Payments in the hundreds of millions, if not billions, of dollars may actually have a significantly lower after-tax cost to the payor, if the settlement can be structured to avoid the provisions of the Code and Regulations that make fines and penalties nondeductible. In this area, however, things often are not as simple as they may seem.

INSURANCE AND OTHER SETTLEMENTS

Like many industries today, the insurance industry faces scrutiny over allegations of anti-competitive practices and even fraud. Commencing with the New York State Attorney General's investigations into big commercial insurance brokerages, there even has been a trickle-down effect: Individuals have become concerned that their own insurance brokers may have conflicts of interest, perhaps even receiving contingent payouts smacking of something outside the traditional commission structure. As for the big carriers, settlements are already being reported.

American International Group, Inc. (AIG) agreed to pay $126 million in a pact negotiated with federal prosecutors and securities regulators. One of AIG's subsidiaries is to pay an $80 million "penalty" to the Justice Department to settle criminal inquiries into its dealings with PNC Financial Services Group, Inc. and Brightpoint, Inc. In addition, AIG had to pay $46 million into a "disgorgement fund" to settle the Securities and Exchange Commission's civil inquiry into the PNC transactions.

Like other insurance company settlements, these payments raise tax issues. In fact, given the significant tax issues, it is actually surprising that the AIG settlement involves such a large penalty payment. PNC itself had struck a settlement with prosecutors and banking and securities regulators, agreeing to pay $25 million in fines and $90 million in restitution for shareholders.

AIG has now paid twice; this is the second settlement announced for the company, which paid a $10 million fine in September 2003 to settle the SEC's civil charges in the Brightpoint matter. The new PNC pact calls for the SEC filing civil fraud charges against AIG, with AIG neither admitting nor denying wrongdoing. Still, some have questioned whether AIG has paid enough. AIG's shares fell 1% last year as the New York Attorney General and he SEC launched their investigations. Thereafter, in a move to shore up its share price, AIG in January of 2005 announced its biggest dividend increase in more than 25 years.

Those who want to see bigger settlements need only to look to the Marsh & McLennan Companies, which reached an $850 million settlement of civil fraud charges with the New York State Insurance
The settlement roughly matches the amount of such commissions that Marsh & McLennan received in 2003. This deal includes a commitment by Marsh & McLennan to a new business model designed to avoid such conflicts of interest. Marsh also apologized to its customers. There are other claims pending against Marsh & McLennan, notably a civil unfair business practices suit filed by Connecticut's Attorney General. There is also class action litigation filed by shareholders. The restitution monies would be available to provide for clients nationwide. Notably, participation in the restitution fund would require foregoing other litigation against Marsh & McLennan.

According to Marsh & McLennan CEO Michael Cherkasky, the $850 million was actually $100 million higher than the $750 million figure the regulators had been seeking. Partly, this was because Marsh & McLennan wanted to settle quickly, to spread restitution payments over four years, and to avoid paying a fine. Some people have characterized the Marsh & McLennan settlement as too lenient.

The tax aspects of this settlement are noteworthy. Unlike previous settlements that followed investigations into the mutual fund industry and Wall Street brokerages, the New York Attorney General did not demand that Marsh & McLennan pay fines or penalties to the state. Instead, the settlement requires Marsh & McLennan to remedy its poor behavior by returning money to customers. Defending the restitution plan, the Attorney General said that he preferred to negotiate restitution with Marsh rather than impose fines or penalties "because the money should go back to the victims." Despite the lack of a fine, six insurance executives (including one at Marsh & McLennan) have pleaded guilty to criminal charges in the investigation.

Even after all this, the insurance industry settlements are surely not over. Moreover, they represent only the most recent example of investigations into significant businesses, particularly in the financial sector. As noted above, the mutual fund industry has been investigated and had its own rash of settlements. The securities industry also has had its share of problems and investigations, culminating in some huge settlements. The most publicized of these was a $1.5 billion global securities industries settlement in 2003.

TAX IMPLICATIONS OF FINES AND PENALTIES

The general rule is that payments in a business context (either by way of settlement or judgment) are deductible. Section 162(f), however, expressly states that no deduction is allowed for "any fine or similar penalty paid to a government for the violation of any law." This provision denies a deduction for both criminal and civil penalties, as well as for sums paid in settlement of potential liability for a fine. It is the latter element of the provision that often causes great controversy. It may (or may not) be clear that there is a likelihood that a fine would be imposed when a "potential" liability is satisfied.

