Defendants Should Worry About Nondeductible Settlements

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I often advise both plaintiffs and defendants that in every lawsuit there is at least some tax planning to be done. Whether a case is concluded by settlement or by judgment, after verdict and appeal, or before the complaint is even filed, some thought should always be given to the tax consequences of the payment. Those are not small points, either, but are fundamental questions that should be asked on any payment.

Is it income to the plaintiff, and if so, is it capital, ordinary, or wages? Is it deductible to the defendant, or must it be capitalized? Is it subject to withholding? For both plaintiff and defendant, how should the inevitable attorney fees be treated?

Today this analysis increasingly involves tax reporting issues as well. Apart from more traditional Form W-2 and Form 1099 rules requiring information returns to the plaintiff, the prevalence of gross receipts reporting to attorneys (as well as their clients) raises compliance issues that often must be addressed before cutting the checks. Failing to address those issues upfront can mean horrifying surprises and can cause settlements to sometimes unravel.[1] When the defendant is trying to pay a judgment, its tax treatment (for example, withholding) can prompt renewed litigation between the parties.[2] A defendant who has been battered in litigation and who is prepared to pay the judgment will be none too happy to be caught up in subsequent litigation with the same plaintiff over a failure to agree on tax issues. Trying to join the IRS in the suit to have it resolve it is futile, because the Service refuses to join any private litigation.

Despite all of the reasons a defendant should be concerned with these rules, the fact remains that plaintiffs are far more likely than defendants to raise tax issues. Plaintiffs are also far more likely than defendants to hire tax counsel to assist in the process. Part of that phenomenon may be attributable to the fact that many defendants are businesses and already have tax advisers. However, in my experience, tax advisers are rarely brought into the litigation process, or even consulted, until after the settlement or judgment has been paid, when it comes time to address tax reporting issues.

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[1]*See Sheng v. Starkey Laboratories, Inc.*, 53 F.3d 192 (8th Cir. 1995), *remanded* 117 F.3d 1081 (8th Cir. 1997).

[2]*See Redfield v. Insurance Company of North America*, 940 F.2d 542 (9th Cir. 1991).

To Deduct or Not to Deduct?

One primary area that defendants should take an interest in concerns the dreaded topic of nondeductibility. In nearly all litigation arising from the conduct of a trade or business, everyone will assume that the payment, together with associated attorney fees, will be deductible. That can be a dangerous assumption. There are only a couple of exceptions to the normal rule of deductibility, but they are important ones.

The first and most important exception to the general rule of deductibility of settlements and judgments is the requirement that sometimes a settlement payment, and the associated legal fees, must be capitalized. Usually those concern particular kinds of suits over capitalized assets. For example, expect capitalization in a lawsuit over a corporate acquisition, or over title to the corporation's property. The same is true for the underlying legal fees in merger and acquisitions (M&A) deals, or legal fees to acquire a capital asset, such as a factory or building. The IRS says that in those cases the expense must be capitalized over the life of the asset.

Fines and Penalties

Another major area in which the conventional wisdom of deductibility may be questioned concerns payments in the nature of fines or penalties. Under IRC section 162(f), the payment of a fine or penalty is nondeductible. In contrast to the general rule that payments made in the course of a trade or business are deductible (either by settlement or judgment), the code states that no deduction is allowed for "any fine or similar penalty paid to a government for the violation of any law." Section 162(f).

That provision denies a deduction for both criminal and civil penalties, as well as for sums paid in settlement of a potential liability for a fine or penalty. Treas. reg. section 1.162-21(b). It is the latter element of the provision that often causes controversy. One reason is that it may — or may not — be clear that a fine will be imposed when a potential liability is satisfied through a negotiated settlement with a governmental entity.

Whether a fine or penalty may be imposed is likely to depend on the perpetrator's intent. Even so, if the fine or penalty is imposed, the denial of the deduction follows. It doesn't matter whether the violation was intentional or unintentional.

