” includes criminal fines and any similar retributive civil penalty intended to sanction conduct the state specifically seeks to prohibit. It follows implicitly that compensatory or remedial payments are beyond the scope of section 162(f). In addition, civil penalties for the violation of reporting requirements, filing deadlines, and other procedural failings which do not frustrate the primary purpose of the statutory scheme also remain deductible.<sup>118</sup>

The court viewed the civil penalty under the Water Pollution Control Act as punitive, not compensatory. The court said that it served “a deterrent and retributive function similar to a criminal fine.”<sup>119</sup> In determining the size of the penalty, the factors considered were (1) the appropriateness of the penalty as compared to the size of the taxpayer’s business, (2) the effect on the taxpayer’s ability to continue operating its business, and (3) the gravity of the violation.<sup>120</sup> The court found that only the third factor related to the amount of damage caused. The first two factors were purely retributive in nature. Consequently, the penalty imposed on Belle Fourche was held to be nondeductible under section 162(f).

In all three of the cases discussed immediately above, the taxpayer’s claim that the payment was deductible under section 162(a) was thwarted by the court’s determination that the underlying statute was intended to punish violators and deter the prohibited behavior.<sup>121</sup> Therefore, such payments were nondeductible under section 162(f).

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118. *Id.* at 1204.

119. *Id.* at 1205. The court stated that the fact that the penalty at issue followed a strict liability standard was not enough to establish that the penalty was essentially compensatory in light of section 162(f) legislative history suggesting that some penalties for violations of strict liability may be nondeductible.

120. *Id.* at 1206.

121. The importance of the legislative intent underlying a statute to the section 162(f) deductibility analysis is evident in yet another case finding that settlement payments were punitive and, therefore, nondeductible in accordance with legislative history, where both the taxpayer and the government characterized the payments as remedial. *McGraw-Edison Co. v. U.S.*, 300 F.2d 453 (Ct. Cl. 1962) (fines for violations relating to use of child labor under the Walsh Healey Act were nondeductible section 162(f) payments because the legislative history made clear that

B. *Section 162(f) Analysis in Complex Contexts*

As was discussed above, the purpose of the underlying statute, that is, whether the statute and the payment imposed thereunder are intended to punish or deter is a critical determinant of whether a payment falls within the ambit of section 162(f). Additional factors also may be relevant. The cases discussed above were relatively straight-forward. In some instances, however, the facts may be more complex or the statutory structure more involved. The discussion below addresses section 162(f) analyses in more complex contexts.

In *Mason & Dixon Lines, Inc. v. United States*<sup>122</sup> the U.S. Court of Appeals for the Sixth Circuit considered not only the nature of the underlying statute, but also the surrounding statutory landscape in order to reach the conclusion that the payment at issue was remedial in nature. Mason & Dixon Lines, Inc. (“Mason & Dixon”) was an interstate trucking company based in Tennessee. From 1971 to 1975, its trucks were repeatedly found to exceed statutory weight limits under Virginia law, a violation which was punishable with a fine, imprisonment, or both. Mason & Dixon never deducted the fines it paid on its federal tax returns. In 1975, however, it did deduct court costs and liquidated damages paid to Virginia in connection with violations of the Virginia weight limit statute. The IRS disallowed the deductions for the liquidated damages.<sup>123</sup> The court reasoned that the question before it was whether the liquidated damages Mason & Dixon paid were considered “fines or similar penalties paid for violations of law.”<sup>124</sup> Mason & Dixon argued that the payments were compensatory damages, not fines or similar penalties, while the IRS argued the opposite position. The court held for the taxpayer. In determining which position accurately characterized the payments, the court began by noting that Virginia law imposed two separate sanctions for violating its weight restriction laws. The court said, “Section 46.1-16 provides that a person convicted of a misdemeanor for violation of any provision of designated portions of the code establishing weight limits ‘for which no other penalty is provided’ is to be punished by a fine or imprisonment or both.”<sup>125</sup> Mason & Dixon paid fines under this section for its violations of the weight limits. It also paid liquidated damages. Therefore, the court concluded that the liquidated damages must not have been a penalty.

The court also believed that the structure of the liquidated damages provision indicated that the payments were compensatory in nature. The

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such payments were penalties, notwithstanding that the Secretary of Labor characterized the payments as remedial).

122. 708 F.2d 1043 (6th Cir. 1983).

123. The IRS initially also disallowed the deduction for the court costs, but later conceded their deductibility, consistent with Reg. § 1.162-21(b)(2).

124. *Mason & Dixon Lines*, 708 F.2d at 1046.

125. *Id.* at 1047.

amount owed was determined by the extent to which the weight limit was exceeded—the higher the excess, the larger the payment. Because the court viewed the liquidated damages as remedial in nature, it rejected the IRS's application thereto of section 162(f). The court determined that the payments were ordinary and necessary business expenses, and that they were properly deducted under section 162(a).

In contrast to *Mason & Dixon*, where the statutory landscape served as the focus of the court's analysis, in *S & B Restaurant, Inc. v. Commissioner*<sup>126</sup> the Tax Court considered the broad context of facts to reach its conclusion that the payments at issue were not fines or similar penalties within the meaning of section 162(f). After evaluating the factors that led to the payments, the court concluded that the payments served a compensatory, rather than a punitive, purpose.<sup>127</sup> In this case, S & B Restaurant, Inc. ("S & B Restaurant") owned and operated a motel and restaurant named Treadway Inn, located in Pennsylvania. Treadway Inn discharged raw sewage directly into an underground waterway. During the relevant years, a Pennsylvania Clean Streams Law was in effect. The law imposed fines and civil penalties to water pollution.

In February 1973, S & B Restaurant and the Commonwealth of Pennsylvania Department of Environmental Resources entered into an agreement whereby S & B Restaurant agreed to connect Treadway Inn to the sanitary sewer system that was in the process of being constructed once the system became operational. S & B Restaurant also agreed to donate \$1,000 each month (to be increased to \$1,250 upon the construction of 40 additional motel units) to the Clean Water Fund of the Commonwealth until the sanitary sewer system became available. In exchange, the Department of Environmental Resources agreed not to prosecute S & B Restaurant for violating the Clean Streams Laws, provided that the level and nature of sewage Treadway Inn produced did not exceed the levels that existed at the time of their agreement. Underlying the agreement were the Department of Environmental Resources' beliefs that (1) the waste Treadway Inn discharged was not causing practical environmental harm, (2) it would not be ideal for S & B Restaurant to construct its own waste treatment system, and (3) the payments S & B Restaurant agreed to make were approximately equal to what it would have been required to pay the city if the central system had been operational. S & B Restaurant deducted the payments it made to the Clean Water Fund, and the IRS disallowed the deductions under section 162(f).

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126. 73 T.C. 1226 (1980).

127. A similar conclusion was reached in F.S.A. 1992-955 (Nov. 30, 1992) (payment made in settlement of suit brought under Comprehensive Environmental Response, Compensation, and Liability Act ("CERCLA") to cover response costs for waste disposal or clean-up activities was compensatory and not punitive and, therefore, was deductible under section 162(a)).

In response to the IRS's challenge, S & B Restaurant argued that the payments were not a fine or penalty. Instead, it claimed the payments were made in exchange for permission to continue discharging raw sewage and were designed to further the Clean Streams Law's public policy underpinnings. In the alternative, S & B Restaurant argued that it was not barred under section 162(f) from deducting the payments even if they were considered fines or penalties, because the payments were not made pursuant to any type of legal proceedings. The IRS disagreed, asserting that the payments were a penalty, paid to avoid legal action in response to Treadway Inn's violation of the Clean Streams Law.

The court began its analysis by examining the underlying statute, the Clean Streams Law. The court found that while the statute had punitive aspects, one of the purposes of the law was the development of pollution control through the construction and operation of centralized treatment facilities rather than through a multiplicity of facilities. Thus, the law had dual purposes.

Because the law had dual purposes, the next task was to determine which purpose the payments at issue were intended to serve. Evaluating the facts before it, the court determined that the payments were not punitive but, instead, were made in furtherance of the broader goals of the Clean Streams Law. The court was moved by the fact that Treadway Inn was required under the agreement to connect to the municipal sewer system as soon as it became available and that at that time, S & B Restaurant could stop making payments. The court also observed that the total amount S & B Restaurant would ultimately pay under the agreement was indefinite, somewhat distinguishing the payments from fines or penalties, which the court said typically are fixed amounts.<sup>128</sup> The court also noted that the amount of the payments bore a relationship to the fees the Department of Environmental Resources estimated S & B Restaurant would be responsible for paying if the municipal sewage system had been operational. Finally, the Department of Environmental Resources would have taken steps to prevent S & B Restaurant from constructing its own sewage treatment system, and it found that no practical environmental damage was being caused by Treadway Inn's discharge. These facts led the court to determine that, on balance, the agreement was intended

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128. Although current payments were set at \$1,000 per month, they would increase to \$1,250 per month upon the completion of 40 motel units, for which construction was in progress at the time the agreement was set. The payment amounts were contingent on there being no material changes in the quality and quantity of sewage Treadway Inn discharged. If there were changes in the sewage discharged, it was possible the agreement would be revisited. Furthermore, the amount of S & B Restaurant's liability was not a fixed amount because it was unknown when the municipal sewer system would be completed and, therefore, how many months S & B Restaurant would be required to make payments under the agreement.

to ensure that S & B Restaurant would join the centralized sewage system once it was completed.

Essentially, the court believed the Clean Streams Law was intended to encourage use of the centralized system and that allowing S & B Restaurant to deduct its payments under the law would not reduce the effectiveness of the law. The payments could be properly characterized as payments for a “permit” to continuing discharging sewage until the centralized system was available. Therefore, the payments into the Clean Water Fund were held to be deductible under section 162(a), and section 162(f) did not apply.<sup>129</sup>

In *Waldman v. Commissioner*,<sup>130</sup> the Tax Court also considered facts surrounding the origin of the payment at issue. It evaluated the source from which the payment derived, and concluded that the payment was nondeductible as a fine or similar penalty under section 162(f). That case involved a taxpayer, Harvey Waldman, who lived in Marina Del Rey, California, and formed a loan brokerage company in 1967 called National Home Loan Company (“NHL”). NHL was incorporated in 1970 with Mr. Waldman as its sole shareholder. The brokerage company negotiated and serviced loans that were secured by deeds of trust. It also arranged for lenders to provide borrowers with funds, and it collected loan payments from the borrowers on behalf of the lenders.

