DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL, CHICAGO
(RETAILERS, FOOD, PHARMACEUTICALS)

FROM: ASSOCIATE CHIEF COUNSEL (INCOME TAX AND ACCOUNTING)

SUBJECT: Deductibility of settlement payments

This Field Service Advice responds to your memorandum dated August 20, 2001. In accordance with § 6110(k)(3) of the Internal Revenue Code, this Field Service Advice should not be cited as precedent.

LEGEND

Taxpayer =
$A =
$B =
$C =
$D =
Date 1 =
Date 2 =
Year 1 =
Year 2 =

ISSUES

(1) Whether Taxpayer may deduct $A paid under a settlement agreement to the United States, in exchange for the government's promise not to institute further civil or criminal actions against it or its current and former officers, directors, and employees, under various federal statutes, including § 2 of the Sherman Act.

(2) Whether Taxpayer may deduct $B paid under a settlement agreement to the United States in exchange for the government's promise not to institute any civil or criminal actions against it or its current and former officers, directors, and employees under (i) the False Claims Act, 31 U.S.C. § 3729, et seq., (ii)

the Lanham Act, 15 U.S.C. § 1114, et seq., and (iii) common law theories including (a) breach of contract or warranty, (b) negligent or fraudulent misrepresentation, and (c) unjust enrichment or payment by mistake.

CONCLUSIONS

(1) Section 162(f) does not apply to the $A payment. If the other requirements of § 162 are met and if § 162(g) does not apply, then the payment is deductible as an ordinary and necessary business expense.

(2) A portion of the $B payment may be nondeductible under § 162(f). Further factual development as to the intent of the parties is necessary to allocate the payment between compensatory and punitive purposes.

FACTS

Taxpayer is a corporation engaged in the distribution of electron tubes and power semiconductors. Taxpayer's taxable year ends on May 31st and it uses an accrual method of accounting.

ISSUE #1

On Date 1, Taxpayer pled guilty to a one-count information charging it with violating § 1 of the Sherman Act. As a part of the guilty plea, Taxpayer paid a fine of $C. The government believed it could also initiate a civil action against Taxpayer and / or its employees under various federal statutes, including § 2 of the Sherman Act, to recover damages from a conspiracy to monopolize trade and commerce. Instead of initiating an action, the United States entered into an agreement with Taxpayer under which the government promised to refrain from instituting, prosecuting, or maintaining any action, cause of action, suit, or claim, whether known or unknown, against Taxpayer, its subsidiaries, or any of their current or former officers, directors, or employees for monetary damages resulting from their participation in the alleged conspiracy to monopolize or from any other course of action that was a subject of the investigation. In exchange, Taxpayer agreed to pay the United States $A as "actual damages" alleged to have resulted from Taxpayer's conduct. Taxpayer paid the $A in Year 1 and deducted the entire amount as an ordinary and necessary business expense under § 162 on its Year 1 federal income tax return.

ISSUE #2

On or about Date 2, the Defense Electronics Supply Center, a component of the Department of Defense, awarded Taxpayer a $D contract for the production of night vision image converter tubes. As the result of another investigation of Taxpayer, the United States believed that it had causes of action against Taxpayer under:

(1) the False Claims Act, 31 U.S.C. § 3729, et seq.,
(ii) the Lanham Act, 15 U.S.C. § 1114, et seq., and
(iii) common law theories including:

(a) breach of contract or warranty,
(b) negligent or fraudulent misrepresentation, and
(c) unjust enrichment or payment by mistake.

Instead of initiating any of these causes of action, the government entered into an agreement with Taxpayer under which the government agreed to release, waive, and discharge Taxpayer and its affiliates, subsidiaries, and current and former directors, officers, agents, and employees from any civil or administrative monetary claims or causes of action. The government also agreed that it would not bring any criminal charges against Taxpayer or its current or former directors, officers, agents, or employees with respect to the $D contract. In exchange, Taxpayer agreed to pay the United States $B. Taxpayer paid the $B in Year 2 and deducted the entire amount as an ordinary and necessary business expense under § 162 on its Year 2 federal income tax return.

LAW AND ANALYSIS

Section 162(a) allows a deduction for all ordinary and necessary expenses paid or incurred by a taxpayer in carrying on a trade or business. Amounts expended by a taxpayer engaged in a trade or business to avoid or settle litigation may be deductible as an ordinary business expense. See, e.g., Ditmars v. Commissioner, 302 F.2d 481, 485 (2d Cir. 1962); Old Town Corp. v. Commissioner, 37 T.C. 845 (1962), acq., 1962-2 C.B. 5.

