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Internal Revenue Code Section 162(f): An Analysis and its Application to Restitution Payments and Environmental Fines

Jacob L. Todres*

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Part I - Introductory

Although section 162(a) of the Internal Revenue Code states, in unlimited form, the general rule that "[t]here shall be allowed as a deduction *all* the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business,"[1] other provisions of the Code in fact create exceptions to that general rule. One such limiting provision is section 162(f), which states that "[n]o deduction shall be allowed under subsection (a) for any fine or similar penalty paid to a government for the violation of any law."[2]

Section 162(f) was added to the Code by the Tax Reform Act of 1969[3] as part of a congressional adoption, in circumscribed form, of a judicially created doctrine. Under this doctrine, deductions for expenditures meeting all the existing statutory requisites for deductibility were disallowed whenever the court determined that "allowance of the deduction would frustrate sharply defined national or state policies proscribing the particular types of conduct evidenced by some governmental declaration thereof."[4]

Congress was probably spurred to action in this area by the Internal Revenue Service's ruling issued five years earlier.[5] The ruling declared that amounts paid as treble damages under the Clayton Act were deductible as ordinary and necessary business expenses.[6] The legislative response to this ruling, however, was not confined to addressing the deductibility of treble damages. Rather, Congress comprehensively dealt with the entire "public policy" disallowance area by enacting section 902 of the Tax Reform Act of 1969, which enacted section 162(f) and also:[7]

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1. I.R.C. § 162(a)(1994) (emphasis added).
2. I.R.C. § 162(f) (1994).
3. Pub. L. No. 91-172, 83 Stat. 710 (1969).
4. S. Rep. No. 552, 91st Cong., 1st Sess. 273-75 (1969), *reprinted in* 1969-3 C.B. 423 at 596-98.
5. Rev. Rul. 64-224, 1964-2 C.B. 52.
6. *See* John Taggart, *Fines, Penalties, Bribes, and Damage Payments and Recoveries*, 25 Tax L. Rev. 611, 617-18 (1970).
7. In his excellent and frequently cited article, John Taggart also included along with these four provisions the enactment of Code section 186 by Section 904 of the Tax Reform Act of 1969. *Id.* Code section 186 was intended to allow a deduction for certain antitrust and other damage recoveries where the original injury produced a net operating loss which resulted in no tax benefit to the taxpayer. *Id.* at 628. However, while Code section 186 addressed antitrust damages, its thrust is different from the other provisions, all of which deny an ordinary and necessary expense deduction for expenditures deemed by Congress to violate some public policy. Accordingly, Code section 186 is excluded from the present discussion.

(1) added Code section 162(g), which denies a section 162(a) deduction for two-thirds of an antitrust treble-damage payment following a criminal conviction or plea of guilty or *nolo contendere*;
(2) expanded Code section 162(c) (and renumbered it 162(c)(1)) so as to deny a section 162(a) deduction for any illegal bribe or kickback given to an official or employee of any government (the prior section 162(c) having applied only to payments made to foreign government officials); and
(3) added Code section 162(c)(2), which in its original form denied a section 162(a) deduction for any illegal bribe or kickback given to someone other than a governmental official or employee where the taxpayer had been convicted (or pled guilty or *nolo contendere*) in a criminal proceeding for making the payment.[8]

These four provisions originated in the Senate Finance Committee, which indicated in its report (hereinafter "the 1969 Senate Report"), that the legislation was intended to preempt the area. The report stated:

> The provision added by the committee amendments denies deductions for four types of expenditures. . . . The provision for the denial of the deduction for payments in these situations which are deemed to violate public policy is intended to be all inclusive. Public policy, in other circumstances, generally is not sufficiently clearly defined to justify the disallowance of deductions.[9]

The regulations effectuate this intent by providing that "[a] deduction for an expense paid or incurred after December 30, 1969, which would otherwise be allowed under section 162 shall not be denied on the grounds that allowance of such deduction would frustrate a sharply defined public policy."[10] Therefore, if a deduction for payment of a fine or other penalty is not precluded by section 162(f), a section 162(a)

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8. The original version of section 162(c)(2) was significantly changed by section 310(a) of the Revenue Act of 1971, Pub. L. 92-178, 85 Stat. 497 (1971). The original version provided:

> (2) Other bribes or kickbacks.——If in a criminal proceeding a taxpayer is convicted of making a payment (other than a payment described in paragraph (1)) which is an illegal bribe or kickback, or his plea of guilty or nolo contendere to an indictment or information charging the making of such a payment is entered or accepted in such a proceeding, no deduction shall be allowed under subsection (a) on account of such payment or any related payment made prior to the date of final judgment in such proceeding.

9. 1969 S. Rep., *supra* note 4, at 273.
10. Treas. Reg.§ 1.162-1(a) (1975).

deduction cannot be denied to the taxpayer on nonstatutory "public policy" grounds.[11]

The 1969 Senate Report also indicated, questionably, that section 162(f) was a codification of the prior "public policy" case law applying to fines and penalties. "[T]he committee amendments provide that no deduction is to be allowed for any fine or similar penalty paid to a government for the violation of any law. . . . This represents a codification of the general court position in this respect."[12]

The purpose of this article is to analyze section 162(f) and its application to two recently notorious situations involving vast sums of money. The first situation is that of the stock swindler/manipulator in the image of Ivan Boesky or Michael Milken who is caught and ordered to make restitution. The second situation is that of the environmental polluter in the image of the operator of the Exxon Valdiz who incurs penalties as a result of intentional or accidental conduct.[13]

To present section 162(f) in proper perspective, Part II of this article briefly examines the policy considerations that underly the legislative decision to deny deductions, on "public policy" grounds, for payments otherwise deductible under section 162(a). In particular, Part II responds to certain recent criticisms of such disallowances, criticisms which this author believes to be overstated at best. Part III briefly reviews the pre-1969 "public policy" disallowance doctrine as it was developed by the courts. This review is helpful both as background and because such cases are still referred to when difficulties in applying section 162(f) are encountered. Part IV analyzes section 162(f) in detail, and Parts V and VI, respectively, discuss the applicability of section 162(f) to restitution payments and to impositions on the environmental polluter. Part VII is a short conclusion.

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11. It should be noted that while the pre-1969 "public policy" doctrine has been preempted in the context of section 162(a), the doctrine has survived elsewhere. Notably, many post-1969 cases disallow on "public policy" grounds losses otherwise deductible under section 165. *See, e.g.*, Wood v. United States, 693 F. Supp. 452 (E.D. La. 1988); Holt v. Commissioner, 69 T.C. 75 (1977), *aff'd per curiam*, 611 F.2d 1160 (5th Cir. 1980). Lincoln v. Commissioner, 50 T.C.M. 185 (1985); Holmes Enterprises, Inc. v. Commissioner, 69 T.C. 114 (1977); *But see* Medeiros v. Commissioner, 77 T.C. 1255, 1262 n.8 (1981). *See also* Rev. Rul. 77-126, 1977-1 C.B. 47.

12. 1969 S. Rep., *supra* note 4, at 273.

13. With respect to impositions on the environmental polluter, this article will focus only on whether or not section 162(f) is applicable to the payments involved. It will not address the issue of whether such payments must be capitalized or may be deducted immediately. As to the latter issue, *see e.g.*, Thomas H. Yancey, *Emerging Doctrines in the Tax Treatment of Environmental Cleanup Costs*, 70 TAXES 948 (1992); Sloane Elizabeth Anders, *The Federal Tax System and the Environment: Should Payments Made Pursuant to CERCLA be Deductible*, 10 VA. TAX. REV. 707 (1991).

Part II - Policy Considerations

The basic justification advanced in favor of the disallowance of deductions for otherwise deductible expenditures, such as payment of fines and penalties or for illegal, antisocial and other undesirable purposes, is that the government should not bear any part of the cost of reprehensible behavior, even if incurred in the normal course of a trade or business. Rather, the tax law should discourage such activities by denying them the tax recognition afforded to payments made in the course of engaging in inoffensive business behavior.[14]

Opponents, who argue that such "public policy" considerations ought not result in the disallowance of otherwise available section 162(a) deductions, generally make one or more of the five arguments discussed in the following paragraphs.[15] Upon examination, these arguments appear to be the same as the objections voiced to the pre-1969 judicially created public policy doctrine.[16] These arguments did not "carry the day" then and are no more persuasive today.

"Purity" Objection on the *Taxation of Net Income*—Having made the fundamental decision that only net income should be subject to income taxation,[17] Congress, notwithstanding its undoubted power to make exceptions,[18] ought not do so on a selective basis. However, in light of the fact that the current income tax is in numerous respects so very far removed from a pure tax on net income,[19] such a "purity" objection in not persuasive.

Purpose of the Income Tax—Opponents of disallowance of deductions assert that the basic purpose of the income tax is to raise revenue and that the tax system is not a proper vehicle to punish wrongdoers. However, we must not lose sight of the forest for the trees. The tax law, is one part of many laws legislated by Congress to govern the United States. Our conceptions of morality and right and wrong

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14. *See generally* James W. Colliton, *The Tax Treatment of Criminal and Disapproved Payments*, 9. TAX REV. 273, 277-78 (1989).

15. *See generally*, Colliton, *supra* note 14.

16. *See generally*, George G. Tyler, *Disallowance of Deductions on Public Policy Grounds*, 20 TAX L. REV. 665, 667 n.10 (1965).

17. *See, e.g.*, I.R.C. §§ 162, 212, & 165 (1994) (allowing deductions for trade or business expenses, costs of earning non-trade or business income, and for losses incurred in trade or business or certain profit-seeking activities); Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30, 33 (1958); Colliton, *supra* note 14, at 273-74.

18. *See, e.g.*, Colliton, *supra* note 14, at 280 (recognizing that Congress could tax gross income should it choose to do so).

19. *See, e.g.*, I.R.C. § 7872 (1994) (taxing imputed income); I.R.C. § 475, 1256 (1994) (taxing unrealized gains and losses). See Murphy v. United States, 992 F.2d 929 (9th Cir. 1993) (upholding section 1256).

ought not stop at the threshold of title 26 of the U.S. Code and magically reappear at title 27. To the contrary, if Congress identifies certain conduct as unacceptable, the tax law should act on that judgment by adding costs to such behavior. In 1983 The United States Supreme Court adopted this point of view when, without benefit of a specific statute and on purely public policy grounds, it denied tax exempt status to a university that engaged in racial discrimination.[20]

Unintended Penalties—This argument rests on the theory that disallowing a deduction for a particular penalty or fine imposes (in the form of higher taxes) an additional punishment not intended by the relevant legislative body. This point is valid only if the legislature intended such payment to be deductible. If that was not the intent, then allowing a deduction for such a payment would lessen the intended sting of the penalty and would be improper.[21] Admittedly the legislature's actual intent is usually unknown,[22] but, when faced with this issue, the Supreme Court assumed that the payments involved (penalties) were not intended to be deductible.[23] Moreover, when the legislature enacts or reenacts a fine or penalty, courts should presume the legislature intended the fine or penalty to be nondeductible since the legislature acted with either actual or constructive knowledge of section 162(f).

Unequal Impact on Equally Guilty Taxpayers—A further argument in opposition to the public policy disallowance is that the rendering of particular payments nondeductible affects taxpayers differently depending, not on their relative culpability, but solely on their marginal tax rates. The following excerpt, which was directed specifically at section 162(f), illustrates the argument:

> The effect of this codification of moral outrage is that the wrongdoer must pay additional fines in the form of higher taxes. Equally guilty taxpayers who are taxed at different marginal rates pay different amounts of tax. Three examples will illustrate this disparity of treatment. Assume that Taxpayers A, B, and C were involved in a profitable illegal enterprise and that a state government agency appropriately fined each $40,000 because of his activities. Under section 162(f) the fine is not deductible to A, B, or C.

20. Bob Jones Univ. v. United States, 461 U.S. 574 (1983).

21. *See* Taggart, *supra* note 6, at 615 n.5.

22. *Id.*

23. Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30, 35-36 (1958). *See infra* notes 57-63 and accompanying text.

> If Taxpayer A is an individual taxed at a marginal rate of 28 percent, his extra tax because of the deduction disallowance is $11,200. His total cost of the penalty is $51,200, consisting of the $40,000 fine plus $11,200 in increased taxes. The economic effect of the deduction denial is the same as if the federal government imposed its own fine on Taxpayer A for the violation at a rate of 28 percent on the amount of the state fine. ...
> By comparison, Taxpayer B committed the same offense and was fined the same $40,000, but is taxed at the marginal rate of 15 percent. He will only face an additional tax of $6,000 as a result of the fine. He is equally guilty, but pays substantially less than Taxpayer A because he is taxed at a lower marginal rate. His total cost of fine plus deduction denial is $46,000.
>
> Finally, a taxpayer who has no taxable income suffers no detriment from the deduction denial. Assume that Taxpayer C committed the same offense and was fined the same amount but is in jail and has no taxable income. The deduction denial causes Taxpayer C no tax detriment. He has no taxable income to offset with the deduction. His total cost is only the $40,000 fine, with no additional tax penalty.[24]

Although the commentator is correct to the extent that the *change* from deductible to nondeductible would affect A, B, and C differently, he is incorrect in asserting that they receive unequal treatment by reason of the mere *existence* of a disallowance rule. In fact, the opposite is true, because making the fines nondeductible actually levels out the unequal treatment that would have resulted if deductions had been allowed. This leveling effect can be seen in the following chart, which shows the net costs to A, B, and C if deductions had been allowed:

	A	*B*	*C*
Fine paid	$40,000	$40,000	$40,000
Value of deduction	*11,200*	*6,000*	*-0-*
Net cost	$28,800	$34,000	$40,000

Clearly, a system that allows such deductions causes inequality of treatment, while a system that eliminates deductibility is corrective. Absent deductions, each of the taxpayers has the same net cost of $40,000. Presumably, the legislature intended this effect by imposing a $40,000 fine. It seems unlikely that the legislature intended the punishment to be $40,000 less a tax savings

24. Colliton, *supra* note 14, at 283-84 (footnote omitted).

depending on the wrongdoer's marginal income tax bracket. (The figures of $51,200 and $46,000 in the excerpt are specious; the commentator did not subtract the deductions of $11,200 and $6,000 before he added them back.)

Disparate Rules for Comparable Expenditures—The argument here is that the process of line-drawing sometimes leads to differing results to taxpayers who are engaged in similar activities. For instance, a taxpayer who pays a punitive imposition to a government will not be able to claim a deduction for such payment by virtue of section 162(f), but one who pays a similar imposition to a non-governmental payee will encounter no similar disallowance of his deduction.[25] Similarly, under section 162(c)(3), a deduction is disallowed for the payment of a kickback, rebate or bribe made in connection with the Medicare or Medicaid programs, but such disallowance provision does not extend to a similar payment made to another government agency, such as the Veterans Administration.[26]

On reflection, this objection has little weight. It is not to having a line, but to where the line is drawn. By its very nature a line is located between points that are not distant from one another. If that were a sufficient reason for rejecting a rule, precious few would enjoy existence.

Part III - The Pre-1969 "Public Policy" Doctrine

Prior to the enactment of the Tax Reform Act of 1969, the courts frequently disallowed, on "public policy" grounds, deductions for expenditures that, in ordinary understanding, seemed to be qualified for deductibility but which, in the courts' view, were inappropriate for the tax system to sanction. While judicially created doctrines sometimes develop well-defined contours and parameters, this doctrine was not well-defined because something as amorphous as public policy was the guiding principle. Rather, disparate and inconsistent outcomes resulted as the "public policy" disallowance doctrine was utilized to challenge the deductibility of, among others, illegal expenditures,[27] expenditures that were not per se illegal but which were part of a larger scheme that was illegal,[28] antitrust treble-damage payments,[29] legal fees incurred in the

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25. *See generally* Catherine M. Del Castillo, *Should Punitive Damages Be Nondeductible? The Expansion of the Public Policy- Doctrine*, 68 TEX. L. REV. 819 (1990).

26. Colliton, *supra* note 14, at 293. It should be noted that other disallowance sections, such as section 162(c)(1), could disallow the deduction for the payment to the Veteran's Administration. I.R.C. § 162(c) (1) (1994). However, those other sections also contain arbitrary lines which could result in equally guilty taxpayers being treated differently. *See* Colliton, *supra* note 14, at 287-92.

27. *See, e.g.*, United States v. Worcester, 190 F. Supp. 548 (D. Mass. 1961); Boyle, Flagg & Seaman, Inc. v. Commissioner, 25 T.C. 43 (1955).

28. *See, e.g.*, Doyle v. Commissioner, 231 F.2d 635 (7th Cir. 1956); McGrath v. Commissioner, 27 T.C. 117 (1956).

29. *See, e.g.*, Rev. Rul. 64-224, 1964-2 C.B. 52.

defense of criminal charges,[30] legal fees incurred in connection with civil matters arising out of criminal cases[31] and fines and penalties paid.[32] One commentator aptly described the confusion in this area as follows:

> It may be received learning that the path of the common law resembles rather the gnarled oak than the clean lines of a Brancusi sculpture. In the field of the public policy exception, however, even the outlines of the trees had been lost to view as the result of unchecked proliferation of obscure distinctions.[33]

Rather than try to make sense out of the myriad of lower court "public policy" cases, it will suffice for present purposes to examine in some detail, in chronological order, the six decisions rendered by the Supreme Court in this area.

Before doing so, however, it may be helpful to dispose of a potentially confusing point that is properly viewed as being purely semantic in character. Evidently due to a reluctance to be perceived as judicial activists by overruling, on "public policy" grounds, a statute that expressly allowed deductions of all "ordinary and necessary" business expenses, some courts clothed their actions in the fiction that the expenditures in question were not "ordinary and necessary," no matter how normal and essential they were to the conduct of the business.

The Supreme Court focused on this point in its 1943 decision in *Commissioner v. Heininger*,[34] the first of the six subject decisions. After

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30. *See, e.g.*, Commissioner v. Tellier, 383 U.S. 687 (1966).

31. *See, e.g.*, Commissioner v. Heininger, 320 U.S. 467 (1943).

32. *See, e.g.*, Universal Atlas Cement Co. v. Commissioner, 9 T.C. 971 (1947), *aff'd*, 171 F.2d 294 (2d Cir. 1948), *cert. denied*, 336 U.S. 962 (1949); Commissioner v. Longhorn Portland Cement Co., 148 F.2d 276 (5th Cir. 1945), *cert. denied*, 326 U.S. 728 (1945).

33. Note, *Business Expenses, Disallowance, and Public Policy: Some Problems of Sanctioning With The Internal Revenue Code*, 72 Yale L.J. 108, 109 (1962) *See also* Tyler, *supra* note 16, at 675 (holding that the lower court pronouncements are an "uncharted sea"). In addition to the six cases discussed in the text, there are three other cases that are sometimes cited in the "public policy" area but which are distinguishable. In both Textile Mills Securities Corp. v. Commissioner, 314 U.S. 326 (1941) and Cammarano v. United States, 358 U.S. 498 (1959), the Supreme Court held that a taxpayer's lobbying expenses were not deductible as ordinary and necessary business expenses. However, the result was based on the existence of long-standing regulations, not on "public policy" grounds. *See* Tyler, *supra* note 16, at 670. In Clarke v. Haberle Crystal Springs Brewing Co., 280 U.S. 384 (1930), the Supreme Court, speaking through Justice Holmes, disallowed a deduction for a loss resulting from the adoption of the prohibition amendment. While this decision has an underlying public policy flavor, it has never been viewed as such; rather, it has been analyzed in terms of the effect of the constitutional amendment. See *Business Expenses*, *supra* note 33, at 109 n.3.

34. 320 U.S. 467 (1943).

remarking that the payments in question plainly "were both 'ordinary and necessary' if those words [are] to be given their commonly accepted meaning," the Court noted that "[t]he Bureau of Internal Revenue, the Board of Tax Appeals, and the Federal courts have from time to time, however, narrowed the generally accepted meaning of the language used in [the then current predecessor of section 162(a)] in order that tax deduction consequences might not frustrate sharply defined national or state policies proscribing particular types of conduct."[35] The Court then endorsed the public policy approach, referred to as "the principle involved." The Court also cited a number of instances in which it had been applied although it was careful not to approve or disapprove any specific application because, as it said, "each case should depend upon its peculiar circumstances."[36]

The validity of the "principle" referred to in *Heininger*, that non-deductible public policy expenditures did not pass the "ordinary and necessary" test of the statute (hereinafter referred to as "the special-meaning-of-necessary approach"), was called into question by the Court's 1952 opinion in *Lilly v. Commissioner*,[37] the second of the six subject decisions. The Court proceeded by "[a]ssuming for the sake of argument that, under some circumstances, business expenditures which are ordinary and necessary in the generally accepted meanings of those words may not be deductible as 'ordinary and necessary' expenses under . . . [the immediate predecessor of section 162(a)] when they 'frustrate sharply defined national or state policies proscribing particular types of conduct'" (which the Court was able to do by finding that "the expenditures now before us do not fall in that class").[38]

It is noteworthy that, although the Court refrained from endorsing the special-meaning-of-necessary approach, it nevertheless attempted to define the test by holding that "[t]he policies frustrated must be national or state policies *evidenced by some governmental declaration of them*."[39]

On March 17, 1958, the Supreme Court issued opinions in three companion cases in the "public policy" disallowance area. *Tank Truck Rentals, Inc. v. Commissioner*,[40] the Court specifically embraced the special-meaning-of-necessary approach. The Court said that "[a] finding of 'necessity' cannot be made . . .if allowance of the deduction would

35. *Id.* at 471, 473.
36. *Id.* at 473.
37. 343 U.S. 90 (1952).
38. *Id.* at 96-97.
39. *Id.* at 97 (emphasis added).
40. 356 U.S. 30 (1958).

frustrate sharply defined national or state policies proscribing particular types of conduct, evidenced by some governmental declaration thereof."[41] Interestingly, the other two opinions, *Hoover Motor Express Co., Inc. v. United States*,[42] and *Commissioner v. Sullivan*,[43] contain no comparable statement.

