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Audit Crackdown on Deductibility Of Government Settlements

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The IRS issues a dizzying array of guidance. There are various types of regulations (final, proposed, and temporary), revenue rulings, private letter rulings, field service advice, notices, actions on decision, technical advice memoranda, audit guidelines, and so on. All of these pieces of guidance are not of equal weight, of course, and some are, technically speaking, not even treated as authority. Truth is, tax practitioners read and rely on much of this guidance, however it is denominated.

Indeed, it has been more than a quarter century since the U.S. Supreme Court itself cited letter rulings.[1] There was considerable hubbub after that, and the IRS has taken steps to try to make it less likely that taxpayers place their reliance on informal guidance. Through a nearly endless series of litigation under the Freedom of Information Act, Tax Analysts has done an incredible job of freeing up this information from the IRS when at times the IRS has shown indications it wants to make only some guidance public.[2]

The internet age has given virtually everyone access to a vast array of official as well as unofficial information. In my own practice, I find today that even fairly unsophisticated clients are reading IRS guidance. Not too many years ago only tax professionals had ready access to this kind of information.

In this marching evolution of information accessibility, there is a tendency to become overwhelmed, and not to wade through some regulation releases, pieces of proposed legislation, and unofficial guidance, such as audit directives, private letter rulings, and so on. The sheer volume of what one *can* read has a chilling effect on what many of us *do* read. Becoming a selective reader may be a modern survival skill.

Yet, with the increasing importance of payments made to the government, it would be wise not to opt out of reading the government's latest foray into the high stakes topic of government settlement deductibility.

Not Freud's IDD

On May 30, 2007, the IRS released an industry director directive (IDD) on the tax deductibility of government settlements. The directive comes from the IRS Large and Midsize Business Division. It is labeled "Directive Number One," presumably meaning there may be others.[3] Since it is formatted as a memorandum, the "from" line reads "John Risacher, Industry Director, Retailers, Food, Pharmaceuticals and Healthcare." The memo is directed to "Industry Directors, Director, Field Specialists, Prefiling and Technical Guidance, Director, International Compliance Strategy and Policy, and Director of Examination, SBSE."

The IDD provides field direction regarding the deductibility of settlements with a government agency. The battleground is the line between deductibility as a business expense and nondeductible fine or penalty treatment under section 162(f). It is hardly surprising that the government would be looking at this question. After all, one cannot walk by a newsstand without the latest government settlement screaming its presence from the headlines. The government likes to trumpet these things, counting on an *in terrorem* effect on others.

Before we get to the text of the IDD, one interesting thing about it is not clear from its face. The IDD elevates deductions that are claimed for False Claims Act (FCA) and Environmental Protection Agency cases to Tier I issue status. Tier I issues are of high strategic importance to LMSB and are supposed to have a significant impact on one or more industries. That the IDD now treats these settlement deductions as Tier I issues is significant and makes the IDD of greater importance.

The background section of this IRS memorandum sets the stage by noting that settlements are enforcement tools used by governmental agencies to resolve violations of law, and to punish companies short of going to court. According to the IRS, that means the settlement payment can include compensatory amounts, punitive payments, or a combination of the two. The specific types of settlements addressed in this memorandum include settlements with the Justice Department under the FCA and with the EPA for supplemental or beneficial environmental projects.

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[1] *See Rowan Companies v. United States*, 452 U.S. 247 (1981).

[2] *See Tax Analysts v. IRS*, 416 F. Supp.2d 119, *Doc 2006-776, 2006 TNT 9-12* (D.D.C. 2006); *Tax Analysts v. IRS*, 117 F.3d 607, *Doc 97-20023, 97 TNT 131- 10* (D.C. Cir. 1997); *Tax Analysts v. IRS*, 214 F.3d 179, *Doc 2000-10164, 2000 TNT 67-13* (D.C. Cir. 2000).

[3] *See* LMSB-04-0507-042, *Doc 2007-13682, 2007 TNT 111-7*.

