Office of Chief Counsel
Internal Revenue Service
Memorandum

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date: October 31, 2012

to: Associate Area Counsel
(CC:LB&I (Area 1)

from:
( )

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subject: Disallowance of Deduction Under § 162(f)

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Year 1 =

Date 1 =

Taxpayer =

State =

Agreement =

Statute 1 =

Statute 1(a) =

Statute 1(b) =

Statute 2 =

Statute 3 =

Statute 3a =

X =

Organization =

Activity =

Y =

Year 2 =

ISSUE

Whether a portion of the Taxpayer's payment under the Agreement in satisfaction of claims against it by the Attorney General of State is nondeductible as a fine or similar penalty under § 162(f) of the Internal Revenue Code.

CONCLUSIONS

[redacted]

FACTS

In Year 1, the Attorney General of State (Attorney General) initiated an investigation into practices relating to the
engaged in by the Taxpayer. On Date 1, the Taxpayer and the Attorney General entered into the Agreement. The Agreement made certain background findings, including the following:

-The Taxpayer is engaged in the .

-The Taxpayer consists of
.

- .

-To , the Taxpayer engaged in certain deceptive and illegal practices, including:

-

The “ ” section of the Agreement (operative section) provided:

> -The Attorney General alleges that, by engaging in these practices, the Taxpayer violated Statute 1 and Statute 3.
>
> -The Taxpayer is willing to enter into the Agreement, without admitting or denying the Attorney General’s findings.
>
> -The Attorney General is willing to accept the terms of the Agreement pursuant to Statute 3(a) in lieu of commencing a civil action.

Statute 1 contains laws related to .

Statute 1(a) provides are unlawful.

Statute 1(b) provides that the Attorney General may bring an action to enjoin the and to obtain restitution of any money or property obtained .

Statute 2 provides for recovery in a civil action by the Attorney General of not more than dollars for each violation of Statute 1 .

Statute 3 provides that

, the Attorney General may seek (and a court may award) an injunction, restitution, and damages in the State Court for repeated .

Statute 3(a) provides that, in lieu of instituting a civil action in connection with enforcing a State law, the Attorney General may accept an agreement by the person violating the law to discontinue the unlawful act.

Pursuant to the terms of the Agreement, the Taxpayer paid X to Organization, which was required to distribute these funds to State not-for-profit corporations, to inure to the benefit of State residents by funding programs aimed at furthering Activity. In addition, the Taxpayer paid Y to the State to cover the costs of the investigation. The Taxpayer deducted these amounts on its Year 2 return. The question you ask is whether § 162(f) bars the Taxpayer from deducting X because it constituted a "fine or similar penalty."

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. Under § 162(a), amounts expended by a taxpayer engaged in a trade or business to avoid or settle litigation may be deductible as an ordinary and necessary 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) 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.

In order to evaluate the characterization of a settlement payment for purposes of § 162(f), it is necessary to look to the origin and character of the liability giving rise to the payment. Bailey v. Commissioner, 756 F.2d 44, 47 (6th Cir. 1985); Ostrum v. Commissioner, 77 T.C. 608 (1981); Middle Atlantic Distributors v. Commissioner, 72 T.C. 1136, 1144-45 (1979); Uhlenbrock v. Commissioner, 67 T.C. 818, 823 (1977). If the law is designed to compensate the injured party for its damages, section 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) (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) (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), affd, 880 F.2d 1311

(Fed. Cir. 1989)(civil penalties under the Clean Air Act and the Clean Water Act had a punitive purpose and were nondeductible); Huff v. Commissioner, 80 T.C. at 824 (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).