The significance of the rule that fines and penalties are nondeductible—as well as the considerable incentives that taxpayers have to avoid this rule—are well illustrated by Exxon's liability in the Exxon Valdez oil spill litigation. The Congressional Research Service reported that the U.S. government's $1.1 billion Alaska oil spill settlement with Exxon actually cost Exxon a maximum of $524 million when Exxon's tax deductions for the payments were taken into account. This study revealed that more than half of the civil damages totaling $900 million could be deducted on Exxon's federal income tax returns. The study also indicated that because the civil penalties would be paid out over ten years, the real return to the government would be significantly eroded by inflation.

The tax benefits are clearly not lost on Marsh & McLennan, the latest corporate colossus to agree to pay a whopping settlement. It was too long after the release of information about the $850 million Marsh & McLennan settlement that the Wall Street Journal noted the probable deductibility of the settlement. Clearly, the $850 million settlement figure sounds awfully impressive. As the Journal noted, the "financial-services giant looks likely to end up paying a lot less thanks to a tax deduction that could shave hundreds of millions from the headline figure."14

Although the New York Attorney General got great press for his largest-yet settlement, those with a degree of tax savvy noted that the money earmarked for restitution has significant tax benefits. Restitution (or disgorgement of profits) is generally deductible as a business expense. This tax deduction strategy is hardly new, and it helps reduce the bottom-line impact. The same ideas were at work with the various headline settlements in the Wall

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2 Id.
3 Id. See also Francis and Schoeder, "AIG Settles With Regulators," Wall St. J., 12/1/04, page C3.
6 Id.
7 Id.
10 See Zuckerman, "Pain of Wall Street Settlement to Be Eased by U.S. Taxpayers," Wall St. J., 2/1/05.
12 Reg. 1.162-21(b)(1).
14 Id.
Street research scandal and in several settlements among mutual funds dealing with improper trading of fund shares. An analyst suggested that Marsh's tax rate (a mix of U.S. and foreign taxes) is about 35%, dramatically reducing the after-tax cost of the $850 million settlement. The report does suggest that it is possible that not all of the $850 million settlement is deductible, so one can scale back the benefits depending on exactly what position Marsh decides to take. Interestingly, a New York State Insurance Department official even suggested that the settlement was deductible. Wisely, a spokesman for the state Attorney General's office did not comment about the tax impact.

Whether a payout constitutes a fine or penalty may in some cases depend on the intent of the perpetrator. The disallowance of the deduction, however, does not require that the violation of law have been intentional. No deduction will be permitted for the payment of a fine even if the violation is inadvertent, or if the taxpayer must violate the law in order to operate profitably.

**Hodge-Podge of Case Law**

One of the more important cases to define the line between nondeductible fines or penalties and deductible compensatory damage payments is Allied-Signal, Inc., 54 F.3d 767, 75 AFTR2d 95-1287 (CA-3, 1995), aff'd TCM 1992-204. The Third Circuit affirmed the Tax Court's denial of any deduction for an $8 million payment Allied-Signal paid into a trust to eradicate a toxic chemical pesticide from the environment.

The court found that the payment was made with the virtual guarantee that the district court having jurisdiction over the environmental damage suit would reduce the criminal fine by at least the amount previously levied against Allied-Signal.

This kind of *quid pro quo* analysis comes up frequently in fine or penalty cases. The issues surrounding these fine vs. compensatory line drawings are discussed with increasing frequency by commentators.

It often is worthwhile for taxpayers to litigate the question of what constitutes a fine or penalty. For example, in Jenkins, TCM 1996-539, the Tax Court held that a shareholder of a fertilizer manufacturer was entitled to deduct, through his S corporation, amounts he paid to two states as “penalties” for deficiencies in the fertilizer produced by his company. The IRS had disallowed the deduction (passed through from his S corporation), arguing that the payments represented nondeductible penalties.

The Tax Court, however, looked to the purpose of the state legislation, finding that it was to compensate the consumer, not to punish the manufacturer. The Tax Court noted that the penalty was calculated by determining the value of the deficient ingredient that the consumer paid for but never received, plus an additional amount that was to compensate for additional crop yield. In this case, the Tax Court found for the taxpayer because the statute was remedial, not punitive. Jenkins demonstrates that it is important to look beyond the “fine or penalty” language to discover the purpose of the statute pursuant to which the fine or penalty is levied.

The mere fact that a penalty is civil rather than criminal does not get the taxpayer out of the woods. For example, in Haworinsky, 105 TC 94 (1995), the Tax Court held that Section 162(f) prohibited a man from deducting treble damages he was required to pay when he breached a scholarship program contract. Finding that the payment was a civil penalty, the Tax Court concluded that Section 162(f) applies both to criminal fines and to certain civil penalties.

