Tax Deductions for Damage Payments: What, Me Worry?

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It is axiomatic that when businesses are sued and pay out settlements and judgments, they expect to do so on a deductible basis. That is especially true in America, where litigation is simply a cost of doing business. It should come as no surprise that there has never been serious question about the deductibility of lawyers' fees or settlement payments to resolve litigation.

Granted, some types of payments in that context raise capitalization issues. For example, a lawsuit (and legal expenses) over title to property must be capitalized and then deducted ratably over the life of the asset. Those oddities aside, in the vast majority of cases, we deduct. We deduct slip-and-fall cases, suits by employees, suits by shareholders, and suits with customers and suppliers.

Although the general rule is that payments in a business context (either by way of settlement or judgment) are deductible, there is one flat no-no. The Internal Revenue Code expressly denies a deduction for ''any fine or similar penalty paid to a government for the violation of any law.''[1] That includes criminal and civil penalties, as well as sums paid in settlement of potential liability for a fine.[2] 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 of a fine being imposed when a ''potential'' liability is satisfied.

If you think there aren't huge dollar swings in that context, think again. Exxon's $1.1 billion Alaska oil spill settlement actually cost Exxon no more than $524 million after tax.[3] More recently, Marsh & McLennan agreed to fork out $850 million to settle civil fraud charges brought by New York Attorney General (and New York gubernatorial hopeful) Eliot Spitzer.[4] The tax deduction was no secret. *The Wall Street Journal* noted it, saying that Marsh & McLennan ''looks likely to end up paying a lot less thanks to a tax deduction that could shave hundreds of millions from the headline figure.''[5] Given Marsh's tax rate of about 35 percent (between U.S. and foreign taxes), that tax deduction shaves more than $300 million from the cost of the $850 million settlement.[6]

Sure, the tireless Spitzer got great press for his largest settlement to date. Yet earmarking the money for restitution had significant tax benefits to Marsh & McLennan. Restitution (or disgorgement of profits) is generally deductible as a business deduction, so paying ''restitution'' is a lot less painful. That tax strategy is hardly new. The same ideas were at work with several headline settlements in the Wall Street research scandal and several mutual fund settlements involving improper trading of fund shares.[7]

Settlements usually involve compromises of claims. The settling party who is accused of doing some wrong usually does not admit any wrongdoing in the settlement. In line with the hazards of litigation, payments made by a settling party tend to fall between what each party originally hoped for at the initial stages of litigation. If you settle with the Environmental Protection Agency, the Securities Exchange Commission, or some other agency breathing down your business's neck, the payment will presumably be *less* than the asserted liability. Otherwise, you wouldn't settle.

Whether a settlement payout truly constitutes a fine or penalty may depend on the intent of the perpetrator. However, the violation of law need not have been intentional to incur nondeductibility. A fine is nondeductible even if the violation is inadvertent or if the taxpayer can show that he must violate the law to operate his business profitably.

Congress Takes Aim

Those tax incentives (and their erosion of tax revenue) are not lost on Congress or the president. Nor is the apparent social policy gaffe presented by the fact that Congress might be seen as encouraging bad behavior by allowing tax deductions for reprehensible business conduct. When you add those up, it's no wonder there's concern. On two prior occasions, the White House proposed a remedy to this continuing problem.[8] Now Congress has taken aim and may pull the trigger.

The $70 billion tax bill authored by Senate Finance Committee Chair Chuck Grassley, R-Iowa, targets damage payments.[9] Although section 162(f) already plainly prohibits companies from deducting penalties assessed by (and paid to) federal agencies like the SEC, there has recently been controversy about settlements reached with the government that seek to characterize payments as

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[1] Section 162(f).

[2] Reg. section 1.162-21(b).

[3] ''Deductions Will Help Exxon Slip Away From Much of Its Oil Spill Liability, Says CRS,'' *Highlights & Documents*, Mar. 21, 1991, p. 2853.