In either case, no deduction will be permitted for the payment of a fine or penalty. Even if the violation is inadvertent, or if the taxpayer must violate the law to operate profitably (the latter suggesting that the generally accepted ordinary and necessary business expense maxim would apply), the deduction prohibition still applies.[3]

Frequently, the line-drawing exercises that take place here are imprecise. Although a fine or penalty (nondeductible under section 162(f)) and a punitive damages payment may both relate to "bad" conduct, they really invoke different tax rules. Surprisingly, there is significant case law regarding whether a fine or penalty is really intended to be punitive (in which case the payment is nondeductible) or remedial in nature. Whenever a fine or penalty is being discussed, "remedial" becomes a very good — if not downright holy — word.

Environmental payments and many other sorts of payments to governments and quasi-governmental entities are ripe to be examined in this context. Corporate counsel should be alert to examining anything that carries the "fine or penalty" moniker before making any payments. Addressing the character of a payment before a payment is made is important because it is not solely an interpretive endeavor. Sometimes it is possible to enter into a settlement agreement with the governmental agency and to specify that the payment is remedial rather than punitive. Those expressions of intent can be respected by the courts and the IRS, though clearly they are not binding.[4]

False Claims Act Payment

Recently the IRS considered the tax treatment to a payer in settling claims brought under the Federal False Claims Act. The False Claims Act is a special federal law that encourages citizens to sue on behalf of the United States to recover amounts for fraud, overcharging government contracts, and so on. Under the federal False Claims Act,[5] the government can recover damages from those who make false monetary claims against the United States. Three types of damages are available under the False Claims Act, including a civil penalty of at least $5,000 for each false claim, three times the actual damages, and the costs of investigating and prosecuting any alleged violation.

In recent years, some industries have suffered a plethora of those suits, particularly the healthcare and defense industries. The "plaintiff" in the case is actually the United States, though the case is generally brought by a "relator" who serves in the capacity of a private attorney general to recover funds for the government. The relator is entitled to a fee or bounty that ranges from 15 percent to 28 percent, depending on the type of case and the court award.

Sometimes the United States will intervene in the litigation, and that intervention is often viewed as the linchpin of the successful False Claims Act case. A defendant is far more likely to fear the power of the federal government behind the suit, rather than a private plaintiff acting on his own.

The False Claims Act had some recent publicity in the tax field when it was singled out, along with employment discrimination claims, for favorable tax treatment to the plaintiff. Under the American Jobs Creation Act of 2004 (P.L. 108-357), effective generally for settlements or judgments occurring after October 22, 2004, there is an above-the-line deduction for attorney fees paid in the context of employment discrimination claims and federal

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

[4] *See Robinson v. Commissioner*, 102 T.C. 116 (1994), *aff'd in part rev'd in part* 70 F.3d 34 (5th Cir. 1995), *cert. denied* 519 U.S. 824 (1996). *See also* Wood, "Tax Language in Settlement Agreements: Binding or Not?," *Tax Notes*, Dec. 31, 2001, p. 1872.

[5] 31 U.S. Code 3729.

False Claims Act claims.[6] A Senate floor colloquy suggested that the law was retroactive despite its stated effective date,[7] but the Supreme Court appears to disagree.[8]

At least with federal False Claims Act claims a plaintiff who incurs contingent attorney fees in bringing the False Claims Act case will not be whipsawed by limitations on the deductibility of attorney fees. Those limitations include the 2 percent threshold for miscellaneous itemized deductions, the phaseout for high-income taxpayers, and, most dreaded of all, the alternative minimum tax. For False Claims Act cases today (and generally those resolved after October 22, 2004), the False Claims Act relator should be taxable only on his or her net recovery after attorney fees.

Regrettably, that ''only pay tax on net'' rule does not extend to state counterparts to the False Claims Act (of which there are many), nor to most litigation arising outside the two preferred types of claims (again, the federal False Claims Act, or, more generally, claims arising in employment litigation).[9]

The Supreme Court's recent *Banks*[10] decision holds as a general rule that the plaintiff has gross income even if the defendant pays contingent attorney fees directly to the plaintiff's counsel. That doesn't obviate the gross income to the plaintiff. However, the Court declined to decide the implications of that paradigm for federal False Claims Act relators. For False Claims Act cases after October 22, 2004, the Jobs Act offers protection. For False Claims Act cases before that, *Banks* does not apply. Presumably that leaves the state of the law on attorney fees in the circuits as it was before *Banks* — in a state of disarray.

