Feeling Sick About *Wellpoint*, Part I

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The difference between an immediate tax deduction and a capitalized expense can seem like the line between feast and famine. True, sometimes the stakes can be a mere one or two years' timing difference. After all, if capitalization is required, perhaps the asset in question will end up as the subject of a disposition in short order. That means, as we all know in practice, one looks at the spread between the two treatments.

But there's a sharp contrast between a whopping deduction today compared to the same amount spread ratably over, say, 30 years. In some cases the stakes are, well, too big to fail. That was the situation in *Wellpoint*, recently decided by the Seventh Circuit Court of Appeals.

Wellpoint embodies a hybrid of two of my favorite tax areas, acquisitions on the one hand and the treatment of settlements and judgments on the other. Our sad story begins in Tax Court.

Settling up

In *Wellpoint, Inc.*, 96 TCM 260, Dec. 57,563(M), TC Memo. 2008-236, *aff'd*, 2010 U.S. App. LEXIS 5903 (7th Cir. 2010), the Tax Court considered a company's deduction of three settlement payments totaling over $113 million made to resolve lawsuits brought against the company by the Attorneys General of the states of Kentucky, Ohio and Connecticut. The first issue was whether these amounts were business expenses or penalties. The second was whether the legal and professional expenses Wellpoint incurred in defending these lawsuits were deductible.

Tax Court Judge Kroupa ruled that both the settlement payments and the related legal fees were capital expenditures that could not be deducted. As is so often the case in Tax Court litigation, many of the facts were stipulated. Wellpoint provided commercial health insurance through its subsidiaries doing business in all of the states in question. Many of Wellpoint's subsidiaries were Blue Cross/Blue Shield licensees.

In Kentucky, Ohio and Connecticut, Wellpoint merged with Blue Cross and Blue Shield Plans, which had charitable purpose provisions in their governing documents. Post-merger, the Attorneys General (that's a fun plural to say) of Kentucky, Ohio and Connecticut began investigating some of the constituent companies. They did not like what they found, for there seemed to be nothing charitable going on.

The basic complaint in each state was the same: Wellpoint's subsidiaries continued to have expressed charitable purposes in their governing documents. That meant they were receiving various benefits under federal and state law. To the three states, that meant Wellpoint should be viewed as holding these assets impressed with a charitable trust.

In essence, the three Attorneys General argued that no charitable purposes were being met. That meant the respective states should logically be entitled to those assets.

To Capitalize or Deduct?

After a period of scuffling, Wellpoint and its subsidiaries resolved the litigation in all three states by a transfer of cash. Yet this was not the usual cash settlement payment. In Kentucky, Wellpoint transferred the money (about $45 million) to the Commonwealth of Kentucky for the specific purpose of creating a section 501(c)(3) organization to promote Kentucky healthcare.

In Ohio, Wellpoint directed the money (about $36 million) to establish the Anthem Foundation, also targeting health care. In Connecticut, the money (about $40 million) went directly into a newly formed charitable corporation to serve the health needs of Connecticut. The amounts to the three states were paid in 1999 and 2000. Between these two tax years, Wellpoint deducted all the settlement payments. It also deducted approximately $800,000 in related legal and professional fees.

Although these settlements may sound unusual, in at least one respect they were not. The three settlement agreements made it quite clear that Wellpoint was not admitting any liability, and was only entering into each of the settlements as a compromise and to avoid further litigation. Consider that denial of liability question again at the end of our story.

Harsh but Fair?

Much of the Tax Court's opinion in *Wellpoint* is predictable. The court starts with an analysis of the origin of the claim doctrine, noting that it had to determine the nature of the claim in each of the respective lawsuits. The origin of the claim axioms give way to *cy-pres*, an odd doctrine that few outside of academia ever consider.

The basic claim of the Attorneys General in all three cases, said Judge Kroupa, was *cy-pres.* When it would be impossible or illegal to give an instrument its literal effect, you should construe it so the intention of the party is carried out as near as it can be. If property is dedicated to a particular charitable purpose and that purpose is not being carried out, a *cy-pres* proceeding seeks to carry out a charitable purpose that is as close as possible to the original purpose.

Deducting Litigation

The Tax Court goes on to answer the question whether payments to resolve litigation over the *cy-pres* doctrine should be deductible under Internal Revenue Code Section ("Code Sec.") 162 or must be capitalized under Code Sec. 263. You might think that business expense deductions here would be obvious. You also might think that an alternative might be charitable contribution deductions. The urge to deduct is strong.

Nevertheless, the Tax Court weighed in with the usual smattering of cases standing for the proposition that the costs of resolving litigation over title to property involve *capital* expenditures. From the usual cases standing for the proposition that title to property equals capitalization, the court went on to say that settlement payments and legal fees expended to resolve disputes over the *ownership* of assets are *also* capital in nature. The court cites *Anchor Coupling Co.,* CA-7, 70-1 USTC ¶9431, 427 F2d 429 (1970).

In contrast to the capitalization authorities, the court admits that a deduction is usually allowed for expenses incurred in defending a business and its policies from attack. For this, the court cites our old friend *INDOPCO Inc.*, SCt, 92-1 USTC ¶50,113, 503 US 79 (1992); *see also S.B. Heininger*, SCt, 44-1 USTC ¶9109, 320 US 467 (1943).

Part II will appear in the June 2010 issue.