'It's Deductible': Sharp Pencils And Boeing's Imbroglio

By Robert W. Wood

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John F. Kennedy once famously said, "The slogan — 'It's deductible' — should pass from our scene."[1] While President Kennedy made the comment about expense accounts and business entertainment, the message may have broader application and still seems timely 45 years after JFK said it. In fact, perhaps the hubris of the "It's deductible" slogan can be obnoxious anywhere it surfaces.

That may be part of Senate Finance Committee Chair Chuck Grassley's, R-Iowa, recent and repetitive message about Boeing. Every so often, a tax issue hits the popular press. Usually it is a consumer tax issue (such as the alternative minimum tax or new offer in compromise rules) or one that is largely political (like estate tax repeal). Occasionally, it is outrage over some purported big business boondoggle or taxpayer preference. Perhaps, as with all such things, there's a lot under the surface. The ongoing flap over the tax deductibility of Boeing's significant settlement payment to the government is no exception.

In mid-May, the Justice Department and Boeing reached an agreement for Boeing to pay $615 million to avoid criminal charges and to settle civil claims. The claims involve Boeing's improper hiring of a Pentagon official and supposed purloining of proprietary documents from Lockheed Martin Corp. about government rocket launchings. The settlement was undoubtedly heavily negotiated. News reports said the settlement ended a protracted three-year Justice Department investigation into high-profile contracting scandals.

In fact, this is the largest financial penalty *ever* imposed on a military contractor for weapons program improprieties.[2] I'm not sure how relevant all of the specifics of the charges are, but a *précis* at least supports a kind of prurient interest. There is a voyeur's delight in gazing at the inner (turgid) workings of the military industrial complex. After improperly acquiring Lockheed Martin proprietary documents and using them to win competitive bidding, Boeing allegedly illegally recruited a senior Air Force procurement official at a time when she still had authority over billions of dollars in Boeing contracts. That led to skirting of normal procurement procedures in a controversial $20 billion Air Force leasing program.

The resulting uproar led to the firing of Boeing's CFO in 2003, and the resignation of its chairman, Phil Condit. In fact, Boeing's former CFO Michael Sears and Darlene Druyun (the former Air Force official) both served time in federal prison for their roles in this mess. Boeing was also stripped of about $1 billion worth of rocket launchers (tied to the improper use of Lockheed documents). Even with all that, the current settlement is not the only legal action on the horizon. Boeing faces pending civil damage claims related to the Lockheed Martin documents. As so often occurs with multiple cases, the civil claims may well be influenced by Boeing's settlement with the government.

Clearly, Boeing's settlement — which involves no formal admission of wrongdoing — must be seen as a major Boeing victory, paving the way for this messy scandal to pass into Boeing's jet stream.[3] Yet oddly, as final details of the $615 million settlement were hammered out, tax issues took center stage. In early July, Sens. Grassley, John McCain, R-Ariz., and John Warner, R-Va., sent a letter to Attorney General Alberto Gonzales expressing "outrage" at the possibility that Boeing would be able to 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."[4] There's been a good deal of jockeying ever since.

Understandably, Boeing has announced that the settlement did not explicitly address tax issues. Of course, Boeing *surely* did consider taxes, even if (as Grassley laments) the government representatives with whom Boeing negotiated did not. Yet, doing PR damage control in the wake of the tax flap, Boeing announced that its

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[1]President John F. Kennedy's Special Message to the Congress on Taxation, Apr. 20, 1961.

[2]*See* Pasztor, "Boeing to Settle Federal Probes for $615 million," *The Wall Street Journal*, May 15, 2006, p. A1.

[3]*See id.*

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

initial take was that $50 million of the settlement represented a ''penalty to resolve criminal charges'' and therefore would not be deductible. The remaining $565 million, on the other hand, was to settle civil charges, leaving its tax status unclear.[5] Boeing appeared the wide-eyed innocent, saying that it has now commissioned outside tax counsel to look into the question and that there were some questions about how all of this should be treated for tax purposes.[6]

The three senators, however, 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 a taxpayer's expense. *The New York Times* noted that McCain and Grassley had raised similar concerns back in 2003 about a $1.4 billion settlement with several Wall Street firms involved in allegedly biased reports by their research department.[7] Some of that huge settlement was deductible. Indeed, $432.5 million of it went to finance independent research, and $80 million to finance investor education programs.[8]

Interestingly, a Government Accountability Office study found that four large federal agencies (including the Justice Department) 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.[9] Given all the publicity, tax effects are likely to be more explicitly considered in the future.