Mr. Waldman was charged under California law with 29 counts of conspiracy to commit grand theft; charges which stemmed from NHL’s misrepresentation about the security interests for the loans it arranged. Lenders were led to believe they would receive second deeds of trust, but actually received third, fourth, or fifth deeds of trust. Additionally, when a borrower defaulted on the loan, NHL continued to pay the lender and obtained title itself to the property that secured the defaulted loan by signing the lender’s name on the grant deed. The lender was not made aware of the default or the transfer of title to the property. Mr. Waldman did not receive amounts converted by NHL, nor did he report such amounts as income. He pleaded guilty to one count of conspiracy to commit grand theft and the remaining counts were dismissed. His prison sentence was stayed on the condition that he pay restitution to the victims. Pursuant to that agreement, in 1981, Mr. Waldman paid \$28,500 in restitution and deducted the amount as a legal or professional fee. The IRS

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129. Because the court in *S & B Restaurant* found that the payments were not a fine or similar penalty, it was unnecessary for the court to address *S & B Restaurant*’s alternative argument that the payments did not fall under section 162(f) because they were not required in relation to legal proceedings. The court did note, however, that section 162(f) lacked a specific requirement that the payment be related to a legal proceeding. Nonetheless, the court acknowledged that legislative history suggested Congress may have intended for such a requirement to be part of the law. *S & B Rest.*, 73 T.C. at 1234 (citing S. REP. NO. 91-552, 274 (1969), H.R. REP. NO. 91-782, 331-32 (1971) (Conf. Rep.), S. REP. NO. 92-437, 72-74 (1971)).

130. 88 T.C. 1384 (1987).



disallowed the deduction under section 162(f). For purposes of section 162(f), as was stated above, “a ‘fine or similar penalty’ includes an amount paid pursuant to a conviction or plea of guilty in any criminal proceeding.”<sup>131</sup> Had Waldman not pleaded guilty to the charge of conspiracy to commit grand theft and instead been acquitted of all charges, he would not have been ordered to pay restitution. Therefore, although restitution is typically considered to be compensatory in nature because it is paid to make a wronged party whole, here the court found that the payment was made pursuant to Mr. Waldman’s guilty plea, complicating the characterization of the payment.

Because the amount Mr. Waldman paid was characterized as restitution on the one hand but arose from a criminal context on the other, the Tax Court had to determine, under section 162(f), the purpose of the restitution. The court found that the restitution could not have been ordered absent Mr. Waldman’s guilty plea and, therefore, that the restitution amount was covered by Regulation section 1.162–21(b)(1)(i).<sup>132</sup> Then, the court went

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131. *Id.* at 1386–87 (citing Reg. § 1.162–21(b)(1)(i)).

132. This outcome stands in contrast to *Spitz v. United States*, 432 F. Supp 148 (E.D. Wis. 1977), where the court found restitution payments ordered because of a taxpayer’s conviction of theft to be neither a fine nor a penalty. In *Waldman*, the court did not differentiate the facts of *Spitz* from those before the court, but merely stated that *Spitz* was neither persuasive nor binding. Subsequently, in *Cavaretta v. Commissioner*, 99 T.C.M. (CCH) 1028, 2010 T.C.M. (RIA) 2010–004, the Tax Court also found a restitution payment to be deductible under section 162(a) despite the fact that it was ordered in conjunction with a criminal sentence. The court said the restitution was not punitive and it was not even clear that the payment was part of the criminal sentence—the payment was in addition to, not instead of, a prison sentence. The court concluded that the restitution was a noncriminal, compensatory payment, which could be deducted under section 162(a). A restitution payment was also found to be compensatory in *Stephens v. Commissioner*, 905 F.2d 667 (2d Cir. 1990). In *Stephens*, the taxpayer was convicted of wire fraud. He was sentenced to prison and ordered to make restitution payments, which he deducted on his 1984 federal tax return. The court determined that the deductibility of the restitution payments was governed by section 165, as opposed to section 162, because at issue was a loss in a “transaction entered into for profit” rather than an “ordinary and necessary business expense.” The court found that the public policy considerations of section 162(f) nonetheless were relevant in determining whether the restitution payments were deductible. Because the court believed allowing the deduction would not frustrate sharply defined public policy, it said the restitution payments passed muster under section 162(f) and were deductible under section 165. This finding disregarded the reasoning of *Waldman* that but for the criminal conviction such restitution payments would not have been ordered and, therefore, deduction of such payments would be barred by section 162(f). The application by the *Stephens* court of section 162(f) analysis to determine deductibility under section 165 also stands in direct contrast to the Tax Court’s ruling in *Ramos v. Commissioner*, 42 T.C.M. (CCH) 924, T.C.M. (P-H) ¶ 81,473 (1981). In *Ramos*, the court rebuffed the IRS’s claim that section 162(f) disallowed the taxpayer’s deduction under section 165 for a “business casualty loss.”

on to say that although it was unnecessary to determine whether the restitution constituted a civil penalty, because it was paid pursuant to a guilty plea, such an analysis would start by identifying the payment's purpose. The court acknowledged that some civil payments designated as penalties were deductible if they were "imposed to encourage prompt compliance with a requirement of the law or as a remedial measure to compensate another party."<sup>133</sup> The court said, however, that when both penal and compensatory purposes were served by a payment, the court was required to determine which purpose the payment was intended to satisfy. The IRS argued that restitution was imposed to enforce the law, while Waldman argued that it was compensatory. The court ultimately rejected Waldman's position.

In the course of its analysis, the court considered whether the restitution payments were made "to a government" for purposes of section 162(f). The court found that the government exercised complete control over the disposition of Waldman's payments. It did not believe "that a government must actually 'pocket' the fine or penalty to satisfy the 'paid to the government' requirement of section 162(f)." It held that "[p]etitioner's 'fine or penalty' was 'paid to a government' and is not deductible."<sup>134</sup> Having decided that, the court ultimately concluded that in the context before it and given the criminal conviction, the restitution payment was penal or punitive and, in essence, constituted a fine.<sup>135</sup>

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The Tax Court said section 162(f) had no bearing on a deduction claimed under section 165, and it sustained the taxpayer's loss. The conflicting verdicts and reasoning provided by the courts in these cases serve as an example of the lack of clear answers when it comes to the effect of section 162(f).

133. *Waldman*, 88 T.C. at 1387 (quoting *Huff v. Commissioner*, 80 T.C. 804, 824 (1983); *S. Pac. Transp. Co. v. Commissioner*, 75 T.C. 497, 646–54 (1980)).

134. *Waldman*, 88 T.C. at 1389. A similar conclusion was reached in *Bailey v. Commissioner*, 756 F.2d 44 (6th Cir. 1985). In *Bailey*, the taxpayer was fined for violating the terms of a consent decree with the Federal Trade Commission. The fine was subsequently applied as restitution in a settlement of a multidistrict class action lawsuit. In agreeing to apply the fine against the restitution the taxpayer owed, the court noted that the ultimate disposition of the funds would not alter the status of the payment as a penalty. *See also* *Ginsburg v. Commissioner*, 67 T.C.M. (CCH) 3091, 1994 T.C.M. (RIA) ¶ 94, 272 (finding that restitution ordered as a substitution for, and as a credit against, a criminal forfeiture penalty assessed under RICO was a nondeductible fine or similar penalty under section 162(f)). Subsequently, in *Kraft v. United States*, 991 F.2d 292 (6th Cir. 1993), the court again found a restitution payment to be nondeductible under section 162(f). Citing *Bailey*, the court determined that the payment was nondeductible because the taxpayer's obligation to make the restitution payment stemmed from a criminal proceeding.

135. Not only do the courts seem to be schizophrenic when it comes to restitution, but conflicting conclusions also have been reached by the IRS. *See* P.L.R. 2012–40–007 (July 11, 2012) (payments made under New Jersey law as restitution were not section 162(f) fines or penalties because such restitution payments were

In *Allied-Signal Inc. v. Commissioner*,<sup>136</sup> the U.S. Court of Appeals for the Third Circuit analyzed the facts surrounding the taxpayer's agreement to make the payment at issue, and determined that section 162(f) barred a deduction for the payment. Allied-Signal, Inc. ("Allied") was a Delaware corporation with its principal place of business in Morristown, New Jersey. It developed a highly toxic chemical known as Kepone in the late 1940s and early 1950s, which it marketed as an insecticide. In 1966, Allied moved its Kepone manufacturing operation to Hopewell, Virginia and contracted with Life Science Products Company ("Life Science") to manufacture Kepone at the Hopewell facility. Life Science ignored safety precautions and the environmental and health rules posed by its operations. In 1975, the Virginia State Department of Health and Human Services ordered Life Science to halt operations. This caused the Hopewell plant to close and Life Science to become insolvent.