More pointedly, in *Hoover Motor Express Co.*, the Court's reluctance to declare an otherwise ordinary and necessary expenditure nondeductible solely on public policy grounds is vividly illustrated.[44] The Court went out of its way to create a new definition of "necessary" tailored to *Hoover*'s facts.[45] Applying this definition, the Court held that Hoover's fines were not "necessary" because they were avoidable.[46] However, the Court has since ignored avoidability as a parameter of "necessary."[47]

In any event, the special-meaning-of-necessary approach was put to rest in the last of the six cases. In *Commissioner v. Tellier*,[48] the Government had conceded that the expenditures in question were both "ordinary" and "necessary" *within the meaning of section 162(a)*.[49] But that was not the end of the matter. As reported by the Court, "[t]he Commissioner and the Tax Court determined, however, that even though the expenditures meet the literal requirements of § 162(a), their deduction must nevertheless be disallowed on the ground of public policy."[50] Significantly, the Court entertained the argument, despite the concession of statutory ordinariness and necessity.[51] Ultimately, the Court did hold in favor of the taxpayer, but only because it concluded that "no such 'public policy' exception to the plain provisions of § 162(a) is warranted *in the circumstances presented by this case*."[52] Thus, despite the demise of the special-meaning-of-necessary approach as a matter of language, the identical underlying issue remained: did "public policy" require disallowance of the claimed deduction?

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41. *Id.* at 33-34.
42. 356 U.S. 38 (1958).
43. 356 U.S. 27 (1958).
44. *Hoover Motor Express Co.*, 356 U.S. at 38.
45. *Id.* at 39.
46. *Id. See* Tyler, *supra* note 16, at 666 n.3.
47. *See* Arthur W. Andrews, *Rule 11 and the Nondeductibility of Monetary Sanctions Imposed Upon Attorneys*, 32 Ariz. L. Rev. 279, 306 (1990). *See also*, Mason and Dixon Lines, Inc. v. United States, 708 F.2d 1043, 1045 (6th Cir. 1983).
48. 383 U.S. 687 (1966).
49. *Id.* at 689.
50. *Id.* at 690.
51. *Id.* at 690-91.
52. *Id.* at 691 (emphasis added).

We now turn to the six cases in which the Supreme Court addressed that issue.

Commissioner v. Heininger.[53] In this case, the taxpayer, a dentist, sold false teeth through the mail.[54] The Post Office thought the taxpayer's circulars and advertisements were false and misleading. A hearing was held at which the taxpayer, with counsel, vigorously defended himself. The hearing officer found against the taxpayer and issued a fraud order prohibiting the local postmaster from delivering mail to the taxpayer and from cashing any postal money orders payable to the taxpayer.[55] Fearing that this order would destroy his business, the taxpayer promptly sought and obtained an injunction in the local federal district court against enforcement of the order.[56] On appeal, the court of appeals reversed and dissolved the injunction.[57] At issue was the deductibility, as an ordinary and necessary business expense, of the taxpayer's legal fees at the Post Office hearing and in the courts.[58] After holding that contesting the destruction of his business was most appropriate and, therefore, within the usual ambit of ordinary and necessary business expenses, the Supreme Court held there was no public policy objection to the deduction.[59] The only relevant public policy, said the Court, was to protect the public from fraudulent practices committed through the mails. This policy was intended neither to punish violators nor to prevent an accused from defending himself against such allegations. The Court viewed the legal fees as having only a remote relation to the underlying illegal act. This remote relationship was not enough to make them nondeductible.[60]

Lilly v. Commissioner.[61] In this case, the taxpayers were in the optical business. Pursuant to established and widespread industry practice, they had made payments (equal to one-third of the amounts received by them from purchasers of eyeglasses) to the doctors who had prescribed the eyeglasses and recommended purchase from them.[62] Although the payments were not illegal when made,[63] the Board of Tax

53. 320 U.S. 467 (1943).
54. *Id.* at 469.
55. *Id.*
56. *Id.*
57. *Id.*
58. *Heininger*, 320 U.S. at 470.
59. *Id.* at 471.
60. *Id.* at 474-75.
61. 343 U.S. 90 (1952).
62. *Id.* at 92.
63. From the opinion it appears that after the years in issue in the case several states, including North Carolina, passed legislation making such payments illegal. *Id.* at 97.

Appeals and the Fourth Circuit upheld the Commissioner's disallowance of these payments on the ground that they violated public policy.[64] Noting that the payments were not illegal and that the court was not voicing approval of the business ethics or the public policy involved in making such payments, the Supreme Court reversed and held the payments to be deductible.[65] The payments were found to be ordinary and necessary business expenses because such payments "were normal, usual and customary in size and character"[66] and essential for the continued existence of the business. Based on *Heininger*, the Court declared that ordinary and necessary business expenses would be nondeductible only when disallowance was necessary to prevent the frustration of sharply defined national or state policies that proscribe particular types of conduct.[67] According to the Court, such policies had to be evidenced by some governmental declaration of them[68] and during the years in issue there was no such declaration.

Tank Truck Rentals, Inc. v. Commissioner.[69] In *Tank Truck*, which was one of three companion cases decided by the Supreme Court on the same day, the issue focused on the deductibility of some $41,000 in fines that were incurred by the taxpayer for over 700 intentional and 28 innocent violations of Pennsylvania's maximum weight laws for trucks.[70] The taxpayer, a Pennsylvania corporation, trucked bulk liquids in Pennsylvania and five surrounding states, each of which imposed maximum weight limits for motor vehicles operating on its highways.[71] Pennsylvania restricted truckers to 45,000 pounds while the other states allowed a maximum weight of 60,000 pounds. Due to competitive factors and the nature of the bulk liquid trucking business, it would have been impossible for any industry member to survive economically if it complied with Pennsylvania's maximum weight restrictions. Consequently, the taxpayer, like every other member of the industry, deliberately operated its trucks overweight in Pennsylvania and paid the resultant fines whenever it was caught.[72]

In upholding the lower courts' disallowance of any deduction for the fines, the Supreme Court started by acknowledging that the income tax

64. *Id.* at 92.
65. Id. at 94.
66. *Lilly*, 343 U.S. at 96.
67. *Id.*
68. *Id.* at 97.
69. 356 U.S. 30 (1958).
70. *Id.* at 31.
71. *Id. at 32.*
72. *Id.* at 33.

laws were intended to tax only net income, not gross income (section 23(a)(1)(A) of the 1939 Code, like its successor provision, current Code section 162(a), allowed a deduction for "[a]ll the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business").[73] Nevertheless, the Court held that the payment of the fines gave rise to no deductions. Borrowing from the reasoning in *Heininger* and *Lilly*, the Court noted that "[a]llowance of the deduction would frustrate sharply defined national or state policies proscribing particular types of conduct, evidenced by some governmental declaration thereof."[74]

Here, a penal statute was enacted to protect highways from damage and to insure the safety of all persons using them. If the deduction in issue were allowed, said the Court, it would "encourage continued violations of state law by increasing the odds in favor of noncompliance."[75] The Court further stated that such a deduction "could only tend to destroy the effectiveness of the State's maximum weight laws.[76]

The Supreme Court cautioned, however, that the public policy disallowance doctrine should not be applied in an absolute sense, but that each case must turn on its own facts. "The test of nondeductibility always is the severity and immediacy of the frustration resulting from allowance of the deduction."[77] Such a "flexible" standard was necessary, the Court said, in order "to accommodate both the congressional intent to tax only net income, and the presumption against congressional intent to encourage violation of declared public policy."[78]

Lest too much be read into the "encourage" language, it should be noted that the Court did not limit its holding to intentional violations. Rather, it held that, "since the maximum weight statutes make no distinction between innocent and willful violators," the fines innocently incurred by the taxpayer were nondeductible as well.[79]

As to what sort of expenditures should be denied deductibility, the Court described two categories, one considered to be the clearest instance and one considered to be less clear.

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73. *Id.*
74. *Tank Truck Rentals*, 356 U.S. at 33-34.
75. *Id.* at 36.
76. *Id.*
77. *Id.* at 35.
78. *Id.*
79. *Tank Truck Rentals*, 356 U.S. at 36.

> Certainly the frustration of state policy is most complete and direct when the expenditure for which deduction is sought is itself prohibited by statute. If the expenditure is not itself an illegal act, but rather the payment of a penalty imposed by the State because of such an act, ... the frustration attendant upon deduction would be only slightly less remote, and would clearly fall within the line of disallowance.[80]

Commissioner v. Sullivan.[81] In this case, the Supreme Court encountered the very situation it had described in *Tank Truck* as the most clear candidate for nondeductibility under the "public policy" disallowance doctrine. Under applicable Illinois law, not only was conducting a gambling operation illegal, but the mere payment of wages and rent in connection with such an operation was specifically forbidden.[82] These types of expenditures were at issue in *Sullivan*. The Court undoubtedly had before it a case in which, in the words of the simultaneous *Tank Truck* opinion, "the expenditure for which deduction is sought is itself prohibited by statute."[83] Yet, amazingly, the Court allowed the claimed deductions.

> The amounts paid as wages to employees and to the landlord as rent are "ordinary and necessary expenses" in the accepted meaning of the words. That is enough to permit the deduction, unless it is clear the allowance is a device to avoid the consequence of violations of a law, as in *Hoover Motor Express* . . . and *Tank Truck* . . . , or otherwise contravenes the federal policy expressed in a statute or regulation . . . "[84]

In support of its conclusion, the Court stated as follows:

> At times the policy to disallow expenses in connection with certain condemned activities is clear. . . . Any inference of disapproval of these [rent and wage] expenses as deductions is absent here. The Regulations, indeed, point the other way, for they make the federal excise tax on wagers deductible as an ordinary and necessary expense. The policy that allows as a deduction the tax paid to conduct the business seems sufficiently hospitable to allow

80. *Id.* at 35-36.
81. 356 U.S. 27 (1958).
82. *Id.* at 28.
83. *Tank Truck Rentals*, 356 U.S. at 35.
84. Sullivan, 356 U.S. at 29.

> the normal deductions of the rent and wages necessary to operate it. We said in *Heininger* that the "fact that an expenditure bears a remote relation to an illegal act" does not make it nondeductible. If we enforce as federal policy the rule espoused by the Commissioner in this case, we would come close to making this type of business taxable on the basis of its gross receipts, while all other businesses would be taxable on the basis of net income. If that choice is to be made, Congress should do it.[85]

Whether or not one agrees with *Sullivan*, it is certainly difficult, if not impossible, to reconcile its holding with the rationale that was expressed in Tank Truck.

Hoover Motor Express Co. v. United States.[86] This third case decided on the same day as *Tank Truck* and *Sullivan*, involved overweight fines similar to those involved in *Tank Truck* except that none of the violations were intentional.[87] First, the Court held that the taxpayer's payments gave rise to no deduction inasmuch as such expenditures were not "necessary" within the meaning of the statute, not on "public policy" grounds, but because the fines could have been avoided with little effort.[88] In fact, the Court seemed to go out of its way to create this new definition of "necessary" tailored to the facts of the case before it.[89] Second, it followed *Tank Truck* in holding that allowing a deduction for a fine paid for even an inadvertent violation of a state's maximum weight law would frustrate the state's public policy where that law does not distinguish between intentional and unintentional infractions.[90]

Commissioner v. Tellier.[91] In this 1966 case, the last section 162(a) "public policy" cases[92] to come before it, the Court was faced with the

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85. *Id.* at 28-29.

86. 356 U.S. 38 (1958).

87. *Id.*

88. Id. at 40. Here the taxpayer incurred the fines largely from violations of the axle weight limits, rather than a violation of over-all truck weight limit. Normally, these violations occurred because the freight load shifted during transit. *Id.* Such violations could have been prevented by tying down the load or compartmentalizing the truck. *Id.* Other violations occurred when the taxpayer accepted the weight stated on the bill of lading in small communities having no weighing facilities. These violations could have been prevented by carrying a scale in the trucks. *Id.*

89. As pointed out above, the Court has since ignored avoidability as a parameter of "necessary." *See supra* notes 45 and 46 and accompanying text.

90. *Sullivan,* 356 U.S. at 40.

91. 383 U.S. 687 (1966).

92. In 1983 the Supreme Court decided Bob Jones Univ. v. United States, 461 U.S. 574 (1983), in which it applied public policy to disallow tax exempt status to educational institutions

need to reconcile these three companion cases together with *Heininger* and *Lilly*.

In *Tellier*, the issue was the deductibility under section 162(a) of the cost incurred by the taxpayer in the unsuccessful defense of a criminal prosecution. The taxpayer, who had been engaged in the business of underwriting, selling and purchasing securities for resale to the public, was charged with committing securities and mail fraud, charges of which he was ultimately convicted.[93] In the course of defending against the charges, the taxpayer paid almost $23,000 in legal expenses, the deductibility of which was challenged.[94]

In upholding the deductibility of the legal expenses, the Court first considered whether the expenses fit within the usual ambit of ordinary and necessary business expenses under section 162(a).[95] Notwithstanding that the Government had conceded the point, the Court discussed the meanings of "ordinary" and "necessary" as used in the statute, and concluded that it was "clear that the respondent's legal fees were deductible under § 162(a) if the provisions of that section are to be given their normal effect in this case."[96]

The Court then examined the Government's argument "that even though the expenditures meet the literal requirements of § 162(a), their deduction must nevertheless be disallowed on the ground of public policy."[97] Rejecting that contention, the Court explained that "the federal income tax is a tax on net income, not a sanction against wrongdoing" and that illegal income is taxed the same as lawful income.[98] With only a few limited and well-defined exceptions, the basic rule for deductions is the same.

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that were guilty of racial discrimination and to also disallow a section 170 charitable deduction for contributions to such institutions. However, *Bob Jones* did not involve the section 162 "ordinary and necessary" business expense deductions.

93. *Tellier*, 383 U.S. at 35.

94. *Id.*

95. In its discussion of "ordinary," the Supreme Court seemed to changed its focus from prior cases. Here, the Court stated simply that the principal function of the term "ordinary" was to distinguish expenses from capital expenditures. *Id.* at 689-90. However, in the past, the Court had defined "ordinary" as customary or usual to the group of which the taxpayer was a member, as initially pronounced in Welch v. Helvering, 290 U.S. 111 (1933), and Deputy v. duPont, 308 U.S. 488 (1940). *See, e.g.*, Commissioner v. heininger, 320 U.S. 467, 472 (1943).

See generally JOHN E. DAVIDIAN & JACOB L. TODRES, REDUCING PERSONAL INCOME TAXES: A GUIDE TO DEDUCTIONS AND CREDITS §§ 2.03 and 2.04 (Law Journal Seminars Press, 1992).

96. *Tellier*, 383 U.S. at 690.

97. *Id.*

98. *Id.* at 691.

To elaborate on this principle, the Court pointed out that "[d]uring the Senate debate in 1913 on the bill that became the first modern income tax law, amendments were rejected that would have limited deductions for losses to those incurred in a 'legitimate' or 'lawful' trade or business."[99] The Court also quoted the following portion of the floor statement of Senator Williams, who was in charge of the bill:

> [T]he object of this bill is to tax a man's net income; that is to say, what he has at the end of the year after deducting from his receipts his expenditures or losses. It is not to reform men's moral characters; that is not the object of the bill at all. The tax is not levied for the purpose of restraining people from betting on horse races or upon 'futures,' but the tax is framed for the purpose of making a man pay upon his net income, his actual profit during the year. The law does not care where he got it from, so far as the tax is concerned, although the law may very properly care in another way.[100]

The Court further noted that this principle was reflected in its *Sullivan*,[101] *Lilly*[102] and *Heininger*[103] opinions.

The Court then continued that, absent specific legislation or a long-standing regulation requiring disallowance, it had only "countenanced" exceptions to the basic rule of deductibility in extremely limited circumstances. Citing *Heininger*,[104] *Lilly*,[105] and *Tank Truck*,[106] the Court explained:

> Only where the allowance of a deduction would "frustrate sharply defined national or state policies proscribing particular forms of conduct" have we upheld its disallowance. Further, the "policies frustrated must be national or state policies evidenced by some *governmental* declaration of them." Finally, the "test of nondeductibility always is the severity and immediacy of the frustration resulting from allowance of the deduction."[107]

As illustrations of situations in which judicial disallowance was justified, the Court cited *Tank Truck* and *Hoover Motor Express*, and said, "we upheld the disallowance of deductions claimed by taxpayers for

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99. *Id.*
100. 50 Cong. Rec. 3849 (1913) *quoted at Tellier*, 383 U.S. at 691-92.
101. Commissioner v. Sullivan, 356 U.S. 27 (1958).
102. Lilly v. Commissioner, 343 U.S. 27 (1958).
103. Commissioner v. Heininger, 320 U.S. 467 (1943).
104. *Id.*
105. Lilly v. Commissioner, 343 U.S. 27 (1958).
106. Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30 (1958).
107. *Tellier*, 383 U.S. at 694 (citations omitted).

fines and penalties imposed upon them for violating state penal statutes; to allow a deduction in those circumstances would have directly and substantially diluted the actual punishment imposed."[108]

Turning to the situation before it, the Court found that Mr. Tellier's legal expenses were "far outside that sharply limited and carefully defined category" of expenditures that ought to be judicially rendered nondeductible on public policy grounds.[109] "No public policy is offended," it said, "when a man faced with serious criminal charges employs a lawyer to help in his defense."[110] Rather, it continued, "[i]n an adversary system of criminal justice, it is a basic [sic] of our public policy that a defendant in a criminal case have counsel to represent him."[111] To disallow the deduction because of a conviction, it concluded, would be adding to the prescribed punishment "an additional financial burden that Congress has neither expressly nor implicitly directed."[112] "We decline," said the Court, "to distort the income tax laws to serve a purpose for which they were neither intended nor designed by Congress."[113]

Part IV - Section 162(f)

The law has changed in a vital respect since *Tellier* was decided. With regard to ordinary and necessary business expenses, Congress has replaced the "public policy" disallowance doctrine with specific rules that preclude a deduction of certain kinds of expenditures that otherwise fit within section 162(a). One of these disallowance rules is found in section 162(f). In this part, a number of issues that arise under 162(f) will be examined, including: (a) whether civil, as well as criminal, exactions are covered; (b) what is meant by "fine" and "penalty;" (c) what penalties are "similar" to fines; (d) whether payments to third parties are covered; (e) what is a "law" within the meaning of the section; and (f) whether certain indirect exactions are covered.

A. Civil versus Criminal

The language of Section 162(f), "[n]o deduction shall be allowed under . . . [section 162(a)] for any fine or similar penalty paid to a government for the violation of any law" is clearly broad enough to

108. *Id.*
109. *Id.*
110. *Id.*
111. *Id.*
112. *Tellier*, 383 U.S. at 694-95.
113. *Id.* (citations omitted).

encompass civil, as well as criminal, fines and penalties.[114] The current Treasury Regulations so provide[115] and have consistently done so since the initial proposed regulations issued in May, 1971.[116] A problem was created, however, by the following language in the 1969 Senate Report which may be read as indicating that section 162(f) was intended to apply to only criminal fines and penalties:

> This provision [section 162(f)] is to apply in any case in which the taxpayer is required to pay a fine because he is convicted of a crime (felony or misdemeanor) in a full criminal proceeding in an appropriate court. This represents a codification of the general court position in this respect.[117]

The difficulties with a criminal-only application of Section 162(f) were immediately noted,[118] and in the course of amending Section 162(c) in the Revenue Act of 1971[119] the Senate Finance Committee set forth its earlier intent with respect to Section 162(f) in much more detail.

> In connection with the proposed regulations relating to the disallowance of deductions for fines and similar penalties (section 162(f)), questions have been raised as to whether the provision applies only to criminal "penalties" or also to civil penalties as well. In approving the provisions dealing with fines and similar penalties in 1969, it was the intention of the committee to disallow deductions for payments of sanctions which are imposed under civil statutes but which in general terms serve the same purpose as a fine exacted under a criminal statute. The provision was intended to apply, for example, to penalties provided for under the Internal Revenue Code in the form of assessable penalties (subchapter B of chapter 68) as well as to additions to tax under the internal revenue laws (subchapter A of chapter 68) in those cases where the government has the fraud burden of proof (i.e., proof by clear and convincing evidence). It was also intended that

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114. I.R.C. § 162 (f) (1994).

115. Treas. Reg. § 1.162-21(b) provides:

(b) Definition. (i) For purposes of this section a fine or similar penalty includes an amount --

* * *

(ii) Paid as a civil penalty. . .

116. 36 Fed. Reg. 9637-9640 (proposed May 27, 1971).

117. S. Rep., *supra* note 4, 1969-3 C.B. at 597.

118. *See* Taggart, *supra* note 6.

119. Pub. L. No. 92-178, 85 Stat. 497 (1971).

> this rule should apply to similar type payments under the laws of a State or other jurisdiction.[120]

However, because post-enactment commentary is not necessarily controlling,[121] the problem persists.

For the next several years, the cases by-and-large ignored the state of the legislative record and simply held that civil penalties were within the ambit of section 162(f).[122] One case noted the issue, but decided not to resolve it.[123] Finally, the Claims Court in Adolf Meller Co. v. United States[124] and the Tax Court in Southern Pacific Transportation Co. v. Commissioner[125] dealt with the issue and both concluded that the 1971 Committee Report accurately reflected Congress' intent in enacting section 162(f). Both courts acknowledged that legislative history subsequent to enactment of a statute is ordinarily entitled to very little weight.[126] Nonetheless, they were convinced that Congress intended to codify the previous judicially developed public policy doctrine by enacting section 162(f), and that the doctrine applied to both civil and criminal sanctions.[127] Therefore, according to the courts, if the first

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120. S. Rep. No. 437, 92d Cong. 1st Sess. (1971), *reprinted in* 1972-1 C.B. 559, 600.

