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Deducting Corporate Legal Settlements

By Robert W. Wood • Wood LLP • San Francisco

When companies are sued and pay out settlements and judgments, they expect to do it on a deductible basis. In America, where litigation is a cost of doing business, there is often simply no question about the deductibility of lawyers' fees or settlement payments to resolve litigation. Everyone does it. Granted, some types of payments in that context raise capitalization issues.

For example, a lawsuit (and legal expenses) over title to property must be capitalized and then deducted ratably over the life of the asset. In the merger and acquisition field, some transactional litigation and related fees and expenses may have to be treated as transaction costs. Like litigation over title to property, they may need to be capitalized as part of the deal.

But even then, in a practice that may be more recognized since the Supreme Court's *INDOPCO* decision, amounts can often be bifurcated into several categories. Deductions may therefore be available despite the predominantly capital nature of the deal.

But capitalization situations aside, in the vast majority of cases, companies deduct settlements and judgments, along with the legal fees they entail. Although the general rule is that payments in a business context (either by way of settlement or judgment) are deductible, there is really only one flat no-no. The Internal Revenue Code expressly denies a deduction for "any fine or similar penalty paid to a government for the violation of any law." [Internal Revenue Code Section ("Code Sec.") 162(f).]

This prohibition includes criminal and civil penalties, as well as sums paid in settlement of potential liability for a fine. 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.

What's in a Name?

There is a tendency to lump discussions of punitive damages paid to private parties together with settlement payments made by

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companies seeking to avoid a government penalty. In the case of a payment to a government, the case law suggests that it may not be too difficult to discern whether the payment is made as a *quid pro quo* for dropping the asserted penalty. The IRS may try to ferret out exactly what happened and exactly the type of payment that is being made, verbiage aside.

However, the settling government agency may be willing to consider accepting a payment into a remediation fund. This can be a way to dispose of a potential penalty assertion. Where one is dealing at arm's length with adverse parties, why should the IRS have the last say on what the payment is truly for?

The intent of the payer is surely relevant to tax characterization, as is the language agreed to by the parties. Even though the language of a settlement agreement is clearly not determinative, it is surely worth something.

When civil punitive damages are sought and the case settles, a variety of amorphous factors may undermine any attempt to draw bright lines.

This is true with fines or penalties, and even with punitive damages. Punitive damages may be premised on various theories. One of them may be the potential inadequacy of compensatory damages when it may be too difficult or costly to measure those damages accurately. Those theories undermine the legal axiom that punitive damages are always designed to punish.


In fact, punitive damages in some cases may be there to do more than punish. One of the factors juries may be considering in punitive damage awards is the adequacy of the compensatory damages. Doesn't that imply that some of the punitive damages might really be compensatory in character? After all, sometimes something is not what you call it.

When a case settles and no punitive damages are paid, will the government be free to engage in characterization battles? Presumably, yes. The IRS has already displayed a tendency to view as punitive something that the parties may expressly call compensatory. Although it may be an aberration, at least one court has found punitive damages to exist even though the case was settled before trial and the settlement did not allocate any of the award to punitive damages. [See *E.P. Barnes*, 73 TCM 1754, Dec. 51,827(M), TC Memo. 1997-25.]

Historical Case Law

One of the most important cases to define the line between nondeductible fines or penalties and deductible compensatory damage payments is *Allied-Signal, Inc.*, CA-3 (unpublished opinion), 95-1 USTC ¶15,151 (1995). In that case, the Third Circuit affirmed the Tax Court's denial of any deduction for an \$8 million payment Allied-Signal paid into a trust to eradicate a toxic chemical pesticide from the environment.

The court found that the payment was made with the virtual guarantee that the district court would reduce the criminal fine by at least the amount previously levied against Allied-Signal. That kind of *quid pro quo* analysis comes up frequently in fine or penalty cases.



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The issues surrounding these fine-versus-compensatory demarcations are discussed frequently by commentators.

Sometimes a “penalty” may not be intended to punish, and that may make the issue worth litigating. For example, in *S.C. Jenkins*, 72 TCM 1470, Dec. 51,685(M), TC Memo. 1996-539, the Tax Court held that a shareholder of a fertilizer manufacturer was entitled to deduct, through his S corporation, amounts he paid to two states as “penalties” for deficiencies in the fertilizer produced by his company.

The IRS had disallowed the deduction (passed through from his S corporation), arguing that the payments represented nondeductible penalties. The Tax Court, however, looked to the purpose of the state legislation. The court found that it was to compensate the consumer, not to punish the manufacturer.

The Tax Court noted that the penalty was calculated by determining the value of the deficient ingredient that the consumer paid for but never received, plus an additional amount that was to compensate for additional crop yield. The Tax Court found for the taxpayer because it was a remedial statute, not a punitive one. *Jenkins* demonstrates that it is important to look beyond the mere “fine or penalty” language to discover the purpose of the statute under which the fine or penalty is levied.

The mere fact that a penalty is civil rather than criminal does not get the taxpayer out of the woods. For example, in *J.W. Hawronsky*, 105 TC 94, Dec. 50,814 (1995), the Tax Court held that Code Sec. 162(f) prohibited a taxpayer from deducting treble damages he was required to pay when he breached a scholarship program contract. Finding that the payment was a civil penalty, the Tax Court concluded that Code Sec. 162(f) applies both to criminal fines and to some civil penalties.

Fines, Late Fees and Compensatory Payments

Although Code Sec. 162(f) bars a deduction for any fine or similar penalty paid to a government for a violation of law, many payments have been ruled not to constitute fines for that purpose. Thus, a late filing fee, which is really designed to encourage prompt compliance with the law, has not been treated as a fine. [See Reg. §1.162-21(b)(2).]

Another exception to the nondeductibility of fines relates to so-called compensatory fines. Even a fine (as distinguished from a late fee) can be deducted if it is compensatory. If a fine is imposed only to compensate a governmental entity for harm it has suffered, as distinguished from a fine having a punitive motivation, a deduction will be allowed.

Thus, a fine that is essentially a reimbursement to the government for the amount of lost custom taxes has been held deductible. [See *Middle Atlantic Distributors, Inc.*, 72 TC 1136, Dec. 36,335 (1979), *acq.*, 1980-2 CB 2.] Similarly, a payment to the Clean Water Fund to avoid prosecution for water pollution was held deductible in *S&B Restaurant, Inc.*, 73 TC 1226, Dec. 36,857 (1980).

Even fines that may appear to be punitive on the surface may be held to be deductible. The key is proving the requisite compensatory character of the payment. Thus, in *Mason Dixon Lines, Inc.*, CA-6, 83-1 USTC ¶9385, 708 F2d 1043 (1983), statutory liquidated damages imposed for the violation of truck weight limitations were held to be deductible.

Although liquidated damages could be equated with penalties, the theory of that case was that the statutory liquidated damages compensated the state for damage to the highways caused by overweight vehicles. Liquidated damages imposed by contract, even when denominated as “fines,” have been viewed as compensatory on the same theory. Indeed, even the IRS has agreed with that position. [See Rev. Rul. 69-214, 1969-1 CB 52 (1969).]