Allied worked with various federal and state agencies to mitigate the damage caused by Life Science's disregard of safety precautions, taking steps to decontaminate the Hopewell plant and the surrounding area. Allied also sponsored research on minimizing the effects of Kepone on the environment and on treating Kepone poisoning in individuals. In 1976, Allied and Life Science were indicted for violations of the Refuse Act of 1899, which "prohibits the discharge of refuse matter from a manufacturing establishment into any navigable waters of the United States."<sup>137</sup> Allied and Life Science were also indicted for violations of the Water Pollution Control Act, which "prohibits the discharge of any pollutant except in compliance with law."<sup>138</sup> Both statutes were punishable by a fine or imprisonment. Allied and Life Science faced additional charges for failing to secure proper permits and unlawfully discharging Kepone. Allied entered a plea of *nolo contendere* to the 940-count indictment, which the district court of jurisdiction accepted. Allied also agreed to pay certain fines. During the proceedings, the presiding judge inquired as to whether the fines could be allocated to the State of Virginia. Subsequently, the judge led Allied to believe that he would reduce the fine Allied was required to pay if Allied made voluntary payments in accordance with his suggestions in order to repair the damage it had caused in

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primarily compensatory and not predominantly penal in nature, even though they proceeded from the commission of a crime); P.L.R. 2010-45-005 (July 29, 2010) (section 162(f) was inapplicable where restitution payments under plea agreement were clearly compensatory). *But see* F.S.A. 1997-2031 (Feb. 4, 1997) (stating that restitution payments made pursuant to criminal charges are nondeductible section 162(f) fines or penalties regardless of whether the payment represents compensation to the victim).

136. 95-1 U.S.T.C. ¶ 50,151, 75 A.F.T.R.2d 1287 (3d Cir. 1995).

137. 95-1 U.S.T.C. ¶ 50,151 at 87,538, 75 A.F.T.R.2d at 1289.

138. *Id.*

Virginia. In response, Allied created a charitable endowment fund,<sup>139</sup> to which it contributed \$8 million in 1977. The endowment fund was dedicated to repairing Kepone damage caused by Allied's actions and, more generally, to improving the environment in Virginia. After making the contribution, Allied brought a motion to reduce the court-ordered fine from the amount ordered, \$13,240,000, which was the maximum amount provided by law, to \$1,438,000, the minimum amount allowed under the law. The government objected to any reduction of the fine which would allow Allied to incur an after-tax cost of less than \$13 million. Ultimately, the judge ordered a fine of \$5 million, essentially reducing the "official" fine by the amount Allied contributed to the endowment fund.

Allied treated the \$8 million contribution to the endowment fund as an ordinary and necessary business expense and, therefore, deducted the amount under section 162(a) in 1977.<sup>140</sup> Allied argued that the payment amount was ordinary and necessary because it restored Allied's reputation. Allied also deducted legal expenses incurred in connection with establishing the endowment fund and handling other Kepone-related matters. Allied did not deduct the \$5 million paid to the government. The IRS disallowed the deductions for legal expenses and for the \$8 million contribution. At the trial level, the Tax Court concluded that Allied was entitled to deduct the legal expenses, but that the \$8 million payment to the endowment was substantively a "fine or similar penalty" paid to a government for the violation of law under section 162(f). The Tax Court rejected the argument that the payment was made voluntarily and that it was remedial in nature. Rather, it found that the payment was made "with the virtual guarantee that the district court would reduce the criminal fine by at least that amount and, in essence, was a substitute fine."<sup>141</sup> The Tax Court considered whether there might be a dual purpose at play, but ultimately determined, based on the facts that, "if there was a compensatory or remedial purpose for the payment, it was minimal. The payment was for punishment and deterrence of environmental crimes."<sup>142</sup>

On appeal, the Third Circuit considered whether the \$8 million contribution comprised a fine or similar penalty paid to a government within the meaning of section 162(f).<sup>143</sup> Allied argued that the \$8 million payment was made voluntarily, rather than pursuant to its plea, the contribution was compensatory rather than punitive, and the payment was not made to the government. The appellate court disagreed with all three contentions. It found

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139. The endowment fund was intended to qualify under section 501(c)(4) as an organization operated exclusively to promote social welfare.

140. Allied took the position, inter alia, that the expense restored Allied's business reputation. *Allied-Signal*, 95-1 U.S.T.C. ¶ 50,151 at 87,538, 75 A.F.T.R.2d at 1291.

141. 95-1 U.S.T.C. ¶ 50,151 at 87,540, 75 A.F.T.R.2d at 1291-92.

142. 95-1 U.S.T.C. ¶ 50,151 at 87,540-41, 75 A.F.T.R.2d at 1292.

143. *Id.*

that the payment could not be characterized as voluntary because it was made with the expectation of a quid pro quo (the fine reduction),<sup>144</sup> the payment was essentially a fine or similar penalty even though the trial judge appeared to be motivated by both punitive and remedial purposes,<sup>145</sup> and the “paid to a government” requirement in section 162(f) was satisfied because the payment was made at the direction of the government and was paid in lieu of a portion of the assessed criminal fine.<sup>146</sup>

Together, *Mason & Dixon, S & B Restaurant, Waldman, and Allied* illustrate that a wide range of factors can be relied upon by the court in characterizing a contested payment. Understanding both the background of the underlying laws that were violated or allegedly violated and the factual circumstances surrounding the payment at issue is critical to characterizing a payment under section 162(f).

C. *Section 162(f) Analysis of Settlement Payments under the Federal False Claims Act and Other Laws*

In many instances, the statute giving rise to the taxpayer’s payment is the False Claims Act (the “FCA”).<sup>147</sup> In 2012, the Department of Justice secured \$4.9 billion in settlements and judgments in civil cases alleging fraud against the government under the FCA. According to DOJ, the \$4.9 billion in fines and penalties constituted a record recovery for a single year with respect to the FCA, eclipsing the previous record by more than \$1.7 billion.<sup>148</sup> In 2013, the DOJ recovered \$3.8 billion in FCA settlements.<sup>149</sup> When considering settlement payments made to resolve claims under that statute, courts traditionally have considered how the statute was being relied upon and what

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144. The record made clear that despite earlier statements to the contrary, Allied was ultimately faced with the decision either to pay the \$13.24 million fine ordered by the trial court or to make a “voluntary” contribution in accordance with the requirements informally set forth by the judge. Given the facts, it was clear that the payment was not truly voluntary.

145. The court found that, in effect, the payment was a criminal fine diverted from the U.S. Treasury to the endowment fund.

146. For all practical purposes, in the view of the court, there were no differences between Allied’s payment, where the payment was used to benefit the public, and a payment to the government, which the government then uses for a public purpose.

147. 31 U.S.C. §§ 3729–3733.

148. Press Release, U.S. Dep’t of Justice, Justice Department Recovers Nearly \$5 Billion in False Claims Act Cases in Fiscal Year 2012 (Dec. 4, 2012), <http://www.justice.gov/opa/pr/2012/December/12-ag-1439.html>.

149. Press Release, U.S. Dep’t of Justice, Justice Department Recovers \$3.8 Billion in False Claims Act Cases in Fiscal Year 2013 (Dec. 20, 2013), <http://www.justice.gov/opa/pr/2013/December/13-civ-1352.html>.

the purpose of the payment was.<sup>150</sup> Those considerations were applied even before section 162(f) was enacted, as exemplified in *Grossman & Sons, Inc. v. Commissioner*,<sup>151</sup> a case that is cited often by courts that grapple with section 162(f) and the deductibility of payments made in connection with the FCA.

Before describing the cases, a brief description of the FCA may be helpful. Congress first enacted the FCA in 1863 to provide a remedy for government payments fraudulently obtained by suppliers of goods to the Union Army during the Civil War.<sup>152</sup> Though it has been amended considerably since its enactment, the FCA remains a deterrent to the false or fraudulent solicitation and receipt of funds from the federal government.<sup>153</sup> Specifically, anyone who “knowingly presents, or causes to be presented, a false or fraudulent claim for payment or approval,” or engages in any of the other enumerated acts is liable to the government for a civil penalty of not less than \$5,500 and not more than \$11,000 plus treble damages, that is, damages that are three times the amount of damages that the government sustains because of such act.<sup>154</sup> A “claim” for such purposes, is “any request or demand, whether under a contract or otherwise, for money or property . . . that is presented to an officer, employee, or agent of the United States; or is made to a contractor, grantee, or other recipient, if the money is to be spent or used on the [g]overnment’s behalf” and the government provides any portion of the amount demanded or will reimburse such contractor, grantee, or other recipient for any portion of the amount demanded.<sup>155</sup> The Attorney General or a private individual (a “relator”) may bring such a claim. Relators may bring such an action on behalf of the government under the qui tam provision of the

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150. For IRS audit guidelines relating to deductions for payments in settlement of FCA claims, see Internal Revenue Service, Coordinated Issue—All Industries—False Claims Act Settlements With Department Of Justice (DOJ) (Sept. 5, 2008) [hereinafter Issue Paper], <http://www.irs.gov/Businesses/Coordinated-Issue--All-Industries---False-Claims-Act-Settlements-WithDepartment-Of-Justice-%28DOJ%29>; Internal Revenue Service, Tier 1 Issues: Government Settlements Directive #1, May 30, 2007 [hereinafter IDD #1], [http://www.irs.gov/pub/irsutl/redactedfinaliddgovernmentsettlementinitiative\\_\\_2\\_.pdf](http://www.irs.gov/pub/irsutl/redactedfinaliddgovernmentsettlementinitiative__2_.pdf); Internal Revenue Service, Attachment I to Industry Director Directive on Government Settlements Directive #1 [hereinafter Attachment to IDD #1], <http://www.irs.gov/Businesses/Attachment-I-to-Industry-Director-Directive-on-Government-Settlements-Directive-%231>; Internal Revenue Service, Industry Director Directive on Government Settlements Directive #2, September 14, 2007 [hereinafter IDD #2], <http://www.irs.gov/Businesses/Industry-Director-Directive-on-Government-Settlements-Directive-%232>.

151. 48 T.C. 15 (1967).

152. H.R. REP. NO. 111-97, at 2 (2009).

153. 31 U.S.C. §§ 3729–33.

154. 31 U.S.C. § 3729(a)(1); 28 C.F.R. § 85.3(a)(9).

155. 31 U.S.C. § 3729(b)(2).