Fines, Late Fees, and Compensatory Payments

Although Section 162(f) bars a deduction for any fine or similar penalty paid to a government for a violation of law, many payments have been ruled not to constitute fines for this purpose. Thus, a late-filing fee, which is really designed to encourage prompt compliance with the law, has not been treated as a fine for this purpose. Another exception from the scope of Section 162(f) and its denial of deductions for the payment of fines relates to so-called “compensatory” fines. Even a fine (as distinguished from a late fee) can be deducted if it is compensatory. If a fine is imposed only to compensate a governmental entity for harm it has suffered, as distinguished from a fine having a punitive motivation, a deduction will be allowed. Thus, a fine that is essentially a reimbursement to the government for the amount of lost custom taxes has been held deductible.

Similarly, a payment to the Clean Water Fund in order to avoid prosecution for water pollution was held deductible, in S&B Restaurant, Inc., 73 TC 1226 (1980). Even fines that may appear to be punitive on the surface may be held to be deductible as long as the requisite compensatory character of the payment can be proven. Thus, in Mason and Dixon Lines, Inc., 708 F.2d 1043, 52 AFTR2d 83-5134 (CA-6, 1983), statutory “liquidated damages” imposed for the violation of truck weight limitations were held to be deductible.

Liquidated damages obviously could be equated with penalties. The theory of Mason and Dixon Lines, however, was that the statutory liquidated damages compensated the state for damage to the highways caused by overweight vehicles. Liquidated damages imposed by contract, even where denominated as “fines,” have been viewed as compensatory on the same theory. Indeed, even the IRS has agreed with this position.

Despite all this teaching, the line...
between compensatory and noncompensatory fines is sometimes difficult to discern. The Regulations take the position that civil environmental fines are nondeductible. Moreover, it may be difficult for the taxpayer to show that a fine is imposed with a compensatory motive. How does one find out the motive of the government on any subject? How high the stakes are, of course, depends on the size of the fine and the degree to which it is likely to be recurrent.

**Purpose of and Motive Behind Payments**

Several cases are particularly important in exploring the purpose of a payment, particularly *Talley Industries, Inc.*, TCM 1994-608, rev'd 116 F.3d 382, 79 AFTR2d 97-3096 (CA-9, 1997), on remand TCM 1999-200, aff'd 18 Fed. Appx. 661, 88 AFTR2d 2001-7027 (CA-9, 2001). In *Talley*, a company and several of its executives were indicted for filing false claims for payment with the federal government. The contracts in question allegedly resulted in a loss to the Navy of approximately $1.56 million. Because of various potential liabilities, however, the settlement ultimately agreed to between the company and the Justice Department was $2.5 million. The company deducted this amount on its tax return, and the IRS asserted that the settlement essentially amounted to a fine or penalty that could not be deducted.

The Tax Court granted summary judgment for the taxpayer, holding that the settlement payment was not a fine or penalty, except for a very small amount ($1,885) that was explicitly for restitution. The *Talley* Court found that the government had never suggested that it was attempting to exact a civil penalty from the company. Noting that $2.5 million was less than double the alleged $1.56 million loss, the court inferred that the settlement was not intended to be penal or punitive, but rather to be compensatory.

The Ninth Circuit, however, concluded that there was a material issue of fact and that the matter was ripe for summary judgment. The appellate court gave this instruction to the Tax Court on remand: "If the $940,000 represents compensation to the government for its losses, the sum is deductible. If, however, the $940,000 represents a payment of double damages [under the False Claims Act], it may not be deductible. If the $940,000 represents a payment of double damages, a further genuine issue of fact exists as to whether the parties intended payment to compensate the government for its losses (deductible) or to punish or deter Talley . . . (non-deductible)."

The Tax Court's opinion on remand is extraordinarily detailed, referring to extremely specific findings of fact about many of the developments occurring during the settlement of the case. The court resolved the question of whether the parties intended the settlement to include double damages under the False Claims Act. The Tax Court concluded that even though the settlement agreement was silent on this point, the parties did intend this. Then, the court turned to whether the purpose of the $940,000 double damage payment was to compensate the government for its losses or to deter or punish the taxpayer.

The taxpayer and the government had polarized arguments, the taxpayer arguing that no portion of the $940,000 could be considered a penalty, and the government arguing that the entire amount was a penalty. The question centered on whether the amount was intended to reimburse the government for losses. The taxpayer sensibly noted that the government's actual losses exceeded $2.5 million, so the $940,000 was merely a portion of it and had to be regarded as a reimbursement.