[4] *See* McDonald, ''Marsh, Spitzer Settle With $850 Million, an Apology to Clients,'' *The Wall Street Journal*, Feb. 1, 2005, p. C1.

[5] *See* McDonald, ''Marsh's Settlement Looks Likely Eligible for a Tax Deduction,'' *The Wall Street Journal*, Feb. 7, 2005, p. C1.

[6] *Id.* The analyst commenting on Marsh's tax position was Justin Fuller, who covers the company for Morningstar Inc.

[7] *Id.*

[8] The Clinton administration's 2000 and 2001 budget proposals both included provisions to make punitive damages nondeductible. Neither proposal was acted on by Congress. *See* ''General Explanation of the Administration's Revenue Proposals,'' *Doc 1999-4614*, *1999 TNT 21-36*; ''General Explanation of the Administration's Revenue Proposals,'' *Doc 2000-3672*, *2000 TNT 26-9*.

[9] The Tax Relief Act of 2005, S. 2020, sections 533 and 534, *Doc 2005-24551*, *2005 TNT 234-39*.

"remedial." In contrast to fines, payments that are remedial or compensatory in nature are deductible.[10]

Obviously, importing deductibility characterization can reduce the effective cost of the payment. The proposed law attempts to legislate around that built-in incentive by saying that payments made in lieu of fines cannot be deducted. The legislation would also bar companies from deducting punitive damage payments to civil plaintiffs. The Finance Committee estimates the provision is worth $60 million a year, a paltry number in the great expanse of the government's fiscal policy.

Yet, attempting to make social policy, Grassley said, "A civil settlement is supposed to sting like a bee, not annoy like a gnat," and he added, "Letting companies deduct settlement payments from their income taxes takes away the sting."[11] Predictably, U.S. business interests have reacted negatively, claiming that such a law might actually discourage companies from settling claims with the government. Bruce Josten, chief lobbyist for the U.S. Chamber of Commerce, argues that the provision runs counter to the entire goal of settling disputes without litigation as a means of reducing the burdens on the courts.[12]

Grassley proposed those cutbacks in 2004, several times trying to add the revisions to an international tax bill, and again to a highway bill earlier in 2005. He may have been inspired by the Clinton administration. In 1999 and again in 2000, the Clinton White House included a substantially similar provision in its budget proposal for fiscal 2000 and 2001.[13]

The New York State Bar Association produced a thorough report on the deductibility of punitive damages in 2001.[14] That analysis highlights the pros and the cons of allowing deductibility, and some of its points deserve mention. Supporters of nondeductibility mention the social policy goals sought by various code provisions, including golden parachute payments, greenmail, excessive employee compensation, and so on. Yet, a huge unanswered question is whether nondeductibility would have any deterrent effects on defendants and how such a sea change would affect juries that impose punitive damage awards and businesses that pay them.

Many of the revenue projections now integral to our tax legislative process seem akin to witchcraft. If punitive damages or negotiated settlements with the government in lieu of penalties become nondeductible, there would have to be a fundamental change in the information provided to juries so they could take into account the after-tax effects of punitive damages. The after-tax effects of any settlement with the government must also be considered.

[10]Reg. section 1.162-21(b)(2).

[11]*See* Mullins, "Business Fights Tax Bill Barring Deductions for Some Settlements," *The Wall Street Journal*, Nov. 10, 2005, p. A4, quoting Sen. Grassley.

[12]*Id.*

[13]*See* "General Explanations of the Administration's Revenue Proposals," *supra* note 8.

[14]*See Tax Notes*, Nov. 26, 2001, p. 1209.

Characterizing (and Recharacterizing) Payments

There is a tendency to lump discussions of punitive damages (paid to private parties) together with settlement payments made by companies seeking to avoid a government penalty. That is unfortunate because those are different circumstances. In the case of a payment to a government, it may not be too difficult to discern whether the payment is made as a quid pro quo for dropping the asserted penalty. Perhaps it will not be too difficult to ferret out exactly what happened and exactly the type of payment that is being made, verbiage aside.