FCA.<sup>156</sup> Once a qui tam action is filed, a copy of the complaint and a written disclosure of all material evidence are served on the government, and the action remains under seal for 60 days.<sup>157</sup> During that time, the government must decide whether to intervene in the action.<sup>158</sup> If it declines to intervene, the relator may continue with the claim as a private action,<sup>159</sup> and is entitled to receive an amount between 25 and 30 percent of the proceeds of the action or settlement that the court determines is reasonable.<sup>160</sup> If the government does in fact intervene, however, it has primary responsibility for prosecuting the action and the relator is entitled to recover an amount ranging between 15 and 25 percent of any civil penalties imposed on the defendant that are payable from the proceeds of the action or settlement.<sup>161</sup>

In the *Grossman* case, Grossman & Sons, Inc. (“Grossman”) was an Ohio corporation that operated as a wastepaper and rag broker. Its sister corporation, Rose Wiping Cloths, Inc. (“Rose”) was an Ohio corporation that processed and manufactured wiping cloths. The Grossman brothers owned and operated the two corporations. From 1950 through 1952, the two companies entered into contracts with the Navy to supply the Navy with wiping cloths.

In 1953, the Grossman brothers were indicted, and later convicted, of conspiring to produce, and sell to the Navy, wiping clothes which were inferior to those promised in their bids and contracts.<sup>162</sup> A civil suit was also brought by the United States against the Grossman brothers and their companies under the FCA, alleging that they had entered into a conspiracy to defraud the government by submitting bids to provide wiping cloths according to certain specifications and instead knowingly providing an inferior and defective product and billed the Navy therefor, thus seeking to defraud the government. The civil lawsuit sought double the damages the government sustained, as well as \$2,000 for each false claim presented to the United States for payment and the cost of litigation. Grossman and Rose initiated a civil lawsuit against the government for the amounts they claimed were due to the companies by virtue of outstanding contracts.

As the civil litigation progressed, it became clear to the Grossman brothers that it would be highly preferable to avoid protracted litigation, if at all possible. Therefore, the parties began discussing a possible settlement of the pending lawsuits, and the Grossman brothers made an offer to settle the pending claims. They drafted a letter, stating that despite their belief that the government’s claims were unfounded, they were “willing to compromise these

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156. 31 U.S.C. § 3730(b)(1).

157. 31 U.S.C. § 3730(b)(2).

158. 31 U.S.C. § 3730(b)(4).

159. 31 U.S.C. § 3730(b)(4)(B).

160. 31 U.S.C. § 3730(d)(2).

161. 31 U.S.C. § 3730(d)(1).

162. *Grossman & Sons, Inc. v. Commissioner*, 48 T.C. 15, 18 (1967).

claims as an ordinary and necessary expense in conducting their businesses.”<sup>163</sup> Their letter went on to say “[i]t is the position of Grossman and Rose that any compromise payments are solely the obligations of such corporations and such payments have the singular character of common law contractual damages arising from the business of the corporations in performing the duties of Grossman under the several contracts.”<sup>164</sup> The companies proposed that they would pay \$100,000 to settle all of the government’s claims, consisting in part of approximately \$20,000 “paid” by virtue of releasing the government from pending claims for payment on outstanding contracts. The remaining approximately \$80,000 was to be paid over eight years. In exchange, the Grossman brothers and their companies were to be released from all potential further claims stemming from the contracts between the parties. The Attorney General accepted the taxpayers’ settlement offer in a reply letter to the taxpayers’ lawyer that stated, “the Attorney General has accepted the offer in settlement you have proposed on behalf of your clients, as contained in your letters.”<sup>165</sup> Grossman deducted the settlement payment in computing its taxable income in 1959 for federal purposes, and the IRS disallowed the deduction. Among other things, the IRS contended that the settlement payment was not deductible as an ordinary and necessary business expense because,

sound public policy forbids a deduction for amounts paid or incurred in satisfaction of damage claims of the United States under the Federal False Claims Act, whether by judgment or settlement, and the allowance of such deduction would frustrate sharply defined national policy proscribing the conduct of knowingly presenting false claims to the Government.<sup>166</sup>

In considering the propriety of the deduction, the Tax Court relied on the judicially-created public policy doctrine, articulated in *Commissioner v. Heininger*<sup>167</sup> and *Tank Truck Rentals, Inc. v. Commissioner*,<sup>168</sup> and reasoned that it had to either constrict or expand the doctrine until Congress acted. In order to determine whether the payment was ordinary and necessary, the court said it first needed to make an initial determination of the specific purpose for the payment. The settlement agreement was not specific on that point. To be sure, the payment was in settlement of claims under the FCA, but that alone was not sufficient. To determine purpose, the court first examined the

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163. *Id.* at 21–22.

164. *Id.*

165. *Id.* at 23.

166. *Id.* at 26.

167. 320 U.S. 467 (1943).

168. 356 U.S. 30 (1958).



legislative history and judicial interpretation of the FCA. That appears to have been a logical first step. If payments under the FCA had only one discernible purpose, the case could be easily resolved. But the Tax Court found that courts have disagreed as to the purpose of payments under the FCA. Some found the FCA to be penal while others found that it was compensatory in nature. Because the statute was at least partially remedial, amounts paid in relation to claims under the statute were not necessarily punitive.

In light of the outcome of the court's inquiry into the FCA, and because settlement documents did not specify the purpose of the payment, the court turned to a determination of the intent of the parties. Neither the settlement negotiations nor the settlement agreement contained any specific expression of the intent of the parties. The taxpayers asserted, however, that the settlement letter specifically stated that the payment was for damages for breach of contract and the Attorney General accepted the settlement offer as it was framed in that letter. Therefore, the court believed this purpose had to be given effect. The court did not go so far as to characterize all payments stemming from the FCA as remedial, but did find that the payment at issue was deductible under section 162(a) as an ordinary and necessary business expense because, in the absence of a punitive payment, public policy would not be impaired. The court said that allowing the deduction in this case would not "severely or immediately frustrate a sharply defined national policy evidenced by a governmental declaration thereof."<sup>169</sup>

Once section 162(f) was added to the Internal Revenue Code, courts continued to apply the *Grossman* analysis to determine whether a payment was nondeductible under section 162(f) if the settlement documents were unclear about the nature of the payment and the statute underlying the settlement payment allowed for more than one type of payment. An example is *Middle Atlantic Distributors, Inc. v. Commissioner*.<sup>170</sup> There, the Tax Court determined that the statute giving rise to the taxpayer's payment could be used to punish and deter, but also had a compensatory aspect. Consequently, the

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169. *Grossman & Sons*, 48 T.C. at 30–31.

170. 72 T.C. 1136 (1979). See also C.C.A. 2013–08–027 (Oct. 31, 2012) (in determining whether settlement payments for alleged violations of state law were section 162(f) payments, the IRS looked to judicial, administrative, and legislative interpretations of damages provision of the state statute which indicated that such damages were intended to provide restitution and were, therefore, compensatory); G.C.M. 39,596 (Feb. 04, 1987) (payments in settlement of assessed duties under Anti-Dumping Act of 1921 were not section 162(f) fines or penalties because such duties were not intended to penalize, rather, they were viewed as payments to equalize a less than fair value sale with a fair value sale); P.L.R. 1987–04–003 (Oct. 3, 1986) (same); Rev. Rul. 80–334, 1980–2 C.B. 61 (payments to settle claims for unintentional mispricing of petroleum products to customers was not a section 162(f) fine or penalty, but payments for willful violations of petroleum pricing were section 162(f) fines or penalties).

court looked at whether the particular claim giving rise to the settlement payment was made for remedial purposes or punitive purposes. The court said the parties intended for the payment to be liquidated damages, and it was not intended to punish or deter. Therefore, section 162(f) did not prohibit the deductibility.

The taxpayer, Middle Atlantic Distributors, Inc. (“Middle Atlantic”), was a wine and liquor importer organized in Delaware and with a principal office in Florida. It held the required permits to be a liquor importer and wholesaler, and it operated a U.S. Customs bonded warehouse. Imported liquor could be distributed without import duties or U.S. alcohol taxes if foreign military personnel on duty in the United States were going to use the products and the proper withdrawal permits were submitted. Middle Atlantic released liquor from its bonded warehouse to a Turkish Embassy official multiple times between 1957 and 1962. Although the Turkish official submitted withdrawal permits, it was later discovered that the documents were fraudulent. As a result, Middle Atlantic faced criminal and civil charges brought by the United States.

The government alleged that Middle Atlantic introduced, or aided in introducing, whiskey into U.S. commerce with false, forged, or fraudulent customs forms and knew or should have known (or was negligent in failing to discover) that such forms were not true and legitimate. Middle Atlantic was also accused of assisting in the creation of such false, fraudulent, or forged customs forms and of lacking reasonable cause to believe the contents of the forms were true.

In the civil proceeding, the government sought \$502,109.17, the full value of the fraudulently withdrawn liquor, plus costs and interest<sup>171</sup> under section 1592 of Title 19 of the United States Code,<sup>172</sup> a statute prohibiting a person from introducing merchandise into U.S. commerce by means of false documents. Middle Atlantic denied liability, but eventually the parties entered into settlement negotiations, whereby Middle Atlantic offered the government \$100,000 to settle the claims. Middle Atlantic made the offer via letter stating that the amount was offered “as liquidated damages, in order to reimburse the government for all or a portion of the taxes to which it asserts a claim.”<sup>173</sup> The government sent a reply letter, accepting the offer “as set forth in (petitioner’s) letter of April 28, 1969,” and ultimately the parties agreed that the settlement amount would be paid in six installments.<sup>174</sup> Middle Atlantic deducted the

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171. This essentially imposed forfeiture liability on Middle Atlantic. It is well established that forfeiture amounts can be nondeductible under section 162(f). Reg. § 1.162–21(b)(1)(iv). *See also* *Murillo v. Commissioner*, 166 F.3d 1201 (2d Cir. 1998) (finding that amounts the taxpayer forfeited pursuant to a plea agreement took the place of a fine and therefore were nondeductible under section 162(f)).

172. 19 U.S.C. § 1592.

173. *Middle Atl. Distrib.*, 72 T.C. at 1139–40.