121. *See, e.g.*, Gwarthey of Smithfield, Ltd. v. Chesapeake Bay Foundations, Inc., et al., 484 U.S. 49, 63 (1987) ("Conclusions of 99th Congress, however, are hardly probative of the intent of the 92d Congress."); Haynes v. United States, 390 U.S. 85, 87 n. 4 (1968) (holding that views of subsequent Congress provide no controlling basis from which to infer purpose of earlier Congress); Rain Water v. United States 356 U.S. 590, 593 (1957) (stating that amendment merely expression of Congress' interpretation as such, subject to "little if any significance"); United States v. Price, 361 U.S. 304, 313 (1959) ("[T]he views of a subsequent congress form a hazardous basis for inferring the intent of an earlier one."). *See also* Adolf Meller Co. v. United States, 600 F.2d 1360, 1363 (Ct. Cl. 1979); Estate of Stoll v. Commissioner, 38 T.C. 223, 247 (1962).

122. *See, e.g.*, May v. Commissioner, 65 T.C. 1114 (1976) (Code Section 6651(a)(2) addition to Tax); Uhlenbrock v. Commissioner, 67 T.C. 818 (1977) (Code Section 6651(a) addition to Tax) This case refered to the 1971 Senate Finance Committee report, but for a different issue. *See id.*, 67 T.C. at 822 n.5.

In Tucker v. Commissioner, 69 T.C. 675, 679 n.4 (1978), the Court noted the conflict created by the legislative history, but left it unresolved.

123. Tucker, 69 T.C. at 679 n.4 (noting the conflict created by the legislative history, but leaving if unresolved).

124. 600 F.2d 1360 (Ct. Cl. 1979).

125. 75 T.C. 497, 643 (1980).

126. *Adolf Meller Co.*, 600 F.2d at 1363; *Southern Pac. Transp. Co.*, 75 T.C. at 652 n.177. While the Claims Court said such subsequent legislative history is entitled to "very limited weight," the Tax Court stated it as "not necessarily controlling," which is presumably a less negative characterization. *Adolf Meller Co.*, 600 F.2d at 1363.

127. *See also*, *Adolf Meller Co.*, 606 F.2d at 1363; *Southern Pac.Transp. Co.*, 75 T.C. at 652-54; A.D. Juilliard & Co. Inc. v. Johnson, 259 F.2d 837, 844 (2d Cir. 1959), *cert. denied*, 359 U.S. 942 (1959) (holding that civil treble damages for violation of Emergency Price Control Act); McGraw-Edison Co. v. United States, 300 F.2d 453 (Ct. Cl. 1962) (dealing with penalty for employing child labor); Atzingen-Whitehouse Dairy, Inc. v. Commissioner, 36 T.C. 173, 183

sentence of the 1969 Committee Report quoted above limited section 162(f) to criminal fines and penalties, it was inconsistent with the next sentence that said "[t]his represents a codification of the general court position in this respect,"[128] and, at the very least, needed clarification. In the courts' view, the 1971 Committee Report was consistent with the pre-statute cases and therefore accurately clarified and reflected Congress' intent in 1969.

Giving section 162(f) a criminal-only interpretation would also have been inconsistent with the statutory language. As the courts pointed out, section 162(f) did not explicitly limit its application to criminal fines and penalties.[129] Where such limitations were intended, Congress clearly spelled them out as in section 162(g) and 162(c)(2) as originally enacted.[130]

Also, as noted in *Adolf Meller*, Congress amended section 162(c), one of the companion provisions to section 162(f).[131] In doing so, Congress specifically focused on the proposed regulation under section 162(f). This process essentually represents a reenactment by the 1971 Congress of section 162(f) thereby giving the Committe Report more weight.[132] Moreover, as pointed out in *True v. United States*,[133] the 1971 Senate Finance Committee had virtually the same membership as the 1969 Committee, inasmuch as only two of its sixteen members had changed.[134]

Today, it is widely accepted that section 162(f) applies to civil and criminal and penalties.[135] The more current issue is to determine what types of civil penalties are within the "any fine or similar penalty" language of section 162(f).

(1961) (dealing with payment for violation of New Jersey's minimum milk price provisions). Criminal fines and penalties *a fortiori* were within section 162(f) since Congress was codifying the judicial public policy doctrine exemplified by Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30 (1958) which involved criminal fines. *See supra* notes 57-63 and accompanying text.

128. S. Rep. No. 552, 91st Cong. 1st. Sess. 274 (1969), *reprinted in* 1969-3 C.B. 423 at 597.

129. *See, e.g.*, Adolf Meller Co. v. United States, 600 F.2d 1360, 1363 (Ct. Cl. 1979); Southern Pac. Transp. Co. v. Commissioner, 75 T.C. 497, 651 (1980).

130. *See Adolf Meller Co.*, 600 F.2d at 1363. *See also* Taggart, *supra* note 6 at 622-23.

131. *Adolf Meller Co.*, 600 F.2d at 1363.

132. *Id.*

133. 894 F.2d 1197 (10th Cir. 1990).

134. *Id.* at 1204 n.15.

135. *See, e.g.*, True v. United States, 894 F.2d 1197 (10th Cir. 1990); Colt Indus., Inc. v. United States, 880 F.2d 1311 (Fed. Cir. 1989). *Also see* the cases cited in the next section of the text.

B. ". . .Any Fine or Similar Penalty. . ."

Before analyzing which civil exactions are within the phrase "any fine or similar penalty," it is interesting to note that none of the tax cases in this area have felt compelled to define the basic terms "fine" and "penalty." In *Southern Pacific Transportation Co. v. Commissioner,*[136] the Tax Court declined to accept the taxpayer's proposed definition that a fine is an exaction due to a violation of a criminal statute while a penalty is one imposed on account of a civil violation.[137] The court stated it was not convinced that the proposed distinction was appropriate, pointing out that a recent case had not differentiated the terms in the suggested manner, and that the regulations also made no such distinction.[138] The court noted, however, that the Senate Report for the Revenue Act of 1971 impliedly supported the proposed definition.[139] In a footnote, the court merely cited the dictionary definition of the terms:

> A penalty has been defined as "the suffering *** which is annexed by law or judicial decision to the commission of a crime or public offense ***; a sum of money made recoverable in a civil action by the state *** for the less serious offenses not mala in se"; whereas a fine is "a sum formerly paid as compensation or for exemption from punishment but now imposed as punishment for a crime -- distinguished from *forfeiture* and *penalty.*"[140]

A recent case added that both definitions include involuntary payments,[141] and other cases refused to adopt the Supreme Court's determination of what constitutes a "penalty" for discharge in bankruptcy purposes.[142]

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136. 75 T.C. 497 (1980).

137. *Southern Pac. Transp. Co.*, 75 T.C. at 650.

138. *Id.* The recent case referred to was Middle Atl. Distrib., Inc. v. Commissioners, 72 T.C. 1136, 1143 (1979), the other leading case in this area. Interestingly, the part of the Middle Atlantic opinion cited did not attempt to define "fine" or "penalty," but merely distinguished between those civil penalties that were within section 162(f) (and therefore not deductible) and those that were outside of section 162(f) (and therefore deductible). For purposes of the case, however, the Tax Court did accept the taxpayer's proposed definition because the Commissioner never objected to it.

139. *Id.* at 650-51 n.175.

140. *Id. quoting* MERRIAN WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY (1971).

141. Allied-Signal, Inc. v. Commissioner, 63 T.C.M. 2672, 2681 (1992) (noting that "penalty" and "fine" both involve involuntary payments).

142. *See* Misbin v. Commissioner, 50 T.L.M. 151 (1985); Patton v. Commissioner, 71 T.C. 389 (1978). Both cases rejected the Supreme Court's definition of "penalty" for discharge in bankruptcy purposes.

1. Punitive-versus-Remedial

The starting point for determining the scope of the phrase "any fine or similar penalty," is the statutory language itself. The language of section 162(f) suggests that fines are a broader category than penalties. While all fines are included within the section 162(f) disallowance, the same is not true for penalties; rather, only those penalties which are "similar" to fines are included. Unfortunately, neither the statutory language nor the regulations indicate the meaning of "similar."[143]

The leading case to address this issue is *Southern Pacific Transportation Co. v. Commissioner.*[144] In this case the taxpayer, a railroad, incurred civil penalties for violating the Safety Appliance Act[145] and the Twenty-Eight Hour Act.[146] The Safety Appliance Act requires railroads engaged in interstate commerce to equip trains with

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143. Treas. Reg. § 1.162-21 (b) provides:

(b) Definition.

(1) For purposes of this section a fine or similar penalty includes an amount -

(i) Paid pursuant to conviction or a plea of guilty or nolo contendere for a crime (felony or misdemeanor) in a criminal proceeding;

(ii) Paid as a civil penalty imposed by Federal, State, or local law, including additions to tax and additional amounts and assessable penalties imposed by chapter 68 of the Internal Revenue Code of 1954;

(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.

(2) The amount of a fine or penalty does not include legal fees and related expenses paid or incurred in the defense of a prosecution or civil action arising from a violation of the law imposing the fine or civil penalty, nor court costs assessed against the taxpayer, or stenographic and printing charges. Compensatory damages (including damages under section 4A of the Clayton Act (15 U.S.C. 15a), as amended paid to a government do not constitute a fine or penalty.

144. 75 T.C. 497 (1980). *Southern Pacific* was actually the second Tax Court case to focus on what a "similar" penalty means. The first was Middle Atl. Distrib., Inc. v. Commissioner, 72 T.C. 1136 (1979), which was decided 15 months earlier. While *Middle Atlantic* is sometimes referred to as the leading case, (*see, e.g.*, supra note 48), *Southern Pacific* deals with the issue in much more detail than *Middle Atlantic* does. In addition, it seems to this author that *Southern Pacific* is cited more often on this issue than *Middle Atlantic*. In any event, the two cases arrive at the same result.

145. 45 U.S.C. §§ 1-16 (1994).

146. 45 U.S.C. §§ 71-74 (1994).

specified operating and safety equipment and to keep such equipment in good operating condition.[147] The Twenty-Eight Hour Act provides that animals being transported in interstate commerce cannot be confined for a period in excess of twenty-eight hours (or longer under certain circumstances) without unloading the animals into pens for at least five hours for rest, water and feeding.[148]

The court found that the taxpayer used all due care in attempting to comply with both laws and that the violations were unavoidable.[149] The court also found that similar violations are commonly incurred by the railroad industry in general and that they constituted ordinary and necessary expenses of engaging in the railroad business.[150] The taxpayer argued that these penalties were not disallowed by section 162(f) because they were not "similar" to fines imposed by criminal statutes.[151]

The Tax Court agreed that the literal language of section 162(f) implies that there are some penalties that do not fall within the scope of section 162(f), and that the word "similar" in the statute must be given some effect.[152] Since the wording of the statute does not make the meaning altogether clear, and, since the regulations make no distinction between penalties based upon the word "similar," the court looked to the legislative history to discover the meaning intended by Congress.[153] As a starting point, the Tax Court noted that the 1969 Senate Report was both "cryptic and somewhat ambiguous."[154] However, it recognized that Congress was attempting to codify the pre-1969 general judicial position on the deductibility of fines and penalties.[155] Two years later, in connection with the enactment of the Revenue Act of 1971, the Senate Finance Committee clarified its intentions from 1969.[156] It did not intend to limit the disallowance of section 162(f) to criminal penalties. Rather, its "intent was to 'disallow deductions for payments of sanctions which are imposed under civil statutes but which in general terms serve the same purpose as a fine exacted under a criminal statute.'"[157] The

147. *Southern Pac. Transp.*, 75 T.C. at 647.

148. *Id.* at 647

149. *Id.* at 648.

150. *Id.*

151. *Id.* at 650-51. The taxpayer also argued that section 1.162-21(b)(1)(ii) of the regulations was invalid because it disallowed a deduction for all civil penalties without differentiating "similar" from non-similar ones. *Id.*

152. *Southern Pac. Transp.* 75 T.C. at 651.

153. *Id.*

154. *Id.*

155. *Id.*

156. *Id.*

157. Southern Pac. Transp. Co., 875 T.C. at 651-52, *quoting* S. Rep. No. 92-437, 92d Cong.

court went on to quote the following paragraph from the 1971 Senate Finance Committee Report:

> On the other hand, it was not intended that deductions be denied in the case of sanctions imposed to encourage prompt compliance with requirements of law. Thus, many jurisdictions impose "penalties" to encourage prompt compliance with filing or other requirements which are really more in the nature of late filing charges or interest charges than they are fines. It was not intended that this type of sanction be disallowed under the 1969 action. Basically, in this area, the committee did not intend to liberalize the law in the case of fines and penalties.[158]

In summarizing the legislative history and its understanding of section 162(f), the Tax Court stated:

> Thus, Congress, by use of the word "similar," was not intending to distinguish between criminal and civil sanctions, but rather was intending to make a distinction between different types of civil penalties. If a civil penalty is imposed for purposes of enforcing the law and as punishment for the violation thereof, its purpose is the same as a fine exacted under a criminal statute and it is "similar" to a fine. However, if the civil penalty is imposed to encourage prompt compliance with a requirement of the law, or as a remedial measure to compensate another party for expenses incurred as a result of the violation, it does not serve the same purpose as a criminal fine and is not "similar" to a fine within the meaning of section 162(f)....[159]

Applying these standards to the facts in *Southern Pacific,* the Tax Court held that the civil penalties incurred by the taxpayer were within section 162(f) and were, thus, not deductible.[160] The purpose of the Safety Appliance Act and Twenty-Eight Hour Act penalties was to enforce the law and punish violations thereof. The taxpayer's attempt to distinguish these penalties from criminal fines on the ground that the taxpayer's actions were not inherently reprehensible conduct, as criminal conduct normally is, was not accepted by the court. The appropriate

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1st Sess. (1971), *reprinted in* 1972-3 C.B. at 600.

158. *Id.* at 652, *quoting* S. Rep. No. 437, 92d Cong. 1st Sess. (1971), *reprinted in* 3 C.B. at 652.

159. *Id.*

160. *Id.*

consideration is not the type of conduct that gives rise to the penalties, but the purpose that the statutory penalties serve.[161]

With the exception of one case,[162] and despite some minor variations in the precise formulation used,[163] the punitive-versus-remedial distinction set forth in *Southern Pacific* has been followed by the Tax Court,[164] other courts[165] and the Internal Revenue Service.[166] This approach also resembles the approach taken in the pre-1969 public policy cases.[167]

Before analyzing some of the issues that arise in applying *Southern Pacific*'s punitive-versus-remedial dichotomy with respect to civil penalties, it is important to resolve one of the loose ends raised, but not resolved, by the decision. In *Southern Pacific* the taxpayer challenged the validity of section 1.162-21(b)(l)(ii) of the regulations, which defines

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161. *Id.*

162. Colt Indus., Inc. v. United States, 880 F.2d 1311 (Fed. Cir. 1989). Despite all of the cases to the contrary cited *infra* notes 126-27, the Federal Circuit read the legislative history exactly the opposite way:

> The [1971 Senate Finance] committee's comments were to clarify that civil penalties, as well as criminal, are within the ambit of section 162(f), not an effort to distinguish between deductible and nondeductible civil penalties. . . . To the extent that it recognized an exception to the nondeductibility of civil penalties, the committee said only that the deduction of 'late filing charges or interest charges' imposed 'to encourage prompt compliance with filing or other requirements' is not barred.

Id. at 1313. *Colt* has been criticized for a number of reasons. *See* Edwin G. Torres, Note, *Deductions of Civil Penalties Under Section 162(f): Colt Industries, Inc. v. United States*, 43 TAX LAW 823, 828-35 (1990).

163. *See, e.g.*, Stephens v. Commissioner, 905 F.2d 667, 672 (2d Cir. 1990) (discussing punitive versus compensatory); True v. United States, 894 F.2d 1197, 1204 (10th Cir. 1990) (referring to retributive versus compensatory or remedial). *See also* Andrews, *supra* note 48, at 315 n.307.

164. *See, e.g*, Allied-Signal, Inc. v. Commissioner, 63 T.C. 2672, 2682 (1992); Waldman v. Commissioner, 88 T.C. 1384, 1387 (1987); Henson Robinson Co. v. Commissioner, 48 T.C.M. 508, 509 (1984); Huff v. Commissioner, 80 T.C. 804, 821 (1983).

165. *See, e.g.*, Stephens v . Commissioner, 905 F.2d 667, 672 (2d Cir. 1990); True v. United States, 894 F.2d 1197, 1204 (10th Cir. 1990); Bailey v. Commissioner, 756 F.2d 44, 46 (6th Cir. 1985). See also Colt Indus., Inc. v. United States, 11 Cl. Ct. 140, (1986), *aff'd with other reasoning*, 880 F.2d 1311 (Fed. Cir. 1989).

166. In several public revenue rulings, the Internal Revenue Service has impliedly followed the punitive/remedial dichotomy by equating nondeductibility with the punitive nature of a violation. *See, e.g.*, Rev. Rul. 88-46, 1988-1 C.B. 76, 77, and Rev. Rul. 78-196, 1978-1 C.B. 45. However, the reliance upon this dichotomy is much more explicit in its private letter rulings. See, e.g., P.L.R. 8708004 & P.L.R. 8704003.

While the Internal Revenue Code section 6110(9)(3) states that private letter rulings may not be used or cited as precedent, the Supreme Court has indicated that they may serve as evidence of the Internal Revenue Service's administrative position. Rowan Co., Inc. v. United States, 452 U.S. 247, 261 n.17. They are being used herein for this limited purpose.

167. *See, e.g.*, *Business Expenses*, *supra* note 33, at 120.

a fine or similar penalty as "a civil penalty imposed by Federal, State or local law" without any qualification to reflect the statute's use of the word "similar."[168] While the court avoided this issue by not relying on the regulation in reaching its decision, the taxpayer's point seems valid. In *True v. United States*,[169] a case involving the deductibility of a civil penalty imposed under the Federal Water Pollution Control Act, the taxpayer raised the same argument. The Tenth Circuit agreed that "[t]aken literally and in isolation" the regulation seems invalid. However, when read in conjunction with section 1.162-21(b)(2), which provides that "[c]ompensatory damages... paid to a government do not constitute a fine or penalty," the regulations affirm that compensatory (i.e. remedial), civil sanctions remain deductible.[170] Therefore, the regulation, when read in conjunction with section 1.162-21(b)(2), is valid.

a. Whose Intent

In applying the punitive-versus-remedial dichotomy to determine the deductibility of civil penalties, the initial concern is discerning exactly whose intent is relevant. Normally, some statute will authorize the imposition of the civil penalty at issue, and an administrative official or judge will actually impose the penalty. Whose intent is controlling? The statute's or the imposer's? What if there is conflicting intent? For instance, if a judge is so angered at a particular wrongdoer that, despite the fact that the statute is generally remedial and not punitive, what if the judge "throws the book" at the wrongdoer in order to punish this scoundrel?

As strange as it may sound, none of the cases have explicitly focused on this issue. Just as Supreme Court Justice Stewart may know obscenity when he sees it,[171] in these cases the courts seem to know on whom to focus. In some cases, the focus is on the statute[172] while in others it is on the judge.[173] In all fairness to the process, in the vast

168. 75 T.C. at 649.

169. 894 F.2d 1197 (10th Cir. 1990).

170. *Id.* at 1204. Interestingly, the Tenth Circuit noted that the regulations could be read to make nondeductible the purely procedural violations that Congress had intended to exclude from section 162(f). However, since the case did not involve such a procedural infraction, the court did not address the issue. *Id.* at 1204 n.18. Presumably, the regulations could be subject to challenge in an appropriate case.

171. Jacobellis v. Ohio, 378 U.S. 184, 197 (1962) (Stewart, J., concurring).

172. *See, e.g.* True v. United States, 894 F.2d 1197 (10th Cir. 1990); Mason and Dixon Lines, Inc. v. United States, 708 F.2d 1043 (6th Cir. 1983); S & B Restaurant, Inc. v. Commissioner, 73 T.C. 1226 (1980); Middle Atl. Distrib., Inc. v. Commissioner, 72 T.C. 1136 (1979). *See also* Rev. Proc. 92-91, 1992-2 C.B. 503; Rev. Rul. 88-46, 1988-1 C.B. 76.

173. *See, e.g.*, Stephens v. Commissioner, 905 F.2d 667 (2d Cir. 1990); Allied-Signal, Inc. v. Commissioner, 63 T.C.M. 2672 (1992).

majority of these cases, the focus hits the appropriate target, even if the court does not adequately explain why it selected that particular target.

As a starting point, the *Southern Pacific* case itself focused upon the underlying statute. In response to the taxpayer's contention that section 162(f) should only apply to penalties imposed on conduct that is inherently reprehensible and similar to criminal conduct, the court responded that "the appropriate consideration is not the type of conduct which gives rise to the violation resulting in the penal imposition but is the purpose which the statutory penalty is to serve."[174] Later the court added, "petitioner committed violations of both... [statutes]. Each statute evidences a defined public policy and imposes a civil penalty as retribution for a violation of that policy,"[175] again focusing on the statute itself.

Where the underlying statute is federal the tax tribunal should attempt to determine the purpose of the statute from its language, pertinent legislative history and, of course, available precedent.[176] If a state statute controls, these same factors are, of course, relevant.[177] However, under principles laid down by the Supreme Court in *Commissioner v. Estate of Bosch*,[178] if the state's highest court has decided the nature of the statute, its ruling should be dispositive.[179]

1) Dual Purpose Statutes

Often a statute will have many purposes, some of which are punitive while others are remedial. In these dual purpose situations the Tenth Circuit and the Tax Court differ on how to proceed. In True v. United States,[180] the Tenth Circuit was faced with determining the deductibility of a civil penalty imposed under section 311(b)(6) of the Federal Water Pollution Control Act.[181] After analyzing all of the punitive and remedial features, the court decided that "on balance" the provision serves a deterrent and retributive function similar to a fine.[182] On several

174. *Southern Pac. Transp. Co.*, 75 T.C. at 653.