The Tax Court, however, was not persuaded by the wholesale notion of the payment, and noted that the nature of the settlement was a compromise of numerous issues. There was correspondence about the settlement offer, and the taxpayer had actually tried to get into the settlement agreement the recitation that the amounts would be treated as restitution. In large part, the fact that the government rejected this proposal led the court to conclude that the taxpayer failed to carry its burden of showing that some remediation purpose was in fact intended.

For the second time *Talley* went to the Ninth Circuit. There, in a brief opinion, the appellate court reviewed *de novo* the Tax Court's conclusions of law, and its factual findings for clear error. Finding no error in the Tax Court's ruling, the Ninth Circuit again held that *Talley* failed to establish the compensatory nature of the disputed settlement.

As noted above, in *Allied-Signal* the Tax Court considered a deduction claimed by the taxpayer for payments made pursuant to the resolution of a suit involving environmental violations. In addition to other payments, the company made an $8 million payment into a nonprofit environmental fund. The court determined that the entire payment to the endowment fund was nondeductible because the payment was made with the virtual guarantee that the sentencing judge would reduce the criminal fine to which the company was subject by at least that amount. The Tax Court rejected the company's argument that the payment was not a fine or penalty because it did not serve to punish or deter, concluding that the payment served a law enforcement rather than a compensatory purpose. In a widely noted decision, the Third Circuit affirmed the Tax Court.

Recently, in TAM 200502041 the Service held that certain payments made to the federal government under the False Claims Act constituted nondeductible penalties. This is an important TAM, one that bases its conclusion on a reading of the purposes of the False Claims Act. Reading that Act as imposing a multiple of actual damages, the IRS concluded that a portion of the payments in question represented this multiplier of actual damages to punish bad conduct, and therefore that the payment was nondeductible as a fine or penalty. Because the settlement agreement did not identify which portion of the payment was meant to be compensatory and which portion was meant to be punitive, the IRS had to divine an allocation based on its perception of the intent of the parties.

In the environmental area in particular, taxpayers often make every attempt to avoid penalty characteriza-

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22 Reg. 1.162-21(c), Examples 2 and 7.
tion and to emphasize the remedial effects (or intent) of the payments.23

Payments of Restitution
The deductibility of restitution payments has been considered, among other cases, Kraft, 991 F.2d 292, 71 AFTTR2d 93-1493 (CA-6, 1993). There, the Sixth Circuit held that payments of restitution to Blue Cross/Blue Shield arising out of a criminal action for fraud were nondeductible. Although the restitution was paid to a private party and not to the government, the court held the payments nondeductible.

Although traditionally the IRS has analogized restitution payments to penalties, a number of courts have disagreed and found restitution payments to be deductible.24

Payments Against Public Policy
The IRS has occasionally objected to the deductibility of a payment where allowing the payment as a deduction raises public policy issues. No Code provision specifically authorizes the Service to disallow deductions based on public policy. Indeed, the fact that a liability from being deductible, as long as it may be restricted under Section 162(f), the IRS cannot generally disallow deductions based on public policy.25 Thus, where a taxpayer sought to deduct a payment made to an arsonist to burn down his building, no deduction was allowed.

The question of when a payment may not be deductible based on public policy restrictions is closely tied to the restriction on the deductibility on fines or penalties. It has been argued that the public policy doctrine and Section 162(f) are interrelated, and that the nondeductibility of fines or penalties under Section 162(f) was designed to replace the old restriction on public policy grounds.26

Despite the enactment of Section 162(f), it can be argued that when a payment is made to a private party that will definitely reduce the amount of a government-imposed fine, allowing a deduction for the payment could subvert the purposes of Section 162(f). That was essentially the position taken in Allied-Signal, where (as discussed above) the court denied the taxpayer any deduction for the $8 million it paid to a trust with a virtual guarantee that the criminal fine would be reduced by at least that amount.

Cases such as Allied-Signal are troubling. After all, it would seem difficult to control the circumstances in which the Section 162(f) type of restriction would apply. The factual determinations that must be made, and that were made in the Allied-Signal case, are still important. Negotiated settlements for a variety of types of legal violations occur with great frequency. It seems fairly certain that Congress did not intend that all of these negotiated settlements would be brought within the ambit of Section 162(f). Nevertheless, determining precisely where to draw the line is not easy.