In fact, on July 18, 2006, Grassley fired off point-blank questions at Gonzales. Grassley can be an imposing figure. If Gonzales was not squirming, perhaps he should have been, when Grassley leveled these questions and comments:

> I am very troubled that . . . DoJ 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 . . . . It means millions of dollars to their client . . . . It is actually worse that DoJ doesn't even know what the tax treatment is of the Boeing settlement. It tells me that DoJ 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 DoJ wants to make certain that a settlement is not deductible the law gives clear guidance on how that can be accomplished.[10]

The Justice Department has formally responded to Grassley, saying that the Boeing settlement had been fully signed on June 30, 2006, *before* Grassley's complaint was made. So there. However, the Justice Department also notes 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 Department letter to Grassley goes on to state that:

> 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.''[11]

Amazingly, Grassley's posturing, Boeing's damage control, and the Justice Department's supposed shame doesn't stop here. The last chapter (for now) in this hubbub involved Boeing announcing on July 26, 2006, that it will not seek tax deductibility for the settlement — even though the bulk of the settlement is (under current rules, it says) tax 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 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

[5] *Id.*
[6] *Id.*
[7] *Id.*
[8] *Id.*
[9] *See id.*

[10] *Doc 2006-13587, 2006 TNT 138-17*.
[11] *See* July 14, 2006, letter from Assistant Attorney General William Moshella to Sen. Charles Grassley, quoting GAO, Tax Administration: Systematic Information Sharing Would Help IRS Determine the Deductibility of Civil Settlement Payments, GAO-05-747, p. 26 (September 2005).

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.[12]

Grassley's foot-stomping over Boeing focused on the apparent disconnect between zealous prosecutors and other government officials who trumpet an outsized settlement, while not also trumpeting (and possibly even being ignorant of) the fact that the settlement is wholly or partly deductible. Perhaps the government officials have learned the trumpeting part exceedingly well from the likes of New York Attorney General Elliot Spitzer. In any event, despite JFK's admonition, it seems unlikely that settling companies will adhere to Kennedy's proclamation. Perhaps, though, they will utter the phrase only to themselves and only under their breath.

I don't know whether the government should be considering tax issues as it negotiates civil and criminal settlements. I do think, however, that at least some tax issues are considered a bit more than the above quotes suggest. Indeed, although I've had only limited experience doing this, I've occasionally been told by government lawyers (who are decidedly nontax people in, for example, the Justice Department) that they are consulting with someone at the IRS over issues such as the issuance of Forms 1099. I would think that when those lines of communication are opened, more global tax issues may be discussed as well.

Regardless of the extent of government sensitivity to tax issues, however, it is clearly not improper for a taxpayer to be considering the issues. In fact, it is almost incomprehensible that the taxpayers will *not* be considering them. I would imagine Boeing was considering tax issues all along, as any company of significant size would do when negotiating for the payment of a significant amount.

At the same time, both taxpayers *and* the government could probably benefit from a primer on some of the issues, since the lines are not quite as neatly drawn as Grassley has suggested.

Surveying the Landscape

The general rule is that payments in a business context (either by way of settlement or judgment) are deductible. However, the code disallows a deduction for "any fine or similar penalty paid to a government for the violation of any law."[13] That affects both criminal and civil penalties, as well as sums paid in settlement of potential liability for a fine.[14] It is the latter element of the provision that often causes controversy. It may (or may not) be clear that there is a likelihood of a fine being imposed when a "potential" liability is satisfied.