Section 162(f), however, prohibits a deduction under § 162(a) for any fine or similar penalty paid to a government for the violation of any law. Section 1.162-21(b)(1) of the Income Tax Regulations defines a “fine or similar penalty” to include any amount (i) Paid pursuant to conviction or a plea of *nolo contendere* for a crime in a criminal proceeding; (ii) Paid as a civil penalty imposed by federal, state, or local law; (iii) Paid in settlement of the taxpayer’s actual or potential liability for a fine or penalty (civil or criminal); or (iv) Forfeited as collateral posted in connection with a proceeding which could result in imposition of such a fine or penalty. Section 1.162-21(b)(2) provides that compensatory damages paid to a government do not constitute a fine or penalty.

Section 162(f) disallows a deduction for civil penalties that are imposed for the purpose of enforcing the law or as punishment for violation of the law. However, a civil payment, even if it is labeled a penalty, may be deductible if it is imposed to encourage compliance with the law or as a remedial measure to compensate another party. Waldman v. Commissioner, 88 T.C. 1384, 1387 (1987), aff’d, 850 F.2d 611 (9th Cir. 1988); Huff v. Commissioner, 80 T.C. 804, 821-22 (1983); S. Pac. Transp. Co., 75 T.C. 497, 646-54 (1980); Allied-Signal, Inc. v. Commissioner, T.C. Memo 1992-204, aff’d, 54 F.3d 767 (3d Cir. 1995). Where a payment could serve both punitive and compensatory purposes, it is necessary to determine which purpose the payment was designed to serve. S&B Restaurant, Inc. v. Commissioner, 73 T.C. 1226, 1232 (1980); Middle Atl. Distribs. v. Commissioner, 72 T.C. 1136, 1145 (1979); Grossman & Sons, Inc. v. Commissioner, 48 T.C. 15, 31 (1967).

The characterization of a payment for purposes of § 162(f) depends on the origin of the liability giving rise to the payment. Bailey v. Commissioner, 756 F.2d 44, 47 (6th Cir. 1985); Middle Atl. Distribs., 72 T.C. at 1144-45; Uhlenbrock v. Commissioner, 67 T.C. 818, 823 (1977). The origin of a settlement payment would generally be the original claim to which the payment relates. See Adolf Meller Co. v. United States, 600 F.2d 1360, 1363-64 (Cl. Ct. 1979). However, courts will typically give effect to the express characterization of a settlement payment by the parties to a settlement agreement. See Middle Atl. Distribs., 72 T.C. at 1145; Grossman & Sons, Inc., 48 T.C. at 29; Rev. Rul. 80-334, 1980-2 C.B. 61.

In ascertaining whether a payment is punitive or compensatory, courts analyze the purpose of the statute imposing the penalty (or forming the basis of claims that are settled). Both the language of the statute and its legislative history are relevant to this inquiry. If the law is designed to compensate the injured party for its damages, then § 162(f) is likely to be inapplicable. See, e.g., Mason and Dixon Lines, Inc. v. United States, 708 F.2d 1043, 1047 (6th Cir. 1983) (holding that liquidated damages for violating state truck weight limits were compensatory based on the structure and language of the relevant provision). If the law is designed to be punitive or to deter the type of conduct committed by the taxpayer, then the payment is likely covered by § 162(f). See, e.g., True v. United States, 894 F.2d 1197, 1205 (10th Cir. 1990) (holding that amounts paid for violating the Federal Water Pollution Control Act were penalties because "on balance" the civil penalty provision served "a deterrent and retributive function similar to a criminal fine"); Colt Indus., Inc. v. United States, 11 Cl. Ct. 140, 146-47 (1986) (holding that civil penalties under the Clean Air Act and the Clean Water Act had a punitive purpose and were nondeductible), aff'd, 880 F.2d 1311 (Fed. Cir. 1989); Huff, 80 T.C. at 824 (concluding that a civil penalty had a punitive purpose based on a state supreme court decision holding that the statute imposing the penalty was designed to penalize defendants).

If it cannot be determined whether a statute imposing a penalty serves compensatory or punitive purposes, or if the statute serves both purposes, it is necessary to consider the specific facts surrounding the payment at issue, including a comparison of the payment amount with the actual damages caused by the conduct at issue. If a payment exceeds the amount needed to compensate the victim, or if it is in addition to a separate compensatory payment, it can often be inferred that the payment had a punitive purpose. See, e.g., Adolf Meller Co., 600 F.2d at 1361-62 (holding that a $43,000 payment in settlement of a customs penalty was punitive where it was in addition to lost customs duties paid).