However, if the settling government agency freely engages in recharacterization efforts (saying it will accept a payment to a "remediation fund," for example) as a means of disposing of a penalty assertion, why should the IRS have the last say on what the payment is truly for? The intent of the payer is surely relevant to tax characterization, as is the language agreed to by the parties. Even though it is clearly not determinative, it's worth something.

When civil punitive damages are sought and the case settles, a variety of amorphous factors may undermine any attempt to draw bright lines. Punitive damages may be premised on various theories, one of which is the potential inadequacy of compensatory damages when it may be too difficult or too costly to measure those damages accurately. Those theories undermine the legal axiom that punitive damages are *always* designed to punish.

In fact, punitive damages in some cases may be there to do more than punish. One of the factors juries may be considering in punitive damage awards is the adequacy of the compensatory damages.[15] Doesn't that imply that some of the "punitives" might really be compensatory? Moreover, sometimes something is not what you call it. When a case settles and no "punitive damages" are paid, will the government be free to engage in characterization battles?

The IRS has already displayed a tendency to view as punitive something that the parties may expressly call compensatory. At least one court has found punitive damages to exist even though the case was settled before trial and the settlement did not allocate any of the award to punitive damages. In *Barnes v. Commissioner*,[16] the plaintiff was fired the day after she gave a deposition in a case involving her employer. She brought a wrongful termination action, seeking damages of at least $10,000. The case settled for $27,000, and Barnes excluded the entire settlement under pre-1996 section 104(a)(2).

The IRS disagreed, and the matter wound up in Tax Court, which noted that Barnes's attorney testified that Barnes had a strong case for mental distress with the likelihood of punitive damages. The court found that persuasive and consequently split the settlement amount between tax-free mental distress and taxable punitive damages.

[15]*See Pacific Mutual Life Insurance Co. v. Haslip*, 499 U.S. 1, 61 (1991) (Justice O'Connor dissenting).

[16]T.C. Memo. 1997-25, *Doc 97-1505*, *97 TNT 11-13*.

Historical Case Law

Even without a new law, the line drawing that taxpayers, the IRS, and the courts have had to engage in is considerable. One of the most important cases to define the line between nondeductible fines or penalties and deductible compensatory damage payments is *Allied-Signal, Inc. v. Commissioner*.[17] In that case, 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 would reduce the criminal fine by at least the amount previously levied against Allied-Signal. That kind of quid pro quo analysis comes up frequently in fine or penalty cases. The issues surrounding these fine-versus-compensatory demarcations are discussed frequently by commentators.[18]

Sometimes a ''penalty'' may not be intended to punish, and that may make the issue worth litigating. For example, in *S. Clark Jenkins, et ux. v. Commissioner*,[19] 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. The Tax Court found for the taxpayer because it was a remedial statute, not a punitive one. *Jenkins* demonstrates that it is important to look beyond the mere ''fine or penalty'' language to discover the *purpose* of the statute under which the fine or penalty is levied.[20]

The mere fact that a penalty is civil rather than criminal does not get the taxpayer out of the woods. For example, in *Hawronsky v. Commissioner*,[21] the Tax Court held that section 162(f) prohibited a taxpayer 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 some 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 that purpose. Thus, a late filing fee, which is really designed to encourage prompt compliance with the law, has not been treated as a fine.[22]

Another exception to the nondeductibility 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.[23]

Similarly, a payment to the Clean Water Fund to avoid prosecution for water pollution was held deductible in *S&B Restaurant, Inc. v. Commissioner*.[24] 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-Dixon Lines, Inc. v. U.S.*,[25] statutory ''liquidated damages'' imposed for the violation of truck weight limitations were held to be deductible.

Although liquidated damages could be equated with penalties, the theory of that case was that the statutory liquidated damages compensated the state for damage to the highways caused by overweight vehicles. Liquidated damages imposed by contract, even when denominated as ''fines,'' have been viewed as compensatory on the same theory. Indeed, even the IRS has agreed with that position.[26]

Despite all that guidance, the line between compensatory and noncompensatory fines can be difficult to discern. The regulations take the position that civil environmental fines are nondeductible.[27] 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

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[17]54 F.3d 767, *Doc 95-2752*, *95 TNT 47-8* (3d Cir. 1995).