Yet, the preamble to the IDD states that outside the context of Justice and EPA settlements, its principles can apply to *any* settlement between a governmental entity and a defendant under *any* law in which a penalty *can* be assessed. Note that this penalty *can* be assessed, not that it actually *will* be assessed or that it has been assessed. That is significant.

It is also not surprising that the Government Accountability Office suggests that most taxpayers deduct the *entire* civil settlement amount, even though Justice records reveal that almost every settled case includes substantial penalties. Settlement may be all about issues of perception. Plainly, the payer and the payee settling a dispute may not agree on everything, including the degree of exposure the payer faces for potential fines and penalties.

Publicity Wars

Yet the IDD also reveals that the government settles cases *without regard* to the tax consequences of a payment. That hardly seems a revelation. Recall the huge flap that developed over Boeing's 2006 settlement and its tax benefits. In mid-2006, Boeing settled the largest penalty *ever* imposed on a military contractor for weapons program improprieties.[4] As final details of the $615 million settlement were hammered out, tax issues took center stage. In July 2006 Sens. Chuck Grassley, R-Iowa, John McCain, R-Ariz., and John Warner, R-Va., sent a letter to Attorney General Alberto Gonzales expressing outrage at the possibility that Boeing could deduct the $615 million. Allowing the Boeing settlement to be tax deductible, the senators said, would result in ''leaving the American taxpayer to effectively subsidize its misconduct.''[5]

The three senators made it clear they were shocked and outraged about the possibility that Boeing could legitimately whittle down the net after-tax penalty with a deduction that effectively is at taxpayer's expense. McCain and Grassley had raised similar concerns in 2003 about a $1.4 billion settlement with several Wall Street firms involved in allegedly biased reports by their research departments.[6] Some of that huge settlement was deductible. Indeed, $432.5 million of it went to finance independent research, and $80 million of it was to finance investor education programs.[7]

Interestingly, a GAO study found that four large federal agencies (including Justice) do not negotiate with companies over whether settlement payments are tax deductible. Instead, the GAO says the agencies believed that was the IRS's job.[8]

On July 18, 2006, Grassley questioned Gonzales:

> I am very troubled that . . . Justice was completely blind as to the real amount of the penalty, that is, the after-tax amount. To have a situation where the federal government is negotiating a settlement without understanding what the real settlement amount will be, the after-tax amount, is embarrassing. . . . I can assure you that the lawyers on the other side of the table . . . are very aware of the after-tax amount . . . means millions of dollars to their client. . . . It is actually worse that Justice doesn't even know what the tax treatment is of the Boeing settlement. It tells me that Justice lawyers gave away 35 percent of the store without even knowing it. And let me make sure you understand one matter, the tax law in this area is quite clear: a fine or penalty is not deductible. If the government clearly states it is a fine or penalty, it is not deductible. It is when the lawyers start getting out their sharp pencils to find the gray areas that the trouble starts. But if Justice wants to make certain that a settlement is not deductible the law gives clear guidance on how that can be accomplished.[9]

Justice formally responded to Grassley, saying that the Boeing settlement had been fully signed on June 30, 2006, *before* Grassley's complaint was made. Justice also noted that as a matter of policy, its agreements are ''tax neutral,'' leaving the difficult issues of deductibility to the expertise of IRS tax lawyers. In fact, the Justice letter to Grassley goes on to state:

> It is the department's policy and practice in settling fraud investigations to remain tax neutral and defer those issues to consideration by the IRS after settlement. The Department and the IRS agreed some time ago that this approach was both practicable and appropriate. . . . As a general matter, compensatory damages are deductible while penalties are not. The Department and the IRS have devised a system that routinely provides the IRS the information it needs to ensure that taxpayers are treating their settlement payments properly. Indeed, this information-sharing arrangement is consistent with the Government Accountability Office's recommendation that the IRS ''work with federal agencies that reach large civil settlements to develop a cost effective permanent mechanism to notify [I]RS when such settlements have been completed and to provide IRS with other settlement information that it deems useful in ensuring the proper tax treatment of settlement payments.''[10]

Responding to public attention, Boeing announced that it would not seek tax deductibility for the settlement — even though the bulk of the settlement is arguably deductible. Grassley responded:

> It's good Boeing won't seek a tax deduction for its $615 million settlement. That's the right decision. However, Boeing's lawyers believed the settlement

[4]*See* Pasztor, ''Boeing to Settle Federal Probes For $615 Million,'' *The Wall Street Journal*, May 15, 2006, p. A1.