The Most Painful Cut?

Settlement payments are most painful when they are nondeductible. In my experience, this issue sometimes creeps up on defendants, who seem to automatically assume that just because a piece of litigation arises out of the conduct of their trade or business, the settlement payment, along with the unavoidable attorney fees, will be deductible.

Recently the IRS determined in TAM 200502041, *Doc 2005-1011, 2005 TNT 11-8*, that a portion of the lump sum payment to settle claims under the False Claims Act was nondeductible by the payer. The IRS concludes that the payment of the False Claims Act amount was, in effect, a fine or penalty. It reached that conclusion primarily based on a government spreadsheet that showed that part of the settlement payment would serve a punitive purpose.

The code forbids a deduction for ''any fine or similar penalty paid to a government for the violation of any laws.''[11] That provision denies a deduction for both criminal and civil penalties, as well as for sums paid in settlement of potential liability for a fine.[12] It is the latter element of the provision that often causes controversy; it may or may not be clear that it is likely a fine will be imposed.

One of the more important cases defining the line between nondeductible fines or penalties and deductible compensatory payments is *Allied-Signal, Inc. v. Commissioner*.[13] The Third Circuit denied a deduction for an $8 million payment by Allied-Signal into a trust to eradicate a toxic chemical from the environment. The court found that the payment was made with a guarantee that the taxpayer's criminal fine would be reduced by at least the amount of the $8 million settlement payment.

That kind of quid pro quo analysis means that even labeling something in a settlement agreement as a remedial payment not connected to a fine or penalty may not work. Of course, names are important. Writing a check and specifying that a payment is for penalties to a governmental entity is likely to result in the denial of a deduction. It will be up to the taxpayer to demonstrate that the payment was made under a scheme that is not intended to punish but to remediate.[14]

Although section 162(f) bars a deduction for any fine or similar penalty paid to a government for violation of law, there has been much fraying about the edges of that code provision. Many payments have been ruled not to constitute fines for that purpose. A late filing fee, for example, hasn't been treated as a fine as long as the late fee is really designed to encourage prompt compliance with the law and not to penalize.[15]

Similarly, some ''fines'' have been characterized as compensatory payments, either to remediate some problem or to reimburse the government for some amount. Under that theory, a fine that really represents a reimbursement to the government for the amount of lost customs taxes has been held deductible.[16] Similarly, liquidated damages imposed for violations of truck weight limitations were held deductible, compensating the state for damage to highways caused by overweight vehicles.[17]

Factual Inquiries

Unfortunately, the line between compensatory fines and noncompensatory ones is sometimes difficult to discern. There are tough factual issues. How does one show that the purpose of a fine is compensatory and not punitive? Not surprisingly, the courts often look to the circumstances to see not only the motive of the levying

[6] *See* Wood, ''Jobs Act Attorney Fee Provision: Is It Enough?,'' *Tax Notes*, Nov. 15, 2004, p. 961.

[7] *See* Wood, ''Effective Date of Attorney Fee Deduction Misses Many Judgments,'' *Tax Notes*, Dec. 14, 2004, p. 1643.

[8] *See Banks v. Commissioner*, 2005 U.S. Lexis 1370, *Doc 2005-1418, 2005 TNT 15-10* (U.S. Jan. 24, 2005). *See also* Wood, ''Tax Language in Settlement Agreements: Binding or Not?'' *Doc 2001-31594, 2001 TNT 248-13*.

[9] *See* Wood, *supra* note 6.

[10] *See Banks*, *supra* note 8.

[11] Section 162(f).

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

[13] 54 F.3d 767, *Doc 95-2752, 95 TNT 47-8* (3d Cir. 1995).

[14] *See Jenkins v. Commissioner*, T.C. Memo. 1996-539, *Doc 96-32146, 96 TNT 242-12* (1996).