[18]*See* Raby, ''Moral Righteousness and Tax Deductions,'' *Tax Notes*, Nov. 22, 2004, p. 1115; Wiegenfeld, ''Increasing the Cost of Settlements: Proposed Legislation Would Expand the Fine and Penalty Nondeductibility Rule,'' *Tax Notes*, Dec. 15, 2003, p. 1341; Raby, ''When Will Public Policy Bar Tax Deductions for Payments to Government?'' *Tax Notes*, Mar. 27, 1995, p. 1995. *See also* Manns, ''Internal Revenue Code Section 162(f): When Does the Payment of Damages to a Government Punish the Payor?'' 13(2) *Virginia Tax Review* 271 (Fall 1993).

[19]T.C. Memo. 1996-539, *Doc 96-32146*, *96 TNT 242-12*.

[20]For additional discussion, see Schnee, ''Some Fines and Penalties Can Be Deducted,'' 58(1) *Tax'n for Accountants* 20 (January 1997).

[21]105 T.C. 94, *Doc 95-7783*, *95 TNT 155-9* (1995).

[22]Reg. section 1.162-21(b)(2). *See also Southern Pacific Transportation Co. v. Commissioner,* 75 T.C. 497 (1980); supp. op., 82 T.C. 122 (1984).

[23]*Middle Atlantic Distributors, Inc. v. Commissioner,* 72 T.C. 1136 (1979), *acq.*, 1980-2 C.B. 2.

[24]73 T.C. 1226 (1980).

[25]708 F.2d 1043 (6th Cir. 1983).

[26]Rev. Rul. 69-214, 1969-1 C.B. 52 (1969).

[27]Reg. section 1.162-21(c), examples (2) and (7).

stakes are, of course, depends on the size of the fine and the degree to which it is likely to be recurrent.

Purpose and Motive of Payments

There are several cases that are particularly important in exploring the purpose of a payment. In *Talley Industries, Inc., et al. v. Commissioner*,[28] a company and several of its executives were indicted for filing false claims for payment with the federal government. The Navy contracts in question allegedly resulted in a loss to the Navy of approximately $1.56 million. However, because of various potential liabilities, the settlement that was ultimately agreed to between the company and the Justice Department was $2.5 million. The company deducted that amount on its tax return, and the IRS asserted that essentially the settlement 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 a criminal restitution order paid as result of a guilty plea. The Tax 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,[29] the court inferred that the settlement was not intended to be penal or punitive, but rather to be compensatory.

Unfortunately for the taxpayer, the Ninth Circuit reversed and remanded the case, concluding that there was a material issue of fact and that the matter was not ripe for summary judgment. On remand, however, the Tax Court went through a detailed series of findings of fact. It is useful to review the instruction the Ninth Circuit gave to the 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 and Stencel (non-deductible).[30]

The *Talley* case 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 Tax Court resolved the question 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 that point, the parties did intend that. The Tax Court then turned to the question whether the purpose of the $940,000 double damage payment was to compensate the government for its losses or to deter or punish Talley and Stencel.

The taxpayer argued that *no* portion of the $940,000 could be considered a penalty, and the government argued 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 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 many issues. There was correspondence about the settlement offer, and the taxpayer had 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 that proposal led the Tax Court to conclude that the taxpayer failed to carry its burden of showing that some remediation purpose was in fact intended.

For a second time, the *Talley* case went to the Ninth Circuit. There, in a brief opinion, the Ninth Circuit 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.[31]

As noted above, in *Allied-Signal, Inc. v. Commissioner*[32] the Tax Court considered a deduction claimed by Allied-Signal for payments made as part of 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 Tax 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 purpose, not a compensatory purpose. In a widely noted decision, the Third Circuit affirmed the Tax Court.