The resulting taxpayer incentives can be huge. One famous case involved the Exxon Valdez oil spill litigation. The U.S. government's $1.1 billion Alaska oil spill settlement with Exxon reportedly cost Exxon only $524 million when Exxon's tax deductions were taken into account.[15] A Congressional Research Service study revealed that more than half of the civil damages totaling $900 million were deductible. Because the civil penalties would be paid out over 10 years, the study also indicated that the real return to the government would be significantly eroded by inflation.[16]

Tax benefits were clearly also not lost on Marsh & McLennan in its whopping 2005 settlement. It wasn't too long after the release of information about the $850 million settlement in M&M's civil bid rigging and conflict of interest flap with Spitzer that *The Wall Street Journal* reported that tax deductions "could shave hundreds of millions from the headline figure."[17]

Whether a payout constitutes a fine or penalty may in some cases depend on the intent of the perpetrator. However, the denial of the deduction 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 to operate profitably.[18]

Just the Facts

The facts surrounding the alleged violations, the negotiations, and the terms and negotiation of the settlement can all be critical. So can the nature of the statute, although we'll come back to that latter item later. Given those moving parts, taxpayers are likely — I think understandably so despite Grassley's outrage — to analogize their facts to one of the cases in which the IRS tried to block a tax deduction and lost.

One of the more important cases to define the line between nondeductible fines or penalties and deductible compensatory damage payments is *Allied-Signal, Inc. v. Commissioner*.[19] The IRS, the Tax Court, and the Third Circuit all said no to any deduction for an $8 million payment Allied-Signal made into a trust to eradicate a toxic chemical pesticide from the environment. The courts found 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, and such line-drawing is

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

[13] Section 162(f).

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

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

[16] *Id.*

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

[18] *Tank Truck Rentals, Inc. v. Commissioner*, 356 U.S. 30 (1958).

[19] 54 F.3d 767, *Doc 95-2752*, *95 TNT 47-8* (3d Cir. 1995).

discussed with increasing frequency by commentators.[20] Yet, that does not change the fact that it is often worthwhile for taxpayers to litigate whether their particular payment constituted a fine or penalty, and just what constitutes a fine or penalty in the first place.

For example, in *S. Clark Jenkins, et ux. v. Commissioner*,[21] 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 argued that the payments represented nondeductible penalties. But the Tax Court looked to the purpose of the state legislation, which was to compensate the consumer, not punish the manufacturer. The penalty was calculated by determining the value of the deficient ingredient the consumer paid for but never received, plus an additional amount to compensate for crop yield. That, said the Tax Court, was a remedial statute, not a punitive one.

Those cases demonstrate 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.[22] On the other hand, 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*,[23] 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 to both criminal fines and some civil penalties.

Fines, Late Fees, and Compensatory Payments

Sharp pencils are appropriate here. 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 be within the prohibited class. A late filing fee, which is really designed to encourage prompt compliance with the law, is not a fine for this purpose.[24] Another exception from the denial of deductions for fines relates to so-called compensatory fines, a euphemism that sounds strangely like government spin. A fine can be deducted if it is compensatory. A compensatory fine is one imposed only to compensate a governmental entity for harm it has suffered, as distinguished from a fine with a punitive motivation.

Thus, a fine that is essentially a reimbursement to the government for the amount of lost custom taxes was held deductible.[25] Similarly, a payment to the Clean Water Fund to avoid prosecution for water pollution was held deductible.[26] Yet, the regulations state that civil environmental fines are nondeductible.[27]

Even fines that may appear to be punitive on the surface may be deductible as long as you can prove the requisite compensatory character. Thus, statutory "liquidated damages" imposed for the violation of truck weight limitations were held to be deductible.[28] Liquidated damages may be equated with penalties, yet here 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. Even the IRS has agreed with that position.[29]

Motive of Payments

Despite all that authority, the line between compensatory and noncompensatory fines can be difficult to discern. 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.

Several cases are particularly important in exploring the purpose of a payment. In *Talley Industries Inc. et al. v. Commissioner*,[30] 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 the Justice Department was $2.5 million. When the company deducted that amount on its tax return, the IRS asserted that the settlement amounted to a fine or penalty that could not be deducted.

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 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.