174. *Id.* at 1140–41.

payments as ordinary and necessary business expenses under section 162(a) in the years such payments were made (1969–1975), and the IRS disallowed the deductions under section 162(f).

The court determined that the question before it was whether the payment was a fine or similar penalty within the meaning of Regulation section 1.162–21(b)(1)(iii) or instead was compensatory damages to the United States. The court understood that section 162(f) was intended to apply to civil penalties “which in general terms serve the same purpose as a fine exacted under a criminal statute.”<sup>175</sup> Additionally, the court understood that “a criminal ‘fine or similar penalty’ is one imposed to punish and/or deter.”<sup>176</sup>

After identifying the relevant legal standard, the court turned to the provision under which the civil lawsuit was brought, and determined that the statute could be used to punish or deter, but that it was also used for remedial purposes. In addition to looking at situations in which the provision had been utilized, the court noted that the law contained a mitigation provision. The Customs Service’s policy of reducing its claim from the value of the goods at issue to an amount equal to the government’s revenue loss when the taxpayer did not have culpable intent was evidence that the Customs Service itself recognized the remedial purpose of the statute. In the court’s view, the policy reinforced the notion that the provision could be utilized for remedial purposes and was not solely punitive. Not surprisingly, the court decided it needed to evaluate the intent of the parties to determine whether the settlement amount was punitive or remedial. That inquiry led the court to conclude that the settlement at issue did not have the effect of a penalty. The court reasoned that

[I]t is clear throughout the settlement negotiations between petitioner and the United States, as well as in the settlement document itself, that petitioner was offering to make only a settlement payment representing liquidated damages. It is equally clear that, when the United States accepted petitioner’s offer in settlement, it accepted the settlement as “liquidated damages.” We conclude, therefore, that at all relevant times during the settlement negotiations, the United States was attempting to recover, and subsequently recovered, only reimbursement for lost revenue and other damages. Obviously, such an intent by the Government does not also comport with an intent to punish or deter. We conclude that

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175. *Id.* at 1143 (quoting S. REP. NO. 92–437, at 599–600 (1971)).

176. *Id.* (citing *Tank Truck Rentals, Inc. v. Commissioner*, 356 U.S. 30, 35–36 (1958), which describes how the “public policy” doctrine applies to determining the deductibility of fines and penalties).

the amounts at issue herein were not paid as a “fine or similar penalty.”<sup>177</sup>

The court believed that if the government had intended the payment to be penal in nature, it could have insisted on indicating such intent in the settlement agreement.<sup>178</sup> Instead, the government appeared to accede to a payment that was intended to be a payment of damages.

As the law under section 162(f) developed, the courts continued to apply the approach described above when considering settlement payments in contexts that on their face were ambiguous. For example, in *Talley Industries, Inc. v. Commissioner*,<sup>179</sup> the U.S. Court of Appeals for the Ninth Circuit considered how to characterize a payment when the underlying statute had a dual purpose and the settlement agreement was inconclusive. Like other courts had done, it determined that the parties’ intent surrounding the payment was critical to the application of section 162(f).

In the case, Stencel Aero Engineering Corp. (“Stencel”), a subsidiary of Talley Industries, Inc. (“Talley”), was a manufacturer of ejection seats for military aircraft. Stencel manufactured the seats for various federal government departments under contracts for production and also performed research and development projects for the government. In March 1985, Stencel and a number of its officers were indicted for fraudulent conduct relating to billing practices for work performed pursuant to the government contracts. In the criminal action, Stencel pleaded guilty to ten counts of making false and fraudulent statements in violation of section 1001 of Title 18 of the United States Code. The false statements related to falsified employee time cards, which allocated hours worked on fixed-price contracts to contracts that did not have a fixed price. Pursuant to Stencel’s plea, the court required the company to pay a \$10,000 fine on each count and to make full restitution to the government.<sup>180</sup> The government also brought civil claims against Stencel under the FCA and the Truth in Negotiations Act (“TINA”), as well as common law breach of contract claims.

The Navy suspended Talley and Stencel from government contract work when the criminal and civil actions commenced. Talley’s suspension was lifted after the criminal proceedings concluded, but Stencel remained suspended while its civil liability was negotiated. Stencel was one of three

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177. *Id.* at 1145.

178. *Id.* at 1146.

179. 116 F.3d 382 (9th Cir. 1997).

180. Restitution was ordered in the criminal judgment against Stencel in the amount of \$1,885, a deduction was claimed therefore, and the IRS disallowed it. The Tax Court apparently applied the same reasoning as it did in *Waldman*—because the restitution was ordered pursuant to a criminal plea, it was deemed to be a fine or similar penalty under section 162(f).

companies that could manufacture ejection seats, and the Navy was Stencel's primary customer. Therefore, it was urgent for both parties to reach a settlement quickly. In January 1986, the parties entered into an "Interim Agreement" whereby Stencel paid the Navy \$600,000 and the parties continued to negotiate the total potential civil liability. The government subsequently estimated its total actual loss to be \$1.56 million. Ultimately, the parties reached a settlement agreement, whereby Stencel and Talley agreed to pay the government \$2.5 million, minus the \$600,000 Stencel had already paid pursuant to the Interim Agreement.

In tax year 1986, Talley and its subsidiaries deducted the \$2.5 million paid to the government pursuant to the settlement agreement as an ordinary and necessary business expense under section 162(a). The IRS disallowed the deduction under section 162(f). The Tax Court decided the deductibility on summary judgment, ruling that there was no genuine issue of material fact. It ruled that the entire \$2.5 million payment was deductible as a payment intended to compensate the Navy for its losses. The IRS principally argued that none of the \$2.5 million payment was deductible because the payment exceeded the government's actual loss of \$1,560,000. Its fallback position was that the \$940,000 excess of the \$2.5 million payment over the government's actual loss (\$1.56 million) was intended as punishment and, therefore, was not deductible. The IRS appealed the Tax Court's decision regarding the \$940,000 portion of the settlement.

In reviewing the Tax Court's decision, the Ninth Circuit found that a genuine issue of material fact existed and, therefore, that summary judgment was granted in error.<sup>181</sup> The appellate court recognized that whether a civil penalty was a "fine or similar penalty" under section 162(f) depended on

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181. Deductibility of a settlement payment made under the FCA was also addressed at the summary judgment stage in *Fresenius Med. Care Holdings, Inc. v. United States* 2010-2 U.S.T.C. ¶ 50,493, 106 A.F.T.R.2d 5028 (D. Mass 2010), on further proceedings, 2013-1 U.S.T.C. ¶ 50,323, 111 A.F.T.R.2d 1938 (D. Mass. 2013), *aff'd*, 763 F.3d 64 (1st Cir. 2014). In that case, the taxpayer argued that the plain language of the settlement agreement indicated the payment was not punitive. In response, the government argued that the language in the agreement identifying the payment as non-punitive was in reference to punishment for purposes of Double Jeopardy. The court said it was unclear what the language was intended to signify, given the wording and placement in the agreement and, therefore, it was not a reliable indicator of the parties' mutual intent. As a result, the purpose of the payment could not be determined at summary judgment. In a later proceeding, the court adopted a different line of reasoning, stating that the agreement "unambiguously decline[d] to address the punitive or compensatory nature of the settlement payments for the purposes of the Internal Revenue Code." 2013-1 U.S.T.C. ¶ 50, 323, 111 A.F.T.R.2d 1938. The court concluded that the statement in question only addressed Double Jeopardy and Excessive Fines rather than tax characterization. The court proceeded to determine the ultimate question of the settlement payment's tax characterization on other grounds, as discussed below.

whether “a civil penalty is imposed for purposes of enforcing the law and as punishment for the violation thereof” or whether “the civil penalty is imposed to encourage prompt compliance with a requirement of the law, or as a remedial measure to compensate another party for expenses incurred as a result of the violation.”<sup>182</sup> In the former instance, the payment would not be deductible, while in the latter it would be deductible. Payments that did not serve the same purpose as a criminal fine and were not “similar” to a criminal fine would be deductible.

The court went on to note that if the payment in question could serve each of those purposes, that is, law enforcement and compensation, the Tax Court should have determined the predominant purpose. Stencel’s civil liability was under the FCA and the TINA. The IRS argued that Stencel’s payment was one of multiple damages under the FCA and, therefore, constituted a nondeductible “fine or similar penalty.”<sup>183</sup> In contrast, Talley argued that the payment was intended to compensate the government for its actual losses and was not paid as a compromise relating to the government’s right to a multiple of its damages under the FCA.<sup>184</sup> Even if the payment did reflect multiple damages, Talley argued, the purpose of the payment was to compensate the government rather than to punish Talley, and such purpose would be controlling.

The parties presented conflicting evidence to the court as to the nature of the \$940,000 excess amount and the parties’ intentions with respect to such payment. Therefore, the court determined that there was a genuine issue of material fact as to the nature of the payment. The purpose of the payment depended on the purpose it was designed to serve, as evidenced by the parties’ intent at the time of their agreement. Because the settlement agreement did not articulate how the payment should be characterized and the parties presented conflicting evidence as to their intent, the court found that there was a genuine issue of material fact regarding how the \$940,000 payment should be characterized.<sup>185</sup> Consequently, further proceedings were necessary to

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182. *Talley Indus., Inc.*, 116 F.3d at 385–86 (quoting *S. Pac. Transp. Co. v. Commissioner*, 75 T.C. 497, 652 (1980)).

183. Note that the IRS has taken a more moderate position in other guidance. See F.S.A. 1997–02–031 (Feb. 4, 1997) (settlement payments made to resolve civil charges on various grounds including state anti-trust law should be nondeductible to the extent payments exceed the government’s actual losses).

184. Stencel’s liability under the TINA and for breach of contract was limited to the amount of the government’s actual losses. The FCA provided for the payment of multiple damages.