In the environmental area in particular, taxpayers often make every attempt to avoid penalty characterization and to emphasize the remedial effects (or intent) of their payments.[33] Nonetheless, even Herculean efforts are no guarantee that payments will end up being deductible.

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[28]T.C. Memo. 1994-608, *Doc 94-10953*, *94 TNT 244-9*; *rev'd, remanded*, 116 F.3d 382, *Doc 97-18539*, *97 TNT 121-31* (9th Cir. 1997).

[29]The False Claims Act as it then existed allowed the government to seek only a maximum of double damages.

[30]116 F.3d at 387.

[31]*See Talley Industries, Inc. v. Commissioner*, 18 Fed. App. 661, *Doc 2001-29836*, *2001 TNT 232-6* (9th Cir. 2001), *aff'g* T.C. Memo. 1999-200, *Doc 1999-21339*, *1999 TNT 118-94*.

[32]T.C. Memo. 1992-204, *92 TNT 74-10*, *aff'd*, 54 F.3d 767, *Doc 95-2752*, *95 TNT 47-8* (3d Cir. 1995).

[33]*See* Wiegenfeld, *supra* note 18; Raby, "Two Wrongs Make a Right: The IRS View of Environmental Cleanup Costs," *Tax Notes*, May 24, 1993, p. 1091; and Raby, "When Will Public Policy Bar Tax Deductions for Payments to Government?" *Tax Notes*, Mar. 27, 1995, p. 1995.

Payments of Restitution

The deductibility of restitution payments is considered in many cases. In *Jess Kraft, et ux. v. U.S.*,[34] 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, many courts have disagreed and found restitution payments to be deductible.[35]

For example, in *Spitz v. U.S.*,[36] the court ordered Spitz to make a restitution payment to the party he harmed as part of his criminal sentencing. In fact, his probation was expressly conditioned on his making the restitution payment. The district court allowed Spitz to deduct the restitution payment.[37]

Payments Against Public Policy

The IRS has occasionally objected to the deductibility of a payment based on public policy grounds, despite the fact that no code provision specifically authorizes the IRS to disallow deductions based on that doctrine. Fortunately, the Supreme Court determined in 1966 that the IRS cannot disallow deductions under a general public policy theory.[38] Thus, the fact that a liability is based on a taxpayer's fraud, breach of fiduciary duty, or mismanagement is generally not enough to prevent the payment from being deductible, as long as the liability arose out of the taxpayer's trade or business. Examples of that rule include:

- damages caused by a taxpayer's fraud in negotiating a lease (held deductible);[39]
- damages paid by a stockbroker for improperly churning a client's account (held deductible);[40]
- damages paid by a director for breach of fiduciary duty to a corporation (held deductible);[41]
- damages paid by an executive for mismanagement and misuse of corporate assets (held deductible);[42] and
- punitive damages paid by a corporation to a victim of a fraudulent scheme in settlement of a breach of contract and fraud action (held deductible).[43]

There is a limit, however. If the payment itself is illegal under federal law, the deduction will be disallowed.[44] Thus, when a taxpayer sought to deduct a payment made to an arsonist to burn down his building (a taxpayer with considerable chutzpah) no deduction was allowed.

The public policy doctrine and section 162(f) are interrelated. Indeed, the enactment of section 162(f) with its nondeductibility for fines or penalties was in some sense designed to replace the old restriction on public policy grounds.[45] Yet, despite the enactment of section 162(f), 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 to the private party arguably subverts the purposes of section 162(f). That was essentially the position taken in *Allied-Signal, Inc. v. Commissioner*,[46] discussed above.

Cases like *Allied-Signal* are troubling. Negotiated settlements for a variety of types of legal violations occur with great frequency. Surely Congress did not intend that all of those negotiated settlements would be brought within the ambit of section 162(f). Yet determining precisely where to draw the line is not easy. If one reviews some of the case law with the public policy view in mind, it is possible to discern disturbing trends even when the "public policy" moniker is not used.