175. *Id.* at 654.

176. *See, e.g.*, True v. United States, 894 F.2d 1197 (10th Cir. 1990); Middle Atl. Distrib., Inc. v. Commissioner, 72 T.C. 1136 (1970); Rev. Proc. 92-91, 1992-2 C.B. 503; Rev. Rul. 88-46, 1988-1 C.B. 76.

177. *See, e.g.*, Mason and Dixon Lines, Inc. v. United States, 708 F.2d 1043 (6th Cir. 1983) (dealing with Virginia's limit on vehicle weight); S & B Restaurant, Inc. v. Commissioner, 73 T.C. 1226 (1980) (addressing Pennsylvania's Clean Streams Law).

178. 387 U.S. 456 (1967).

179. *See, e.g.*, Waldman v. Commissioner, 88 T.C. 1384 (1987); Huff v. Commissioner, 80 T.C. 804 (1983); Henson Robinson Co. v. Commissioner, 48 T.C.M. 508 (1984).

180. 894 F.2d 1197 (10th Cir. 1990).

181. 33. U.S.C. § 1321(b)(6) (Supps. II 1972).

182. *True*, 894 F.2d at 1205.

occasions[183] when faced with dual purpose statutes, the Tax Court did not attempt to weigh the various factors and come up with an overall characterization of the statute. Instead, it defined its role as having to decide only what was the character of the particular penalty under consideration. "Where a payment ultimately serves each of these purposes, i.e., law enforcement (nondeductible) and compensation (deductible), the court's task is to determine which purpose the payment was designated to serve."[184] In making this determination, the intent of the judge or of the official imposing the penalty becomes crucial.[185]

2) Parties' Characterization

Another factor that may be either relevant, or perhaps controlling, is whether the involved parties have entered into an agreement characterizing the penalty payment. In *Middle Atlantic Distributors, Inc. v. Commissioner*,[186] the United States Customs Service initially sought over $500,000 from the taxpayer as a "penalty or liquidated damages" under 19 U.S.C. section 1592. The action arose because a Turkish official withdrew liquor from the taxpayer's warehouse under false pretenses. Instead of using the liquor for members of the Turkish armed forces, in which event no import duties or alcohol taxes were due, the official defrauded both the taxpayer and the government and injected the liquor into United States commerce. In the course of settling the matter, the taxpayer offered $100,000 "as liquidated damages, in order to reimburse the Government for all or a portion of the taxes to which it asserts a claim."[187] The government accepted the offer.[188] After determining that section 1592 was a dual purpose provision and that the court had to decide the purpose for this particular payment, the Tax Court emphasized the characterization contained in the settlement agreement.[189] Following a pre-1969 case,[190] the Tax Court stated that "[o]nce again, we conclude that the characterization of the payment as damages by the parties must be given effect".[191] Similarly, Revenue

183. *See* Waldman v. Commissioner, 88 T.C. 1384, 1387 (1987), *aff'd*, 850 F.2d 611 (9th Cir. 1988); S & B Restaurant, Inc. v. Commissioner, 73 T.C. 1226, 1232 (1980); Middle Atl. Distrib., Inc. v. Commissioner, 72 T.C. 1136, 1145 (1979).

184. *Waldman*, 88 T.C. at 1387.

185. *See supra* note 135.

186. 72 T.C. 1136 (1979).

187. *Id.* at 1140.

188. *Id.*

189. Middle Atl. Distrib., 72 T.C. at 1145.

190. Grossman & Sons, Inc. v. Commissioner, 48 T.C. 15 (1967).

191. *Middle Atl. Distrib.*, 72 T.C. at 1146.

Ruling 80-334[192] held that the I.R.S. would accept a characterization in a consent order between the Department of Energy and a petroleum company under its jurisdiction that payments to be made were not penalties, but merely refunds of unintentional overcharge and, therefore, deductible.

It should be emphasized that in *Middle Atlantic*, the Tax Court stated that it would give effect to the parties' characterization after it had determined that the statute involved was a dual purpose one.[193] Therefore, it does not follow that such a characterization will govern in the face of a single purpose statute to the contrary.[194]

3) Case-law Application

In discerning whose intent is relevant to determine the punitive or remedial question, three cases are especially noteworthy. Two of the cases, *Stephens v. Commissioner*[195] and *Allied-Signal, Inc. v. Commissioner*,[196] are important because they focus solely upon the judge's intent. The third case *Colt Industries, Inc. v. United States*,[197] is important because the Federal Circuit marched to the beat of a different drummer by considering the statute's intent differently from other circuits.

In *Stephens*, the taxpayer and others had defrauded Raytheon by embezzling money from it.[198] In 1982, the taxpayer was convicted of four counts of wire fraud, one count of transporting the proceeds of fraud in interstate commerce, and one count of conspiracy. At the sentencing, the Assistant United States Attorney alerted the court that the money the taxpayer had embezzled was frozen in a Bermuda bank account and suggested that the court order the taxpayer to make restitution. The sentencing judge agreed and, in sentencing the taxpayer, imposed a fine and concurrent five-year prison sentence for all the counts other than the interstate transportation of the proceeds of fraud count. On this latter count, in addition to a fine, the court imposed a consecutive five-year prison term, which was suspended and probation was substituted on

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192. 80-2 C.B. 61.

193. *Middle Atl. Distrib.*, 72 T.C. at 1145.

194. It should be noted that there are instances where the parties to a settlement or consent order provide what the tax consequences of the payment will be. *See, e.g.* United States v. Western Ele. Co., Inc., 1991-1 Trade Cases ¶ 69,329 at p. 65,267 (D.D.C. 1991) ("The civil penalty provided for ... [herein] shall be deemed not to be a deductible expense for income tax purposes"); United States v. Missouri Valley Constr. Co., 741 F.2d 1542, 1545-46 (8th Cir. 1984). Presumably, such a characterization of nondeductibility will govern.

195. 905 F.2d 667 (2d Cir. 1990).

196. 63 T.C.M. 2672 (1992).

197. 880 F.2d 1311 (Fed. Cir. 1989).

198. Stephens v. Commissioner, 905 F.2d 667, 668 (2d Cir. 1990).

condition that the taxpayer make restitution of $1 million to Raytheon. In 1984 Stephens made the restitution payment. Since Stephens had previously included the $1 million in his income for 1976, he claimed a deduction for the 1984 restitution payment under section 165(c)(2).[199] The Commissioner denied the deduction, arguing, *inter alia*, that section 162(f) precluded the deduction. Although the Tax Court below[200] and the Second Circuit[201] both held that the deduction was governed by section 165(c)(2) and not by section 162(a), each nevertheless decided that the principles of section 162(f) were relevant in determining whether to disallow the deduction on public policy grounds under section 165.[202] In reversing the Tax Court and permitting the deduction, the Second Circuit focused only upon the judge's intent in requiring restitution.[203] It focused on the sentencing proceedings and ultimately determined that the nature of the restitution payment was more compensatory than punitive and was primarily a remedial measure to compensate another party.[204] The Second Circuit never focused on the nature of the underlying statute.[205]

If one were to attempt to reconcile the Second Circuit's opinion in *Stephens* and *Southern Pacific*'s focus on the underlying statute, one slight opening exists in the *Stephens'* analysis. In presenting the punitive-versus-remedial dichotomy, the *Stephens* court quoted from *Waldman v. Commissioner*.[206] In *Waldman*, the court said that "'[w]here a payment ultimately serves each of these purposes, i.e., law enforcement (nondeductible) and compensation (deductible), our task is to determine which purpose the payment was designed to serve.'"[207] Perhaps this statement could be interpreted as an implicit finding by the court that the underlying statute in *Stephens* had a dual purpose and, therefore, an inquiry into the judge's intent in imposing this particular payment is consistent with the dual purpose cases. Unfortunately, the quote is used

199. *Id.* at 669. Code section 165(c)(2) allows a deduction for losses incurred in a transaction entered into for profit. I.R.C. §165(c)(2) (1994).

200. 93 T.C. 108, 111-12 (1989).

201. *Stephens*, 905 F.2d at 670.

202. 93 T.C. at 112; 905 F.2d at 672.

203. *Stephens*, 905 F.2d 672-73.

204. *Id.*

205. The Tax Court's disposition of the case arguably was more consistent with *Southern Pacific*'s focus on the statute. The Tax Court held the restitution was not deductible because it was made as a result of a criminal conviction, in lieu of a prison term and as a condition of probation. 93 T.C. at 113. Implicitly, the Tax Court was focusing upon the criminal nature of the underlying statute involved. *See infra* notes 186-234 and accompanying text.

206. 88 T.C. 1384, 1387 (1987), *aff'd*, 850 F.2d 611 (9th Cir. 1988).

207. *Stephens*, 905 F.2d at 673.

more as an exposition of the punitive-versus-remedial standard than as an application to *Stephens'* facts.

Although it is not completely clear whether *Stephens* relied on the statute's intent, *Allied-Signal, Inc. v. Commissioner*[208] did not consider statutory intent. In *Allied-Signal*, the taxpayer pled *nolo contendere* to an indictment that contained 940 counts of discharging Kepone and other toxic wastes into the environment in Hopewell, Virginia. Initially, the judge imposed the maximum fine of $13.24 million dollars on the taxpayer. The Tax Court found that the judge made his intent very clear at sentencing:

> "Allied knew it was polluting the waters." In addition to punishing petitioner, the sentencing judge wanted to send a message to other corporations. He stated "I hope after this sentence, that every corporate official, every corporate employee that has any reason to think that pollution is going on, will think, 'If I don't do something about it now, I am apt to be out of a job tomorrow.' I want the officials to be concerned when they see it."[209]

The judge then reiterated an earlier wish that the fines could be used to directly benefit the people who had been hurt by the taxpayer's actions. Unfortunately, the judge felt that this desire could not be accomplished. He ordered the fine paid in ninety days, but indicated that he might then entertain a motion to reduce the fine.[210] The taxpayer obtained tax advice and was informed by several sources that if it took voluntary remedial action, such as contributing to a foundation to engage in research to eradicate Kepone from the environment, it would have a "good shot" at obtaining a tax deduction for the payment.[211] However, the taxpayer did not want to make such a payment without assurance that its fine would be reduced dollar-for-dollar. A number of contacts were then had by the taxpayer's attorneys and the judge designed to assure the taxpayer that any "voluntary" payment would in fact result in an abatement of the fine. Although the judge always emphasized that he could not give any binding assurances, eventually the taxpayer was virtually certain that any such "voluntary" payments would be appropriately recognized at the hearing on the motion to reduce the fine. Accordingly, the taxpayer established the Virginia Environmental Endowment Fund (hereinafter the "Fund"), a section 501(c)(4)

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208. 63 T.C.M. 2672 (1992).
209. *Id.* at 2677.
210. *Id.*
211. *Id.* at 2677-78.

organization and contributed $8 million to the Fund. As anticipated, at the hearing on the motion to reduce the fine, the judge reduced the fine from $13.24 million to $5 million.[212] On behalf of the Department of Justice, the local United States Attorney objected and argued that the taxpayer would probably try to claim a tax deduction for the payment to the Fund and would, thereby, effectively reduce the effect of the fine and its intended penal and deterrent purpose.[213]

In reaching a decision on the deductibility of the $8 million payment to the Fund, the Tax Court never focused on the punitive or remedial nature of the underlying statute.[214] In fact, the opinion never cites the underlying statute that was violated. To the extent that intent was focused on, it was solely the judge's intent. After quoting from the *Waldman* case,[215] the Tax Court stated that the trial judge's statements indicated that there may have been a dual purpose for his imposition, and the Tax Court's job was to determine which purpose the payment in question was designed to serve. Based on the facts, the Tax Court had no trouble deciding that any compensatory or remedial purpose for the payment was minimal, and that the payment was essentially for punishment and deterrence for environmental crimes.[216]

One curious aspect of the *Allied-Signal* case is that the taxpayer, in addition to its federal fine and payment, also settled with Virginia and the City of Hopewell for $5.25 million.[217] This payment was "for Kepone-related costs that . . . [Virginia and Hopewell] incurred and the penalties assessed by the Virginia Water Control Board. The settlement covered damages to . . . Hopewell's waste treatment system as well as the expense borne by . . . [Virginia] with regard to the Kepone incident."[218] Since penalties were involved, one would have expected the I.R.S. to challenge the deductibility of at least a portion of this amount. Surprisingly, it did not. The I.R.S. agreed with the taxpayer's deduction of the entire $5.25 million under section 162(a).[219]

From a policy standpoint, one may wonder what would and should occur if a taxpayer in Allied-Signal's position did in fact take its chances and make a truly voluntary payment that the judge later expressly took into account by imposing a fine lower than otherwise would have been

212. *Id.* at 2680. The extra $240,000 was a bonus given to the taxpayer. *Id.* at 2679.

213. Allied-Signal, Inc., 63 T.C.M. at 2679.

214. *Id.* at 2672.

215. *See supra* note 142 and accompanying text.

216. *Allied-Singnal, Inc. 63 T.C.M.* at 2683.

217. *Id.* at 2680.

218. *Id.*

219. *Id.*

imposed. Unlike in *Allied-Signal*, there would be no question of conversion of a definite fine into something else. However, the bottom line might be exactly the same.

In *Colt Industries, Inc. v. United States*,[220] the taxpayer's affiliated subsidiary corporation, Crucible, Inc., manufactured basic and fabricated steel products in Midland, Pennsylvania. It was subject to a number of environmental protection laws and regulations, including the Federal Clean Air Act, the Federal Clean Water Act, the Pennsylvania State Implementation Plan, and the rules and regulations of the Pennsylvania Department of Environmental Resources.[221] Beginning in 1976 and continuing thereafter, the Environmental Protection Agency determined that Crucible was in violation of a number of pertinent environmental laws. It eventually recommended that suit be instituted against Crucible for civil penalties of $25,000 per day for the violation of the Clean Air Act and $10,000 per day for the violation of the Clean Water Act. A settlement was eventually reached and a consent decree was entered whereby Crucible paid $1.6 million to the Pennsylvania Clean Air and Clean Water Funds in satisfaction of the civil penalties, which were sought by the Environmental Protection Agency. The taxpayer claimed a deduction for this payment under section 162(a), and the I.R.S. disallowed the deduction under section 162(f).

The Claims Court below held that a deduction was unavailable because the pertinent provisions of the Clean Air and Clean Water Acts were punitive and not compensatory.[222] In arriving at its decision the Claims Court adopted and applied the *Southern Pacific* analysis and reached its decision only after ascertaining the intent of the statutes involved.[223]

On appeal, the Federal Circuit affirmed the Claims Court, however, the court's reasoning is very unusual. Initially, as noted above, the Federal Circuit read the 1971 Senate Finance Committee Report differently than every other court that focused upon the report.[224] It then went on to decline Colt's invitation to determine the purpose (whether punitive or remedial) of the $1.6 million payment involved.

> The argument is also unacceptable because, as a necessary predicate according to Colt, the court would have to "determine the purpose or purposes served by the specific civil penalty payment at issue in order

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220. 880 F.2d 1311 (Fed. Cir. 1989).

221. *Id.* at 1312.

222. Colt Indus., Inc. v. United States, 86-2 U.S.T.C. ¶ 9749 (Cl. Ct. 1986).

223. *Colt Indus., Inc.*, 880 F.2d at 1312 (interpreting 86-2 U.S.T.C. at 85841-44).

224. *See supra* note 124 and accompanying text.

> to ascertain whether the payment is barred from deduction." But that is not our office; "Congress has delegated to the Commissioner, not to the courts, the task of prescribing 'all needful rules and regulations for the enforcement' of the Internal Revenue Code. . . . In this area of limitless factual variations, 'it is the province of Congress and the Commissioner, not the courts, to make the appropriate adjustments.' . . . (citations omitted)
> As is apparent, neither the statute nor the regulations prescribe a "purpose" inquiry. It is therefore beyond our mandate to embark on one to make our own assessment of the deductibility of a particular penalty. "The role of the judiciary in cases of this sort begins and ends with assuring that the Commissioner's regulations fall within his authority to implement the congressional mandate in some reasonable manner."[225]

Apparently, under the Federal Circuit's view, and contrary to every other court that has addressed the issue, a purpose inquiry is never necessary. A court must merely decide if a regulation is valid. If it is, the court is to go no further. The court is not even to determine if the application of the regulation to the facts involved is appropriate. Notice that the role of the judiciary is very limited under this approach. To date, no other court has adopted this limited view of the court's role.[226]

b. Factors Considered

In determining whether a civil penalty is deductible, a court needs to decide if the penalty's purpose is punitive, remedial, or compensatory. This decision will be based on all available relevant material, whether it be the pertinent legislative history,[227] a definitive ruling by a state's highest court,[228] the record of what a sentencing judge said in imposing the penalty,[229] or something else. Although the courts in this area have not yet used the phrase, this seems to be but another manifestation of the multi-purpose "facts and circumstances" test. As such, it is usually futile to attempt to delineate the factors that have been considered by the various courts, since, by definition, there are no artificial boundaries. Rather, anything relevant can and should be considered. However, a number of factors have arisen in certain cases that have some logical relevance in reaching the required decision. This portion of the article

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225. *Colt Indus., Inc.*, 880 F.2d at 1312.
226. *See* Torres, *supra* note 162.
227. *See supra* note 138.
228. *See supra* note 141.
229. *See, e.g.*, Stephens v. Commissioner, 905 F.2d 667, 673 (2d Cir. 1990); Allied-Signal, Inc. v. Commissioner, 63 T.C.M. 2672 (1992).

will briefly focus on these factors. Notably, most of the factors are not, or may not be, conclusive in and of themselves, except perhaps for the first factor of whether the penalty arose in a criminal case or is in-lieu of criminal punishment. This is because often there are multiple factors present to justify the court's decision.

1) Penalties Arising in Criminal Cases or In Lieu of Criminal Punishment.

A line of Tax Court cases appear to hold that a penalty imposed in a criminal case or in lieu of a criminal punishment is automatically non-deductible under section 162(f). In *Huff v. Commissioner*,[230] the taxpayer was an employee, officer, and director of a business engaged in an illegal pyramid type of operation. In a judgment entered on January 14, 1971 and pursuant to a stipulation between the parties, the corporations involved were enjoined from making certain false or misleading representations. By its terms, this judgment extended to the taxpayer. Subsequently, an action was brought against the corporations and a number of their employees and officers, including the taxpayer, alleging that the final judgment in the prior action had been violated. After a trial, the taxpayer was found guilty of violating the prior judgment and also of violating a section of California's Business and Professions Code, which prohibited the making of false or misleading statements. The second action, however, was a civil, non-criminal action.[231] In addition certain other relief, the taxpayer was ordered to pay to the State of California a civil penalty of $50,000, the deductibility of which under section 162(f) was before the court.[232]

The taxpayer argued that the phrase "similar penalty," used in section 162(f), encompassed only civil penalties imposed in criminal or quasi-criminal proceedings.[233] The basis for this argument was the language in the Senate Finance Committee Report on the Revenue Act of 1971 quoted previously.[234] Although the court did not accept this argument and ultimately held that the penalty was nondeductible because its purpose was to penalize for past illegal behavior,[235] the court stated

230. 80 T.C. 804 (1983).

231. *Id.* at 809-810.

232. *Id.* at 813. The taxpayer's employer paid the $50,000 penalty. *Id.* at 812-13. However, after the court held that the employer's payment of the penalty constituted gross income to the taxpayer, the issue then became whether the penalty was deductible under section 162(f).

233. *Huff*, 80 T.C. at 822.

234. *See supra* note 91 and accompanying text.

235. *Huff*, 80 T.C. at 824.

that "[i]nsofar as petitioners suggest that civil penalties imposed in criminal or quasi-criminal proceedings fall within the term 'similar penalty' used in section 162(f), we agree."[236]

Although the Tax Court in *Huff* never states its reasons for arriving at the conclusion that all penalties imposed in criminal or quasi-criminal proceedings are within section 162(f), it is presumably derived from the fact that the nondeductibility of criminal fines was always more certain than the nondeductibility of civil penalties. When the civil penalty arises out of a criminal case, it is perhaps inherently more "similar" to a fine.

The next Tax Court case to address this issue provides a very clear additional reason for this result, namely section 1.162-21(b)(1)(i). In *Waldman v. Commissioner*,[237] the taxpayer was charged with twenty-nine counts of conspiracy to commit grand theft. He pled guilty to one count, and the remaining counts were dismissed. He was sentenced to one-to-ten years in prison, but execution of the sentence was stayed on condition he pay specified amounts of restitution to his victims. In 1981, the taxpayer paid $28,500 in restitution and deducted this amount on his tax return. The I.R.S. disallowed the deduction. As a result, the deductibility of the restitution payment under section 162(f) was before the court.[238]

Although neither party referred to the regulations, the Tax Court held that section 1.162-21(b)(1)(i) of the regulations was dispositive.[239] That section provides that a fine or similar penalty includes an amount paid pursuant to a conviction or plea of guilty in any criminal proceeding. The court reasoned that the taxpayer's restitution was paid pursuant to his plea of guilty and, thus, fit within the regulation's definition of fine or similar penalty. Had the taxpayer pled not guilty and had he subsequently been acquitted, the restitution payment would never have been ordered.[240]

Subsequently, *Stephens v. Commissioner*[241] focused not just on the fact that the penalty was imposed in a criminal case, but also on the fact that it was in lieu of an additional criminal punishment. In this case, as was previously described in more detail,[242] the taxpayer had embezzled

236. *Id.* at 822.

237. 88 T.C. 1384 (1987), *aff'd*, 850 F.2d 611 (9th Cir. 1988).

238. *Id.* at 1385-86.

239. *Id.* at 1387.