185. In reviewing the Tax Court’s reasoning, the Ninth Circuit rejected two arguments on which the Tax Court had relied in reaching its conclusion that the entire \$2.5 million settlement payment was deductible. First, the court said it was improper for the Tax Court to rely on a double jeopardy analysis. The payment might still have been penal despite the fact that it was not punishment for purposes of double jeopardy.

determine deductibility. Very importantly, the court noted that the burden to demonstrate entitlement to a deduction rested with the taxpayer.<sup>186</sup> Therefore, if the taxpayer could not prove that the payment was intended to serve as compensation, it would not be entitled to deduct the \$940,000 payment.

On remand, the Tax Court noted the parties' repeated references to double damages throughout the settlement process. Acknowledging that the double damages provision had both compensatory and deterrent purposes, the court then sought to discern the parties' intentions. Although the taxpayer argued that it intended for the entire payment to compensate the government for its losses, this intention was not memorialized in the settlement documents. In negotiations leading up to the settlement, Talley's representative did note that its settlement offer would compensate the government for its losses. The government attorney explicitly rejected the terms of that offer, however. Additionally, in internal communications the government lawyer characterized a portion of the settlement as a penalty. This was not articulated in the actual settlement agreement and the taxpayer apparently was not aware of it. Nonetheless, because Talley did not clarify the question of how to characterize the payment in the settlement agreement itself and could not prove mutual intent for the payment to constitute compensation, the court found that Talley was not entitled to deduct the contested amount.<sup>187</sup> The case is a vivid reminder of the importance of burden of proof and the factual record when the settlement agreement is not specific about what a payment is intended to be.<sup>188</sup>

Another case that highlights the importance of the factual record when the settlement agreement is not specific about the purpose of the payment at

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Second, even though the amount of the payment was less than double the amount of the government's damages, a portion of the settlement payment might still be a payment of multiple damages under the FCA. Because the parties settled their claims, it was plausible to the court that the government agreed to accept less than the full amount to which it was entitled. Furthermore, there was no reason to assume the full \$2.5 million payment was of the same character. Rather, the court believed it could be reasonable to bifurcate the payment—there was a genuine issue as to how a portion of the payment should be characterized. Therefore, summary judgment was not appropriate.

186. *Talley Indus.*, 116 F.3d at 387 (citing *Norgaard v. Commissioner*, 939 F.2d 874, 877 (9th Cir. 1991)).

187. *Talley Indus., Inc. v. Commissioner*, 77 T.C.M. (CCH) 2191, 1999 T.C.M. (RIA) ¶ 99, 200.

188. In *Talley Indus.*, because the settlement agreement did not characterize the settlement payment for tax purposes and an internal government communication had unilaterally characterized the settlement payment as a penalty, the taxpayer was unable to prove mutual intent that the settlement payment in question was compensatory. In essence, section 162(f) was applied because the taxpayer did not meet its burden of proof.

issue is *Fresenius Medical Care Holdings, Inc. v. United States*.<sup>189</sup> There the taxpayer argued during summary judgment that the plain language of the settlement agreement indicated that the payment was non-punitive and therefore, was compensatory and deductible. In response, the government argued that the disputed language related only to punishment for purposes of double jeopardy. The district court said it was unclear what the language was intended to signify, given the wording and placement in the agreement and, therefore, it was not a reliable indicator of the parties' mutual intent. As a result, it could not determine the purpose of the payment at summary judgment and allowed the case to proceed to trial.

Based on further evidence presented at trial about the settlement negotiations and how the settlement amount was derived, a jury found in favor of the taxpayer that section 162(f) did not apply to the major portion of the settlement payment. In a post-trial ruling the district court upheld the jury verdict, but adopted a different line of reasoning than espoused at the summary judgment stage when the case had been handled by another judge. The court stated that the agreement "unambiguously decline[d] to address the punitive or compensatory nature of the settlement payments for the purposes of the Internal Revenue Code."<sup>190</sup> It was willing to look beyond whether the taxpayer could prove a meeting of the minds with the government, and held that "even in the context of settlement, the parties' joint intent is not the exclusive means" of determining whether payments are compensatory. Rather, it "was necessary to consider both the language of the settlement agreements and non-contractual evidence regarding the purpose and application of the payments."<sup>191</sup> The First Circuit Court of Appeals affirmed the holding of the trial court. In doing so, the First Circuit both criticized and rejected the reasoning of the Ninth Circuit Court of Appeals in *Talley*, on which the Government clearly based its appeal.<sup>192</sup> The decision of the First Circuit in *Fresenius* created an apparent conflict between the Circuit Courts of Appeals that should support elevation of the question to the Supreme Court.

*Grossman, Middle Atlantic, Talley Industries, and Fresenius* illustrate the attention paid by courts to parties' intentions. Messy litigation over the parties' intent could be avoided if the parties agree about the tax characterization of a settlement payment.<sup>193</sup> But that in and of itself can be a

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189. *Fresenius Med. Care Holdings, Inc. v. United States*, 2013–1 U.S.T.C. ¶ 50,232, 111 A.F.T.R.2d 1938 (D. Mass 2013), *aff'd*, 763.F.3d 64 (1st Cir. 2014).

190. *Id.*

191. *Id.*

192. *Fresenius Med. Care Holdings, Inc. v. United States*, 763F.3d 64 (1st Cir. 2014).

193. *But see* F.S.A. 2001–46–008 (Apr. 30, 2001) (settlement agreement relating to state law claims was not binding as to characterization or allocation of the payments where settlement was not a product of bona fide, arm's-length, adversarial negotiations).



negotiation which neither party wants to undertake. As long as that is the case, taxpayers and the IRS will continue to have differences about whether section 162(f) applies. The IRS may have a house advantage because the burden of proof is borne by the taxpayer. That makes it imperative for taxpayers to try to build a record through negotiations that will support deductibility.

Collectively, the cases discussed above provide an understanding of how courts have applied section 162(f) and the issues they have considered in evaluating the nature of a given payment. The analyses have been highly fact-intensive, and have depended upon the statute underlying the liability and the intent of the parties when agreement was reached.

### III. RECENT GOVERNMENTAL FOCUS

#### A. *Legislative Response*

Little progress has been made since the enactment of section 162(f) in defining its precise scope despite the development of the case law. In recent years, lawmakers have viewed the ambiguity inherent in section 162(f) as an invitation to propose legislation to clarify and expand its scope.

As mentioned above, Senators Grassley, Baucus, and McCain proposed the Government Settlement Transparency Act of 2003.<sup>194</sup> As proposed, deductions thereunder would have been denied for amounts “paid or incurred (whether by suit, agreement, or otherwise) to, or at the direction of, a government . . . in relation to the violation, or potential violation, of any law.”<sup>195</sup> The bill would have “den[ie]d a deduction for any payment, including those where there is no admission of guilt or liability and those made for the purpose of avoiding further investigation or litigation.”<sup>196</sup> In introducing the bill Senator Baucus reiterated the public interest at stake, stating:

Over the past several months, we have become increasingly concerned about the approval of various settlements that allow penalty payments made to the government in settlement of a violation or potential violation of the law to be tax deductible. This payment structure shifts the tax burden from

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194. S. 936, 108th Cong. (1st Sess. 2003).

195. CONG. RESEARCH SERV., BILL SUMMARY & STATUS FOR S. 936, 108TH CONG. (1ST SESS. 2003), on file with the Library of Congress, <http://thomas.loc.gov/cgi-bin/bdquery/z?d108:SN00936:@@D&summ2=m&>.

196. U.S. GOV'T PRINTING OFFICE, CONGRESSIONAL RECORD – SENATE, S. 5487, Apr. 29, 2003, <http://www.gpo.gov/fdsys/pkg/CREC-2003-04-29/pdf/CREC-2003-04-29-pt1-PgS5486.pdf#page=2>.

the wrongdoer onto the backs of the American people. This is unacceptable.<sup>197</sup>

The bill was referred to the Committee on Finance, but ultimately was never passed.<sup>198</sup>

The Tax Relief Act of 2005, approved by the Senate on November 18, 2005, contained amendments to section 162(f).<sup>199</sup> As proposed in the Senate, the legislation would have amended section 162(f) by carving out an exception from the deduction prohibition for (1) certain restitution payments or payments required to come into compliance with law, (2) court-ordered payments not involving a government or nongovernmental regulatory agency, and (3) amounts paid or incurred as taxes due.<sup>200</sup> The legislation also required that governmental agencies involved in a settlement with a taxpayer, report to the taxpayer and the Secretary of the Treasury information about such settlement, including the amount of the settlement, the amount paid as restitution or remediation of property, and the amount paid to come into compliance with law.<sup>201</sup> Though the legislation passed the Senate with a 64 - 33 vote, it was ultimately left out of the House's version of the bill, the Tax Relief Extension Reconciliation Act of 2005 (H.R. 4297). The reconciliation bill that was signed by President George W. Bush on May 17, 2006 did not contain any amendments to section 162(f).<sup>202</sup>

Despite a failed attempt with the Government Settlement Transparency Act of 2003, Senator McCain delivered a statement at the Senate Armed Service Committee Hearing in connection with the 2006 Boeing settlement discussed above,<sup>203</sup> stating that "in high-quantum corporate fraud settlements, the Department [of Justice] might want to revise its policy by specifically allocating the payments under a given settlement as either penalty or otherwise, and specifically prohibit the settlor from recovering [a] penalty from any third-party. Particularly in defense procurement fraud cases, this could really make a difference."<sup>204</sup> Such a change was thought to be necessary to ensure the deterrence value and punitive effect of such settlements.

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197. *Id.*

198. See BILL SUMMARY & STATUS FOR S. 936 *supra* note 195.

199. S. 2020, 109th Cong. (1st Sess. 2005).

200. *Id.*

201. *Id.*

202. CONG. RESEARCH SERV., BILL SUMMARY & STATUS FOR S. 2020, 109TH CONG. (1ST SESS. 2005), on file with the Library of Congress, <http://thomas.loc.gov/cgi-bin/bdquery/z?d109:S2020>:

203. See text *supra* accompanying notes 27, 54–57, 66–67, 194–198.

204. Press Release, Sen. John McCain, McCain Statement on Boeing Settlement (Aug. 1, 2006), <http://www.mccain.senate.gov/public/>

In late 2012, Representative Jo Bonner introduced a bill to prevent the deduction of compensatory damages paid to any person or governmental entity on account of BP's Deepwater Horizon explosion on April 20, 2010.<sup>205</sup> The bill was referred to the House Committee on Ways and Means on October 26, 2012 with no further action taken as of the time of writing this article.