Unfortunately for the taxpayer, the Ninth Circuit then reversed and remanded the case, concluding that there was a material issue of fact and that the matter was not

[20] *See* William L. 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).

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

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

[23] 105 T.C. 8, *Doc 95-7783*, *95 TNT 155-9* (1995).

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

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

[26] *S&B Restaurant, Inc. v. Commissioner*, 73 T.C. 1226 (1980).

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

[28] *Mason-Dixon Lines, Inc. v. United States*, 708 F.2d 1043 (6th Cir. 1983).

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

[30] 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).

ripe for summary judgment. On remand, however, the Tax Court made detailed 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 (nondeductible). 116 F.3d at 387.

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 whether the parties intended the settlement to include double damages under the False Claims Act. Even though the settlement agreement was silent on that point, the Tax Court concluded that was what the parties intended. Then the Tax Court 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 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 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 numerous issues. There was correspondence about the settlement offers and the taxpayer had actually tried to get the settlement agreement to state 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. Yet, 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]

Nondeductibility was also the order of the day in *Allied-Signal*.[32] In the environmental area in particular, taxpayers often make every attempt to avoid penalty characterization and to emphasize the remedial effects (or intent) of the payments.[33] In addition to 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 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, not a compensatory purpose.

Restitution Payments

Authorities on the deductibility of restitution payments are closely related to the fine or penalty authorities. In *Jess Kraft, et ux. v. United States*,[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. Traditionally, the IRS has analogized restitution payments to penalties. However, a number of courts have disagreed and found restitution payments to be deductible.[35]

Violation of Public Policy

Grassley would presumably be happy to know that the IRS has occasionally objected to the deductibility of a payment as against public policy.[36] No code provision specifically authorizes the IRS to disallow deductions based on that doctrine. Even so, the government has occasionally raised the issue when a legal action involves penalties or punitive provisions, and the settlement or judgment payment could therefore be seen to acquire a similar taint.

Grassley would probably be unhappy that the Supreme Court determined in 1966 that the IRS could not disallow deductions under a general public policy theory.[37] It is certainly arguable 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.[38] Still, it can be argued that when a

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[31]*See Talley Industries, Inc. v. Commissioner*, 18 Federal Appellate 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, *aff'd*, 54 F.3d 767, *Doc 95-2752*, *95 TNT 47-8* (3d Cir. 1995).

[33]*See* William L. Raby, "Two Wrongs Make a Right: The IRS View of Environmental Cleanup Costs," *Tax Notes*, May 24, 1993, p. 1091; and William L. Raby, "When Will Public Policy Bar Tax Deductions for Payments to Government?" *supra* note 20.

[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 Burgess J.W. Raby and William L. Raby, "Restitution Payments May Produce a Tax Deduction," *Tax Notes*, Oct. 21, 1996, p. 335. *See also* Schnee, *supra* note 22, and William L. Raby, "Deductibility of Restitution Payments," *Tax Notes*, May 31, 1993, p. 1221.

[36]*See* Wood, "Denying Deductions Based on Public Policy," *Tax Notes*, Mar. 27, 2006, p. 1415.

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

[38]*See* Raby, "When Will Public Policy Bar Tax Deductions for Payments to Government?" *supra* note 20.

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). Perhaps that's a public policy argument.

That was essentially the issue in *Allied-Signal*,[39] where the Third Circuit denied the taxpayer any deduction for the $8 million it paid to a trust established to eradicate a chemical from the environment after finding that it was paid with the virtual guarantee that the court would reduce the criminal fine by at least that amount. Cases such as *Allied-Signal* are troubling, for 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.

As recent news reports make clear, 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 this 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*,[40] 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), the decision seems wrong.[41]

Although the deductibility of expenses may be restricted under section 162(a), the IRS cannot generally disallow deductions based on public policy. The fact that a liability is based on the 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 this rule include:

- Damages caused by a taxpayer's fraud in negotiating a lease were held deductible.[42]
- Damages paid by a stockbroker for improperly churning a client's account were held deductible.[43]
- Damages paid by a director for breach of fiduciary duty to a corporation were held deductible.[44]
- Damages paid by an executive for mismanagement and misuse of corporate assets were held deductible.[45]
- Punitive damages paid by a corporation to a victim of a fraudulent scheme in settlement of a breach of contract and fraud action were held deductible.[46]

There is a limit, however. If the payment itself is illegal under federal law, the deduction will be disallowed.[47] 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.