[5]*See* Wayne, ''3 Senators Protest Possible Tax Deduction for Boeing in Settling US Case,'' *The New York Times*, July 7, 2006, p. C3.

[6]*Id.*

[7]*Id.*

[8]*Id.*

[9]*Doc 2006-13587, 2006 TNT 138-17.*

[10]*See* July 14, 2006, letter from Assistant Attorney General William Moshella to Grassley, quoting the GAO, Tax Administration: Systematic Information Sharing Would Help IRS Determine the Deductibility of Civil Settlement Payments, GAO-05-747, p. 26, *Doc 2005-21141, 2005 TNT 201-33* (Sept. 2005).

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> was tax deductible. This tells me Department of Justice lawyers failed to take into account the settlement's tax treatment and allowed Boeing's lawyers to effectively negotiate a 35 percent discount. Any junior lawyer knows to look at a settlement's tax treatment, yet Justice lawyers were asleep at the switch. That's inexcusable. The Justice Department has to pay attention to the tax treatment in these big settlements. We can't depend on having klieg lights from Congress for the right thing to happen. Justice should be doing it right from the beginning. I want to commend Senator McCain for his leadership in the Boeing issue. I'm glad we have this result, but we need the right result every time. For that to happen, the Justice Department has to do a better job of paying attention to the tax consequences of settlements. In the meantime, I'll keep working to advance my legislation clarifying what is and isn't deductible in settlements.[11]

Settlements and Taxes

It is hard to read the recent IDD without reflecting on the controversy over Boeing's 2006 settlement. Perhaps the IRS memorandum stating that the government does not pay attention to tax language is meant to be critical. In any case, the IDD states that settlement language is typically neutral as to whether a portion of the settlement constitutes a penalty.

Interestingly, up until some point in 2005, many Justice settlement agreements apparently included this statement: "The parties agree that this agreement is not punitive in purpose or effect." As a taxpayer, that would make me think the payment is entirely compensatory. The IRS, however, suggests that this phrase relates to double jeopardy under the Constitution and has no bearing on tax issues.[12]

In a cursory way, the memorandum notes the nature of Justice and EPA settlements. Regarding the EPA, the IDD notes that a portion of the civil penalty that was proposed for an environmental violation is typically reduced in exchange for the company's agreement to perform a Supplemental Environmental Project (SEP). The memorandum notes that most defendants will deduct the entire amount of the SEP as a section 162 expense or they will capitalize it and claim depreciation deductions. Treating a portion as a nondeductible penalty is evidently rare.

Turning to the FCA, the stakes are even larger. Settlements and judgments between 1987 and 2006 totaled more than $18 billion, with $9 billion of that arising between 2001 and 2006. Here again, the concern is what portion of these whopping payments the defendants are deducting. More than 75 percent of the settled cases involve healthcare fraud. Approximately 14 percent of the FCA cases involve defense contractors. The remaining 11 percent involve a broad range of other industries.

Issue Spotting and Mandatory Audits

The memorandum states flatly that examination is mandatory for FCA settlements of at least $10 million and for SEP projects of at least $1 million. That does not mean payments below those thresholds are exempt. Examiners are directed to use a risk analysis process to determine if settlements and projects below those thresholds merit examination.

Sensibly, the memorandum directs that the government attorneys involved in these settlements should be key contacts, coordinating interviews and requests for records relevant to the particular settling taxpayer involved. Since the identity of these companies is typically no secret (the memorandum notes that soon after settlements are reached, most are covered by the media), the memorandum advises considering prefiling agreements with the taxpayer. The prefiling agreement project may substantially cut back on what the IRS perceives as a trend in favor of immediate and 100 percent deductibility for those settlements.