In *Oden v. Commissioner*,[47] 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 malice 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), that decision seems wrong.[48]

Discrimination and Harassment Cases

Some taxpayers have expressed concern whether exemplary or punitive damages will give rise to normal business expense deductions even though 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 Discrimination in Employment Act or the Fair Labor Standards Act. The Treasury regulations flatly state that an amount that is otherwise deductible under section 162 will not be made nondeductible by reason of the fact that allowing the deduction would frustrate public policy.[49] But as with so many flat statements, even that does not obviate all of the line drawing.

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[34] 991 F.2d 292, *Doc 93-4425*, *93 TNT 79-15* (6th Cir. 1993); *cert. denied*, 510 U.S. 976 (1993).

[35] *See Jon T. Stephens v. Commissioner,* 93 T.C. 108, *rev'd*, 905 F.2d 667 (2d Cir. 1990). For a helpful collection of those cases, see Raby and Raby, "Restitution Payments May Produce a Tax Deduction," *Tax Notes*, Oct. 21, 1996, p. 335. *See also* Schnee, *supra* note 20; and Raby, "Deductibility of Restitution Payments," *Tax Notes*, May 31, 1993, p. 1221.

[36] 432 F. Supp. 148 (E.D. Wis. 1977).

[37] *See also Patch v. Commissioner,* T.C. Memo. 1995-449, *Doc 95-8820*, *95 TNT 186-5*, *aff'd without opinion*, 96 F.3d 1439, *Doc 96-26870*, *96 TNT 192-13* (4th Cir. 1996).

[38] *Commissioner v. Tellier*, 383 U.S. 687 (1966).

[39] *Helvering v. Hampton*, 79 F.2d 358 (9th Cir. 1935).

[40] *Ditmars v Commissioner*, 302 F. 2d 481 (2d Cir. 1962).

[41] *Graham v. Commissioner,* 326 F. 2d 878 (4th Cir. 1964).

[42] *Great Island Holding Corp.*, 5 T.C. 150, *acq.*, 1945 C.B. 3 (1945); and *acq., sub nom.,* 1945 C.B. 7.

[43] Rev. Rul. 80-211, 1980-2 C.B. 57.

[44] Rev. Rul. 82-74, 1982-1 C.B. 110.

[45] *See* Raby, "When Will Public Policy Bar Tax Deductions for Payments to Government?" *Tax Notes*, Mar. 27, 1995, p. 1995.

[46] *Supra* note 17.

[47] T.C. Memo. 1988-567.

[48] Regarding the deduction of Michael Milken's settlement, see Sheppard, "Milken's Deduction for His Settlement," *Tax Notes*, Mar. 9, 1992, p. 1189.

[49] Reg. section 1.162-1(a). *See also* Rev. Rul. 80-211, 1980-2 C.B. 57.

In a blow to the traditional notion that virtually any legal expense (of a noncapital and nonpersonal nature) is deductible, in *Daniel Frances Kelly, Jr. v. Commissioner*,[50] the Tax Court held that the legal costs of defending against a sexual assault charge were nondeductible. The taxpayer had been charged with criminal sexual assault and sought to deduct the legal fees as a business expense. The Tax Court found that the sexual harassment charges arose out of the individual's personal activities and not out of any profit-seeking activities.

The *Kelly* court distinguished *Clark v. Commissioner*,[51] a case that also dealt with deductibility of legal fees surrounding a sexual assault charge, noting the personal nature of Kelly's activities. In *Clark*, the taxpayer had been wrongfully accused of assault with intent to rape during the course of his employment activities. *Kelly* seems inconsistent with *Clark*, because the court in *Clark* found the expenses to be deductible. However, in that case there was a finding that Clark had been working within the course and scope of his employment and that he had not actually committed the rape. The Tax Court in *Kelly* stated that, unlike the situation in *Clark*, sexual assault activity was not within the course and scope of the defendant's employment, nor was it conducted for a legitimate business purpose. In *Kelly*, contrary to *Clark*, the Tax Court found that Kelly was pursuing a purely personal desire.