Policy Against Discrimination and Harassment?

Few would dispute the notion that federal law evinces a strong policy against discrimination. Perhaps for that reason, 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 even though allowing the deduction would frustrate public policy.[48]

But as with so many flat statements, even that does not obviate all of the line drawing. 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*,[49] 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 business or profit-seeking activities.

The court distinguished *Clark v. Commissioner*,[50] because of the personal nature of the claim. In *Clark* the taxpayer had been wrongfully accused of assault with intent to rape during the course of his employment. In *Kelly*, however, the Tax Court found that Kelly was pursuing a purely personal desire. *Clark* seems inconsistent with *Kelly* because the court in *Clark* found the legal fees 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 had not committed the rape. The Tax Court in *Kelly* stated that sexual assault activity was not within the course and scope of the defendant's employment, nor was it conducted for a legitimate business purpose.

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[39] *Supra* note 19.

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

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

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

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

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

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

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

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

[48] Reg. section 1.162-1(a). *See also* Rev. Rul. 80-211, *supra* note 46.

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

[50] 30 T.C. 1330 (1958).

Most tax advisers assume that claims made against an officer of a company for sexual harassment, gender or race discrimination, wrongful termination, and so forth, result in settlements that are deductible by the company. The conclusion may turn on the facts and on whether there is an express indemnity obligation under the law, in the employment contract, or other governing documents (including bylaws). Reading *Kelly,* you are left with the impression that you must ask whether the conduct giving rise to the expense really advances the business.

Of course, virtually all harassment and discrimination cases arguably arise out of some personal activity. Depending on one's reading of the nexus between the conduct and the business, perhaps many harassment cases could be considered outside the course and scope of employment. Indeed, the kind of line drawing done in *Kelly* is reminiscent of the origin of the claim test.

The origin of the claim test is the overarching rule for determining the tax treatment (for a payer or a payee) of a settlement or judgment payment. The origin of the claim test is axiomatic, yet it is possible to come out with quite different results depending on how one chooses to view a course of conduct leading up to the litigation in question. Some of the seminal cases in this area, such as *United States v. Gilmore,*[51] involve precisely such line drawing. Although 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.

Deductibility of Punitive Damages

There seems to be no end of confusion about this topic among many business people and even tax practitioners. Despite the confusion, punitive damages paid to private parties are deductible. For example, the IRS ruled that liquidated damages paid under the Fair Labor Standards Act are deductible as business expenses.[52] 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.[53] As long as punitive damages are paid or incurred by a taxpayer in the ordinary conduct of its business, they will be deductible.[54]

Some of the historic confusion may arise from the tax treatment of recipients of punitive damages. A controversy raged for years about the tax treatment of punitive damages in the hands of the recipient. With *O'Gilvie v. United States,*[55] 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. There is considerably more authority discussing the nature of punitive damages on the income side. Some courts may actually be willing to make determinations as to what, in effect, constitutes punitive damages, even when there has been no judgment.

For example, in *Barnes v. Commissioner*,[56] a woman filed a wrongful termination suit under state law seeking damages for lost future wages and mental distress. She settled and excluded the amount from her income. The IRS disagreed, and the matter wound up in Tax Court. The conclusion of the Tax Court regarding the claimed section 104 exclusion is unextraordinary.