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

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

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

governmental agency, but also the motive of the taxpayer in attempting to resolve the situation by settlement. When a remediation payment made by a taxpayer results in a dollar-for-dollar reduction of a previously assessed fine, motivations may be suspect.[18]

Sometimes it's not clear why a taxpayer succeeds or fails when it comes to a particular fact pattern. The taxpayer in *Colt Industries, Inc. v. U.S.*[19] failed to achieve a deduction for significant environmental payments because the court didn't buy the argument that a substantial payment for environmental violations was compensatory in nature. In contrast, the taxpayer depicted in FSA 200210011, *Doc 2002-5751, 2002 TNT 47-32*, was allowed to deduct a settlement payment made to the federal government arising from antitrust violations. In that case, even though the company pleaded guilty to one count of violating the Sherman Act, the entire amount of the settlement payment to the government was held deductible.

Only punitive (as opposed to remedial) damages fall within the scope of nondeductibility. A civil settlement payment can raise the question whether the payment represents a fine or penalty or some other type of damages. If the payment is a fine or penalty, its purposes must be analyzed to see if the payment was intended to be punitive or remedial.

The facts in TAM 200502041 are important. The taxpayer was a company that worked for agencies of the federal government. Suspecting that the taxpayer had overbilled it, the government began an investigation. Settlement discussions led to an agreement under which the taxpayer paid a sum for release of the company for liability for all of the conduct underlying the investigation.

The settlement agreement provided that the taxpayer denied any wrongdoing or liability in connection with the government's claims. The settlement agreement did not allocate the lump sum payment to any of the claims, nor did it characterize the payment for tax purposes. Failure to include tax language in a settlement agreement is nearly always a mistake; it certainly was here.

What Is Ordinary?

As most businesses would, the company in TAM 200502041 claimed a tax deduction for the full amount of the settlement payment. After all, most settlements are deductible as ordinary and necessary business expenses. An expense can be ordinary and necessary and yet occur only once during the life cycle of a business. The ''ordinary and necessary'' requirement for business expense deductions has generated substantial confusion. An expense is ordinary if a businessperson would commonly incur it under the circumstances. Taxpayers often confuse that ordinary requirement with the notion that the expenses must arise over and over again. However, the courts have noted that business expenses may be fully deductible even if they are irregular, as when a lawsuit for product liability is brought only once during the lifetime of a business.

What is considered necessary for a business has also been liberally interpreted. It is not necessary to inquire whether the taxpayer really had to incur an expense (such as taking a client to lunch) if incurring that expense was appropriate or helpful. The word ''necessary'' is a bit overstated.

Another requirement for the deductibility of business expenses is that they be reasonable. One might say that attorney fees and settlement amounts paid in lawsuits are never reasonable! Be that as it may, the ''reasonableness'' of payments in this context between parties dealing at arm's length is rarely questioned. Litigation is by its nature adversarial, so the reasonableness of a payment to dispose of litigation (or discharge a judgment) is rarely questioned, assuming the requisite nexus can be established between the lawsuit and the business.

Penalty or Not?

When the IRS National Office reviewed the situation in TAM 200502041, the taxpayer argued that it should be able to rely on the estimated actual damages that were provided in one of the government's spreadsheets. That spreadsheet was prepared based on amounts that would be needed to reimburse the government agencies that had paid the claims. The taxpayer claimed that any additional amounts paid under the settlement were intended to compensate the government for whistle-blower fees, presettlement interest, and investigatory costs.

The IRS agent who examined the taxpayer's return thought differently. The IRS argued that the government's actual damages were the amount that was ultimately disbursed to the agencies. Unfortunately, as often occurs with private rulings, much of the information that might make the ruling even more interesting has been redacted. In particular, the dollar amounts in question have been redacted, so it is not possible to determine how big a spread there was between the numbers.

Noting that the settlement agreement was silent as to the compensatory or deterrent nature of the settlement payment (again, a huge mistake by the defendant), the National Office considered all of the facts and circumstances. The IRS claimed to be trying to determine the intent of the parties. Bear in mind that the intent of the parties is one of the crucial factors in determining tax treatment. If the IRS has no expression of the intent of the parties, it must try to divine it.

The relevant inquiry, of course, is the parties' intent at the time the settlement agreement was reached. The TAM rejects reliance on dollar amounts that are in government spreadsheets that were prepared weeks before the final settlement, particularly because of evidence that the government reduced its estimate of actual damages before the final settlement was arrived at.