240. *Id.* at 1386-87. Since the parties had argued the case under the punitive-versus-remedial rubric, the Tax Court also addressed this argument and found that the penalty involved was punitive. *Id.* at 1387-88.

241. 93 T.C. 108 (1989), *rev'd*, 905 F.2d 667 (2d Cir. 1990).

242. *See supra* notes 155-164, and accompanying text.

money from Raytheon. In addition to sentencing the taxpayer to several concurrent five-year prison terms and substantial fines, the judge imposed an additional consecutive five-year prison term and a fine on one of the counts and suspended this prison term and substituted probation on condition the taxpayer make restitution.[243] In finding the restitution payment nondeductible under section 162(f), the Tax Court stated:

> It is equally clear that the restitution payment involved herein was made as the result of a criminal conviction and that it was ordered in lieu of an additional prison term and as a condition of probation. That the payment had the effect of reimbursing Raytheon for all or part of its loss and, therefore, had a civil aspect, does not detract from this overriding fact.[244]

Interestingly, in *Stephens* and *Waldman*, both courts cited section 1.162-21 (b) (1) (i) of the regulations as authority for holding that the taxpayer's restitution payment was not an allowable deduction.[245] It would appear, however, that when a civil penalty is imposed in lieu of a criminal penalty, the language of clause (iii) of the regulation is more fitting. It is an amount "paid in settlement of the taxpayer's actual or potential liability for a fine ...(civil or criminal)." An earlier Revenue Ruling[246] relied on this regulation in a very similar "in lieu of" situation.

In Revenue Ruling 79-148 the taxpayer was a manufacturer who sold certain products to Country X. A federal district court held that the sales violated federal law, which restricted sales of such products to Country X. The taxpayer pled *nolo contendere* to the charges. Before sentencing, the taxpayer offered to contribute to a local charity an amount equal to the maximum fine that the federal court could impose for the violation. The taxpayer was sentenced but the sentence was suspended, and the taxpayer was placed on two years probation and directed to pay the proffered amount to the charity.[247] Relying on regulation section 1.162-21(b)(1)(iii), the I.R.S. ruled that the amount paid to the charity was not deductible under section 162(f) because the payment was in lieu of the taxpayer having to pay a fine to the federal government.[248]

243. *Stephens*, 93 T.C. at 109.

244. *Id.* at 113 (citation omitted).

245. *See Waldman*, 88 T.C. at 1387.

246. Rev. Rul. 79-148, 1979-1 C.B. 93.

247. *Id.* The Revenue Ruling does not describe the specifics of the original sentence that was ultimately suspended.

248. *Id.* at 94.

The final Tax Court case to be considered in accordance with this line of cases is *Allied-Signal Inc. v. Commissioner.*[249] As discussed previously,[250] in sentencing the taxpayer for environmental crimes the court reduced the original $13.24 million fine to $5 million as a consequence of the taxpayer having made a voluntary $8 million contribution to a fund established to deal with local environmental concerns. In deciding that the $8 million payment was not deductible, the Tax Court reasoned that the contribution was not voluntary, since it was made with the virtual assurance that any amount contributed would reduce the criminal fine dollar for dollar.[251] Also the Tax Court found that the judge's purpose in imposing the original sentence was almost entirely punitive.[252]

Notwithstanding the taxpayer's argument that the $8 million contribution was not within section 162(f) because it was not ordered by the sentencing judge as part of the sentence nor was it imposed as a condition for reducing the sentence, the Tax Court found that this was essentially the payment of a fine. The Tax Court observed that "[w]hile the form of the payment [did] not necessarily fit within the letter of section 162(f), in substance petitioner paid a criminal fine."[253] If by this statement, the court meant that the payment was in lieu of a fine, then the case is consistent with the *Huff-Waldman-Stephens* line of cases. However, the court continued by asserting that the contribution was a mere device to obtain a deduction for an amount not otherwise deductible. The court then quotes *Gregory v. Helvering,*[254] and apparently supports its holding here on that case's "substance over form" doctrine. The obvious question is why didn't the court simply hold the payment taxable based on the *Huff-Waldman-Stephens* line of cases, especially since the payment arose out of a criminal case and was in lieu of a criminal fine?

The Ninth and Sixth Circuits follow the *Huff-Waldman-Stephens* line of cases while the Second and Tenth Circuits do not. There is also a district court case in the Eastern District of Wisconsin to the contrary. The Ninth Circuit apparently adopted this line of reasoning when it

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249. 63 T.C.M. 2672 (1992).

250. *See supra* notes 167-76 and accompanying text.

251. 63 T.C.M. at 2681-82.

252. *Id.* at 2682.

253. *Id.* at 2683.

254. 293 U.S. 465, 470 (1935). *Gregory* is, of course, the paradigm of the substance over form doctrine in the tax law.

affirmed *Waldman* "substantially for the reasons stated by the Tax Court."[255]

The Sixth Circuit case adopting the *Huff-Waldman-Stephens* reasoning is *Bailey v. Commissioner*.[256] In *Bailey*, the taxpayer was the protagonist in a fraudulent pyramid type scheme similar to *Huff*.[257] In 1976 the Northern District of California fined Bailey $1,036,000 pursuant to 15 U.S.C. § 45(1)[258] for violating a 1971 consent decree with the Federal Trade Commission under which he agreed to cease and desist from operating his business in a deceptive manner. However, the court granted Bailey's request that the payment of this $1,036,000 fine be applied as restitution in settlement of a pending multidistrict class action against the corporations and its officers in the District Court for the Southern District of Florida. The California court's order authorizing the transfer expressly stated that "the ultimate disposition of these funds in no way shall alter their status as civil penalties" imposed under 15 U.S.C. § 45(l).[259] Bailey claimed a reduction in his 1977 federal income taxes under code section 1341[260] as a result of the $1,036,000 payment. The I.R.S. disallowed that claim, and Bailey filed a petition with the Tax Court seeking a redetermination. In an unreported opinion The Tax Court granted the Commissioner's motion for summary judgment on

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255. Waldman v. Commissioner, 850 F.2d 611 (9th Cir. 1988).
256. 756 F.2d 44 (6th Cir. 1985).
257. *See supra* note 186.
258. Bailey, 756 F.2d at 46. 15 U.S.C. § 45(l) provides:

> (l) Penalty for violation of order; injunctions and other appropriate equitable relief
> Any person, partnership, or corporation who violates an order of the Commission after it has become final, and while such order is in effect, shall forfeit and pay to the United States a civil penalty of not more than $10,000 for each violation, which shall accrue to the United States and may be recovered in a civil action brought by the Attorney General of the United States. Each separate violation of such an order shall be a separate offense, except that in the case of a violation through continuing failure to obey or neglect to obey a final order of the Commission, each day of continuance of such failure or neglect shall be deemed a separate offense. In such actions, the United States district courts are empowered to grant mandatory injunctions and such other and further equitable relief as they deem appropriate in the enforcement of such final orders of the Commission.

259. *Id.*
260. Under I.R.C. section 1341, a special method of computing tax liability is available where a taxpayer receives an item of income under a claim of right and includes the item in income and in a later year must return the item because in reality he did not have an unrestricted right to the income. I.R.C. § 1341 (1994). Under § 1341 the taxpayer will pay the lesser of (1) his normal tax for the year of restoration, computed with a deduction for the restored item; or (2) a tax computed without such deduction, but reduced by the amount the tax in the year of receipt would have been decreased if the amount restored had been excluded. *See Bailey*, 756 F.2d at 46.

several grounds, one of which was that the $1,036,000 payment was not deductible under section 162(f).[261]

The Sixth Circuit affirmed the Tax Court, because it found that Bailey's obligation to pay the $1,036,000 arose from his failure to obey the terms of the consent order. The court reasoned that Bailey "forfeited the $1,036,000 as punishment for his violations of the Federal Trade Commission Act, and the payment was thus a fine 'imposed for purposes of enforcing the law and as punishment for a violation thereof.'"[262] The court concluded that,

> [t]he fact that the California district court, upon Bailey's application, permitted him to apply the $1,036,000 civil penalty toward the settlement of his potential liabilities in the multidistrict class action does not change the status of the payment as a civil penalty. The characterization of a payment for purposes of § 162(f) turns on the origin of the liability giving rise to it.[263]

Two obvious difficulties arise in trying to connect this holding in Bailey with the *Huff-Waldman-Stephens* line of cases. First, *Bailey's* facts make it much easier to treat the restitution payment like the underlying fine because the judge, in authorizing the application of the fine towards the restitution explicitly, provided that "'the ultimate disposition of these funds in no way shall alter their status as civil penalties' imposed under 15 U.S.C. § 45(l)."[264] Second, despite its obvious punitive nature, the underlying fine was a civil, not a criminal, fine.[265]

However, two counter-arguments indicate that *Bailey* belongs to the *Huff-Waldman-Stephens* line of cases. First, although the Sixth Circuit was aware of the California court's direction not to change the nature of the payment, it never referred to this direction as a rationale for its holding.[266] Second, and more significantly, in *Kraft v. United States*,[267] the Sixth Circuit cited *Bailey* as its precedent for holding that

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261. *Bailey*, 756 F.2d at 46. For section 1341 to be applicable, a deduction must be available for the amount restored in the year of restoration. Therefore the issue of the deductibility of the $1,036,000 payment arises. *Id.*

262. *Id.*

263. *Id.* (citations omitted).

264. *Id.* at 46 (citing district court's order). *See also* United States v. Bestline Prods., 412 F. Supp. 754 (N.D. Cal. 1976).

265. *Bailey*, 756 F.2d at 46-7.

266. *Id.*

267. 991 F.2d 292 (6th Cir. 1993). *Kraft* involved a podiatrist who was accused of cheating Blue Cross/Blue Shield. As part of a Rule 11 Plea Agreement the taxpayer, Dr. Kraft, pleaded guilty to one count of the Indictment and one count of the Information. *Id.* As part of the plea agreement he agreed to pay $160,000 restitution to Blue Cross/Blue Shield prior to sentencing.

a restitution payment arising in a criminal proceeding is automatically a nondeductible penalty:

> Dr. Kraft agreed "to pay Blue Cross/Blue Shield of Michigan $160,000 restitution prior to sentencing pursuant to the [plea agreement]." Though the Krafts maintain that this payment does not constitute a penalty, Sixth Circuit precedent, establishes that Dr. Kraft's restitution payment arose out of criminal proceedings thereby constituting a non-deductible penalty. *See Bailey v. Commissioner*, 756 F.2d at 47 ("Bailey, therefore, forfeited the $1,036,000 as punishment for his violations of the Federal Trade Commission Act, and the payment was thus a fine imposed for purposes of enforcing the law and as punishment for a violation thereof.").[268]

Regardless of whether the *Bailey* decision is a clear adoption of the *Huff-Waldman-Stephens* line of cases, the above quoted material establishes that *Kraft* itself clearly follows the *Huff-Waldman-Stephens* rationale that any penalty payment arising out of a criminal case is not deductible.

Although generally payments arising out of a criminal case are not deductible, the reasoning established by the *Huff-Waldman-Stephens* cases is not universally followed. In the *Stephens* case itself, the Second Circuit reversed the Tax Court and held that the restitution payment was primarily a remedial measure to compensate the victim and was, therefore, deductible, notwithstanding that it arose from a criminal case.[269]

In *Stephens*, the Second Circuit realized that its holding was inconsistent with *Waldman* and tried to factually distinguish *Waldman*. It pointed out that the *entire* sentence in *Waldman* was suspended on condition that the restitution be paid and that therefore the purpose of the restitution was equally compensatory and punitive.[270] By contrast, in *Stephens*, in addition to the restitution, a prison term and fines were also imposed, thereby supporting the inference that the restitution was solely

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As in *Bailey*, the taxpayer claimed he was entitled to section 1341 treatment for the restitution payment and the issue before the court was whether the restitution payment was nondeductible under section 162(f). *Id.* at 293-94.

268. Id. at 298-99 (quoting the Rule 11 Plea Agreement).

269. *Stephens*, 905 F.2d at 672-73. Also, the Second Circuit considered in its reasoning the fact that the restitution was not paid to a "government" as required in section 162(f). *Id.* at 673-74. The court explicitly stated: "Whether either consideration alone would suffice is a matter we need not decide." *Id.* at 672.

270. *Id.*

compensatory.[271] Perhaps realizing its tenuous distinction of *Waldman*, the Second Circuit added that "[t]o the extent that *Waldman* may be interpreted as suggesting that a restitution payment, ordered in addition to punishment and paid directly to a victim, would not be a deductible loss, we respectfully disagree."[272]

Also disagreeing with *Waldman* is a decision from the Eastern District of Wisconsin. In *Spitz v. United States*,[273] the court addressed the deductibility under section 162(f) of a $5,000 restitution payment made by Mr. Spitz. Mr. Spitz was convicted of theft under Wisconsin law for misappropriating funds paid for the construction of a house. As a condition of probation, the court ordered him to pay $5,000 restitution to the victim. In allowing a deduction for this amount, the district court found that the restitution was not a fine. Similarly, it was not a penalty since the payment was of an amount due and owing.[274]

Notably, *Spitz* does not contain any further analysis of the issue. The *Waldman*[275] court's criticism of *Spitz* seems well placed. *Waldman* points out that *Spitz* (a) never explained how the State court, in a criminal proceeding, could determine Spitz's liability to his victim; (b) never focused on the fact that the restitution was ordered as a condition of probation; and (c) never focused on Supreme Court of Wisconsin precedent that restitution is part of the rehabilitative process in that it forces a defendant to live up to his financial responsibilities.[276]

The last case which disagrees with the reasoning in the *Huff-Waldman-Stephens* line of cases is *True v. United States*.[277] One of the issues before the Tenth Circuit was the deductibility under section 162(f) of a penalty assessed under the Federal Water Pollution Control Act[278] as a result of a pipeline leaking oil. After reviewing the pre-1969 judicial public policy background and legislative history of section 162(f), the court embraced the punitive-versus-remedial test described earlier in this article.[279] In introducing the test, the court stated that "*[w]hether the statute is determined to be 'criminal' or 'civil' is not conclusive.*"[280]

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271. *Id.*

272. *Id.* at 674. it should be noted that the Second Circuit also distinguished *Bailey*, on the obvious ground that the payment there was originally imposed as a fine, and it retained its characteristic as a penalty notwithstanding its diversion to the plaintiffs in the civil action. *Id.*

273. 432 F. Supp. 148 (E.D. Wis. 1977).

274. *Id.*

275. Waldman v. Commissioner, 88 T.C. 1384, 1387 (1992).

276. *Id.*

277. 894 F.2d 1197 (10th Cir. 1990).

278. 33 U.S.C. § 1321(b)(6) (1988).

279. *See supra* text accompanying notes 105-129.

280. *True*, 894 F.2d at 1204 (emphasis added).

The court went on to state that criminal fines and similar retributive civil penalties are not deductible, while compensatory or remedial penalties and penalties for procedural-type failings are deductible. In holding that the criminal or civil nature of the statute involved is not determinative, the Tenth Circuit is at odds with *Huff-Waldman-Stephens*, which would automatically hold any penalty imposed in a criminal case is nondeductible.

2) Multiple Impositions

In determining the character of a particular penalty, a number of courts were influenced by the existence of a second sanction imposed by the same statute. In *Mason and Dixon Lines, Inc. v. Commissioner*,[281] the court addressed the character of liquidated damages imposed upon a trucker convicted of operating a vehicle with a weight in excess of the statutory limits. In finding the liquidated damages to be compensatory in nature and hence deductible, the court was influenced by the fact that the state imposed two separate sanctions for violating its vehicle weight laws. Besides liquidated damages, Virginia law provided that any person convicted of violating the weight limit regulations was to be punished by a fine or imprisonment, or both--clearly a punitive sanction. Thus the inference drawn by the court was that the liquidated damages were not a second penalty, but rather a payment of another sort.[282]

Similarly, in *Henson Robinson Co. v. Commissioner*,[283] the Tax Court determined that a penalty imposed by a certain provision of the Illinois Antitrust Act was a nondeductible punitive imposition because a different provision provided for compensation in the form of treble damages.[284]

Similarly, in *Stephens v. Commissioner*,[285] the Second Circuit extended this line of reasoning, to glean the intent not of a statute, but of a judge in imposing restitution. The court was influenced to find the restitution to be compensatory in part because the judge had already punished the defendant with fines and a jail sentence.[286]

281. 708 F.2d 1043 (6th Cir. 1983).

282. *Mason and Dixon Lines, Inc.*, 708 F.2d at 1047.

283. 48 T.C.M. 508 (1984).

284. *Id.* at 509. The Tenth Circuit did likewise in True v. United States, 894 F.2d 1197, 1205-06 (10th Cir. 1990).

285. 905 F.2d 667 (2d Cir. 1990).

286. *Id.* at 673.

3) Use of Penalty for Non-Punitive Purpose

The actual use of the penalty may also determine whether the penalty is deductible. In True v. United States,[287] one of the issues before the district court was the deductibility of a civil penalty imposed under section 311(b)(6) of the Federal Water Pollution Control Act[288] as a consequence of an oil leakage from the taxpayer's pipeline. In finding the penalty deductible, the district court was persuaded in part by the fact that the penalty funds were used to pay the costs of administering the law and to finance the cost of cleaning the oil spills when the costs are not otherwise recoverable.[289] Although the Tenth Circuit reversed the district court and found the penalty to be punitive and, therefore, not deductible, it conceded that "employment of the proceeds...to administer the Act and to finance cleanup costs actually does serve a remedial purpose."[290]

Also, the Sixth Circuit considered the use of funds collected through fines in *Mason and Dixon Lines, Inc. v. United States*.[291] The liquidated damages paid by violators of the Virginia statute were allocated to a fund appropriated for the construction and maintenance of state highways. According to the court, this factor "has the earmarks of a provision for civil compensatory damages."[292] Hence, the court based its decision in part on the state's use of the penalty payment.

However, the Sixth Circuit pointed out a danger in relying too heavily on this fact. In *Mason and Dixon Lines*, the Virginia scheme imposed fines, which were clearly not deductible, and, in addition, liquidated damages, which were deductible, based *in part* on the compensatory nature of the use to which such monies were put. In *Tank Truck*,[293] the penalty statute also contained a similar direction that the money collected be applied to road repairs, yet the payment was held to be nondeductible under the pre-1969 public policy doctrine. The Sixth Circuit distinguished the Pennsylvania scheme in *Tank Truck* on the ground that the Pennsylvania statute involved only one payment which was clearly a fine, but which the statute applied to road repairs.[294] Therefore, in determining the nature of a payment by looking at how the

287. 603 F. Supp. 1370 (D. Wyo. 1985), *rev'd*, 894 F.2d 1197 (10th Cir. 1990) (reversing lower court's finding that the penalty was not deductible).

288. 33 U.S.C. § 1321(b)(6) (1988).

289. *True* 603 F. Supp. at 1374.

290. True v. United States, 894 F.2d 1197, 1205 (10th Cir. 1990).

291. 708 F.2d 1043 (6th Cir. 1983).

292. *Id.*

293. Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30 (1958).

294. *Mason and Dixon Lines, Inc.*, 708 F.2d at 1048.

money is spent, one must also be mindful of the statute's general scheme.

4) Strict Liability

The District Court in *True v. United States*[295] held that a penalty incurred under section 311(b)(6) of the Federal Water Pollution Control Act was deductible despite section 162(f), in part, because section 311(b)(6) imposed strict liability on the operator for a discharge of harmful substances regardless of fault. As such, the Act was a means to shift the cost to the one most able to bear it and to insure against the risk. The court, therefore, found that the penalty was not a punitive provision, but rather a remedial or compensatory one and, thus, deductible under section 162(f).[296]

On appeal the Tenth Circuit disagreed with the district court and held that even a strict liability penalty could be punitive and nondeductible.[297] It based its view on the pre-1969 case of *Hoover Motor Express Co. v. United States*,[298] which it read as a strict liability case, since the statute imposed liability on anyone driving an overweight truck even if the driver "acted with all due care and without willful intent."[299] The Tenth Circuit then analyzed section 311(b)(6) of the Federal Water Pollution Control Act and found that although it did have some remedial purposes, "on balance," the Act served mostly a deterrent and retributive function similar to a criminal fine and was therefore nondeductible.[300]

Arguably, the Claims Court in *Colt Industries, Inc. v. United States*,[301] can be read to approve the District Court's position in *True* that a strict liability penalty is remedial. In response to the taxpayer's reliance on the district court opinion in *True*,[302] the Claims Court in *Colt* merely distinguished *True* without any hint of disagreement on the strict liability point.[303] The Claims Court found *True* inapplicable solely because the penalties in *Colt* were imposed under a different section of the statute, that did not impose penalities regardless of

295. 603 F. Supp. 1370 (D. Wyo. 1985), *rev'd*, 894 F.2d 1197 (10th Cir. 1990).
296. *Id.*
297. *True*, 894 F.2d at 1205.
298. 356 U.S. 38 (1958).
299. 894 F.2d at 1205 (quoting *Hoover Motor Express Co.*, 356 U.S. at 40).
300. *Id.* at 1205-06.
301. 86-2 U.S.T.C. ¶ 9749 (Cl. Ct. 1986), *aff'd*, 880 F.2d 1311 (Fed. Cir. 1989).
302. *Colt* was decided by the Claims Court on October 23, 1986, well before the Tenth Circuit's reversal of this part of the district court's opinion in *True* on January 29, 1990.
303. *Colt Indus., Inc.*, 86-2 U.S.T.C. at 85,843.

fault.[304] Presumably, in *Colt*, but for the absence of a real strict liability provision, *True*'s reasoning would have been followed.