ISSUE # 1

After our telephone conversation on October 19, 2001, we understand that you have concluded that the $A settlement payment was intended to compensate the government, and that § 162(f) is therefore inapplicable. Based on the information you have provided us, we concur with this conclusion. The settlement agreement between Taxpayer and the government describes the payment as "actual damages alleged to have resulted from [Taxpayer's] participation in the alleged monopolization and conspiracy to monopolize." Furthermore, the settlement memorandum prepared by the Department of Justice in connection with the settlement states that the $A may not fully compensate the government for its monetary damages. See § 1.162-21(c) Example 1 (concluding that § 162(f) does not preclude deduction of actual damages paid as a result of a civil suit under § 4A of the Clayton Act after the taxpayer had been convicted and fined under § 1 of the Sherman Act).

ISSUE # 2

In Talley Indus., Inc. v. Commissioner, T.C. Memo 1999-200, aff'd, 2001 U.S. App. LEXIS 20709 (9th Cir. Sept. 17, 2001), the Tax Court considered on remand from the Ninth Circuit the deductibility of a settlement payment made by the taxpayer to discharge its potential civil liability under the False Claims Act and the Truth in Negotiation Act. The court held that the taxpayer could not deduct $940,000, the portion of the payment in excess of the government's $1.56 million actual damages. The settlement agreement did not characterize the $2.5 million payment as either compensation to the government for its losses or as a penalty. The Ninth Circuit's earlier opinion had noted that the False Claims Act has both compensatory and deterrence purposes. Talley Indus., Inc. v. Commissioner, 116 F.3d 382, 387 (9th Cir. 1997) (citing United States v. McLeod, 721 F.2d 282, 285 (9th Cir. 1983)), rev'g T.C. Memo 1994-608; see also Grossman & Sons, Inc., 48 T.C. at 31. Therefore, the deductibility of the $940,000 depended on what purpose the payment was designed to serve. Talley, 116 F.3d at 387 (citing Waldman, 88 T.C. at 1387). The Tax Court stated that this issue turned on the intent of the parties and that the taxpayer bore the burden of proving that the parties intended the $940,000 to represent compensation. Because the taxpayer failed to meet that burden, the Tax Court held that the taxpayer could not deduct the $940,000 portion of the payment under § 162.

The settlement agreement between Taxpayer and the government is silent as to whether the $B payment is intended to be compensation or a penalty. The potential claims that were discharged by the settlement agreement included claims under the False Claims Act, the Lanham Act, and various common law theories. As noted above, the False Claims Act could serve compensatory or punitive purposes. Therefore, as far as the $B payment relates to claims under the False Claims Act, its deductibility will depend on which purpose the payment was designed to serve.

Section 35(a) of the Lanham Act (15 U.S.C. § 1117(a)) provides that any monetary recovery under such section "shall constitute compensation and not a penalty." See also Sands, Taylor & Wood v. Quaker Oats Co., 34 F.3d 1340, 1347 & n.10 (7th Cir. 1994) (stating that monetary recovery under § 35(a) of the Lanham Act must be compensatory in nature and not punitive). Section 35(a) of the Lanham Act provides monetary remedies for any violation of § 43(a), (c), or (d) of the Lanham Act (15 U.S.C. § 1125(a), (c), or (d)), or a willful violation of § 43(c) of the Lanham Act (15 U.S.C. § 1125(c)). However, § 35(b) of the Lanham Act (15 U.S.C. § 1117(b)) provides for monetary recovery in the amount of three times the defendant's profits or damages, whichever is greater. Section 35(b) of the Lanham Act applies to certain violations of § 32(1)(a) of the Lanham Act (15 U.S.C. § 1114(1)(a)) or 36 U.S.C. § 380. Therefore, it appears that §162(f) could not apply to any portion of a payment under § 35(a) of the Lanham Act, because such payments are compensatory by definition. However, it is possible for payments pursuant to § 35(b) of the Lanham Act to be covered by § 162(f). The information you have provided us does not reveal what part of the Lanham Act the government believed Taxpayer violated, or what portion of the settlement should be attributed to Lanham Act violations. Therefore, we cannot draw a conclusion as to what portion of the $B payment may be nondeductible under § 162(f) as a fine or penalty under the Lanham Act.

In sum, the deductibility of the $B settlement payment will depend on ascertaining the intent of the parties as to what purpose the payment was designed to serve. We agree with your conclusion that further development of the facts leading up to the settlement of the case is necessary. Although the settlement agreement is silent as to the purpose of the payment, any correspondence between Taxpayer and the Justice Department regarding the settlement may shed light on the parties' intentions. Any settlement memorandum that may have been prepared by the Justice Department in connection with the $B settlement may also be helpful in this regard.

Although we are unable based on the information provided to conclude what, if any, portion of the $B settlement is nondeductible under § 162(f), it is relevant to compare the settlement amount to the $D amount of the contract to which the government's claims related. The fact that the settlement amount is significantly larger than the total contract amount suggests that some portion of the settlement payment is likely punitive and subject to § 162(f). Further factual development is necessary to determine what that portion should be.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

[redacted]

[redacted]

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Please call if you have any further questions.