That seems to tell us several important things. I believe this is far too narrow a view of the intent of the parties. Still, that the IRS National Office was looking at the intent of the parties at the moment the settlement agreement was struck is revealing. It suggests that intent might modulate over a period of time as short as a couple of weeks — or days. Bear in mind that the average False

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[18]*See* discussion in *Talley Industries, Inc. v. Commissioner*, T.C. Memo. 1994-608, *Doc 94-10953, 94 TNT 244-9, reversed and remanded* 116 F.3d 382, *Doc 97-18539, 97 TNT 121-31* (9th Cir. 1997)

[19]880 F.2d 1311 (Fed. Cir. 1989).

Claims Act case — or, indeed, any other litigation — can be protracted, going on for years and sometimes decades.

Here the taxpayer knew the government was seeking a multiplier on its damages and was aware of the calculation method for determining the amount paid. The government spreadsheet that was prepared when the final lump sum settlement offer was on the table allotted amounts of the settlement to the defrauded federal agencies in compensation for actual losses. The balance of the settlement was represented (by the government, anyhow) to be a multiple of damages.

The IRS, sounding much like a trial lawyer (or perhaps more like a law school professor teaching evidence), argued that the spreadsheet represented the ''best evidence'' of how the government intended the settlement payment to be allocated between compensatory and punitive damages.

As yet another blow to the taxpayer, the IRS concluded that it could disregard the fact that disbursements to the federal agencies were made approximately a year after the settlement and were more than was contemplated in the government's final presettlement spreadsheet. The IRS goes so far as to say that those facts are irrelevant to its determination to the intent of the parties at the time the settlement was reached. The TAM even notes that just as it is irrelevant that the amounts ultimately paid were greater than the government's final presettlement spreadsheet, the ruling states that the same result would apply if the amounts paid were less than the spreadsheet. Once again, that suggests that the National Office is saying that intent is critical at the time the settlement is struck. That isn't the time the payment is made, and it's not the time that the debate is ongoing. It's the time the settlement is struck.

A cynic might suggest that that leaves wide open the question whether the intent of both parties expressed at the time a settlement is struck might be at odds with the balance of the settlement discussions or the context of the litigation itself. For example, does the ruling's focus on the intent at the time of the actual meeting of the minds mean that if plaintiff and defendant have been litigating a business dispute but decide at the time a settlement is struck that the way to solve the litigation is for the defendants to buy the plaintiff's stock for $1 million? Does that mean the purchase price is $1 million, or must that be allocated between the value of the stock and the value of the claim?

Obviously we would need more facts, but it seems the intent of the parties at the time of the striking of the settlement is significant, but not paramount. To take a silly example, despite the intent of both parties, surely a plaintiff and defendant involved in an antitrust suit can't at the last minute conclude that they are settling a personal injury action.

Don't Miss Out!

I often preach (at least some people say I sound like I'm preaching) that every settlement agreement should be specific about the tax treatment of payments. One of the main reasons to do that, even though those statements aren't binding on the IRS or the courts, is to try to establish the intent of the parties. It's one of the prime factors to which the IRS or a court will look in seeking to determine the tax consequences of a settlement payment. The intent of the payer is a biggie.[20]

When a settlement document is silent and merely directs a sum of money for a complete release, the IRS and the courts will have to look behind the settlement agreement — and they are less likely to be charitable in discerning tax treatment. Many of the tax cases concerning the treatment of settlement payments involve general releases. It is not a spurious argument to suggest that the best way to insure some tax scrutiny of a settlement payment is to be silent on the reasons for the payment.

If the IRS has no specific allocation and tax treatment in a settlement agreement, it may adopt a pro rata approach (10 percent of the money allocated to each of 10 claims, for example) or anything else that seems to make sense at the time. That is unlikely to be advantageous to the taxpayer.

With a settlement or judgment, it will be up to the recovering party to demonstrate what portion of the recovery constitutes a nontaxable item or a capital gain. Often the courts have referred to the general nature of a release in denying a taxpayer's requested tax treatment.[21] Don't miss out on the opportunity to plan for the tax treatment of your case.

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[20] *See Knuckles v. Commissioner*, 349 F.2d 610 (10th Cir. 1965).

[21] *See, e.g., Guidry v. Commissioner,* T.C. Memo. 1994-127, *Doc 94-3400, 94 TNT 60-10.*