5) Miscellaneous Factors

a) Graduated Amount. In Mason and Dixon Lines, Inc. v. United States,[305] the Sixth Circuit held that the payment of liquidated damages for a violation of Virginia's vehicle weight laws was deductible despite section 162(f).[306] One of the factors considered by the court in finding the liquidated damages provision compensatory in nature was that the amount of damages was determined by the degree to which the offending vehicle's weight exceeded the prescribed limit. The damages were graduated so that the damages per pound of excess weight increased as the magnitude of the violation increased. Thus, for excess weight of 5000 pounds or less the damages were two cents per pound while the damages went up to five cents per pound when the excess weight was more than 5000 pounds. The Sixth Circuit felt this reflects "the known fact that damage to highways increases with added weight."[307]

This graduated amount reasoning in *Mason and Dixon Lines* is tenuous because the court assumes a correlation between the graduated rate and highway damage. A strong argument could be made that a purely punitive provision could have a similar graduation of the penalty imposed. Logically, one who is guilty of an egregious violation should receive a higher penalty than one who is guilty of only a slight violation. Furthermore, the state may impose graduated punishment in order to deter egregious violations more than minor ones.

b) Indefiniteness of Amount. In *S & B Restaurant,* v. *Commissioner,*[308] the taxpayer and Pennsylvania's Department of Environmental Resources reached on agreement that permitted the taxpayer to continue discharging sewage into a waterway until a local municipal sanitary sewer system became operational, at which time the taxpayer had to connect to that system. In the meantime, the taxpayer had to make monthly contributions to Pennsylvania's Clear Water Fund in an amount designed to approximate what the taxpayer would have been required to pay to the municipal sewer system had it then been in operation. In holding these monthly payments deductible, the Tax Court noted that "[t]he indefiniteness of the total amount of the payments makes

304. 86-2 U.S.T.C. ¶ 9749 at 85,843.

305. 708 F.2d 1043 96th Cir. 1983).

306. *Id.* at 1047-48 *See supra* text accompanying notes 217-18.

307. *Id.* at 1047.

308. 73 T.C. 1226 (1980), See *infra* text accompanying note 306 for a more detail discussion of this case.

them distinguishable in some degree from a fine or penalty which is usually in a fixed amount."[309] Thus, the indefiniteness of the amount removed the payment from the category of a fine or penalty.

c) Toll Charge. In *S & B Restaurant,*[310] the Tax Court also viewed the monthly payments as a license fee, and found the payments deductible. The payments "were made by petitioner in consideration of being allowed to continue to discharge its sewage waste, rather than as a fine or similar penalty imposed by law or 'settlement of the taxpayer's...actual liability for a fine or penalty.'"[311] In other words, the payment was like a license fee or toll charge for being permitted to do something, rather than a punitive imposition.

Revenue Ruling 88-46[312] presents another illustration of the toll charge situation. Under the Federal Clean Air Act, it is unlawful to sell any heavy-duty vehicle or engine unless it is covered by a certificate of conformity. A penalty of not more than $10,000 per truck or engine is imposed for any sale not covered by a certificate of conformity. A certificate of conformity can be obtained either by conforming to certain emission standards or by paying a nonconformance penalty ("NCP") if the truck or engine exceeds the emission standard but not by more than a certain upper limit associated with that standard.[313] In addressing the deductibility of the NCP, the I.R.S. found that the legislative history of the statute indicates that the NCP was not punitive in nature. Instead, two different means exist for receiving a certificate of conformity: to conform completely, to not conform completely, but fall within a range of nonconformity allowable upon the payment of the NCP. Thus, the NCP is not a nondeductible penalty, but an alternative means of compliance.

d) Economic Equalization Payments. It has been suggested that a monetary exaction equal to the savings achieved due to the violation of a law is compensatory and hence deductible.[314] Revenue Ruling 88-46[315] indicates that NCPs are to be set at a level that will eliminate the competitive advantage of a manufacturer of a nonconforming vehicle over a manufacturer of a conforming vehicle. This factor, plus the permissive characterization of the NCP in the legislative history, led the I.R.S. to

309. *Id.* at 1232.

310. 73 T.C. 1226 (1980).

311. 73 T.C. at 1232 (quoting Treas. Reg. § 1.162-21(b)(1)(iii)). *See generally,* John Skarbuck, DEDUCTING COMPENSATORY PENALTIES, 67 Taxes 786, 792 (1989).

312. 1988-1 C.B. 76.

313. *Id.*

314. *See* Skarbuck, *supra* note 312, at 792-93.

315. 1988-1 C.B. 76.

conclude that NCPs were deductible.[316] The logic for allowing a deduction for such payments seems to be that these payments are not punitive at all; rather, their purpose is to equalize the position of noncomplying and complying parties. As such they are remedial and thus deductible.[317]

However, the Federal Circuit in *Colt Industries, Inc. v. United States*,[318] did not find this reasoning persuasive. The court did not dispute *Colt*'s assertion that the penalty imposed returned the violator to the financial position it would have been in had it complied with the laws.[319] However, the court did not agree that such penalties in any way compensated the government.[320] Further, the court pointed out that the EPA was not authorized under either the Clean Air or Clean Water Acts to seek compensatory damages, but instead, was limited to injunctive relief and monetary penalties.[321] This factor has yet to substantially influence the courts.

2. Prompt Compliance Penalties

The Senate Finance Committee Report on the Revenue Act of 1971 stated that sanctions "to encourage prompt compliance with filing or other requirements which are really more in the nature of late filing charges or interest charges" are not within section 162(f).[322] When summarizing the applicability of section 162(f), courts likewise render lip service to this proposition.[323] However, to date, no court has found a penalty to be deductible because it was merely a prompt compliance penalty.

Decisions regarding Internal Revenue Code section 6651(a)(1) and (2) illustrate the nondeductibility of late fees. Section 6651(a)(1) imposes an addition to tax for failing to timely file certain tax returns.[324] The addition is equal to five percent of the tax required to be shown on the return for each month (or fraction thereof) the return is late, up to a maximum of twenty-five percent. Section 6651(a)(2) imposes an addition

316. *Id.*

317. *See* Skarbuck, *supra* note 312, at 793 (relying on Technical Advice Memorandum 8704003).

318. 880 F.2d 1311 (Fed. Cir. 1989). *See supra* text accompanying notes 177-82.

319. *Colt Indus., Inc.*, 880 F.2d at 1314.

320. *Id.*

321. *Id.*

322. This part of the Report is quoted in the text accompanying note 121, *supra*.

323. *See, e.g.*, *True v. United States*, 894 F.2d 1197, 1203-04 (10th Cir. 1990); *Bailey v. Commissioner*, 756 F.2d 44, 46-47 (6th Cir. 1985); *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, 824 (1983).

324. I.R.C. § 6651 (a)(1) (1994).

to tax for failing to pay the amount of tax shown on certain tax returns.[325] The addition is equal to one-half percent of the amount shown on the tax return for each month (or fraction thereof) that the payment is late, up to a maximum of twenty-five percent. The addition will not be imposed in either instance if the failure is due to reasonable cause and not willful neglect. However, despite the character of these exactions, both are nondeductible penalties under section 162(f).[326]

May v. Commissioner,[327] one of the early cases decided under section 162(f), is a good illustration of how the courts have handled the prompt compliance issue. The issue before the Tax Court was the deductibility of $881.34 paid as additions to tax under section 6651(a)(2). The taxpayer specifically referred to the legislative history and argued that this addition to tax should have been considered as interest or as a sanction to encourage prompt compliance in the nature of interest.[328] The court, however, did not accept this argument. Initially the court noted that interest is imposed by section 6601(a). The section 6651(a)(2) amount serves as a penalty for failure to pay the proper amount of tax and for allowing the tax debt to accrue. Additionally, the penalty, unlike interest, can be avoided upon a showing of reasonable cause and is limited to a maximum of twenty-five percent.[329] Finally, the regulations specifically include the section 6651(a) additions to tax in the definition of a fine or penalty within section 162(f),[330] and pre-1969 case law also disallowed a deduction for such amounts.[331]

Rust Communications Groups, Inc. v. United States,[332] a recent case that follows *May*, also involves the deductibility of the section 6651(a)(2) amount. In its analysis, the Claims Court compared section 6651(a)(2) with section 6651(a)(1) and noted that, while section 6651(a)(2) was enacted in 1969, section 6651(a)(1) was its much earlier predecessor. The Supreme Court, in addressing section 6651(a)(1),

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325. I.R.C. § 6651 (a)(2) (1994).

326. May v. Commissioner, 65 T.C. 1114 (1976) (regarding section 6651(a)(2)); Uhlenbrock v. Commissioner, 67 T.C. 818, 822 (1977) (regarding section 6651(a)(1)).

327. 65 T.C. 1114 (1976).

328. *Id.*

329. Id. at 1115-16.

330. *Id.* at 1116. Treas. Reg. § 1.162-21(b)(1)(ii) specifically includes in the definition of fines or similar penalties within section 162(f), all additions to tax, additional amounts and assessable penalties imposed by Chapter 68 of the Internal Revenue Code. Section 6651 is in Chapter 68, Subchapter A, Part I of the Internal Revenue Code. It should be noted that this regulation is based on language contained in the Senate Finance Committee Report on the Revenue Act of 1971, which is quoted in the text at *supra* note 91.

331. 65 T.C. at 1117 (citing Reuter, Jr. v. Commissioner, 37 T.C. 599, 601-02 (1961)).

332. 90-1 U.S.T.C. ¶ 83,932 (Cl. Ct. 1990).

characterized it as a civil penalty that resembled criminal sanctions for failure to pay taxes.[333] The Claims Court interpreted this statement to mean that "civil assessments that enforce timely tax return filings are penalties." The court went on to characterize the section 6651(a)(2) addition as a "penal sanction rather than a service or finance charge."[334] Under the Claims Court's reasoning, it would seem that the 6651(a)(1) addition would a *fortiori* be a penal sanction, since the Supreme Court's characterization was specifically addressed to this provision.

Finally, Revenue Ruling 78-196 illustrates the difficulty in qualifying a prompt compliance penalty as deductible.[335] In this ruling, the issue before the I.R.S. was the deductibility of a liquidity deficiency penalty imposed on a federal savings and loan association by the Board of the Federal Home Loan Bank. The penalty, which was imposed because the savings and loan association failed to maintain the required level of liquid assets, was computed using the amount of the deficiency in liquid assets, the period the deficiency existed, and the given interest rate.[336] Notwithstanding the penalty's obvious similarity to interest, the I.R.S. held that it was not interest and was, therefore, nondeductible under section 162(f). The I.R.S. characterized the penalty as "punitive in nature for allowing the liquidity deficiency to occur" and as being within section 1.162-21(b)(1)(ii) of the regulations. The penalty does not represent a late filing fee because no filing deadline is involved. "Neither is the penalty in the nature of an interest charge because no funds were borrowed, but rather there was a liquid funds deficiency. Also, unlike interest, a liquidity deficiency penalty may be, for good cause shown, compromised, remitted, or mitigated, in whole or in part. . . ."[337] The I.R.S.'s authorities for this finding, in addition to the cited provision of the regulations and the Senate Finance Committee Report on the Revenue Act of 1971, were the section 6651(a)(2) cases of *May* and *Uhlenbrock*.[338]

The I.R.S. presented its position most vividly in connection with the adoption of the present regulations. After the enactment of the Revenue Act of 1971 in December 1971, the Treasury withdrew certain regulations proposed earlier, including those in section 1.162-21 under code section 162(f), and issued new proposed regulations.[339] The flush language of

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333. Spies v. United States, 317 U.S. 492, 495-96 (1943).
334. 90-1 U.S.T.C. at 83,937.
335. 1978-1 C.B. 45.
336. *Id.*
337. *Id.*
338. *Supra* note 275.
339. 37 Fed. Reg. 25936 (Dec. 6, 1972).

newly proposed regulation section 1.162-21(b)(2) contained the following language on prompt compliance penalties:

> Such amount [*i.e.*, a nondeductible fine or penalty] also does not include a sanction imposed to encourage prompt compliance with filing or other requirements if such sanction is really more in the nature of a late charge or interest charge than a fine, as for example, in the case of a so-called penalty which is imposed with respect to the late payment of a State Tax without regard to whether the delay in payment was for reasonable cause.[340]

When the bulk of these proposed regulations were adopted in February, 1975,[341] the paragraph containing the above language was not included. The Treasury indicated that the provision would be reproposed.[342] On the same date, the reproposed portions were issued; they did not include the above language.[343] The Treasury's reason for dropping this language was stated as follows:

> A previous notice of proposed rule making ... contained language excluding from the definition of a fine and similar penalty sanctions imposed to encourage prompt compliance with filing or other requirements if the sanction was more in the nature of a late charge or interest charge than a fine. This language has been removed because it is inconsistent with the general Congressional intent in enacting section 162(f) not to liberalize the law with respect to the nondeductibility of fines and penalties.[344]

Thus, the Treasury does not accept this argument that prompt compliance penalties are outside the scope of section 162(f). However, as noted previously,[345] the Tenth Circuit has intimated that insofar as the regulations might be interpreted "to include the procedural violations Congress intended to exclude from section 162(f),"[346] they might be subject to challenge in appropriate circumstances.

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340. *Id.* at 25,938.
341. T.D. 7345, 40 Fed. Reg. 7437 (Feb. 20, 1975).
342. *Id.*
343. 40 Fed. Reg. 7453 (Feb. 20, 1975).
344. *Id.* These proposed regulations were adopted as final in 40 Fed. Reg. 29,290 (July 11, 1975).
345. *Supra* note 132.
346. True v. United States, 894 F.2d 1197, 1204 n. 18 (10th Cir. 1990).

3. Settlements and Compromises

Very often, rather than going through a trial or an administrative proceeding, an individual charged with misconduct that could result in the imposition of a fine or similar penalty will settle or compromise the matter. The issue is then raised whether such payment in settlement or compromise is within the ambit of section 162(f), and, if it is, how the punitive-versus-remedial dichotomy is applied.

Section 162(f) itself does not specifically address this issue, but simply provides that no deduction is allowed for "any fine or similar penalty paid to a government for the violation of any law."[347] This silence on the part of the statute is meaningful. When Congress enacted the set of provisions in the Tax Reform Act of 1969, which included section 162(f), it explicitly required a criminal conviction or plea of guilty or *nolo contendere* when it desired that there be such a prerequisite.[348] Thus, the failure to state any such requirement suggests that none was intended.[349] The regulations follow this view and provide that a fine or similar penalty includes an amount "[p]aid in settlement of the taxpayer's actual or potential liability for a fine or penalty (civil or criminal)."[350] The only contrary indication is contained in the 1969 Senate Report which arguably construed section 162(f) as applying only to fines arising from a conviction in a full criminal proceeding.[351] However, as discussed previously in this article, this report was criticized and corrected by the Senate Finance Committee in connection with the Revenue Act of 1971.[352]

When faced with this issue, the Claims Court and the Tax Court have both decided that settlements or compromise payments are within section 162(f) and that section 1.162-21(b)(1)(iii) of the regulations is valid. In *Adolf Meller Co. v. United States*,[353] the taxpayer devised a scheme to ship synthetic gemstones into the United States in such a manner as to avoid the delays and disruptions caused by a new procedure recently instituted by the United States Post Office. When custom officials discovered this scheme, they sent the taxpayer a Notice of Penalty demanding over $533,000, which represented a forfeiture of the full value of the gemstones imported in allegedly mislabeled packages, and also demanded over $55,000 for the customs duty due on the

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347. I.R.C. § 162(f) (1994).
348. Compare I.R.C. § 162(g) with § 162(f). *See supra* text accompanying notes 7 and 100.
349. *See* Taggart, *supra* note 6,at 647-48.
350. Treas. Reg. § 1.162-21(b)(1)(iii) (1975).
351. This portion of the report is quoted in the text accompanying *supra* note 88.
352. *See supra* text accompanying notes 88-103.
353. 600 F.2d 1360 (Ct. Cl. 1979).

allegedly mislabeled gems. After negotiations and administrative proceedings, an agreement was reached in which the taxpayer agreed to pay the customs duty allegedly due plus $43,000 in compromise of the original penalty of $533,000. The taxpayer deducted the $43,000 payment on his tax return. When the I.R.S. disallowed this deduction under section 162(f), the taxpayer paid the additional tax and ultimately brought suit for a refund in the Claims Court.

The taxpayer argued the following two points before the Claims Court: that section 162(f) did not apply to civil penalties, and even if it did, section 162(f) did not apply to amounts paid in settlement of such civil penalties.[354] With respect to the first issue, as discussed above,[355] the Claims Court held that section 162(f) does apply to civil penalties. With regard to the settlement payment, the court noted that, under the pre-1969 law, settlements were "treated as though they partook of the character of the obligation which generated them."[356] In other words, the court looked past the settlement payments and determined their deductibility based on the act that necessitated the settlement. The court then indicated that Congress did not intend to change this result in enacting section 162(f) and held that section 162(f) applied to settlement payments and that Treasury regulation section 1.162.21(b)(1)(iii) was valid.[357]

In *S & B Restaurant, Inc. v. Commissioner*,[358] the Tax Court also addressed this issue. The taxpayer owned and operated a motel and restaurant in Pennsylvania. As part of its operations, *S & B* discharged raw sewage directly into an underground waterway, allegedly in violation of the Pennsylvania Clean Streams Law. As a result of negotiations, the taxpayer and Pennsylvania's Department of Environmental Resources entered into an agreement, specifying that the taxpayer could continue to discharge the sewage into the waterway until a local municipal sanitary sewer system became operational, at which time the taxpayer had to connect to that system. In the meantime, the taxpayer had to donate one thousand dollars per month (later rising to $1,250 per month after the taxpayer completed construction of additional motel units) to Pennsylvania's Clean Water Fund. The monthly contribution to the Clean Water Fund was designed to approximate what the taxpayer would

354. *Id.* at 1362.

355. See *supra* text accompanying notes 86-104.

356. 600 F.2d at 1364 (citing McGraw-Edison Co. v. United States, 300 F.2d 453, 456 (Ct. Cl. 1962)).

357. 600 F.2d at 1364.

358. 73 T.C. 1226 (1980).

have been required to pay to the municipal sewer system had it then been in operation. The taxpayer deducted the amounts it paid to the Clean Water Fund during 1974 and 1975. The deductibility of these amounts under section 162(f) was the issue before the Tax Court.

The taxpayer raised two points before the Tax Court. First, the taxpayer argued that the payments did not constitute a fine or penalty. Second, the taxpayer argued the payments were, in any event, outside of section 162(f) because no legal proceeding was ever instituted against the taxpayer and no conviction or other disposition of such proceeding was involved, that is, that the payment was a settlement. After extensively analyzing the facts, the Tax Court concluded that the payments were not fines or similar penalties, but were deductible as fees paid for being permitted to continue to discharge sewage into the waterway.

Although the taxpayer's second point was therefore moot, the Tax Court addressed it anyway. The Tax Court stated that there was no requirement that a legal proceeding be instituted as a precondition to the applicability of section 162(f). In fact, the court noted that requiring the institution of a legal proceeding may present a serious problem by encouraging taxpayers "to pay early and get the deduction."[359] Although the Tax Court merely noted that *Adolf Meller Co.* upheld regulation section 1.162-21(b)(1)(iii)[360] and did not state its view thereon, it did uphold the regulation in subsequent cases.[361] More recently both the Claims Court and the Federal Circuit upheld this regulation.[362]

When determining if a settlement payment is punitive or remedial, logic demands that the court make this decision based upon the nature or character of the underlying claim. The Tax Court and the Sixth Circuit have indicated that it is necessary to look to the "origin of the liability" giving rise to a settlement to determine the characterization of a payment under section 162(f).[363] The subsequent cases on this point rely on the Tax Court's opinions in either *Middle Atlantic Distributors, Inc.*[364] or

359. *Id.* at 1234. *Cf.* Taggart, *supra* note 6, at 620-21 (discussing "pay early and deduct" in the context of treble damage payments under code section 162(g)).

360. *S & B Restaurant, Inc.*, 73 T.C. at 1234 n.7.

361. *See* Henson Robinson Co. v. Commissioner, 48 T.C.M. 508 (1984); Shapiro v. Commissioner, 43 T.C.M. 136 (1981).

362. Colt Indus., Inc. v. United States, 86-2 U.S.T.C. ¶ 85,839 (Ct. Cl. 1986), *aff'd*, 880 F.2d 1311, 1314 (Fed. Cir. 1989).

363. See Waldman v. Commissioner, 88 T.C. 1384 (1987), aff'd, 850 F.2d 611 (9th Cir. 1988); Middle Atlantic Distributors, Inc. v. Commissioner, 72 T.C. 1136 (1979); Uhlenbrock v. Commissioner, 67 T.C. 818 (1977); Kraft v. United States, 991 F.2d 292 (6th Cir. 1993); Bailey v. Commissioner, 756 F.2d 44 (6th Cir. 1985).

364. 72 T.C. 1136 (1979).

Uhlenbrock,[365] both of which adopt the Supreme Court's origin-of-the-liability test as set forth in *United States v. Gilmore*.[366]

In *Gilmore*, the issue before the Supreme Court was the deductibility, under Internal Revenue Code section 212(2), (and its predecessor section under the 1939 Internal Revenue Code) of legal fees attributable to the taxpayer's successful resistance to his wife's claims to certain of his assets in a divorce proceeding. His assets consisted of controlling stock interests in three franchised General Motors dealerships. As president and principal shareholder, the taxpayer received salaries and dividends totalling approximately $150,000 per year, which represented virtually all of his annual income.

The taxpayer was interested in defeating his wife's claim to these assets for two reasons. First, the taxpayer's loss of his controlling stock interests to a hostile ex-wife would likely cost him his corporate positions and the means of earning his livelihood. Second, there was a danger that if the taxpayer was found guilty of his wife's sensational and reputation-damaging charges, General Motors might exercise its option to cancel the dealer franchises.[367] The taxpayer was ultimately victorious in his divorce case, and the Court of Claims below found that eighty percent of his legal fees in the divorce action were deductible as an expense incurred under section 212(2) for the conservation of property held for the production of income.[368]

The Supreme Court reversed the lower court and held that these amounts were not deductible under section 212(2), explaining that in order to be deductible, the underlying claim must arise in connection with profit-seeking activities. The origin and nature of the underlying claim is determinative, rather than the consequence if the claim is not defeated; therefore, despite the fact that a loss in the divorce litigation would have cost the taxpayer his income-producing positions and property, the nature of the claim was personal. The claim arose out of the taxpayer's marital status, which is clearly not a profit-seeking activity.