Nondeductible Fines and Penalties

The memorandum reviews the language of section 162(f) and its regulations. Section 162(f) states succinctly that "no deduction shall be allowed . . . for any fine or similar penalty paid to a government for the violation of any law." The regulations define fines and penalties as amounts:

- paid under a conviction or a plea of guilty (or nolo contendere) for a crime (either felony or misdemeanor) in a criminal proceeding;
- paid as a civil penalty imposed by federal, state, or local law;
- paid in settlement of the taxpayer's actual or potential liability for a fine or penalty (again, civil or criminal).[13]

Significantly, legal fees are exempt from this strict regimen. Legal fees and related expenses paid or incurred in defending a prosecution or civil action arising from a violation of the law imposing the fine or civil penalty are deductible.[14]

Whether a payment constitutes a nondeductible fine or penalty depends on the purpose the specific payment was meant to serve. That, of course, is a tall order when payments are made in a negotiated settlement. Yet, the IDD mentions several TAMs, including 200502041.[15] That TAM allocates an FCA settlement between a portion treated as nondeductible under section 162(f) and a portion deductible as compensatory damages.

In another TAM, 200629030,[16] the IRS concluded that a portion of the costs incurred for the performance of an environmental project was comparable to a nondeductible fine or similar penalty under section 162(f). That

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[11]Senate Finance Committee Memorandum to Reporters and Editors, from Jill Gerber for Grassley, regarding the potential deductibility of Boeing's government settlement, July 26, 2006.

[12]*See* LMSB-04-0507-042, *supra* note 3, Attachment I.

[13]*See* reg. section 1.162-21(b)(1).

[14]*See* reg. section 1.162-21(b)(2).

[15]*Doc 2005-1011, 2005 TNT 11-8.*

[16]*Doc 2006-15299, 2006 TNT 157-17.*

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meant this portion of the cost of performing the environmental project could not be included in the basis of the assets produced in the project (under section 263A or section 1012).

Although the IDD cites those TAMs, perhaps as evidence that such basic allocation issues can be solved, the line between compensatory and noncompensatory fines can be difficult to discern. Predictably, the taxpayer has the burden of establishing the deductibility of any payment.

Motive of Payments

Proving motive is tough, yet it is relevant here. It may be difficult for the taxpayer to show that a fine is imposed with a compensatory motive. Indeed, 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.

Several cases are particularly important in exploring the purpose of a payment. The IDD mentions *Talley Industries, Inc., et al. v. Commissioner*,[17] and it is worthy of note. In *Talley*, a company and several 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 between Talley and Justice was $2.5 million. When the company deducted that amount, the IRS asserted that the settlement was a nondeductible fine or penalty.

The Tax Court granted summary judgment for Talley, 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 Tax Court found that the government had never suggested that it was attempting to exact a civil penalty. 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.

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. 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 FCA], 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 (nondeductible).[18]

Talley 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 FCA. Even though the settlement agreement was silent on that point, the Tax Court concluded that was what the parties intended.

The Tax Court then turned to whether the $940,000 double damage payment was intended to compensate the government for its losses or to deter or punish. The taxpayer and the government were polarized. The taxpayer argued that *no* portion of the $940,000 could be considered a penalty, while the government argued that the *entire* amount was a penalty. The issue was whether the amount was intended to reimburse the government for losses. The taxpayer 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.

Nevertheless, the Tax Court was not persuaded by the wholesale nature of the payment; it noted that the settlement was a compromise of many issues. There was correspondence about the settlement offers and the taxpayer had actually tried to state in the settlement agreement that the amounts would be treated as restitution. That the government rejected this proposal led the Tax Court to conclude that the taxpayer failed to carry its burden of showing that a remediation purpose was intended.

For a second time, *Talley* 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.[19]

Nondeductibility was also the order of the day in *Allied-Signal Inc. v. Commissioner*.[20] As the IDD notes, taxpayers make every attempt to avoid penalty characterization and to emphasize the remedial effects (or intent) of the payments.[21] In addition to its other payments, Allied-Signal 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 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

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[17]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).

[18]116 F.3d at 387.

[19]*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*.