In ascertaining the nature of a payment as punitive or compensatory, courts analyze the purpose of the statute requiring the payment 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 a payment can serve both punitive and compensatory purposes, it is necessary to determine which purpose the particular payment serves. S & B Restaurant v. Commissioner, 73 T.C. 1226, 1232 (1980); Middle Atlantic Distributors v. Commissioner, 72 T.C. at 1145; Grossman & Sons v. Commissioner, 48 T.C. 15, 31 (1967). A civil violation, even if it is labeled a penalty, may be deductible if imposed to encourage compliance with the law or as a remedial measure to compensate another party. See Allied-Signal v. Commissioner, T.C. Memo. 1992-204, affd, 54 F.3d 767 (3d Cir. 1995); Waldman v. Commissioner, 88 T.C. 1384, 1387 (1987), affd, 850 F.2d 611 (9th Cir. 1988); Huff v. Commissioner, 80 T.C. 804, 824 (1983); Southern Pacific Transportation Co. v. Commissioner, 75 T.C. 497, 646-54 (1980).

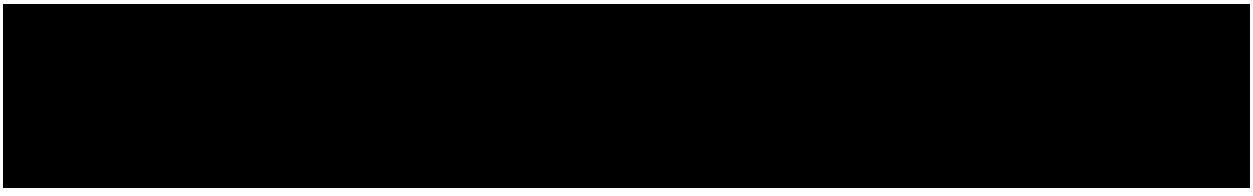
In considering the origin of the liability, the express characterization of a settlement payment by the parties to a settlement agreement also must be considered. See Middle Atlantic Distributors v. Commissioner, 72 T.C. at 1145-1146; Grossman & Sons, Inc. v. Commissioner, 48 T.C. at 29; Rev. Rul. 80-334, 1980-2 C.B. 61. The express terms of the Agreement in this case alleged that Statute 1 and Statute 3 were violated. The Agreement also provided that the Attorney General was willing to accept the terms of the Agreement "in lieu of a civil action." It is necessary, therefore, to determine whether payments for violations of Statute 1 and Statute 3 are in the nature of "fines or similar penalties" within the meaning of Reg. § 1.162-21(b)(1), or "compensatory" in nature within the meaning of Reg. § 1.162-21(b)(2).

Two provisions providing remedies for violations of Statute 1 and Statute 3 include Statute 1(b) and Statute 3. Statute 1 and an amendment to Statute 3 were enacted together. The express language of Statute 1(b) and Statute 3 allow the Attorney General to seek restitution and, in the case of Statute 3, also damages. While "restitution" is not specifically defined in either statute, a memorandum, approving them before they were enacted, made their compensatory purpose clear. In that memorandum, the former Governor of State stated that the

. Thus, both laws were enacted to provide compensation to victims. We have found no indication elsewhere in the legislative history of these provisions that they were intended to constitute a punishment of the perpetrators.

Judicial interpretations of state laws also are important in determining the nature of those laws. See Huff v. Commissioner, 80 T.C. at 824 (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). Case law has interpreted "restitution" under Statute 1(b) and Statute 3 to be compensatory in nature. In certain parties previously had obtained restitution from the defendant for damages arising from unlawful acts. In the current suit, the State was seeking to obtain restitution, civil penalties, and injunctive relief from the defendant under Statute 1(b), Statute 3, and Statute 2 for the same unlawful acts as in the previous action. With regard to the restitution claims, the court denied the State's claims on behalf of those who had already obtained restitution in the previous action. Noting that the Attorney General had asserted that restitution is about making consumers whole, the Court stated that those parties had already received a "full measure" of relief making them whole in the previous action, so that restitution in the current action would have constituted a double recovery. Thus, restitution under Statute 1(b) and Statute 3 is viewed by the Attorney General and the Court as providing compensatory damages. As noted above, this is confirmed by the legislative history.



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CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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Please call at if you have any further questions.

Section 6110(j)(3) of the Internal Revenue Code This document may not be used or cited as precedent.