The origin-of-the-liability test is used both in the simple situation of when an asserted claim against the taxpayer is settled, rendering it necessary to determine if the amount paid represents a punitive or remedial payment, as well as in more complicated situations when the

365. 67 T.C. at 818

366. 372 U.S. 39, 48-49 (1963). *See also* Andrews, *supra* note 46, at 317.

367. 372 U.S. at 41-42.

368. 372 *Id.* at 42-43. Technically, the Court of Claims and the Supreme Court addressed the deductibility of such amounts under section 23(a) (2) of the 1939 Internal Revenue Code. However, section 212(2) of the 1954 (and 1986) Internal Revenue Code are substantially identical. *Id.* at 40 n.3.

taxpayer argues that there has been a transformation of his payment from one type into another. *Middle Atlantic Distributors, Inc. v. Commissioner,*[369] which was already discussed earlier, illustrates the simple situation.[370] In this case, the United States Customs Service initially sought over $500,000 from the taxpayer as a "penalty or liquidated damages" but eventually settled for $100,000. In the course of determining whether the $100,000 was deductible, the Tax Court stated that "the character of the payment involved depends on the origin of the liability giving rise to it."[371] The court, therefore, commenced its analysis by examining the character of the statute under which the Customs Service originally asserted its claim against the taxpayer.

The second situation, when the taxpayer argues there has been a transformation of his payment, is illustrated by *Uhlenbrock v. Commissioner.*[372] In *Uhlenbrock*, the taxpayer was the co-executor of an estate as well as a legatee. The estate filed its federal estate tax return five months late, resulting in an addition to tax under Code section 6651(a)(1) for over $39,000. After exhausting its remaining assets, the estate still owed over $30,000, plus interest, to the government. Ultimately, the beneficiaries and fiduciaries of the estate reached an agreement as to how to share this obligation among themselves. The taxpayer's share came to over $7,900, which he paid in 1973. The taxpayer claimed a deduction on his tax return for this amount, and the I.R.S. disallowed the portion attributable to the section 6651(a) addition to tax for late payment under section 162(f).[373] One of the arguments raised by the taxpayer in support of being able to deduct this amount was that even if a section 6651(a) addition to tax is a nondeductible penalty under section 162(f) (which the Tax Court held it was), under the statute imposing liability on a fiduciary in such circumstances, the amount was transformed into a debt of the estate for which the fiduciary was liable. The addition thereby lost its penalty character.[374] In rejecting this

369. 72 T.C. 1136 (1979).

370. *See supra* text accompanying notes 288-94.

371. 72 T.C. 1136 (1979).

372. 67 T.C. 818 (1977).

373. *Id.* at 821. Technically, the taxpayer claimed the deduction for this amount under section 212 as an expense in connection with the production of income. however, the Tax Court held that the section 162 requisites for deductibility had to be met for the amount to be deductible under section 212. Treas. Reg. § 1.212-1(g). Thus, the Tax Court focused on section 162(f). *Id.*

374. *Id.* at 823. The provision which the taxpayer relied upon was 31 U.S.C. § 192 (1970) which provided:

> *Liability of Fiduciaries.* Every executor, administrator, or assignee, or other person, who pays, in whole or in part, any debt due by the person or estate for whom or for which he acts before he satisfies and pays the debts due to the United States from

argument, the Tax Court referred to the need to look "to the origin of the liability involved to determine its true characterization."[375] In doing so, the court determined that this addition was essentially a penalty for the taxpayer's "failure to exercise ordinary care in seeing to the timely filing of the estate tax return."[376]

Revenue Ruling 81-151 contains another interesting application of the origin-of-the liability doctrine.[377] Here a corporation incurred a fine as a result of pleading guilty to making illegal political contributions. A shareholder's derivative action was later filed against both the corporation and the three officers who caused it to engage in the illegal activity. Essentially, the suit sought to obtain reimbursement from the officers for the illegal contributions and fine. A, the officer involved, ultimately paid an amount to the corporation for his portion of the illegal contributions and fine. The ruling addressed the issue of whether the amount A paid was deductible under sections 162 and 165. In ruling that a deduction was not available under section 162 because of section 162(f), the I.R.S. held that A's reimbursement retained the original underlying character of the expenditures to which it related; thus, as an illegal political contribution and a fine, it was not deductible.[378]

C. ". . .Paid to a Government. . ."

The next requirement for the applicability of section 162(f) is that the fine or penalty must be "paid to a government."[379] The regulations amplify this requirement by providing that it applies to the following payments:

> (1) The government of the United States, a State, a territory or possession of the United States, the District of Columbia, or the Commonwealth of Puerto Rico;
> (2) The government of a foreign country; or
> (3) A political subdivision of, or corporation or other entity serving as an agency or instrumentality of, any of the above.[380]

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such person or estate, shall become answerable in his own person and estate to the extent of such payments for the debts so due to the United States, or for so much thereof as may remain due and unpaid.

375. *Uhlenbrock*, 67 T.C. at 823 (citations omitted).

376. *Id.*

377. 1981-1 C.B. 74.

378. *Id.* at 75. The reader should compare this ruling with Barone v. Commissioner, 85 T.C. 462 (1985). *See infra* text accompanying notes 361-64.

379. I.R.C. § 162(f) (1994).

380. Reg. § 1.162-21(a) (1975).

While this requirement seems relatively straight forward and non-controversial, no legislative history is on point.[381] A number of cases and Revenue Rulings seem to honor this requirement only in the breach. The Tax Court appears to take the position that so long as a court orders a payment, the "paid to a government" requirement will be met even if a government does not ultimately pocket the payment. In *Waldman v. Commissioner*,[382] the taxpayer was sentenced to a one-to-ten year prison term, but execution of the sentence was stayed on condition that he pay specified amounts of restitution to his victims. Waldman paid $28,500 in restitution. The issue before the Tax Court was the deductibility of this amount in light of section 162(f). In determining if the fine met the "paid to a government" requirement, the court stated:

> The State, moreover, exercised complete control over the ultimate disposition of petitioner's payments. The court ordered petitioner to pay specified amounts of restitution to specified victims and informed him that "If the court and the victims are not satisfied that things are going along as they should be, we will not hold a probation violation hearing; I will simply dissolve the stay of execution and you will be committed to State Prison." We do not believe that a Government must actually "pocket" the fine or penalty to satisfy the "paid to a government" requirement of section 162(f). Petitioner's "fine or penalty" was "paid to a government" and is not deductible.[383]

The Ninth Circuit presumably adopted this reasoning when it affirmed *Waldman* "substantially for the reasons stated by the Tax Court in its opinion."[384] The Tax Court continued this approach in *Stephens v. Commissioner*[385] and may have even extended it in *Allied-Signal, Inc. v. Commissioner*.[386]

381. The 1969 Senate Report merely repeats the statutory language without focusing on it. *See supra* note 4, at 274; 1969-3 I.R.B. at 597. The Senate Finance Committee Report on the Revenue Act of 1971 is silent on this point. *See supra* note 91.

382. 88 T.C. 1384 (1987), *aff'd*, 850 F.2d 611 (9th Cir. 1988). *See supra* text accompanying notes 193-95.

383. *Waldman*, 88 T.C. at 1389.

384. 850 F.2d at 611.

385. 93 T.C. 108 (1989), *rev'd*, 905 F.2d 667 (2d Cir. 1990). *See supra* text accompanying notes 158-64

386. 63 T.C.M. 2672 (1992). *Allied-Signal* is discussed in more detail *supra* notes 167-76 and accompanying text.

In *Waldman*,[387] the sentencing court ordered the payment of restitution as a condition to staying the execution of the one-to-ten year prison term, but in *Allied-Signal*[388] the court never directly ordered anything. Instead, as discussed previously,[389] the court informally assured the taxpayer that it would reduce the fine previously imposed by the amount of the taxpayer's "voluntary" contribution to a local environmental fund. In addressing the "paid to a government" requirement, the Tax Court merely cited *Waldman* and stated, "[t]he fact that the payment at issue in this case was made to the Endowment does not change our result." The payment was held to be within section 162(f) and therefore nondeductible.[390]

Waldman sidesteps the literal "paid to a government" requirement, but other cases and the I.R.S. basically ignore it. In *Bailey v. Commissioner*,[391] as previously discussed,[392] Bailey was fined $1,036,000 for violating an earlier consent decree with the Federal Trade Commission. However, the sentencing court granted Bailey's request that the $1,036,000 be applied as restitution in settlement of another case, then pending, which arose from the same facts. In addressing Bailey's argument that section 162(f) was inapplicable because the payment was not a penalty paid to a government, but rather a restitution to private litigants, the Sixth Circuit merely relied upon the origin-of-the-liability doctrine.[393] Since this payment originated as punishment for the violation of the Federal Trade Commission Act, its nature as a nondeductible fine remains unchanged, even though it was ultimately applied to restitution to victims.[394]

Bailey can be explained away because the judge who imposed the original fine, and who later permitted the application of the fine towards restitution, specifically stated that "the ultimate disposition of these funds in no way shall alter their status as civil penalties."[395] However, a later Sixth Circuit case involving a restitution payment to a private, nongovernmental entity, merely cited *Bailey*, noting that the restitution payment arose out of a criminal proceeding and held the payment to be

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387. 88 T.C. at 1384.
388. 63 T.C.M. at 2672.
389. *See supra* text accompanying notes 168-72.
390. 63 T.C.M. at 2683.
391. 756 F.2d 44 (6th Cir. 1985).
392. *See supra* text accompanying notes 212-18.
393. This doctrine is discussed , *infra*, in notes 311-26 *infra* and accompanying text.
394. 756 F.2d at 46-47.
395. *Id.* at 46.

nondeductible under section 162(f).[396] That court never even discussed the "paid to a government" requirement.

In Revenue Ruling 81-151,[397] the I.R.S. relied on the origin-of-the-liability test to establish the basic nondeductible, punitive nature of a payment, but then virtually ignored the "paid to a government" requirement. In this Revenue Ruling, as discussed previously,[398] a corporation made illegal political contributions and was fined. Consequently, the corporation, derivatively, sued the officers for reimbursement. In holding that the amount paid to the corporation by one of the officers was nondeductible under section 162(f), the I.R.S. focused solely on the nature of the payment and not on the "paid to the government" requirement. Because the origin of the liability was an illegal contribution and a fine, the officer's payment to the corporation was nondeductible. The ruling never even mentioned the "paid to a government" requirement.[399]

A possible way of harmonizing *Bailey*, Revenue Ruling 81-151, and, perhaps, even *Allied-Signal* is suggested in Revenue Ruling 79-148.[400] Here, before being sentenced for unlawfully selling products to a foreign country in violation of federal law, the taxpayer offered to contribute to a local charity an amount equal to the maximum possible fine the taxpayer was facing. At sentencing, the court suspended the taxpayer's sentence, placed him on probation, and directed him to pay the proffered amount to the charity. In determining the nondeductibility of charity payments under section 162(f), the I.R.S. relied on section 1.162-21(b)(1)(iii). This section stipulates that a fine or similar penalty includes an amount paid in settlement of an actual or potential liability for a fine or penalty. Here, the payment to charity in lieu of a fine was ruled to be nondeductible under section 162(f).

Revenue Ruling 79-148 suggests that once a payment is determined to be a "fine or similar" penalty under the normal requisites, including the "paid to a government" requirement, any settlement, arrangement or payment in lieu of such amount will automatically remain within section 162(f). One commentator referred to this concept, at least with respect to Revenue Ruling 79-148, as piggybacking the "paid to a government" requirement onto the "fine or similar penalty" requirement.[401]

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396. Kraft v. United States, 991 F.2d 292 (6th Cir. 1993).

397. 1981-1 C.B. 74.

398. *See infra* text accompanying notes 325-26.

399. 1981-1 C.B. at 74-75.

400. 1979-1 C.B. 93. Rev. Rul. 79-148 is discussed in more detail *supra* text accompanying notes 202-04.

401. Andrews, *supra* note 46, at 327

Piggybacking gives the court and others greater flexibility in fashioning a non-fine alternative remedy without automatically taking the alternative out of section 162(f) and making it deductible. The problem with this approach, however, is that it is inconsistent with the literal requirements of section 162(f), which imposes both a "fine or similar penalty" and a "paid to a government" requirement.

Two cases notably apply the literal "paid to a government" requirement. In upholding the deductibility of a victim's restitution payment because it consitituted neither a fine nor a penalty, *Spitz v. United States*[402] recognized the "paid to a government" requirement. The court reasoned that "although the payment was funneled through the State Department of Public Welfare, it was paid to...[the victim] not 'to a government' within the meaning of § 162(f)."[403]

Finally, in *Stephens v. Commissioner*,[404] the Second Circuit reversed the Tax Court and held that a restitution payment fell outside the scope of section 162(f). It emphasized that the Tax Court's reliance on the origin of the liability argument and on *Waldman* was not well placed.

> Stephens' payment was made to Raytheon, and not "to a government." The Tax Court, relying on *Waldman* found that "the fact that the payment in question was made to a private person as restitution rather than to a Government agency in and of itself does not preclude the application of section 162(f)." In *Waldman*, noting that "the characterization of a payment for purposes of section 162(f) depends on the origin of the liability giving rise to it," the Tax Court disallowed a deduction for restitution payments made as a condition of probation because the "payments . . . were . . . in satisfaction of...criminal liability to the State."
>
> To the extent that *Waldman* may be interpreted as suggesting that a restitution payment, ordered in addition to punishment and paid directly to a victim, would not be a deductible loss, we respectfully disagree. In codifying the public policy exception to deductibility of expenses under Section 162, Congress was clear and specific, limiting the exception to bribes, kickbacks and other illegal payments; a portion of treble damage payments; and fines and similar penalties paid *to a government*.[405]

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402. 432 F. supp. 148 (E.D. Wis. 1977). *Spitz* is discussed in more detail, *supra*, text accompanying notes 228-30.

403. *Spitz*, 432 F. Supp. at 150.

404. 905 F.2d 667 (2d Cir. 1990).

405. *Id.* at 673-74 (emphasis added) (citations omitted).

Stephens, however, must be read cautiously. Immediately after the above material, *Stephens* added that "[w]hether or not payment to a private party always insulates restitution from the public policy exception of Section 165, it does so on the facts of this case."[406]

There are two additional grounds for the decision in *Stephens*. In addition to the fact that the payment was to an individual and not to a government, the Second Circuit also relied on the ground that the restitution payment involved was "primarily a remedial measure to compensate another party, not a 'fine or similar penalty.'"[407] Pointedly, the Second Circuit refused to decide if either ground alone would suffice. "Two considerations drawn from Section 162(f) and the cases construing that provision combine to support our conclusion in this case. Whether either consideration alone would suffice is a matter we need not decide."[408]

D. "...For the Violation of Any Law."

The final requirement of section 162(f) mandates that the payment be "for the violation of any law."[409] This requirement will not detain us long because no case exists on point and the legislative history is silent. The regulations, make clear that the law need not be a federal law, but can be a state or local law as well.[410]

The only commentator to recently, or perhaps ever, focus on this "for the violation of any law" requirement did so from the vantage of whether sanctions imposed upon attorneys under Rule 11 of the Federal Rules of Civil Procedure are deductible under section 162(f).[411] The basic issue pertained to whether the Federal Rules of Civil Procedure rise to the level of a "law" under section 162(f). Based on a Tenth Circuit case that interpreted a reference to "any statute" in the Equal Access to Justice Act to be broad enough to include Rule 11, and on the fact that the Federal Rules of Civil Procedure are generally accorded the force of a statute, the author concluded that Rule 11 is within the ambit of "any

406. *Id.* at 674.
407. *Id.* at 672-73.
408. *Id.* at 672.
409. I.R.C. § 162(f) (1994).
410. Treas. Reg. § 1.162-21(b)(1)(i)(1975) (refers to conviction or plea of guilty or *nolo contendere* in a criminal proceeding, without limiting it in any way); § 1.162-21(b)(1)(ii) (specifically refers to a civil penalty imposed by Federal, State or local law); Treas. Reg. § 1.162-21(c) Exs.(6),(7) and (8)(referring respectively to violations of a state maximum vehicle weight law, state environmental law and a local housing code).
411. Andrews, *supra* note 46, at 329.

law" in section 162(f).[412] Although not mentioned there, the section 162(f) regulations contain an example of a nondeductible fine, one imposed for the violation of a city housing code.[413] Such codes typically are not denominated "laws." Therefore, if a housing code is given the force of a law for the purposes of Section 162(f), the Federal Rules of Civil Procedure may too be considered a law and, hence, a sanction imposed under Rule 11 would be nondeductible.

E. Miscellaneous

1. Payment of Another's Fine

An interesting issue arises when an individual pays a penalty on behalf of another. Suppose the government fines A $100 under a law that makes him liable even though the forbidden act was actually the fault of B. A thereafter recovers the $100 from B. If section 162(f) would have denied a deduction for payment of the $100, does it follow that B's reimbursement of the $100 to A is nondeductible?

Clearly the mechanics of the payments should not be controlling. The result should be the same if B pays the $100 to A who, either before or afterwards, pays it to the government or if B actually makes the payment directly to the government on behalf of A.

Two preliminary points must be briefly addressed before going to the heart of the issue. First, the case presently under discussion drastically differs from the issue that arises when a taxpayer who is liable to a government for an exaction otherwise within section 162(f) pays another person instead. In that situation, the money never rests with the government, while here it does.[414] Second, the present case also differs from the issue arising when a fine or penalty is imposed on A because of B's act or omission, and A pays the exaction without reimbursement from B. Interestingly, the latter situation arose in Tank Truck,[415] the leading case in the pre-162(f) "public policy" disallowance area. In *Tank Truck*, the taxpayer trucking company, which had sent out its drivers with overweight loads, paid fines imposed on its drivers.[416] The Supreme Court, after noting the fact that it was the drivers who had actually been

412. *Id.* at 330.

413. Treas. Reg. § 1.162-21(c) Ex.(8) (1975).

414. The other situation -- where the person liable to a government pays another person instead -- is the restitution situation specifically addressed *infra* Part V.

415. *Supra* note 41.

416. Tank Truck Rentals, Inc., 56 U.S.30,34n.7 (1958).

fined, simply proceeded as if the fines paid by the taxpayer had been imposed on it.

In *Barone v. Commissioner*,[417] the taxpayer owned a tractor and engaged exclusively in pulling tractor trailers in interstate driving for ICCC. On one trip, following an inspection of the truck, ICCC was charged with violating a rule of the Virginia State Corporation Commission's Rules and Regulations Governing the Operation of Motor Vehicles Under Lease because of an inadequate lease that ICCC had given to the taxpayer. Rather than contest the charge, ICCC paid the $200 fine and then withheld the $200 from the taxpayer's paycheck without his consent. The taxpayer claimed a deduction for the $200 withheld from him by ICCC, but the I.R.S. disallowed the deduction. The I.R.S. argued before the Tax Court that section 162(f) required the disallowance of this deduction. The Tax Court disagreed with the I.R.S. and found section 162(f) inapplicable because the fine was imposed solely on ICCC, not the taxpayer. No authority exists to extend section 162(f) to the payment of a fine imposed on another.[418]

Interestingly, the Tax Court in *Barone* did not mention Revenue Ruling 81-151,[419] which suggests a different result. In this ruling, as noted previously,[420] an officer of a corporation reimbursed the corporation for part of the illegal political contributions made by the corporation over a period of years and for part of the resulting fine it incurred. In disallowing the deduction under section 162(f), the I.R.S. utilized the origin-of-the-liability doctrine. Because the reimbursement concerned illegal political contributions and fines, the reimbursement retained this underlying character and was nondeductible. Similarly, in *Barone*, the amount paid by the taxpayer should not be deductible since its origin was as a fine paid to a government, a payment clearly nondeductible under section 162(f).

Perhaps Revenue Ruling 81-151 is distinguishable because in *Barone* the taxpayer truck driver was in no way responsible for the inadequate lease given by his employer. It also represented the payment of another's fine. In the Revenue Ruling, however, the officer involved approved the illegal political contributions and, thus, bore some direct responsibility for the underlying imposition. In the Ruling, a court approved the settlement of the derivative suit against the officer, thereby implicitly recognizing the meritorious nature of the claim against the officer. His

417. 85 T.C. 462 (1985).

418. *Id.* at 467-68.

419. 1981-1 C.B. 74.

420. *See supra* text accompanying notes 325-26.

reimbursement, therefore, could be deemed to be more directly connected to the underlying payment.

Applying these principles to the hypothetical involving A and B, when B is responsible for the exaction against A, the "origin of the liability" doctrine should apply to make B's reimbursement to A nondeductible, like the underlying exaction upon A. Where B is not responsible for the exaction against A, but pays it either involuntarily (as did Mr. Barone) or in some other, non-culpable capacity, then the payment ought to be deductible, insofar as section 162(f) is concerned.

Part V - Restitution Payments

In attempting to determine if restitution payments by a stock swindler/manipulator or by someone who embezzled or otherwise stole funds[421] are deductible, two possible approaches exist. The first, which is narrow in scope, simply addresses the issue through the prism of section 162(f). The other approach views the issue from the vantage point of restitution.

A. The Section 162(f) Prism.

Under section 162(f), Spitz, Waldman, Bailey, *Kraft and Stephens* are the only cases to address the deductibility of restitution payments.[422] These cases are split on the issue. The Tax Court and Sixth and Ninth Circuits disallowed the deductions, while a District Court for the Eastern District of Wisconsin and the Second Circuit allowed the deductions.