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

[21]*See* William L. Raby, ''Two Wrongs Make a Right: The IRS View of Environmental Cleanup Costs,'' *Tax Notes*, May 24, 1993, p. 1091, *Doc 93-5780, 93 TNT 108-113*; and William L. Raby, ''When Will Public Policy Bar Tax Deductions for Payments to Government?'' *Tax Notes*, Mar. 27, 1995, p. 1995, *Doc 95-3168, 95 TNT 57-74*.

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punish or deter, concluding that the payment served a law enforcement purpose, not a compensatory one.

Warning Signal

It is not surprising that the government victory in *Allied-Signal* features prominently in the IDD. Allied-Signal's understanding that the proposed $13 million criminal fine would be reduced by the $8 million contribution led the Tax Court to famously hold that the $8 million payment was *in substance* a fine or similar penalty nondeductible under section 162(f). In our current era of increased focus on substance over form, and given the anti-tax-shelter rhetoric that often now permeates tax cases, *Allied-Signal* was ahead of its time.

The IDD quotes some of *Allied-Signal*'s rhetoric. The court sounded prophetic in stating that ''while the form of the payment does not necessarily fit within the letter of section 162(f), in substance petitioner paid a criminal fine.'' Allowing the taxpayer a deduction, the *Allied-Signal* court went on to say, ''would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.''[22]

Audit Techniques

The audit techniques discussion in the text of the IDD is fairly breezy, noting that the facts and circumstances have to be developed and determined. But, the IDD includes audit guidelines as attachments, one set of guidelines regarding FCA settlements and another for EPA cases.

FCA Settlements

The audit guidelines begin with the premise that almost every taxpayer deducts the entire amount of each FCA settlement. Yet, the guidelines assert, a portion generally represents a penalty. To determine if a penalty has been imposed and if so how much, the guidelines say two primary questions must be answered:

- Is a portion of the settlement payment a penalty, and therefore not deductible?
- What amount is the penalty?

With those obvious questions, the guidelines stress to the examiner that the taxpayer must bear the burden of proving that it is entitled to deduct *any* portion of the settlement amount.

Examiners are told that Justice press releases are issued on practically every case, available on the Justice Web site. Plus, national and local newspapers are helpful. The organization Taxpayers Against Fraud gets an indirect plug, since examiners are told that the Taxpayers Against Fraud Web site also touts every settlement.

Once the case is identified, there is a procedure of the IRS contacting Justice, and the examining IRS employee then liaising with the Justice attorney who handled the case. Interviews, requests for records, and so on follow. Although the guidelines say that no two cases are identical, the template for document requests suggests that all communications between Justice and the defendant and its representatives and employees (letters, memos, e-mail, etc.) are needed.

Significantly, the guidelines state that initial letters often formalize the position of Justice that ''multiples'' will be included in any settlement that is reached. The critical documents also include all computations and settlement proposals made by either side, plus everything that leads up to whatever settlement is ultimately reached. As to the meaning of the term ''multiple,'' the guidelines make it clear that Justice uses this term when it means penalty.

Predictably, any correspondence that addresses tax consequences is critical. The guidelines note, though, that ''it is rare for this subject to be addressed; however, the request for this type of correspondence needs to be made.'' Interestingly, discussions between Justice and the relator in the FCA case (and the relator's attorney) are also likely to be requested. It is hard to see how the interaction with the relator is relevant, but perhaps the IRS is looking for a reference to ''multiples'' or other buzz words.

Although audit guidelines need not contain taxpayer arguments, it is noteworthy that the guidelines say that taxpayers frequently argue that a total settlement was to compensate the government for losses such as overbilling. If the settlement is (as almost always occurs) less than the initially publicized amount of the government losses, taxpayers (predictably) argue that since the settlement is less than the losses Justice reported, all of the settlement must be ''singles,'' and thus compensatory and deductible.