Yet, the Tax Court in *Barnes* went on to note that the testimony had established that Barnes had a strong case for punitive damages. As a result, the Tax Court bifurcated the award, treating half of the settlement as in the nature of punitive damages. The question *Barnes* raises is the appropriateness of those determinations. One must acknowledge that a taxing authority or court faces a difficult task in allocating a recovery for tax purposes. Yet, finding that an amount should be treated as punitive damages for tax purposes when the parties have not even gone to trial seems patently unfair.[57]

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 *payer*. President Clinton's 1999 budget proposal to deny deductions on punitive damages paid to plaintiffs in civil lawsuits also may have confused the issue. The proposal would have denied a deduction to any party paying punitive damages. Further, Clinton's proposal would have required a company with insurance for punitive damages to recognize income in the amount that the insurance company actually paid for the punitives. The proposal did not meet with approval from the business community, which was hardly a surprise.[58]

Deducting Antitrust Payments

Finally, it is worth noting that yet another factor contributing to the confusion about punitive damages relates to antitrust actions. Section 162(g) denies a deduction for two-thirds of the damages paid in a treble damage antitrust suit if specific conditions are met. The theory here is that the first third of the damages represents actual or compensatory damages, and should therefore be deductible. A deduction for the remaining two-thirds of the payment is disallowed only when there is a conviction in a related criminal proceeding or a plea of guilty or *nolo contendere*.

The fact that there is a special denial of a deduction for two-thirds of some antitrust payments has probably led to further confusion about punitive damages than would otherwise exist. With the paucity of antitrust payments

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[51] 372 U.S. 39 (1963).

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

[53] *See Downey v. Commissioner*, 97 T.C. 150 (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.

[54] Rev. Rul. 80-211, *supra* note 46.

[55] 519 U.S. 79, *Doc 96-31894, 96 TNT 240-1* (1996).

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

[57] *See* Robert W. Wood, "Will Courts Import Punitive Characterization?" *Tax Notes,* Mar. 3, 1997, p. 1200.

[58] *See* Schlesinger and Hitt, "Clinton Wants to Tax Civil Damages," *The Wall Street Journal*, Feb. 1, 1999, p. A3.

these days, a full discussion of this area is not warranted. Suffice it to say that the conditions specified in section 162(g) are fairly limited, designed to apply only to ''hardcore violations'' of the antitrust laws, when a payment is made that truly represents a ''penal'' payment.[59]

The first determination that needs to be made to evaluate the applicability of section 162(g) is whether there is a ''related criminal proceeding.'' If there is no related criminal proceeding, then even if there is a guilty plea or plea of *nolo contendere*, or even a determination that the defendant is guilty, section 162(g) does not apply. That means a great deal of the case law has focused on the meaning of the term ''related'' in this context.[60] A number of courts have had to consider what constitutes a related criminal proceeding and therefore how much of a settlement payment should be treated as nondeductible under section 162(g).[61]

Conclusions

Tax lawyers may have a tendency to view the world myopically. Tax does not necessarily drive everything, but it does play an integral part in most business decisions. That does not mean it is the only consideration, but it would be hard to deny that a payment deductible against current income is not considerably more desirable than a payment that must be capitalized, or that is entirely devoid of tax benefits.

It therefore seems more than a little odd to only belatedly consider tax issues, or not to consider them at all. Often, tax effects are explicitly examined, but it is not considered either polite or good negotiating strategy to make it known to everyone else that one is doing so. Feigning disinterest or wide-eyed naiveté about tax considerations can be effective.

Until the law is changed on the deductibility of punitive damages,[62] there will be no ambiguity on the deductibility of civil punitive damages. Payments to the government are different and will have to run the gauntlet of existing fine or penalty authorities. Yet, it should hardly be shocking that taxpayers try to negotiate settlements that are — both economically and taxwise — less painful than the government's first shot across the bow.

Indeed, what I find most disturbing is that the record created by such efforts can backfire. Recall that in *Talley*,[63] the company asked the government to agree in the settlement agreement that it was paying restitution. The government refused. In Tax Court (on remand after the Ninth Circuit decision), evidence of that refusal was used to import fine or penalty treatment. Perhaps that was appropriate on the particular facts, but (as I know from personal experience) such a refusal can mean nothing more than that the particular agency wishes to take no position whatsoever on tax matters in the settlement agreement. The IRS and the courts should not be too quick to ascribe one tax treatment, merely because there was an unsuccessful request to document another.