From a technical standpoint, the analysis under section 162(f) remains clear and simple. The threshold issue should be whether the restitution fulfills the "paid to a government" requirement. If it succeeds, one must determine if the payment is a "similar penalty," and, therefore, a deduction is disallowed by section 162(f). This latter determination depends on whether the restitution payment is punitive or remedial in nature.

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421. This section only addresses the issue of restitution by one who wrongfully obtained funds and must now make restitution of such funds. This section does not address the situation where the deductibility of reimbursements made to an individual, but where the individual involved did not pocket anything initially. This latter situation is illustrated by Barone v. Commissioner, 85 T.C. 762 (1985) and Rev. Rul. 81-151, 1981-1 C.B. 74, which are discussed *supra* notes 361-64, and accompanying text.

422. *Supra* Kraft v. United States, 991 F.2d 292(6th Cir. 1993); Stephens v. Commissioner, 88T.C. 1384 (1987) *aff'd*, 850 F.2d 611 (9th Cir. 1988); Bailey v. Commissioner, 756 F.2d 44 (6th Cir. 1985); Spitz v. United States, 432 F. Supp. 148 (E.D. Wis. 1977).

In reality, however, as discussed above,[423] the cases disallowing a deduction for restitution payments either ignore the "paid to a government" requirement or piggyback this requirement onto the fine or similar penalty requirement.[424] They direct their attention toward determining whether the particular restitution payment involved is punitive or remedial in nature. As to this latter determination, since each situation must be judged by its own unique facts and circumstances, different conclusions could be expected. This is especially true in view of the fact that even the criminal law cannot determine if restitution is punitive or remedial.[425]

B. The Restitution Vantage

If the deductibility issue is approached from the vantage of restitution in general, one must start with the seminal case of James v. United States.[426] In *James*, the Supreme Court held that gross income must include embezzled funds in the year in which the funds were misappropriated.[427] The Court went on to strongly imply that a deduction is available when the victim is repaid the misappropriated funds.[428]

When misappropriated funds are voluntarily repaid, so long as income was recognized when the funds were embezzled, the offsetting deduction seems to be available.[429] However, when the court compels the return of misappropriations, the availability of the deduction is more problematic.[430] It is not entirely clear why this occurs. Presumably,

423. *See supra* text accompanying notes 327-53.

424. *See supra* text accompanying note 346.

425. *See generally*, JOE HUDSON AND BURT GALAWAY, CONSIDERING THE VICTIM (1975);STEPHEN SCHAEFFER, COMPENSATION AND RESTITUTION TO VICTIMS OF CRIME (2d ed. 1970); Andrew H. Elder, *Criminal Law -- Sentencing -- Restitution: The Restitution Provisions of the Victim and Witness Protection Act of 1982 Violate the Fifth and Seventh Amendments to the Constitution of the United States -- U.S. v. Melden* 568 F. Supp. 516 (N.D. Ala. 1983), 53 U. CIN. L. REV. 263 (1984); Alan T. Harland, *Monetary Remedies for the Victims of Crime: Assessing the Role of the Criminal Courts*, 30 UCLA L. REV. 52, 57 (1982). *See also* Robert T. Manicke, *A Tax Deduction for Restitutionary Payments? Solving the Dilemma of the Thwarted Embezzler*, 1992 U. ILL. L. REV. 593, 609-12 (1992).

426. 366 U.S. 213 (1961).

427. *Id.*

428. "If and when the victim recovers the embezzled funds there is "of course" a reduction in the embezzler's income." *Id.* at 220. *See also* Tyler, *supra* note 16, at 673-74.

429. *See, e.g.*, Stephens v. Commissioner, 93 T.C. 108 (1989), *rev'd*, 905 F.2d 667 (2d Cir. 1990); Norman v. Commissioner, 407 F.2d 1337 (3d Cir.), *cert. denied*, 395 U.S. 947 (1969); Ianniello v. Commissioner 98 T.C. 165, 174 (1992); Foster v. Commissioner, 57 T.C.M. 661, 665 n.5 (1989); Bowden v. Commissioner, 40 T.C.M. 819, 821 (1980); Yerkie v. Commissioner, 67 T.C. 388, 392-94 (1976).

430. *See, e.g., Stephens* 905 F.2d at 671; Kraft v. United States, 991 F.2d 292 (7th Cir.

once the court intervenes, the payment more closely resembles a non-deductible fine. If it arose in a criminal proceeding or in lieu of a fine, perhaps some notion of public policy intrudes to make the payment nondeductible.[431]

Analytically, to understand why a deduction presents problems in the face of court compulsion, one must backtrack and identify the source of the deduction for the repayment of misappropriated funds. Although some commentators try to cast a broader net,[432] only two possible sources for the deduction truly exist. First, section 162(a) could apply to a taxpayer engaging in the trade or business of embezzling, an unlikely scenario, especially when only one or several embezzlements or series of embezzlements are involved.[433] However, if the obligation to make restitution arises from the taxpayer's regular trade or business activities as, for instance, when a stock trader or arbitrageur violates the securities laws, then section 162(a) would be the source for the deduction. When this is the case, the prior discussion of section 162(f) is applicable.

The second possible source for the deduction is section 165(c)(2). This section allows a deduction for "losses incurred in any transaction entered into for profit, though not connected with a trade or business."[434] In theory, the embezzlement, albeit illegal, is a profit seeking transaction that generates taxable income. Any restitution therefrom is a loss incurred in connection with this transaction. If the deduction is to be disallowed, it must be disallowed on the nonstatutory, public policy grounds that have developed under section 165.[435] While it might initially appear that section 165's judicial public policy considerations differ from those developed under section 162(f), in reality they have converged. Both the section 165 judicial public policy developments and section 162(f) trace their origins to *Tank Truck*[436] and the other pre-1969 Supreme Court cases discussed in Part III of this article.[437] In fact, prior to the 1969 codification of the public policy

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1993); Waldman v. Commissioner, 88 T.C. 1384 (1987) *aff'd*, 850 F.2d 611 (9th Cir. 1988); Bailey v. Commissioner, 756 F.2d (6th Cir. 1985); and .

431. *See supra* text accompanying notes 186-234.

432. *See, e.g.*, Manicke, *supra* note 370, at 596-98, 605-08.

433. *See, e.g.*, *Kraft*, 991 F.2d at 298.

434. I.R.C. § 165(c)(2) (1994). *See, e.g.*, *Stephens*, 905 F.2d at 670; *Kraft*, 991 F.2d at 298; Mannette v. Commissioner, 69 T.C. 990 (1978).

435. *See, e.g.*, Wood v. United States, 863 F.2d 417, 421 (5th Cir. 1989); Holt v. Commissioner, 69 T.C. 75 (1977), *aff'd per curiam*, 611 F.2d 1160 (5th Cir. 1980); Lincoln v. Commissioner, 50 T.C.M. 185 (1985); Holmes v. Commissioner, 69 T.C. 114 (1977); Mazzei v. Commissioner, 61 T.C. 497 (1974).

436. *See supra* note 41.

437. *See, e.g.*, *Stephens*, 905 F.2d at 670-71, 671-72.

developments in section 162(f), the tests for nondeductibility of business expenses under section 162 and losses under section 165 mirrored each other.[438] In addition, *Stephens*,[439] a case concerning section 165(c)(2), held that the principles of section 162(f) apply. Both the Tax Court below and the Second Circuit on appeal extensively analyzed those principles in arriving at their conclusions under section 165(c)(2).[440] Thus, even under section 165(c)(2), the deductibility of the restitution payment depends ultimately on section 162(f), under which the cases are split.

C. Correct Result

This author believes that a deduction should be available for restitution payments. Principles of fairness require that if the receipt of funds results in gross income, the repayment of those funds should result in an offsetting deduction. This is the case with lawfully obtained income, and under the Supreme Court's now famous pronouncement in *James v. United States*[441] is also the case with unlawfully obtained income. The mere fact that a court orders the restitution should not change the result. If anything, once the underlying unlawful act occurred, the law should encourage restitution, which the granting of a deduction accomplishes.

The mere fact that the restitution is somehow connected with an antecedent unlawful act should not be a bar to deductibility. In the *Heininger* case,[442] the Supreme Court upheld the deductibility of legal fees incurred in an unsuccessful attempt to prevent the Post Office Department from closing down a fraudulent business. The Supreme Court stated that "it has never been thought, however, that the mere fact that an expenditure bears a remote relation to an illegal act makes it non-deductible.[443] The Supreme Court reenforced this view in *Commissioner v. Tellier*[444] and in James v. United States.[445] In

438. *Id.* at 672.

439. *See supra* note 196.

440. *Stephens*, 93 905 F.2d at 672. The rationale expressed by the Second Circuit is that "Congress can hardly be considered to have intended to create a scheme where a payment would not pass muster under Section 162(f) but would still qualify for deduction under Section 165." *Id.*

441. *See* James v. United States, 366 U.S. 213 (1961).

442. *See* Commissioner v. Heininger, 320 U.S. 467 (1943).

443. *Id.* at 473.

444. *See* Commissioner v. Tellier, 383 U.S. 687 (1966).

445. *See* James v. United States, 366 U.S. 213 (1961).

James, the Court specifically indicated that a deduction should be available to an embezzler upon the payment of restitution.

Finally, in a related area addressed in tandem with the enactment of section 162(f), Congress recognized that restitution payments arising from criminal conduct should be deductible while any additional punitive sanctions should not. Thus, Code section 162(g) disallows a deduction for only the punitive two-thirds of any antitrust treble damages paid after a criminal conviction or plea of guilty or *nolo contendere*. The one-third restitution remains deductible.[446]

Part VI - Environmental Impositions

The application of section 162(f) to payments imposed on environmental polluters is very straight-forward. The payment of any fine or "similar penalty" imposed for punitive purposes may not qualify for a deduction. Other payments, such as compensatory payments, clean-up costs, or toll charges may be deductible[447] -- at least as far as section 162(f) is concerned. Such latter payments, especially clean-up costs that generate long-term benefits or long-lived assets, may have to be capitalized and then deducted, if at all, via the Tax Code's depreciation or amortization mechanisms.[448] Of course, determining whether an imposition is punitive or remedial might be very difficult. For instance, in *True v. United States*,[449] the District Court held that a civil penalty imposed by Section 311(b)(3) & (6) of the Federal Water Pollution Control Act[450] for leakage of oil failed to constitute punitive damages, whereas, the Tenth Circuit disagreed and characterized them as punitive.

To date, limited authority exists on point. Only three cases address the deductibility of environmental impositions. These are *True v. United States*[451] (Federal Water Pollution Control Act § 311(b)(3) & (6)) *Colt*

446. The 1969 Senate Report, *supra* note 9, makes it clear that the Senate, was aware of the fact that in Rev. Rul. 64-224, 1964-2 C.B. 52, the I.R.S. had ruled that amounts paid or incurred to satisfy treble damage claims were fully deductible. The intent of what is now section 162(g) was to disallow any deduction for the penalty portion (i.e., two thirds) of such amounts. Rev. Rul. 1969-3 C.B. at 596-97.

447. *See supra* text accompanying notes 263-67.

448. *See supra* note 13. *See also* Thomas H. Steele, *The Tax Consequences of the Ownership and Cleanup of Environmentally Contaminated Properties*, 26 Real Prop. Prob. & Trust J. 655 (1991); Eric R. Fox & Michael F. Solomon, *Who Incurs Environmental Clean-up Costs -- And Why -- May Determine Deductibility*, 76 J. Tax. 12 (1992).

449. 603 F. Supp. 1370 (D. Wyo. 1985), *rev'd on other grounds*, 894 F.2d 1197 (10th Cir. 1990).

450. 33 U.S.C. § 1321(b)(3) & (6) (1994).

451. *See* True v. United States, 603 F. Supp. 1370 9D. Wyo. 1985), *rev'd on other grounds*, 894 F. 2d 1197 (10th Cir. 1990).

Industries, Inc. v. United States[452] (Federal Clean Water Act and Federal Clean Air Act), and *S & B Restaurant, Inc. v. Commissioner*[453] (Pa. Clean Streams Law), all of which were previously discussed.[454] However, *Allied-Signal, Inc. v. Commissioner*[455] assumed the nondeductibility of such payments. Revenue Ruling 88-46[456] holds that nonconformance penalties paid under section 206(g)(1) of the Federal Clean Air Act are deductible because they are in the nature of a toll charge or fee.[457] Furthermore Revenue Procedure 92-91[458] provides some conclusory guidance about the air emission allowance program established by Title IV of the Clean Air Act Amendments of 1990.[459] Finally, several examples in the Regulations indicate that no deduction is available for fines or penalties paid for (1) violating the Federal Water Pollution Control Act,[460] (2) selling a new motor vehicle without the required certificate of conformity,[461] and (3) violating a state's air emission standards.[462]

Conclusion

Section 162(f) is an effective provision, which accomplished its framers' intent. It codified a part of the pre-1969 judicial public policy doctrine thereby continuing to limit the deductibility of payments that violate a certain public policy, yet it provides limitations on, and guidelines for, the scope of that public policy denial of deductions. This provision seems to be quite flexible, perhaps too flexible. For instance, notice how the "paid to a government" requirement is sidestepped by the restitution cases previously discussed. The only problem areas are the need to come to a uniform treatment of restitution payments, hopefully by recognizing their deductibility, and to put meaning into the purely procedural penalties which were intended to be deductible but which seem not to be recognized as such by the I.R.S.

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452. *See* Colt Indus., Inc. v. United States, 880, F.2d 1311 (Fed. Cir. 1989).

453. *See* S & B Restaurant, Inc. v. Commissioner, 73 T.C. 1226 (1980).

454. *See supra* text accompanying notes 131-32, 142-44, 232-34, 241-44, 255-59, 263-64, 271-72 and 306-10.

455. *See supra* note 167. This case is discussed *supra* notes 167-76, 205-10 and accompanying text.

456. *See supra* note 265.

457. This Revenue Ruling is discussed *supra* notes 265-70 and accompanying text.

458. 1992-2 C.B. 32.

459. Pub. L. No. 101-549, 104 Stat. 2584 (1990).

460. Treas. Reg. § 1.162-21(c) Ex (2) (1975).

461. *Id.* at Ex (3).

462. *Id.* at Ex (7).

POSTSCRIPT

In an opinion dated December 13, 1994, the Tax Court decided *Talley Industries, Inc. v. Commissioner.*[463] Here a subsidiary of the taxpayer, Stencel, had overcharged the U.S. Navy for various work performed from 1979 through 1984. In March, 1985 Stencel and three of its senior employees were criminally indicated on 43 counts in connection with some of the overcharges that occurred in 1984. Pursuant to a plea agreement with the U.S. Attorney, Stencel pled guilty to 10 counts of submitting false claims to the government. The court accepted the plea agreement and, in part, fined Stencel $10,000 on each of the counts and ordered it to "make full restitution for all losses, to be determined by the U.S. Navy at a later date."[464] Although the losses to the Navy from these 10 incidents was only $1,885, the Navy and Stencil reached a settlement agreement under which Stencel paid $2.5 million for all overcharges from 1979 through 1984, including the 10 for which it pled guilty. Although the Navy estimated its actual losses at only $1.56 million, the court noted that the settlement also covered Stencel's potential liability under the federal Truth in Negotiation Act ("TINA"),[465] the federal False Claims Act ("FCA")[466] as well as for common law causes of action for breach of contract.[467]The I.R.S. disallowed Stencel's deduction for the $2.5 million and the issue before the court was the deductibility of this $2.5 million payment.

It is interesting to note that in its notice of deficiency the IRS disallowed the deduction because (1) it was not deductible under section 162(f); (2) it was not an ordinary and necessary expense; and (3) the deduction would severely and immediately frustrate national public policy.[468]

Before the Tax Court the Commissioner argued that the payment was not deductible under section 162(f) because it was in satisfaction of the restitution order entered against Stencel in a criminal proceeding and was specifically disallowed by Reg. section 1.162-21(b)(1)(i). The IRS added that the full payment should be treated as court-ordered restitution absent explicit language to the contrary in the settlement agreement. As an alternative, the Commissioner argued that at least the $940,000 paid

463. 68 T.C.M. 1412 (1994).
464. *Id.* at 1413.
465. 10 U.S.C. § 2306(f)(1982).
466. 31 U.S.C. § 3729 (1982).
467. 68 T.C.M. at 1413-14.
468. *Id.* at 1414-15.

an excess of the government's actual damages should be treated as a nondeductible fine or similar penalty.[469]

The taxpayer argued that the payment should be deductible regardless of whether it satisfied the court ordered restitution. It argued that the court ordered restitution was wholly independent of the criminal sanctions and was not punitive in nature. In any event, according to the taxpayer, the maximum that could be treated as court ordered restitution is the government's total loss in the 42 instances of mischarging described in the indictment which amounted to only $10,000.[470] With regard to Stencel's civil liability under TINA and FCA, the taxpayer argued that both of these are compensatory and not punitive.[471]

In its decision the court traced the development of section 162(f) and reiterated its adherence to the punitive-versus-remedial dichotomy in determining if a civil imposition is deductible. With respect to the Commissioner's argument that since the restitution was court ordered it fit within section 1.162-21(b)(1)(i) of the Regulations which defines a "fine or similar penalty" to include amounts "[p]aid pursuant to . . . a plea of guilty . . . for a crime . . . in a criminal proceeding," the court agreed. It held that even if such a payment is compensatory, it is nevertheless not deductible under this regulation, the validity of which was not questioned by the taxpayer.[472] However, after a close review of the transcript of the sentencing proceedings, the court held that the District Court only ordered restitution with respect to the 10 counts to which Stencel pleaded guilty.[473] The total losses to the Navy from these 10 incidents was $1,885, and that is how much is nondeductible.[474]

As to the balance of the $2.5 million payment, the court agreed with the taxpayer that the issue of deductibility depended on whether the payment was punitive or remedial. Since the settlement agreement was silent on this issue and since it only provided that the payment was being made in exchange for the government's agreement to surrender any

469. *Id.* at 1415-16.

470. *Id.* at 1415 and note 10.

471. *Id.* at 1415.

472. *Id.* at 1417-18.

473. *Id.* The portion of the transcript of the sentencing hearing quoted at 68 TCM 1413 n. 3 is quite explicit: "Now it is further ordered that the defendant make full and complete restituiton to the United States government for all losses sustained *in connection with these violations*" (emphasis added).

474. Although the settlement agreement did not allocate any specific amount to these 10 incidents, the court took note of the fact that, there was no dispute that this was the Navy's loss on these 10 incidents. 68 T.C.M. at 1418.

claims it might have under TINA and FCA, the court decided the issue must be determined by an analysis of TINA and FCA as well as the facts and circumstances surrounding the adoption of the settlement agreement.[475]

As to the TINA, the court gave it very short shift. Based on the Tax Court's recent decision in *Sundstrand Corp. v. Commissioner*,[476] the court held that the TINA was purely compensatory.

With regard to the FCA the court displayed much more uncertainty. The FCA allows for an award to the government consisting of a civil penalty of $2,000, an amount equal to two times the damages sustained by the government and costs of the civil action.[477] In addition, the Tax Court had already held that the FCA had both compensatory and punitive characteristics.[478] Finally, the supreme Court recently held that a civil penalty under the FCA which bore no "rational relation" to the government's actual losses would be a criminal penalty for double jeopardy purposes.[479]

However, despite the closeness of the question, the court rather conclusorily held that the FCA is basically a compensatory statute, unless the award bears no rational relation to the government's loss, in which case the award in excess of the actual loss may be considered penal.[480] In turning to decide the nature of the $2.5 million payment at issue, the court noted that the government never suggested it was attempting to exact a civil penalty when it negotiated the settlement agreement. In addition, the court focused on the fact that the $2.5 million payment was substantially less than double the government's actual loss of $1.56 million (exclusive of the government's costs of investigation). Based on this, the court concluded that the $2.5 million was compensatory and not punitive in nature.[481]

The court's conclusion as to the compensatory nature of the entire $2.5 million (less $1,885) is troubling. Initially, after carefully laying down the analytical framework, the court seems to have rather abruptly

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475. *Id.* at 1418.

476. 98 T.C. 518, 548-51 (1992), *aff'd*, 17 F.2d 965 (7th Cir. 1994).

477. 31 U.S.C. § 3729 (1982) (as in effect for the years in issue). 68 T.C.M. at 1418.

478. 68 T.C.M. at 1418. The earlier case referred to was *Grossman & Sons, Inc. v. Commissioner*, 48 T.C. 15, 30-31 (1967).

479. United States v. Halper, 490 U.S. 435 (1989).

480. 68 T.C.M. at 1419.

481. *Id.* After deciding the section 162(f) issue the court went on to hold that this payment was an ordinary and necessary expense, and deductible under section 162(a) and that if the payment passed muster under section 162(f) it could not be disallowed on general public policy considerations. *Id.* at 1418-19.

decided that FCA payments are basically compensatory, and that the $2.5 million was also compensatory. Why does the court assume the $2.5 million bears a rational relation to the amount of actual loss simply because it is much less than twice the actual loss of $1.56 million? Similarly, while the costs of the government's investigation may be relevant, the amount is not contained in the opinion and is purely speculative. while, perhaps, $1.56 million might be compensatory, it seems very doubtful if the additonal $940,000 is. It likely represents a settlement of the potential penalty impositions available to the government under the FCA.

While the court's ultimate conclusion is troublesome, the court's method of analysis is consistent with Tax court precedent and that described above. As to amounts paid pursuant to a guilty plea, the court followed *Waldman* and section 1-162-219b)(1)(i) of the regulation. As to the remainder of the payment, the court looked to the settlement agreement which did not characterize it as either compensatory or punitive but which did connect it with the taxpayer's exposure under te TINA and FCA. The court then sought to determine the character of payments under these statutes since that was the origin of the liability (althoug the court did not use those words).