More recently, on November 5, 2015, Senators Chuck Grassley, R-Iowa, and Jack Reed, D-R.I., introduced a new Government Settlement Transparency and Reform Act (S. 413) to amend section 162(f) to prohibit deductions "for any amount paid or incurred (whether by suit, agreement, or otherwise) to, or at the direction of, a government or governmental entity in relation to the violation of any law or the investigation or inquiry by such government or entity into the potential violation of any law," unless the payments are specifically excepted as restitution or as an amount paid to come into compliance with the law.<sup>206</sup> The bill would also compel government agencies involved in a suit or a settlement agreement to file an information return expressly indicating which parts of a settlement are penalties and are not deductible, and which parts are deductible, if any.

In January, 2014, Senators Elizabeth Warren, D-Mass., and Tom Coburn, R-Okla., introduced the Truth in Settlements Act of 2014. That act also would require increased disclosure regarding deductibility of settlement costs paid to the federal government.

#### *B. Executive Branch Response*

In 2004 and 2005, the Government Accountability Office (the "GAO") and the Senate Finance Committee issued questionnaires and requests for information to determine whether taxpayers who engaged in significant settlements with the federal government deducted their settlements and whether federal agencies considered tax consequences during the negotiation of those settlements.<sup>207</sup> The GAO received responses from 34 companies with settlements totaling over \$1 billion. Of the responses, 20 companies reported deducting at least a portion of their settlements.<sup>208</sup>

To determine whether tax considerations were taken into account in negotiations, the GAO surveyed four government agencies, the EPA, the DOJ, the SEC, and the Department of Health and Human Services, and reviewed the

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[index.cfm?FuseAction=PressOffice.PressReleases&ContentRecord\\_id=7879f6e9-c8de-4e18-901d-991a960e4a2c&Region\\_id=&Issue\\_id=](http://www.gao.gov/index.cfm?FuseAction=PressOffice.PressReleases&ContentRecord_id=7879f6e9-c8de-4e18-901d-991a960e4a2c&Region_id=&Issue_id=)

205. H.R. 6579, 112th Cong. (2d. Sess. 2012).

206. S. 413, 114th Cong. (1st. Sess. 2015); *See also* S. 1625, 113th Cong. (1st Sess. 2013).

207. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-05-747, SYSTEMATIC INFORMATION SHARING WOULD HELP IRS DETERMINE THE DEDUCTIBILITY OF CIVIL SETTLEMENT PAYMENTS, (2005) [hereinafter 2005 GAO Report].

208. *Id.*

largest 20 settlements in both 2001 and 2002 for each of the four agencies, cumulatively valued in excess of \$9 billion.<sup>209</sup> The GAO reported that the agencies did not negotiate the tax treatment of the settlement amounts with companies because they stated that it was the IRS's role to determine deductibility.<sup>210</sup> Yet, the IRS has historically looked to the agencies' characterization of the fine as compensatory or punitive in order to determine the deductibility of such fine.<sup>211</sup> Based on its findings, the GAO made recommendations to the Senate Finance Committee in September 2005 aimed at resolving what it viewed as the agencies' game of hot-potato. It stated that the IRS should work with federal agencies that reach large civil settlements "to develop a cost effective means of obtaining information on settlement agreements that would be beneficial to [the] IRS in ensuring the correct tax treatment of the settlement amounts."<sup>212</sup>

As was stated earlier, the SEC implemented a policy in 2003 of using standard language in its settlement agreements which makes clear that the settling party may not take a tax deduction or seek recovery from an insurance carrier with regard to the penalty portion of the settlement payment.<sup>213</sup> With the exception of the SEC, regulatory agencies entering into settlement agreements have largely taken a tax neutral position, opting to leave the deductibility determination to the IRS. In fact, the 2005 GAO Report found that the DOJ Civil Division has a "policy of not addressing the tax treatment of settlement payments in settlement agreements." Officials from the Civil Division justified the tax-neutral approach by pointing out that to characterize the payments more specifically would complicate the negotiation process "by adding additional factors on which to obtain agreement between the parties." The report suggests that the IRS takes the position that "single damages [imposed by the Department of Justice] are generally considered compensatory and therefore tax deductible, and any multiple damages and civil penalties are generally considered punitive and therefore nondeductible"<sup>214</sup>

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209. *Id.*

210. *Id.*

211. Issue Paper, *supra* note 150 (stating that "[a]ll interpretation of the FCA as it applies to each case is that of DOJ. In addition, no penalty amount is based on any computation made by IRS. All figures are those of DOJ. The entire issue is based on the facts, figures, documentary evidence and interpretation of DOJ.").

212. GAO REP. NO. GAO-05-747, *supra* note 207.

213. *Id.* at 14. The SEC has left to the IRS the question of deductibility of disgorgement payments. In at least one instance a disgorgement payment made pursuant to a settlement agreement with the SEC was determined under section 162(f) not to be a fine or penalty paid to the government. *Wang v. Commissioner*, 76 T.C.M. (CCH) 753, 1998 T.C.M. (RIA) ¶ 98, 389.

214. GAO REP. NO. GAO-05-747, *supra* note 207 at 16.

The DOJ is also responsible for negotiating settlements for FCA cases on behalf of the Department of Health and Human Services. In certain circumstances, the DOJ negotiates settlements for other federal agencies, like the EPA. The same tax-neutral position mentioned by the GAO Report can be expected with regard to those settlements negotiated by the DOJ for such other agencies.

In cases where the EPA negotiates on its own behalf, its approach has been to leave the tax treatment out of the settlement. The 2004–2005 GAO survey of the EPA resulted in a finding that “including language referencing IRC section 162(f) is not EPA’s usual practice. EPA officials said that they believe the law is clear that civil penalties payable to a government are generally nondeductible, so they do not see inclusion of such language in settlement agreements as necessary.”<sup>215</sup>

In 2008, the IRS issued a coordinated issue paper regarding the deductibility of FCA settlements with the DOJ.<sup>216</sup> It concluded that the amount of the settlement that represents multiple damages (less relator fees) is nondeductible if the government’s intent was punitive and not compensatory. It makes clear, however, that the issue of deductibility requires a case-by-case analysis for which the taxpayer bears the burden of proof. The issue paper signifies the IRS’s continuing position that deductibility depends on the characterization of the settlement by the federal agency. It states:

The policy and practice of DOJ to remain neutral regarding the tax deductibility of settlement payments, and to not characterize the payment as either singles or multiple damages in their settlement agreements requires examiners to look into these settlements and the facts behind them in order to determine if the settlement includes multiple damages, and if so, whether all or a portion of the multiples were intended to be compensation or a penalty.

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The Service makes no attempt to interpret the application of the FCA. All interpretation of the FCA as it applies to each case is that of DOJ. In addition, no penalty amount is based on any computation made by IRS. All figures are those of DOJ. The entire issue is based on the facts, figures, documentary evidence and interpretation of DOJ.<sup>217</sup>

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215. *Id.* at 12–13.

216. Issue Paper, *supra* note 150.

217. *Id.*

The issue paper likely also signifies a response to the GAO recommendation that the federal agencies work together to facilitate the deductibility determination. In the same vein, the IRS formally commented on the GAO Report, stating that it would engage in corrective action to “work with each agency with significant civil settlements to reach agreements as to 1) what information will be provided, 2) the format of the information, and 3) the frequency of delivery,” providing an implementation date of June 30, 2006.<sup>218</sup>

In February 2012, the Treasury released its General Explanations of the Administration’s Revenue Proposal (the “Green Book”) to explain the President’s budget for the fiscal year 2013.<sup>219</sup> Included in the 2013 Green Book was the explanation of a proposal that would deny deductions for punitive damages paid after December 31, 2013 pursuant to a court judgment or settlement and would require certain information sharing with the IRS.<sup>220</sup> The reason for the proposed change was that the “deductibility of punitive damage payments undermines the role of such damages in discouraging and penalizing certain undesirable actions or activities.”<sup>221</sup> Identical language was included in the 2014 Green Book and the 2015 Green Book explanation of a similar proposal in President Obama’s 2015 budget, effective for damages paid or incurred after December 31, 2014 and December 31, 2015, respectively.<sup>222</sup>

#### IV. NAVIGATING UNCERTAINTY UNDER SECTION 162(f)

With little clarification coming from the legislators and regulatory agencies regarding the metes and bounds of section 162(f), the emerging case

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218. A copy of the letter can be found at page 36 of the 2005 GAO Report, *supra* note 207.

219. U.S. DEP’T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION’S FISCAL YEAR 2013 REVENUE PROPOSALS (Feb. 2012) <http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf>, at 139.

220. *Id.* The explanation provides that the proposal will “disallow a deduction for punitive damages paid or incurred by the taxpayer, whether upon a judgment or in settlement of a claim. Where the liability for punitive damages is covered by insurance, such damages paid or incurred by the insurer would be included in the gross income of the insured person. The insurer would be required to report such payments to the insured person and to the Internal Revenue Service.”

221. *Id.*

222. U.S. DEP’T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION’S FISCAL YEAR 2014 REVENUE PROPOSALS (Apr. 2013) <http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2014.pdf>, at 95; U.S. DEP’T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION’S FISCAL YEAR 2015 REVENUE PROPOSALS (Mar. 2014) [hereinafter 2015 GREEN BOOK], <http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2015.pdf>, at 101.

law and IRS audit guidelines in the context of FCA settlements provide the only practical insight. Together, they establish many factors that are taken into account in determining whether a particular payment is deductible. An understanding of these factors may allow taxpayers to reach some degree of comfort as to the treatment of such payments.