I wish I could conclude this article tidily, but I'm not sure I can. The conclusion of Boeing's story (if it *really* is the conclusion) seems to be that whatever the law on the tax deductibility of settlements, it may sometimes be politically astute to forego a tax deduction to which one is entitled. This seems almost un-American, flying in the face of Judge Learned Hand's famous admonition that, ''Anyone may arrange his affairs so that his taxes shall be as low as possible; he is not bound to choose that pattern which best pays the Treasury. There is not even a patriotic duty to increase one's taxes.''[64]

Presumably, if Boeing is agreeing that it will not seek a tax deduction the way a defendant in a case normally seeks a tax deduction for a settlement payment, that would also apply to any charitable contribution deduction. Still, I'm guessing this is something Boeing lawyers will stew about. Similarly, I'm guessing that if Boeing has agreed it will not claim a tax deduction on its return, that would preclude any amended return and any refund claim that it might think about filing later. Remember that political considerations aside, Boeing may be entitled to a tax deduction under existing federal income tax law (except to the extent it is paying a fine or penalty). All of that makes this more than a bit odd.

On the topic of charitable contributions, incidentally, even if Boeing thinks that its payments to the government might be recast as a charitable contribution, and that such a contribution might somehow be deductible (and perhaps not within the scope of Boeing's commitment to Grassley), I would take a dim view of those efforts. Charitable contributions, after all, ought to be motivated by detached and disinterested generosity, and certainly should not be made with the explicit or implicit understanding of a quid pro quo. The latter point made me question whether Microsoft could legitimately claim charitable contribution deductions for donations that were required by settlement agreements in antitrust actions.[65]

Similarly, I found it hard to understand how Oracle's Larry Ellison could plan to make and deduct a $100

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[59]*See* Senate Finance Committee, Report on Tax Reform Act of 1969, S. Rep. No. 551, 91st Congress 1st Sess. 274 (1969), *reprinted at* 1969-3 C.B. 597.

[60]*See* reg. section 1.162-22(f), examples 1 and 2. *See also McDermott Inc. v. Commissioner*, 101 T.C. 155, *Doc 93-8220*, *93 TNT 159-17* (1993).

[61]*See Flintkote Co. v. United States*, 7 F.3d 870, *Doc 93-11041*, *93 TNT 220-17* (9th Cir. 1993); *see also Fisher Companies, Inc. v. Commissioner*, 84 T.C. 1319 (1985), *aff'd in unpublished opinion*, 806 F.2d 263 (9th Cir. 1986), *acq'd in part*, *nonacq'd in part*, 1990-20 IRB 4.

[62]I am not good at predicting which tax laws will pass and which will not, but it is hard for me to imagine punitive damages in civil cases being made nondeductible, although several legislators have tried to effect this change in the past.

[63]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).

[64]*See Helvering v. Gregory*, 69 F.2d 809 (2d Cir. 1934).

[65]Some of Microsoft's state antitrust actions, notably California, required charitable contributions.

million charitable contribution to Harvard University, when the contribution was inextricably tied to the resolution of his liability in a securities case.[66] Of course, Ellison ultimately reneged on that gift, allegedly over the departure of Harvard's President Lawrence Summers.[67]

Ultimately, taxpayers who pay settlements to private parties, who pay judgments (which may include punitive damages) to private parties, and even those who make payments to the government, have an almost primal need to deduct the payments. Although there are relatively well-established rules for determining when the payments must be capitalized, the range of cases in which a flat denial of the deduction is mandated by law is actually fairly narrow. That makes Grassley's latest campaign — even if he sounds vaguely reminiscent of a considerably less elegant John F. Kennedy — a little hard to square with existing authority.

Of course, we may well not have seen the last of the Boeing settlement flap. Could Boeing's shareholders complain that Boeing should not forego a tax deduction to which it is entitled? I wonder if foregoing a deduction to which one is entitled could somehow be viewed as a public relations expense?

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[66]For discussion, see Wood, "Resolving Litigation by Payments to Charity," *Tax Notes*, Oct. 31, 2005, p. 633; *noted at Tax Notes*, Dec. 5, 2005, p. 1369.

[67]*See The Wall Street Journal*, June 22, 2006, p. A14.