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

Indeed, the kind of line drawing that is done in *Kelly* reminds me a little bit of the origin of the claims test, which is the overarching rule for determining the tax treatment of a settlement or judgment payment. Despite (or perhaps because of) the simplicity of the origin of the claims test, I find that it is also often possible to come up with quite different results depending on how one views the course of conduct leading up to the litigation. The seminal case in that area, *U.S. v. Gilmore*,[52] drew a line between personal activities and income producing behavior. Later cases may involve a somewhat different line drawing. In some of those it is understandable that the authorities would seek to make sense of what may be perceived as tax advantages arising from abhorrent conduct, there should probably be a more systematic and reasoned approach than there is.

[50]T.C. Memo. 1999-69, *Doc 1999-9190*, *1999 TNT 45-16*.

[51]30 T.C. 1330 (1958).

[52]372 U.S. 39 (1963).

Deductibility of Punitive Damages

Returning to Congress's current proposals, unless the proposed provision passes, punitive damages paid to private parties will remain deductible. Given the black letter nature of that rule, it is surprising that there is significant confusion about the topic. There should not be because even the IRS has acknowledged it.

The IRS ruled that liquidated damages paid under the Fair Labor Standards Act are deductible as business expenses.[53] Similarly, the Tax Court has held that liquidated damages paid under the Age Discrimination in Employment Act and the Fair Labor Standards Act are deductible.[54] As long as punitive damages are paid or incurred by a taxpayer in the ordinary conduct of its business, they will be deductible.[55]

A controversy raged for years about the tax treatment of punitive damages in the hands of the recipient suffering what was, or at sometimes characterized as, personal injuries. With *O'Gilvie v. U.S.*,[56] and the parallel changes in the 1996 tax legislation, it is now clear that punitive damages are always taxable to the recipient. The controversy over the treatment of punitive damages to the *recipient* surely did not help the confusion over the treatment of punitive damages to the *payer*.

Paying the Piper

It should be more than evident by now that this area of deductibility can be confusing. Attempts at line drawing between deductible and nondeductible payments can leave one's vision blurred. Although a fuzzy separation may exist, the IRS is virtually always inclined to assume the payments are nondeductible. A "shoot first, ask questions later" approach may not help the public perception of the IRS, but at least it's predictable.

The pending legislative proposals could change the playing field. Unfortunately, they seem unlikely to sharpen the distinction between payments made to the government (that may or may not be in the nature of a fine) and payments of punitive damages to private parties. To my mind, those are wholly separate issues, but perhaps I'm alone. While the IRS will likely continue its one-dimensional role regardless of any congressional action, taxpayers may be preempted from making many of their line-drawing arguments if the legislation passes. In fact, taxpayers may be forced to gamble more on an all-or-nothing approach if settlements are not deductible, but litigation expenses and perhaps jury awards are.

Legislation or not — and regardless of what happens in the flap over payments to obviate prospective governmental fines — I doubt the punitive damages controversy will be over anytime soon. What is, and what is not, correctly classified as punitive damages is likely to be a continuing conundrum, both on the income side of the

[53]Rev. Rul. 69-581, 1969-2 C.B. 25.

[54]*See Downey v. Commissioner*, 97 T.C. 150, *Doc 91-6693*, *91 TNT 161-10* (1991), *on reconsideration*, 100 T.C. 634, *Doc 93-7379*, *93 TNT 138-14* (1993), *rev'd and remanded*, 33 F.3d 836, *Doc 94-8280*, *94 TNT 176-8* (7th Cir. 1994), *cert. denied*, 550 U.S. 1141.

[55]Rev. Rul. 80-211, 1980-2 C.B. 57.

[56]519 U.S. 79, *Doc 96-31894*, *96 TNT 240-1* (1996).

equation (when ''punitive'' characterization imports taxability even in a physical injury case) and on the deduction side. It seems unlikely that Congress will set forth a bright-line rule. Until it does, many taxpayers will continue to seek out deductible pegs on which to hang their hats.