In response, the audit guidelines state: ''This argument has no real merit as it is not factually based and it is not representative of the final settlement agreement.''[23] It is at this point in the audit guidelines that they reference the ostensibly red herring phrase included in most Justice settlement agreements written before June 2005. The offending (and now deleted) phrase is: ''The parties agree that this agreement is not punitive in purpose or effect.'' Taxpayers understandably argue that this sentence means what it says, but the IRS audit guidelines state that Justice had included this phrase, relating only to double jeopardy under the Constitution, and that it has no meaning for tax purposes.[24]

EPA

The audit guidelines for environmental violation enforcement settlements begin with a description of the EPA penalty framework. EPA settlements are far more likely to expressly address tax issues than FCA cases. Indeed, there is often a consent decree lodged in federal court that expressly includes three major components: a civil penalty amount that is separately stated, and typically expressly designated as nondeductible for income tax purposes; injunctive relief that covers compliance projects; and SEPs that are voluntary projects incorporated into a consent decree to negotiate a significant reduction in proposed penalties.

According to the audit guidelines, only a portion of the SEP will typically be used to reduce the penalty

[22]*See Allied-Signal*, at 45.

[23]LMSB-04-0507-042, *supra* note 3, Attachment I.
[24]*Id.*

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amount. That means the actual amount paid for an SEP and a reduced penalty add up to more than the original proposed civil penalty. The big question for the auditor in these cases, then, is to determine the penalty amount that is mitigated (or forgiven) as a result of the taxpayer agreeing to perform an SEP.

Sometimes, the audit guidelines assert, this amount can readily be ascertained in the body of the consent decree. Other times, extensive factual development of the history of negotiations is needed. The audit guidelines suggest that the examiner should contact the IRS environmental technical adviser once it is clear the taxpayer has agreed to perform an SEP. Then the examiner should solicit complete copies of files, correspondence, and so on from the taxpayer, the EPA, Justice, and other involved parties. Any penalty exposure computations prepared by the EPA, the taxpayer, or the taxpayer's representative are to be solicited.

Using *Allied-Signal* as a springboard, the memorandum concludes with the IRS's summary position that:

- Taxpayers may not deduct the portion of costs incurred in performing an SEP that is ''an amount analogous to a nondeductible fine or similar penalty'' under section 162(f).
- Taxpayers many not include in the basis of assets it produces the portion of the SEP cost that is ''an amount analogous to a fine or similar penalty.'' For FCA cases, the question is whether the settlement includes a nondeductible penalty, and that determination can only be developed through communication, coordination, and cooperation between the IRS and Justice.

Conclusions

These summary conclusions in the IDD are ultimately not very helpful, but are just snippets. The big question for EPA cases is just what *is* an amount ''analogous'' to a fine or similar penalty. With slightly different verbiage, the same question applies in FCA cases. Despite Sen. Grassley's exhortations, if Justice (and the EPA) don't attempt to address the pertinent tax questions, the issues are probably not going to be any easier to resolve.

The audit guidelines, and the intense focus on factual development, suggest there will be a greater emphasis on the legal background and dynamics of the dispute than ever before. What does seem clear is that the IDD's focus on getting information from Justice or the EPA lawyer suggests interagency pow-wows after the fact. Indeed, it may mean that the IRS has a chance to help mold the tax position in arrears, and to help frame what the intent of the settlement might have been.

I am not suggesting this is improper, but it is a little troubling to think that, although Grassley's exhortations cannot propel Justice personnel to consider tax issues in framing settlements, the IRS can help Justice (and EPA) do so later. Couple that with the obvious fact (oft repeated in the IDD) that the burden is on the taxpayer to establish deductibility, and the resulting mix, I think, foreshadows a more subtle assault on the deductibility of government settlements.

I do not know if the IDD is a direct response to the widely publicized discussions about the lack of cooperation between the IRS and Justice, and to the criticism leveled at government lawyers that they were (inappropriately) failing to take tax considerations into account in reaching settlements.[25] Still, it is hard not to connect the dots. It does not seem an unfair reading of the IDD to suggest that, rather than the parties having an upfront tax discussion at settlement time, the IRS gets to divine intent after the fact.

Then, the IRS can rely on the systematic advantage represented by the rule that the taxpayer must carry the burden of proving that *any* portion of the settlement is deductible. In any event, the IDD may portend increased scrutiny on settlements and on deductibility in the future.

[25]*See* text accompanying notes 6-12, *supra*.

SUBMISSIONS TO *TAX NOTES*

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