If one reviews some of the case law with this public policy view in mind, it is possible to discern a disturbing trend even where the “public policy” monitor is not used. In Oden, TCM 1988-567, the Tax Court disallowed a sole proprietor’s deduction of a judgment for compensatory damages obtained against her in a defamation suit brought by an ex-employee. Noting that there was no public policy at issue in the defamation, the Tax Court found that there are some actions so extreme that a deduction should not be available. Given the elimination of the public policy grounds for denying a deduction (and the explicit limitation in Section 162(f) to fines and penalties), this decision seems wrong.27

Discrimination and Harassment Cases
Some taxpayers have expressed concern whether exemplary or punitive damages will give rise to normal business expense deductions notwithstanding the fact that they may be incurred in the course of an activity that arguably violates public policy. For example, an employer may incur liability for exemplary damages under the Age

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23 See Raby, "Two Wrongs Make a Right: The IRS View of Environmental Cleanup Costs," Tax Notes, 5/24/93, page 1051; and Raby, supra note 18.


26 Halvering v. Hampton, 79 F.2d 358, 16 AFTTR 649 (CA-9, 1935).


29 Great Island Holding Corp., 5 TC 150 (1949), acq.


31 Rev. Rul. 82-74, 1982-1 CB 110.

32 See Raby, supra note 18.

33 See also "Milken's Deduction for His Settlement," Tax Notes, 3/8/92, page 1189.
Because the court in Clark had been working within the course and scope of his employment, and he had not committed the rape. There, the taxpayer had been wrongfully accused of assault with intent to rape during the course of his employment activities. In Kelly, the Tax Court found that the taxpayer was pursuing a purely personal purpose. The Tax Court in Kelly stated that the sexual assault activity was neither within the course and scope of the defendant’s employment nor conducted for a legitimate business purpose.

Most tax advisors have assumed that sexual harassment, gender or race discrimination, wrongful termination, and a variety of other claims made against an officer of a company would be deductible by the company. The conclusion may turn on the specific facts and whether there is an express indemnity obligation either under the law, or in the employment contract or other governing documents (including bylaws). After Kelly, however, it may be that virtually all harassment or discrimination cases arguably arise out of some personal activity that, at least under one reading of the facts, could be considered outside the course and scope of employment. It remains to be seen exactly how far this particular notion will go.

Indeed, the kind of line drawing that was done in Kelly suggests, in part, the origin of the claim test. That, of course, is the overarching rule for determining the tax treatment of a settlement or judgment payment (to a payor or payee). Although it is possible to make sense of the origin of the claim test, it also is often possible to come out with quite different results depending on how one chooses to view the course of conduct that led up to the litigation. Some of the seminal cases in this area involve precisely this type of line drawing. While it is understandable that the authorities would seek to make sense of what may be perceived as tax advantages arising from aberrant conduct, there should probably be a more systematic and reasoned approach for this than there is.

Deductibility of Punitive Damages

Despite confusion about the topic, punitive damages paid to private parties are deductible. For example, the IRS has ruled that liquidated damages paid under the Fair Labor Standards Act are deductible as business expenses. Similarly, the Tax Court has held that punitive damages paid under the Age Discrimination in Employment Act and the Fair Labor Standards Act are deductible. As long as punitive damages are paid or incurred by a taxpayer in the ordinary course of its business, they will be deductible.

A controversy raged for years about the tax treatment of punitive damages in the hands of the recipient. After O’Givie, 519 U.S. 79, 78 AFTR2d 96-7454 (1996), and the parallel changes in the 1996 tax legislation, it is now clear that punitive damages are always taxable to the recipient. Still, there remains a difficult determination of precisely when “punitive damages” have been paid, since neither the Code nor the Regulations define this term. Often, a liability that might be viewed as partially punitive in nature is settled on appeal or in some other consensual way.

The controversy about the treatment of punitive damages to the recipient surely did not help the confusion over the treatment of punitive damages to the payor. President Clinton’s 1999 budget proposal to deny deductions to any party paying punitive damages to plaintiffs in civil lawsuits also may have confused the issue. Furthermore, this proposal also would have required a company with insurance for punitive damages to recognize income in the amount that the insurance company actually paid for the punitive. Not surprisingly, the proposal did not meet with approval from the business community.

CONCLUSION

Returning to the insurance industry, it should hardly be surprising that those negotiating on behalf of the various firms (such as Marsh & McLennan) would attempt in settlement documents to characterize as much as possible as remedial in nature. Characterization is one thing, of course, but reality can sometimes be another.

34 See also Rev. Rul. 80-211, supra note 30.
38 Rev. Rul. 90-211, supra note 30.
40 See also Rev. Rul. 90-211, supra note 30.
41 See Schlesinger and Hitt, supra note 39.