A. *IRS Audit Guidelines for Examination of Taxpayers' Returns Involving Deductions Taken for False Claims Act Settlements*

Settlements of alleged violations under the FCA in particular have garnered the attention of the IRS. Though the taxpayer ultimately bears the burden of proving that a deduction taken for such a settlement payment is proper, the IRS has issued directives intended for internal departmental use aimed at aiding IRS examiners (the "Exam Team") in determining whether such payments are in fact deductible.<sup>223</sup> An understanding of these directives can provide a taxpayer with practical insight regarding the IRS's process of examining a return on which the taxpayer claims a deduction for a payment made to settle an action under the FCA. That insight can be valuable in reaching a level of comfort with regard to the deductibility of such settlement payments and in establishing a record that supports the taxpayer's filing position with regard to deductibility.

The directives make clear that, in the IRS's view, the portion of the settlement payment that reflects a penalty, or multiple damages, is nondeductible. The amount paid to compensate the government for its obligation to pay a relator from the proceeds of a lump sum settlement, however, is deductible if it is specifically outlined in the settlement agreement.<sup>224</sup>

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223. Note that the audit procedures for FCA settlements discussed generally and cited as IRS Industry Director Directives ("IDDs") in this Part IV.A were designated by the IRS as Tier 1 issues until 2012. A Tier 1 designation indicated that the issues involved presented the highest compliance and significant dollar risk. In 2012, the IRS announced that it would no longer be using the Tiered Issue Process, and would replace that process with Issue Practice Groups ("IPGs") intended to foster collaboration and knowledge-sharing across the IRS Large Business and International Division ("LB&I") and the Office of Chief Counsel. Internal Revenue Service, Memorandum regarding Tiered Issues (2012), <http://www.irs.gov/Businesses/Corporations/Tiered-Issues>. In its announcement, the IRS noted that relevant materials such as IDD's would be moved to the new IPG website. Notably, the two IDD's cited in this Part IV.A have been moved to that website. See Internal Revenue Service, Large Business and International (LB&I) Industry Director Guidance, [http://www.irs.gov/Businesses/Corporations/Large-Business-and-International-\(LB&I\)-Industry-Director-Guidance](http://www.irs.gov/Businesses/Corporations/Large-Business-and-International-(LB&I)-Industry-Director-Guidance).

224. Issue Paper, *supra* note 150.

According to the directives, an IRS Health Care Technical Advisor team actively monitors FCA settlements and notifies the relevant Exam Team that such a settlement has been reached.<sup>225</sup> Once an Exam Team has been notified, it must determine whether the taxpayer who entered into such a settlement has deducted part or all of the settlement by analyzing its tax reporting positions. For example, the IRS Schedule M-1 that accompanies a corporate taxpayer's return requires the corporate taxpayer to report expenses recorded on the corporation's books for the year that are not deducted in that year and any deductions on the return that are not yet charged against the corporation's book income for that year. The Schedule M-3 requires similar reporting of certain partnerships. To the extent that a taxpayer completes such a schedule, the IRS may have sufficient information to determine whether a settlement amount was deducted on the taxpayer's return by matching the settlement amount to the amounts reported to have been deducted.<sup>226</sup> Where a settlement is detected before a return has been filed for the tax year during which the payments were made, however, the Exam Team is urged to discuss a pre-filing agreement with the taxpayer as soon as possible.<sup>227</sup> A pre-filing agreement is part of a larger program, the IRS Pre-Filing Agreement Program, which was implemented to conserve IRS and taxpayer resources by allowing a taxpayer to request consideration of the tax treatment of a completed transaction before the tax return relevant to such transaction is filed. The program is intended to reduce the costs and burdens to both the taxpayer and the IRS of a post-return examination, and to provide the taxpayer with a higher degree of certainty with respect to its ultimate filing position.<sup>228</sup>

If, after reviewing the Schedules M-1 and M-3, as the case may be, it appears that a taxpayer has deducted the settlement amounts, the Exam Team must next determine whether the deduction was proper. The Exam Team is instructed to contact a designated liaison, called a Technical Advisor, who connects the Exam Team to the relevant DOJ attorney for development of the facts and circumstances surrounding the settlement.<sup>229</sup> Field work by the Exam Team is conducted through only that DOJ attorney.<sup>230</sup> Such field work includes obtaining a copy of the settlement agreement<sup>231</sup> and other relevant documentation that the Exam Team may request of the taxpayer or the governmental agency.<sup>232</sup> Examples of documents that are routinely requested include:

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225. Attachment to IDD #1, *supra* note 150.

226. IDD #2, *supra* note 150.

227. IDD #1, *supra* note 150.

228. Rev. Rul. 2009-14, 2009-21 I.R.B. 1031.

229. IDD #1, *supra* note 150.

230. *Id.*

231. IDD #2, *supra* note 150.

232. *Id.*



- (1) communications between the DOJ and the taxpayer, including formal letters, memoranda, and emails that make clear that the settlement includes penalties (designated as “multiples”),
- (2) computations and settlement proposals made by the DOJ and the taxpayer, including the initial proposal, and the taxpayer’s initial offer or counter-offer,
- (3) any communications in which penalties are specifically stated or addressed,
- (4) presentations made to or by the taxpayer, including PowerPoint slides,
- (5) disbursement records that indicate how the settlement amounts are categorized by the government,<sup>233</sup>
- (6) the final signed copy of the settlement agreement,
- (7) notes and minutes of meetings.
- (8) copies of the signed criminal agreements, sentencing memorandum, correspondence with relator, the complaint, mitigation reports, and
- (9) a Corporate Integrity Agreement.<sup>234</sup>

As the Exam Team analyzes the information obtained, it is directed to many of the authorities discussed in this paper, including section 1.162–21 of the Regulations, *Talley, Southern Pacific, Colt Industries*, and IRS Technical Advice Memorandum 2005–02–041 for further guidance in determining the deductibility of the settlement payments.<sup>235</sup>

#### B. *Steps During The Government Investigation*

The focus of the IRS audit guidelines discussed above suggest that long before negotiations occur, steps can be taken by the taxpayer to preserve the deduction for potential settlement payments. First, it is important to be aware that government investigations may result in potential payments. This

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233. Note that the IRS has stated in T.A.M. 2005–02–041 (Oct. 22, 2005) that the government’s actual use of the settlement proceeds is not relevant in determining intent concerning the purpose of the payment at the time of the settlement when there was more contemporaneous information available in the form of a final, “pre-handshake” spreadsheet.

234. Attachment to IDD #1, *supra* note 150.

235. IDD #1, *supra* note 150. The T.A.M. 2005–02–041 (Jan. 14, 2005) provides a comprehensive section 162(f) analysis and concludes that a portion of a FCA settlement represented multiple damages and was, therefore, nondeductible.

should be discussed with counsel on an ongoing basis. Counsel early on should be fully versed in, or fully briefed and educated on, the implications of section 162(f), the burden of proof, and the importance of the factual record and intent, as evidenced by various communications including memoranda, correspondence, drafts, and emails. The taxpayer should decide whether it wants to try to address tax deductibility in the settlement process specifically. If not, the taxpayer and counsel should devise a strategy to build a record to support deductibility, if possible. Second, the company's SEC and other regulatory filings and disclosures should be reviewed for information that might bear on the parties' intent.

### C. Structuring the Settlement—Factors Affecting Deductibility

The IRS and the courts have made clear that the burden of proof rests on the taxpayer to establish entitlement to a full or partial deduction for amounts paid in settlement with the regulatory agencies. The case-by-case approach has not resulted in any bright line tests under section 162(f) for determining deductibility. Rather, a study of past cases identifies multiple factors that may be considered in determining the deductibility of settlement payment depending on the context.<sup>236</sup> These factors include:

- (1) the severity of the conduct giving rise to the investigation or charges, and the facts surrounding that conduct,
- (2) the language of the statutory provision asserted by the government, its legislative history, and interpretations of that law to the extent relevant,
- (3) the purpose and scope of the particular fine or penalty as punitive or compensatory, and where both purposes may be present, a determination of which purpose the particular payment serves,
- (4) whether there is a criminal investigation and, if so, its relationship to the payment in question,
- (5) whether there is a plea or admission of criminal culpability,
- (6) the factual record of negotiations, and the language in the settlement agreement,
- (7) the potential imposition of double or treble damages,
- (8) correlation between damages and injury to the government, including how the government distributes or applies settlement proceeds,
- (9) the nature and intent of any restitution,
- (10) whether the taxpayer received a quid pro quo for the payment and, if so, what,

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236. See cases discussed *supra* text Part II. See also C.C.A. 2013–08–027 (Oct. 31, 2012) for recent IRS pronouncement using some of these factors.

- (11) prospective exclusion from government programs/contracts,
- (12) government policies regarding settlements with respect to the alleged misconduct, and
- (13) the presence of double jeopardy provisions.<sup>237</sup>

Taxpayers will benefit from negotiating settlements with the abovementioned factors in mind. They can be used to build a strong factual record. The presence or absence of any of the particular factors may also influence the decision of the taxpayer to raise or address the tax treatment of the settlement.

## V. CONCLUSION

Section 162(f) is both currently relevant and a developing area of law. Taxpayers can expect continued efforts by lawmakers to broaden the scope of nondeductibility pursuant to section 162(f) as evidenced by the Obama Administration's continued focus to that end in its current budget proposal.<sup>238</sup> Without further clarification of section 162(f), taxpayers and the IRS alike will continue to struggle under section 162(f). At the very least, however, relevant case law and factors discussed herein may help taxpayers navigate the uncertainty of section 162(f) and avoid its applicability.

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237. Note, however, that the relevance of a double jeopardy provision has been largely neutralized since *Talley*, with the Ninth Circuit finding that the fact that the payment was not punishment for purposes of double jeopardy did not mean it was not compensatory for purposes of section 162(f). *See supra* note 185; *see also* Attachment to IDD #1, *supra* note 150.

238. *See* 2015 GREEN BOOK, *supra* note 222.